AIRA Journal

Volume 32 No. 4

WHAT'S INSIDE

CONTENTS

VOL.32: NO.4

PAGE#

From the Executive Director's Desk

TRANSITION

The month of January is named after the Roman god, Janus. Janus was the god of beginnings and transitions. In form, Janus is pictured with two faces, one looking back and one looking forward.

Here at AIRA with the new year we've entered a period of transition. Tom Morrow, AIRA's Executive Director for the past four years, is retiring and Jim Lukenda, a long-time member, CIRA, and board member is carrying forward as AIRA's new Executive Director. In this issue's Executive Director's notes, we're taking the opportunity to look back at Tom's leadership and look forward as Jim begins.

Jim: I am grateful for the opportunity to continue my association with AIRA in the capacity of Executive Director. Following both Tom and Grant Newton sets a high standard for me. This is a challenging time for our profession and our membership. The need for top-quality professional education programs for members and other professionals has never been greater. The implementation of the provisions of the Small Business Reorganization Act of 2019 (Sub-chapter V bankruptcy), the expanding importance of intellectual property and the valuation thereof in bankruptcies and reorganizations, and the continued evolution of the financial markets require our membership to have the most comprehensive educational resources at their disposal. The CIRA and CDBV programs, which have been at the forefront of AIRA's mission, will continue to provide the knowledge and tools necessary for our membership to meet the professional challenges of our industry.

I undertake my role with an association on good footing. We have a robust membership, a full calendar of courses, and other planned events ahead of us. For this I and the membership of the AIRA can thank Tom and the staff in Medford. Over the past four years Tom's leadership has allowed AIRA to maintain a stable financial footing, expand the Grant Newton Educational Endowment Fund, update and extend the means for bringing high quality educational programs to the membership, and most importantly continue to maintain CIRA and CDBV as the recognized quality certification programs in the bankruptcy and reorganization arena. On my behalf, and that of the membership, and the staff in Medford, thank you, Tom for your leadership, counsel, and instruction these past four years and throughout your association with AIRA. With that, I will leave the final words this issue to Tom.

Tom: Four years ago I had the good fortune to take over leadership of this organization from Grant Newton. My objectives were to ensure the viability of the organization into which Grant devoted so much energy. With the help of the terrific AIRA team we have moved forward and now see an increasing number of students coming to us for CIRA training. We also continue to offer several on-site courses, our Annual Conference, the New York POR Conference, the Dallas Energy Conference and VALCON.

As I settled into my duties, I realized the other task I had to ensure AIRA's viability was to establish a succession plan. Working with the board of directors over the last two years we talked about the process of identifying the next leader of the organization. The board considered the qualities that they would like to see in the Executive Director of AIRA. The board spoke to several candidates that met the standards they had established. Out of this process Jim Lukenda emerged as the best person to take over the leadership of the organization.

I am proud of what this organization has done for the restructuring industry. It has been an honor to continue that work for the past four years. I am very confident that I am leaving the organization in the very best hands and have positioned AIRA for many more years of leadership in providing the very best educational opportunities for financial advisors in the restructuring industry.

A Letter from AIRA's President

BRIAN RYNIKER, CIRA
Ryniker Consultants

As many of you have heard, this year AIRA is in a transition period. I take this opportunity to thank Tom Morrow for guiding the board and membership as Executive Director following Grant Newton's retirement four years ago. Tom, I wish you well in your retirement. Further, I welcome Jim Lukenda, a former AIRA president and long-term board member, as our new Executive Director and look forward to working with him over the next few years.

It was great to see everyone at the 18th Annual Advanced Restructuring and Plan of Reorganization Conference (NY POR), held at The Union League Club on Monday, November 18, 2019. We owe many thanks to the planning committee for putting together a schedule of interesting and informative panels, including participation by several bankruptcy judges from the 2nd and 3rd Circuits. Also, we extend congratulations to the Honorable Kathryn C. Ferguson (Bankr. NJ), who was recognized with AIRA's Judicial Service Award at the conclusion of the program. Hon. Rosemary Gambardella (Bankr. NJ) helped present the award (see photo at right) in recognition of Judge Ferguson's many contributions to the bar and restructuring practice, including serving as a US Bankruptcy Judge for the District of New Jersey for 25 years, most recently as Chief Judge. Judge Ferguson has also served on several national committees relating to information technology and executive education, shepherded the recent redrafting of the NJ Bankruptcy Court's Local Rules, and is active in a number of regional organizations for insolvency professionals. A graduate of Rutgers Law School, Hon. Ferguson earlier in her career was a partner with Markowitz and Zindler and clerked for Hon. Judith H. Wizmur.

Do you find the articles included in each issue of AIRA Journal interesting and helpful to your practice? That is certainly our goal. To accomplish this goal, we are looking for great articles on interesting topics from our members to include in future editions. If you or a colleague have recently spoken on an interesting subject at a conference, argued or briefed a novel or interesting issue, 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.

Finally, I encourage everyone to plan now to attend AIRA's 36th Annual Bankruptcy & Restructuring Conference, June 10 - 13, at the Fairmont Chicago, Millennium Park.

From left: Hon. Kathryn C. Ferguson, AIRA President Brian Ryniker, and Hon. Rosemary Gambardella. (Photo taken in library of Union League Club of NYC.)

Implications of Third Circuit Decision Affirming PDVSA IS ALTER EGO OF VENEZUELA

RICHARD J. COOPER, CARMINE D. BOCCUZZI JR., FRANCESCA L. ODELL, BOAZ S. MORAG AND MICHAEL CINNAMON[1]
Cleary Gottlieb Steen & Hamilton LLP

On July 29, 2019, the United States Court of Appeals for the Third Circuit addressed when a judgment creditor of a foreign state may satisfy its judgment by attaching assets of that sovereign's instrumentality. In *Crystallex International Corporation v. Bolivarian Republic of Venezuela*,[2] the court found that the factual record supported the trial court's determination that Venezuela's wholly-owned oil company "is so extensively controlled by its owner [the Republic of Venezuela] that a relationship of principal and agent is created," sufficient to overcome the presumption of separateness otherwise afforded to state-owned instrumentalities.

Background

In 2011, the Republic of Venezuela ("Venezuela" or "the Republic") seized gold deposits held and developed by Crystallex International Corp. ("Crystallex"). Crystallex filed an ICSID arbitration, which resulted in a $1.2 billion award for Crystallex solely against the Republic. The U.S. District Court for the District of Columbia confirmed the award,[3] and the D.C. Circuit affirmed.[4] While the appeal of the confirmation was pending, Crystallex filed an action in Delaware District Court to attach property of Petróleos de Venezuela, S.A. ("PDVSA"), the state-owned oil company of Venezuela, in Delaware on the grounds that PDVSA was the alter ego of the Republic. That property comprised PDVSA's interest in the shares of its wholly-owned subsidiary PDV Holding, Inc. ("PDVH"), a Delaware corporation, through which PDVSA owns CITGO Petroleum Corp.[5] PDVSA, which was not named or served in the attachment action, intervened and moved to dismiss, asserting that (i) it enjoyed sovereign immunity under the Foreign Sovereign Immunities Act ("FSIA") with respect to Crystallex's enforcement action, (ii) it was not the alter ego of the Republic, and (iii) due to U.S. sanctions in effect, the shares Crystallex sought to attach were immune on the ground that they were not being "used for a commercial activity" in the United States,[6] as required under the FSIA.

1 Richard J. Cooper, Carmine D. Boccuzzi Jr., and Francesca L. Odell are Senior Partners in the Restructuring and Sovereign Practice Groups, the Litigation Group, and the Latin American and Sovereign Practice Groups, respectively, at Cleary Gottlieb Steen & Hamilton LLP. Boaz S. Morag and Michael Cinnamon are Counsel and Associate, respectively, in the Litigation Group at the firm. The views expressed in this article reflect those of the authors and not necessarily those of Cleary Gottlieb Steen & Hamilton LLP or any of its clients.

2 932 F.3d 126 (3d Cir. 2019).

3 *Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, 244 F. Supp. 3d 100 (D.D.C. 2017).

4 *Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, 760 F. App'x 1 (D.C. Cir. 2019).

5 *Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, 333 F. Supp. 3d 380 (D. Del. 2018).

6 The PDVH shares are in the United States even though PDVSA has no presence there, and are thus potentially subject to seizure as a consequence of a provision of Delaware law that allows a judgment creditor to attach a debtor's shares in any Delaware corporation, regardless of the location of the shareholder or whether the shares are in certificated or uncertificated form. 8 Del. C. § 324(a).

Under U.S. law, even when an FSIA exception allows for recovery against a sovereign, the instrumentalities of that sovereign are afforded a "presumption of independent status" under *First National City Bank v. Banco Para El Comercio Exterior de Cuba* ("*Bancec*").[7] This presumption can be overcome in one of two ways: (i) where viewing the instrumentality as a separate entity "would work fraud or injustice," or (ii) "where a corporate entity is so extensively controlled by its owner that a relationship of principal and agent is created."[8]

While most alter ego cases under *Bancec* have historically been brought under the "fraud or injustice" prong, the Supreme Court recently articulated five factors to consider in conducting the "extensive control" analysis under *Bancec*:[9] "(1) the level of economic control by the government; (2) whether the entity's profits go to the government; (3) the degree to which government officials manage the entity or otherwise have a hand in its daily affairs; (4) whether the government is the real beneficiary of the entity's conduct; and (5) whether adherence to separate identities would entitle the foreign state to benefits in United States courts while avoiding its obligations."[10]

In the *Crystallex* case, the District Court found that it had jurisdiction over Venezuela under the FSIA's arbitration exception,[11] and that, if PDVSA was Venezuela's alter ego, the exception to the Republic's sovereign immunity would be imputed to PDVSA. The court then found that the *Bancec* "extensive control" exception applied, such that PDVSA was Venezuela's alter ego. Finally, the court also found that Crystallex could attach the shares of PDVH owned by PDVSA to satisfy its judgment against the Republic because they remained "used for a commercial activity," even though their disposition was blocked by U.S. Executive Branch sanctions on Venezuela.[12] PDVSA appealed to the Third Circuit, and the newly-recognized administration of Interim Venezuelan President Juan Guaidó intervened in the appeal.

The Third Circuit Decision

The Third Circuit affirmed the District Court's decision. The court found that the Delaware District Court had jurisdiction over Venezuela, since jurisdiction from the recognition proceeding in the D.C. District Court (which also stemmed from the FSIA's arbitration exception) "carrie[d] over" to the post-judgment enforcement proceeding in Delaware. Crystallex was therefore not required to establish an independent jurisdictional basis for the enforcement action under the FSIA.[13] As to PDVSA, the court held that a finding that PDVSA was Venezuela's alter ego was sufficient to extend jurisdiction to PDVSA for the purposes of the enforcement proceeding.[14]

The court then considered and rejected numerous challenges to the application of *Bancec*, including the argument that the "extensive control" analysis requires a nexus between the abuse of the corporate form and the injury, which the court rejected because, among other reasons, "requiring an independent nexus requirement would likely read the *Bancec* extensive-control test out of the doctrine."[15] The court also considered the argument made by PDVSA bondholders, as *amici*, that the *Bancec* "extensive control" analysis requires consideration of the interests of the alleged alter ego's other creditors (*i.e.*, holders of PDVSA's $25 billion in defaulted bonds and a comparable amount of liabilities to other creditors) and found that *Bancec* does not require specific consideration of these interests. Rather, it noted that the presumption of separateness already takes into consideration the interests of third-party creditors, but that bondholders are or should be aware of the risks of extending credit to entities that are extensively controlled by a sovereign.[16]

The court found that PDVSA met each of the five *Bancec* "extensive control" factors. For example, the court pointed to PDVSA's bond offering materials, which included "risk factors" regarding the Republic's general control over PDVSA, the fact that the Venezuelan constitution "endows the State with significant control over PDVSA and the oil industry," and the Republic's ability to select the parties to whom and the prices at which PDVSA sold oil.[17] The Third Circuit also referenced the District Court's findings that Venezuela controls the rate at which PDVSA converts U.S. Dollars to Venezuelan Bolivars and that President Maduro controlled PDVSA's debt restructuring in 2017.[18] Furthermore, since the Republic owns 100% of the shares of PDVSA, PDVSA's profit runs to Venezuela, and PDVSA also pays taxes at a heightened rate (presumably relative to other Venezuelan corporations) to ensure that the Republic collects a greater portion of its revenues.[19] The court also noted that President Maduro appoints PDVSA's officers and directors[20] and uses PDVSA to effect foreign policy goals, and that PDVSA and Venezuela's Ministry of

7 462 U.S. 611, 627 (1983).

8 *Id.* at 629. *See also Rubin v. Islamic Republic of Iran*, 138 S. Ct. 816, 822-23 (2018).

9 The District Court had used a slightly different five-factor test in its "extensive control" analysis, and the Third Circuit noted that at least one court had articulated a test containing 21 factors. *See Crystallex*, 932 F.3d 126, 140-41; *Bridas S.A.P.I.C. v. Gov't of Turkmenistan*, 447 F.3d 411, 418 (5th Cir. 2006).

10 *Rubin*, 138 S. Ct. at 823 (internal citations omitted).

11 28 U.S.C. § 1605(a)(6) (eliminating immunity from suit for action to recognize arbitral award subject to the New York or Panama Convention).

12 *Crystallex*, 333 F. Supp. 3d at 399, 414, 417-21.

13 *Crystallex*, 932 F.3d at 136-38.

14 *Id.*

15 *Id.* at 141-43.

16 *Id.* at 143-44.

17 *Id.* at 146-47.

18 *Id.* at 147-48.

19 *Id.* at 148. *See also* Decl. of Dr. Roberto Rigobon, *Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, No. 17-mc-00151-UNA (D. Del. Aug. 14, 2017), ECF No. 7 (stating that "[t]he [Venezuelan] Government charges a tax rate of up to 95% on the difference between the actual oil price charged by PDVSA and Venezuela's budgeted oil price").

20 A recent decision from the Delaware Court of Chancery considered a petition by former directors of PDVH, Citgo Holding, Inc. and Citgo Petroleum Corp. appointed by President Maduro, who sought a declaration that they comprised the rightful boards of those entities. The court found that the political question and act of state doctrines required the court to assume the validity of the Guaidó government's appointments to PDVSA's board. *See Jiménez v. Palacios*, No. 2019-0490-KSJM, 2019 WL 3526479 (Del. Ch. Aug. 12, 2019).

Continued from p.7

Petroleum and Mining share physical office space.[21] Lastly, the court found that respecting the corporate form would allow Venezuela to benefit from the U.S. legal system while avoiding its obligations, since PDVSA's bonds are held by U.S. bondholders, and disputes arising from default will likely be resolved in U.S. courts.[22] Based on these and other findings, the court noted that the relationship between PDVSA and Venezuela "clears th[e] bar easily."[23]

In reviewing the trial court's findings, the Third Circuit reinforced that alter ego determinations are made as of the time the court is asked to make such a finding and rejected the argument advanced by the Guaidó administration on appeal that changes in the Venezuelan government since the trial court made its findings in August 2018 should be taken into consideration in determining whether to affirm the decision.[24] Conversely, in deciding whether PDVSA was an alter ego of the Republic in 2018, the trial court considered events dating back to 2002 which it presumably, but not explicitly, found reflective of the status quo as of 2018.[25]

Finally, the court found that the specific asset at issue, the shares of PDVH owned by PDVSA, was not immune from attachment under the FSIA because the shares are "*used for a commercial activity* in the United States," namely the ownership of Citgo Petroleum, and that such ownership continued notwithstanding U.S. sanctions that precluded, for example, the payment of dividends to PDVSA from Citgo.[26]

After the *Crystallex* decision, in *Kirschenbaum v. Assa Corporation*, the United States Court of Appeals for the Second Circuit in New York affirmed a finding that an instrumentality incorporated in New York, but whose shares were 100% owned by and was deemed "interchangeable with" an entity controlled by Iran, was Iran's alter ego under the *Bancec* "extensive control" analysis, where the district court likewise had made no finding on "fraud or injustice."[27] Although the Second Circuit and lower court decisions included little substantive analysis of the *Bancec* factors, prior decisions in the case focused on facts such as ownership of the entity's shares, appointment of directors, and whether the entity had "true separate decision-making authority or real existence except that which is allowed and directed by the Iranian government."[28] This decision further extended the application of the *Bancec* alter ego analysis to cases involving entities that are not covered by the FSIA and do not qualify for any immunity protections, since an "agency or instrumentality" under the FSIA must be formed under the laws of the foreign state, and cannot be incorporated in the U.S. or some third country.[29]

Shortly thereafter, in *Esso Exploration and Production Nigeria Limited v. Nigerian National Petroleum Corporation*, the U.S. District Court for the Southern District of New York found the Nigerian National Petroleum Corporation ("NNPC") to be an alter ego of Nigeria solely under the *Bancec* "extensive control" analysis.[30] In its alter ego determination, the court emphasized: (i) Nigerian President Yar'Adua's influence on NNPC's actions; (ii) "that Nigeria exerts substantial control over NNPC's day-to-day business," as evidenced by, *inter alia*, the fact that Nigeria is NNPC's sole shareholder, that Nigeria's president has historically appointed and/or served as the chairperson of NNPC's board and has the power to appoint and remove other officers, and that Nigeria's president must approve all contracts above a certain monetary threshold; and (iii) that Nigeria and NNPC appear to share office space and bank accounts.[31]

Takeaways

While the court in *Crystallex* emphasized that the presumption of separateness afforded to instrumentalities of foreign sovereigns "is not to be taken lightly," it did not identify what level of control would overcome the presumption of separateness.[32] To the contrary, the court acknowledged the extreme nature of the relationship

21 *Crystallex*, 932 F.3d at 148-49. Regarding the third *Bancec* factor, the court reached as far back as 2002, "when President Chávez fired roughly 40% of the PDVSA workforce in response to a strike protesting his regime." *Id.* at 148.
22 *Id.* at 149.
23 *Id.* at 152.
24 *Id.* at 144.
25 *Id.* at 148.
26 *Id.* at 149-51 (emphasis in original) (citing 28 U.S.C. § 1610(a)(6)).
27 *See Kirschenbaum v. Assa Corp.*, 934 F.3d 191 (2d Cir. 2019); *In re 650 Fifth Avenue and Related Properties*, 830 F.3d 66, 79-81 (2d Cir. 2016).
28 *See id.*; *In re 650 Fifth Avenue and Related Properties*, No. 08 Civ. 10934 (KBF), 2014 WL 1516328 at *12-13 (S.D.N.Y. Apr. 18, 2014).
29 *See Assa Corp.*, 934 F.3d at 197 (noting that defendant is not an agency or instrumentality as defined in 28 U.S.C. § 1603(b)(3), since it is a New York corporation and its parent is a Jersey corporation).
30 *See Esso Expl. and Prod. Nigeria Ltd. v. Nigerian Nat'l Petroleum Corp.*, 397 F. Supp. 3d 323 (S.D.N.Y. 2019). The decision is currently on appeal.
31 *Id.* at 335-340,
32 *Crystallex*, 932 F.3d at 140. In this regard, the court followed in the tradition of *Bancec* itself, where the Court declared that its "decision today announces no mechanical formula for determining the circumstances under which the normally separate juridical status of a government instrumentality is to be disregarded." *Bancec*, 462 U.S. at 633.

between the Republic and PDVSA, ultimately finding that "if the relationship between Venezuela and PDVSA cannot satisfy the Supreme Court's extensive-control requirement, we know nothing that can."[33] Unhelpfully, the Third Circuit provided no insight into the relative importance of the various *Bancec* factors, where to draw the line, or how to apply its analysis in future cases.

This bears particular significance given that *Crystallex* is one of the first cases dealing with the relationship between a foreign sovereign and its instrumentality where the district court specifically found that the "fraud or injustice" prong of *Bancec* was not met,[34] and thus was decided solely on the basis of the "extensive control" prong.[35] Contrast this, for example, with *Bancec* itself, where the Supreme Court found that to not permit Citibank to assert a counterclaim when sued by a Cuban bank, and where Citi's property in Cuba had been expropriated and transferred to the very bank suing it, "would cause [] an injustice."[36] The Third Circuit's decision reinforces that the *Bancec* test is disjunctive—if the "extensive control" test is met, a showing of "fraud or injustice" is not required (and vice versa). By contrast, Delaware law would not permit effective veil-piercing of this type absent some showing of fraud or injustice.[37]

In some ways, the close relationship between Venezuela and PDVSA that gave rise to the Third Circuit's decision is unique—for example, in addition to its ownership of 100% of the shares of PDVSA, the Court pointed to the effective commandeering of PDVSA's assets by the Republic in order to serve Venezuela's foreign and domestic policy agenda, the appointment of government and military personnel in key management roles at PDVSA, and the Republic's practice of collecting taxes from PDVSA at a heightened rate relative to other Venezuelan corporations in order for the Republic to receive a greater portion of its revenues. This decision may demonstrate that, in cases of sufficiently extraordinary actions on the part of the sovereign, conduct between a sovereign and its instrumentality that is otherwise a normal part of the relationship between an entity and its controlling shareholders, such as appointing directors and officers, may become further indicia of an alter ego relationship.[38]

However, even though the relationship between Venezuela and PDVSA may be (or may have been) *sui generis*, there are multiple reasons that this decision may have application significantly beyond this case.

First, Venezuela is unlikely to be the only foreign sovereign whose non-immune assets outside of its borders are insufficient to satisfy claims against it. In many cases, the state's agencies and instrumentalities operating internationally will have more substantial (nonimmune) foreign assets than will the state itself, such that judgment creditors may be incentivized to seek recovery from the sovereign's instrumentalities, even those that were strangers to the creditors' dispute with the sovereign.[39] After the *Crystallex* and *Assa Corp.* decisions, that "instrumentality" could either be a foreign state-owned enterprise such as PDVSA with property in the U.S., or even a U.S. corporation, which through a chain of ownership may be ultimately, albeit indirectly, owned or controlled by the foreign state.[40]

33 *Crystallex*, 932 F.3d at 152.

34 *Crystallex*, 333 F. Supp. 3d at 403-04.

35 A number of cases have considered both prongs. *See, e.g.*, *Bridas*, 447 F.3d at 416-20 (treating the two prongs of *Bancec* as requirements in order to hold a sovereign liable for the actions of its instrumentality).

36 *Bancec*, 462 U.S. at 622.

37 *See Pauley Petroleum Inc. v. Continental Oil Co.*, 239 A.2d 629, 633 (Del. 1968) (finding that veil-piercing "may be done only in the interest of justice, when such matters as fraud, contravention of law or contract, public wrong, or where equitable consideration among members of the corporation require it, are involved").

38 Contrast this with the decision in the case of Banco Central de la Republica Argentina ("BCRA"), where the United States Court of Appeals for the Second Circuit found BCRA not to be the alter ego of the Republic of Argentina. *See EM Ltd. v. Banco Central de la Republica Argentina*, 800 F.3d 78, 91-95 (2d Cir. 2015). The court there noted that "[t]he hiring and firing of board members or officers is an exercise of power incidental to ownership, and ownership of an instrumentality by the parent state is not synonymous with control over the instrumentality's day-to-day operations," and that the central bank's repayment of the sovereign's debts, as well as coordinating and implementing the sovereign's monetary policy, did not establish "extensive control" under *Bancec*. *Id.*

39 Venezuela may also not be unique in that the economic distress the Republic is experiencing is also being experienced by its state-owned oil company, since PDVSA, too, went into default on its unsecured bond and promissory note obligations at the same time as did the Republic. Accordingly, the question may arise whether an instrumentality's creditors may use the *Crystallex* decision to seek recovery from the foreign state's assets to satisfy the obligation of its instrumentality. In some sense, this form of veil-piercing is the more traditional one in the private corporate context, where a creditor seeks to hold the shareholders of an undercapitalized corporate debtor liable on an alter ego theory. In the sovereign context, however, as noted, it is unlikely that the state itself would have some greater pool of assets available in the U.S. than would its instrumentality. As to whether Venezuela's and PDVSA's debts are treated similarly in any restructuring, that is a question for negotiation rather than for courts to resolve in the first instance.

40 At least two Venezuela creditors, OI European Group and Rusoro Mining Ltd., have filed complaints in federal court in Delaware and Texas seeking alter ego declarations at every level of the Citgo ownership structure for the purpose of seeking to satisfy their judgments against the Republic against the substantial assets of Citgo Petroleum. *See* Complaint, *OI European Group B.V. v. Bolivarian Republic of Venezuela*, No. 19-cv-00290-LPS (D. Del. Feb. 11, 2019); Complaint, *Rusoro Mining Ltd. v. Bolivarian Republic of Venezuela*, No. 18-1458 (S.D. Tex. May 7, 2018). As each of the entities from PDVH down to Citgo Petroleum are Delaware corporations, the prevailing view had been that to succeed in such a claim, the creditor would have to satisfy the alter ego test under Delaware law, not the *Bancec* international law standard, and successfully pierce the three corporate veils separating PDVSA from Citgo Petroleum. The Second Circuit's decision in *Assa Corp.*, however, holds without significant analysis that the *Bancec* analysis, rather than New York veil-piercing law, applies even where the entity whose presumption of separateness is sought to be disregarded is a New York corporation separated from the foreign state by a Jersey corporate parent, which, in turn, is owned by Iranian entities ultimately owned by Iran itself. *See Assa Corp.*, 934 F.3d at 195, 197-99. *Assa Corp.* also suggests the analysis under *Bancec* need be done only once, looking at the relationship between Iran and Assa Corporation without explicit consideration of the entities in the ownership chain in between.

Continued from p.9

Second, the Third Circuit's application of the *Bancec* factors illustrates the importance of maintaining corporate formalities, both in principle and in practice. There are likely other instances where, for example, government officials and the instrumentality share physical office space. Alter ego arguments arise only when the foreign state is unable to pay or perform its obligations or has "holdout creditors" who pursue litigation in order to recover the entire amount of their claim through enforcement actions rather than accept a consensual settlement or restructuring of their obligations. Accordingly, agency or instrumentality practices that in the ordinary course cause no harm and no foul can become subjected to judicial scrutiny when the sovereign is unable or unwilling to satisfy its creditors' claims. This risk could be mitigated, for example by instituting policies that require an instrumentality not owned 100% by the sovereign to consider the interests of all shareholders when their country experiences financial distress,[41] and/or to consider having one or more independent directors on the instrumentality's board.

Third, the decision highlights the role that corporate disclosures and other public statements may play in the alter ego analysis. As discussed above, the Third Circuit referenced PDVSA's bondholder disclosures, which contained various risk factors related to Venezuela's ability to "impose further material commitments upon us or intervene in our commercial affairs," as well as statements relating to PDVSA's duties under the Venezuelan constitution and other obligations imposed by Venezuela.[42] The decision also cited a 2014 speech given by PDVSA's then-president, in which he stated that Venezuela was "one of the few oil producing countries in the world that has a strict and tight control over the sovereign management of its natural resources."[43] Instrumentalities and foreign sovereigns should bear this in mind when formulating disclosures and releasing statements, and should consider carefully how best to balance the need to provide investors with appropriate disclosure against the risk that such language could be used against it in a subsequent alter ego case.[44]

Fourth, a foreign instrumentality seeking to own a U.S. company may consider whether there are ways of structuring that transaction such that the instrumentality's ownership interest would not be deemed to be "in the United States" for purposes of the FSIA. As noted above, by statute, Delaware deems the shares (whether certificated or not) of every Delaware corporation to be located in Delaware and hence "in the United States" for FSIA purposes. However, under New York law, the property interest represented by certificated shares in a New York corporation would be deemed located where the certificate is found.[45]

Fifth, sovereigns should ensure that their domestic law treats state instrumentalities as separate entities. The first step of the *Bancec* analysis considers whether the domestic law of the sovereign treats the instrumentality as separate from the state. However, the presumption of separateness will not afford more protection than granted by the sovereign's local law. If the law of the sovereign, therefore, does not treat its instrumentalities as entities distinct from the state, the *Bancec* test will not provide much aid.

For these and other reasons, the *Crystallex* decision may have given more teeth to the "extensive control" analysis as a tool for judgment creditors to pursue the instrumentality's assets in a variety of scenarios in situations where a sovereign is unable or unwilling to satisfy a judgment.

Finally, the Third Circuit's finding that PDVSA's alter ego status was sufficient to confer jurisdiction for purposes of the enforcement action is concerning.[46] The question of "whether PDVSA could be liable for the arbitration award as an 'alter ego' of Venezuela"[47] was not actually before the court, since in the District Court proceeding Crystallex conceded that it did not seek a finding that PDVSA was liable for its judgment against Venezuela, but rather "a more limited finding, namely that the specific property at issue on this motion – the shares of PDVH – though

41 Instrumentalities are defined under the FSIA as "an organ of a foreign state or political subdivision thereof, or a majority of whose shares or other ownership interest is owned by a foreign state or political subdivision thereof." 28 U.S.C. § 1603(b)(2). Accordingly, 50.1% foreign state ownership would satisfy the FSIA requirement of "majority" ownership to qualify for "agency or instrumentality" status under the FSIA. In many alter ego cases, however (*Crystallex*, for example), the sovereign is either the sole shareholder or owns nearly all of the shares of the instrumentality.

42 *Crystallex*, 932 F.3d at 144.

43 *Id.* at 148.

44 Note, however, that PDVSA's risk factors appeared to contain some qualifying language in an attempt to avoid providing specific assurances. *See id.* at 146. While risk factors, and possibly other types of corporate disclosures, should not necessarily constitute admissions of fact, but are rather meant as warnings, the Third Circuit treated them as the former.

45 *Hotel 71 Mezz Lender LLC v. Falor*, 14 N.Y.3d 303, 314 (2010) (noting that if the "intangible interests [in LLCs] sought to be attached . . . were [] evidenced [by written instruments], their situs would be where the written instruments were physically present"). However, after the Second Circuit's decision in *Peterson v. Islamic Republic of Iran*, 876 F.3d 63 (2d Cir. 2017), FSIA immunity in the Second Circuit may be limited to assets located in the U.S., and those considering such issues may find it prudent to seek legal advice.

46 *Crystallex*, 932 F.3d at 137-39.

47 *Id.* at 134.

nominally held in the name of PDVSA, are, at this time, really the property of Venezuela."[48]

However, the Third Circuit's opinion was not similarly cabined and does not even refer to the District Court's statement that if the value of the PDVH shares is insufficient to satisfy the judgment against the Republic, Crystallex has no deficiency claim against PDVSA.[49] Indeed, in several places in its decision, the Third Circuit suggested that it was deciding whether PDVSA was the alter ego of the Republic for all purposes.[50] While this omission may ultimately be cleaned up on a reconsideration petition, the Third Circuit's decision as written could extend beyond the requested finding that a specific PDVSA asset was the property of Venezuela, leaving open the possibility of a subsequent action, if needed, to add PDVSA as a debtor on Crystallex's judgment against the Republic.[51]

Moreover, the Third Circuit's decision makes clear that the FSIA's arbitration (or explicit waiver) exception applies to eliminate the foreign sovereign's immunity from suit or enforcement anywhere in the U.S. The open question after *Crystallex* is whether there must be an independent basis for jurisdiction over a state instrumentality in order to render it liable for a judgment against the sovereign, or whether the alter ego doctrine coupled with the foreign state's lack of immunity alone is sufficient—*i.e.*, must a creditor establish that the instrumentality itself is not immune from suit in the U.S. to hold it liable for the obligation of its parent state? This question is highly significant, since its resolution could either greatly facilitate or, alternatively, foreclose an avenue of recovery from state instrumentalities with property in the United States but who otherwise have no relationship to the dispute between the creditor and the foreign state.

On November 21, 2019, the Third Circuit denied the parties' motions for rehearing of the Third Circuit's decision.[52] The lower court proceedings in the District of Delaware are continuing, with the court likely to rule on several motions in the near future.

48 *Crystallex*, 333 F. Supp. 3d at 390-91.

49 *Id.* at 424 (noting "an important distinction between adding PDVSA to Crystallex's judgment against Venezuela – which would allow Crystallex to attach any of PDVSA's property to satisfy the judgment, without additional proceedings, if for example, the proceeds from the sale of the shares it is attaching are less than the full amount of its judgment – and only attaching specific property, which is the result being permitted here").

50 *See Crystallex*, 932 F.3d at 134, 152 (characterizing the question before the Third Circuit as "whether PDVSA could be liable for the arbitration award as an 'alter ego' of Venezuela," and finding that "if the relationship between Venezuela and PDVSA cannot satisfy the Supreme Court's extensive-control requirement, we know nothing that can").

51 The recent Second Circuit decision in *Assa Corp.* contains similarly concerning language—the court there found that the entities "are Iran's alter egos as a matter of law and are therefore foreign states under the FSIA," and that the alter ego "is subject to the district court's jurisdiction and its property is subject to attachment and execution." *Assa Corp.*, 934 F.3d at 198.

52 Order, *Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, Nos. 18-2797 & 18-3124 (3d Cir. Nov. 21, 2019).

ABOUT THE AUTHORS

Richard J. Cooper
Senior Partner in the Restructuring and Sovereign Practice Groups at Cleary Gottlieb Steen & Hamilton LLP

Richard J. Cooper is one of the preeminent cross-border bankruptcy and restructuring lawyers in the United States and is the recognized leader in cross-border and sovereign restructurings involving companies and countries in Latin America and other emerging markets.

Carmine D. Boccuzzi Jr.
Senior Partner in the Litigation Group at Cleary Gottlieb Steen & Hamilton LLP

Carmine D. Boccuzzi's litigation and arbitration practice focuses on international disputes, including those involving foreign states and state-owned entities, as well as domestic disputes involving the capital markets and antitrust issues.

Francesca L. Odell
Senior Partner in the Latin American and Sovereign Practice Groups at Cleary Gottlieb Steen & Hamilton LLP

Francesca L. Odell's cross-border practice focuses on capital markets, M&A, private equity, project finance, and restructuring transactions, and her clients include many of the largest companies in the oil and gas and telecommunications sectors in Latin America and Brazil.

Boaz S. Morag
Counsel in the Litigation Group at Cleary Gottlieb Steen & Hamilton LLP

Boaz S. Morag's practice includes representing foreign sovereign and private clients and domestic clients in trials and appeals in state and federal courts in the United States and in arbitration hearings internationally.

Michael Cinnamon
Associate in the Litigation Group at Cleary Gottlieb Steen & Hamilton LLP

Michael Cinnamon's practice focuses on international and domestic complex commercial litigation and cross-border regulatory enforcement matters.

POWER INDUSTRY OVERVIEW AND 2020 OUTLOOK: AN INDUSTRY IN TRANSITION

RAY DOMBROWSKI, CHARLES MOORE, PAUL BARRY AND LISA PRICE
Alvarez & Marsal[1]

The electric power industry in the United States represents a crucial underpinning of America's industrial infrastructure, providing power needed to drive the nation's economy. All other critical infrastructures — from transportation to manufacturing and beyond — depend upon the efficient operation by both electric utilities and independent power producers and transmission and distribution system operators across all regions.

Today, the U.S. power sector is an approximately $400 billion industry that has proven to be one of the most reliable and efficient electricity distribution systems in the world. Each year it benefits from advances in technology, less expensive and cleaner fuel supplies and more efficient distribution.

Yet, those same benefits have also become challenges. The shift to natural gas and renewable resources has ramped up the pressure on power producers to balance changing asset composition, costs and investment in new technology driven by the displacement of baseload coal and nuclear generation. In addition, the industry faces the unpredictable fuel prices and the inability to scale renewables in the absence of mass storage. Further, while the shift to renewables is most acutely felt today by companies weighted to coal, companies with other types of generation, transmission and distribution infrastructure, and related original equipment manufacturer (OEM) and service companies are increasingly under similar pressure.

1 This article was produced with research and support from the A&M Insight Center, which serves to provide relevant, industry-specific, actionable insights derived through proprietary studies and research. For a list of Sources, see p. 20

POWER MARKET OVERVIEW

Macrotrends Introduce Unpredictability

Each year, the industry's progress becomes slightly more uncertain as attitudes about energy consumption change. Historically, electricity consumption tracked with the U.S. gross domestic product, expanding and contracting along with the economy. The pattern made it easier to predict future energy needs from a regulatory point of view. However, over the past five to 10 years the correlation between economic growth, energy supply mix and energy consumption has been disrupted. Regulators are using Renewable Portfolio Standards (RPS) to support the expansion of renewable power generation, customers are increasingly building their own distributed energy resources (power generation) as well as adapting energy-saving electrical products. The net effect is that utilities need to balance supply- and demand-side generation, maximize operation of zero emissions generation — principally renewables — and increase operational flexibility and security of their grid management systems.

Faced with changing environmental concerns and public sentiment focused on the reduction of CO_2, climate change and RPS, leaders in the industry are seeking new sources of power generation. The primary fuel source for electric generation through the years has been coal, but recently the industry made a dramatic shift toward other fuels. Advances in hydraulic fracturing have unlocked abundant supplies of natural gas, supporting improved economics for natural gas-fired generation. Improving efficiency and economics of wind and solar have accelerated rapid buildout of renewable generation. As natural gas and renewables have become more important to generation capacity, the industry is relying less on coal and nuclear.

These macrotrends introduced unpredictability into the electric generation market. Abundant natural gas supplies are driving down customer prices, while developing renewable energy sources like wind and solar are becoming a larger portion of the industry's fuel source. Regulatory changes are requiring power generators to invest significant capital at a time when they face a depressed demand for electricity and falling prices. The erratic nature of the market will likely continue until the industry can find an effective solution to store electricity on a mass basis.

Fuel Overview: Costs of Generation and Coal's Decline

The power industry uses a range of fuel sources to generate electricity. Fossil fuels dominated electricity production in the U.S. over the last century and still represent more than 60% of the power generated today. However, coal used in power generation has fallen from 40% of total fuel consumption in the U.S. in 2013 to below 30% now. With advances in drilling technology significantly increasing the availability of natural gas in the early 2010s, natural gas rose from 26% to over 34% of the nation's total fuel source. That ample supply resulted in falling electricity prices, allowing natural gas plants to generate power at lower marginal costs than many coal plants. In addition, environmental regulations have placed further stress on coal, resulting in the retirement of significant coal capacity since 2012.

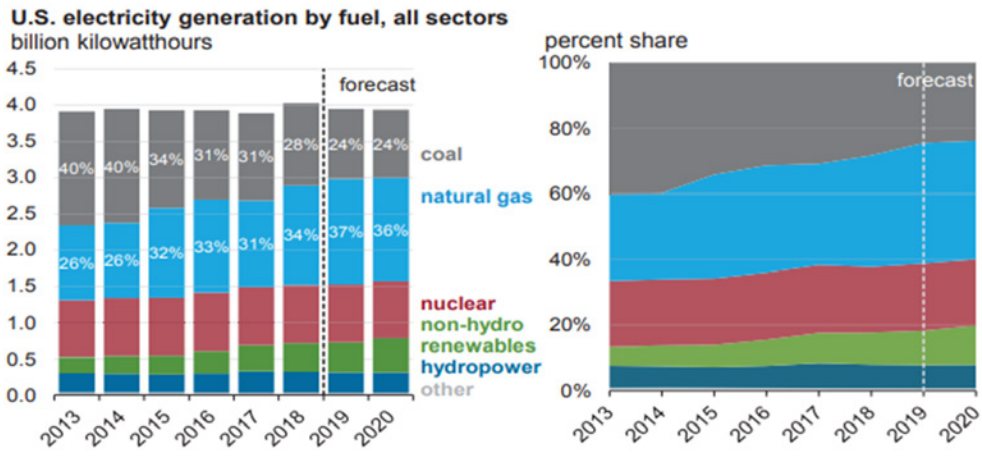
Improving technology, lower development costs and favorable regulations are helping renewable energy generation become a larger share of the industry's total fuel source. In particular, wind and solar generation is increasing and is expected to grow from approximately 5% of power generation in 2013 to an estimated 15% in 2020 (Exhibit 1).

Many states have shifted from coal-fired generation to natural gas and/or nuclear generation, and more recently, to renewables, as environmental regulations encouraged power providers to shut down older coal plants and invest in other fuel sources (Exhibit 2 on next pg.).

Declining power prices, high operating costs (relative to renewables and natural gas) and rising capital requirements from regulation have eroded the economics of coal facilities. Many states in the southeastern and northeastern U.S. increasingly use natural gas, nuclear and hydroelectric generation. In many cases, utilities that have shuttered coal plants face accelerated environmental costs, such as coal ash disposal, and dismantling costs, known as asset retirement obligations (ARO). Nuclear facilities in some markets increasingly face similar situations.

Given these regulatory issues, power generators now consider converting coal plants to natural gas because of its economic viability. Switching fuel sources is an attractive and economical option for utilities that must maintain a certain generating capacity in their fleet and can't justify the cost of other options.

Exhibit 1: Renewable energy has accelerated due to reduced costs and new regulations.



Source: Short -Term Energy Outlook, August 2019

Continued from p.13

Changing Landscape: A Future Focused on Renewables

As the power industry faces social, political and economic pressures to focus on more environmentally favorable policies, power generators increasingly look toward renewable fuel sources. Governments are also dictating the use of renewables. California and New York have independently announced plans to produce at least 50% of electricity from renewable sources by 2030. However, without economically achievable sources of energy storage, renewables cannot be the predominant source of electricity.

Renewables have become economically viable. On an unsubsidized basis, wind and solar generation offer substantially lower costs than coal. Driving down costs further are U.S. Government incentives. Tax credits, including the Production Tax Credit (PTC) for wind and the Investment Tax Credit (ITC) for solar, lower the levelized cost of energy for new generation. In addition, technology improvements and manufacturing cost reductions have and are expected to continue to drive down costs.

In the U.S., solar and wind generation is expected to grow at a compound annual growth rate (CAGR) of 34% and 11%, respectively, between 2016–2020. This growth of renewable sources will continue to pressure fossil fuel generation, with coal falling from 31% of the power produced to 24% over the same period. By 2020, electricity generation from coal, in absolute gigawatts, could fall back to pre-1980 levels.

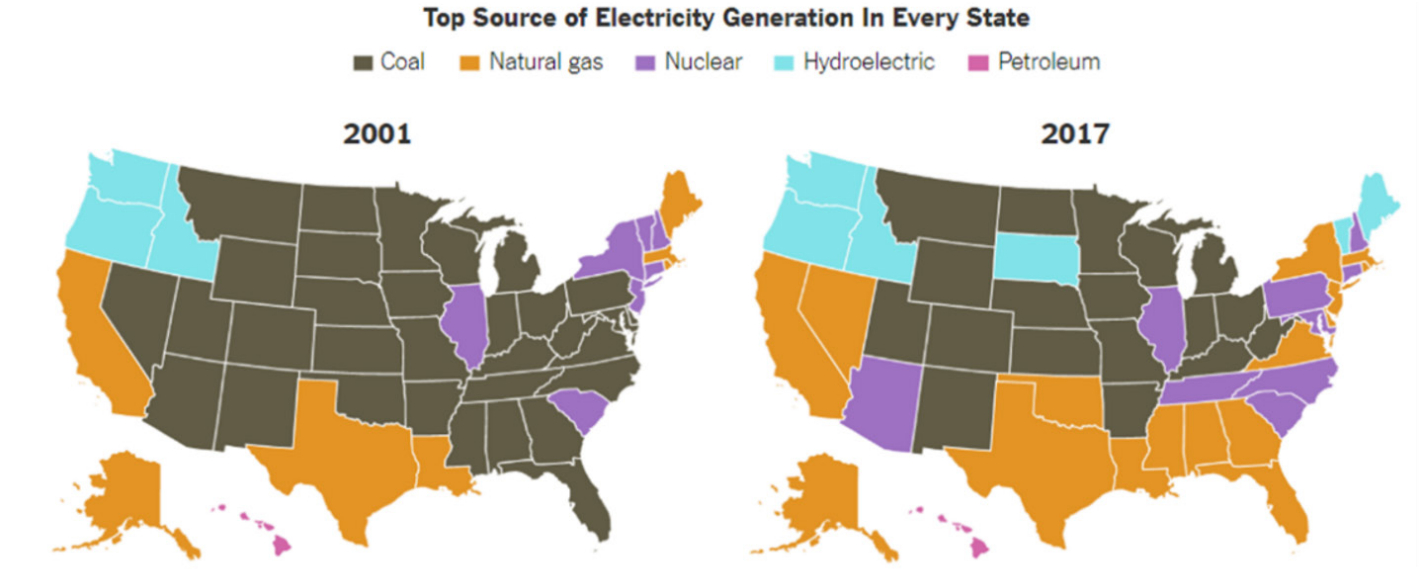
Looking ahead, the U.S. Energy Information Administration (EIA) projects electricity usage to rise slightly and for solar to become the dominant energy source in the nation by 2030. The continued shift to renewable fuel sources, led by solar, could make coal obsolete by 2040, according to the agency.

Significant declines in pricing of key components of solar and wind energy, along with efficiency improvements, strong competition and the benefits of scale, have dramatically lowered their levelized cost of energy (LCOE). In fact, over the past decade, utility-scale photo voltaic (PV) and wind LCOE are now competitive or less expensive than fossil-fuel and nuclear generation, even without government subsidies (See Exhibit 3 on next pg.).

Natural gas is the quickest bridge fuel from coal to renewables until storage is perfected. Gas emits only 50% of the CO2 emissions of coal and can be installed at scale, driving significant CO2 reduction while maintaining stable capacity. That said, in states with high renewable requirements, e.g., California and New York, gas plants that would otherwise dispatch are not being operated optimally.

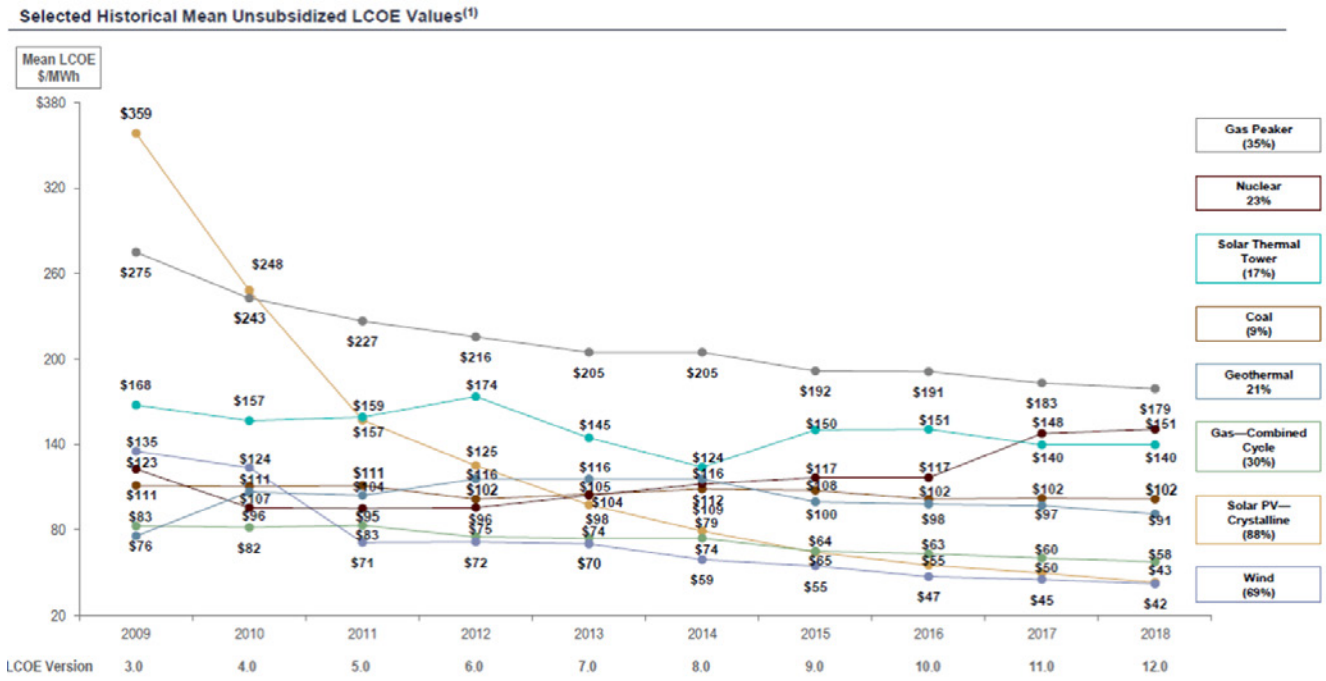
Nuclear, notwithstanding it is a zero-emissions technology, is also under pressure. Many nuclear plants are reaching the end of their useful lives and will require investment in order to continue to operate. Further, given high regulatory requirements, operating costs are higher than gas or renewable generation. The question for these utilities (and their regulators) is whether to extend the life of these plants or replace them with gas or renewables. The decision to retire these plants is

Exhibit 2: Coal sources are declining while natural gas and renewable sources grow.



Source: The New York Times – "How Does Your State Make Electricity?" by Nadja Popovich, dated Dec 24, 2018

Exhibit 3: The levelized cost of energy for renewable energy has fallen dramatically.



Source: Lazard estimates.

more complicated than simply assessing their marginal cost versus renewables or gas. When utilities retire large plants, regions may experience power shortages if not replaced with similar-sized alternate power sources and reliability concerns if more baseload power is needed than will be available post-retirement. Further, funding of costs for used nuclear fuel and plant decommissioning will likely need to be accelerated.

Across the industry, transmission and distribution infrastructure also requires significant investment. This can present difficult capital allocation challenges and/or increase financial pressures for utilities. They must balance building new renewables, funding new renewable transmission lines, upgrading existing grid management systems (e.g., distributed energy resource management systems) and maintaining grid infrastructure, much of which is dated or at the end of its useful life.

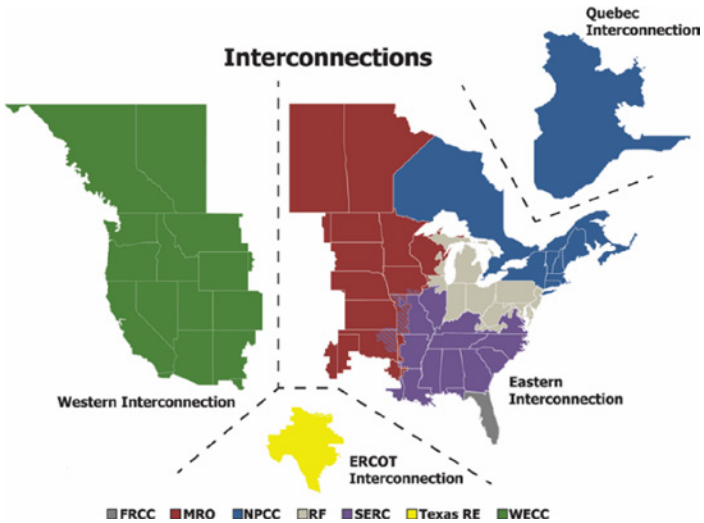
These challenges will likely persist for utilities, power companies, fossil and renewable OEMs and integrated service companies, given expected lower revenues industry wide. In the past, similar periods of disruption have resulted in bankruptcies and significant restructurings. Today, the industry faces tremendous pressure to cut costs, reduce leverage and further consolidate. If companies cannot navigate this transition, expect shrinking margins and corporate failures.

MARKET REGIONS AND STRUCTURES

Many Operators, Many Challenges, Different Structures

The U.S. power system consists of three electrically isolated, interconnected entities: Eastern, Western, and the Electric Reliability Council of Texas (ERCOT) (Exhibit 4). Within each interconnected market, regional transmission organizations (RTOs), independent system operators (ISOs) and balancing authorities oversee the reliable operations and delivery of electricity. Each

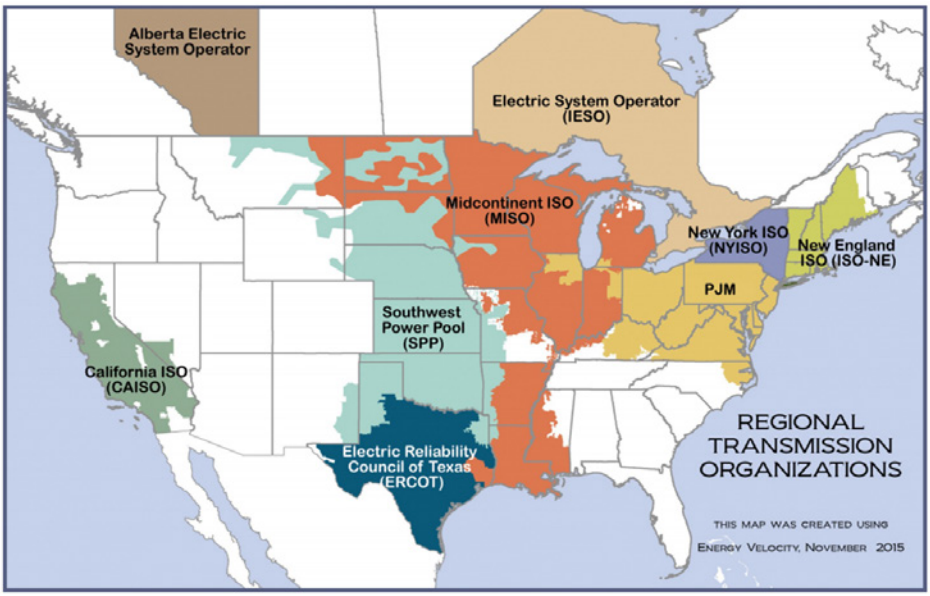
Exhibit 4: Market structure of U.S. power system consists of 3 interconnected entities.



Source: North American Electric Reliability Corporation (NERC)

Continued from p.15

Exhibit 5: RTOs and independent operators set the power market in various regions.



Source:: Federal Energy Regulatory Commission, ABB Velocity Suite

region operates with different economic and regulatory conditions.

Regional transmission organizations and independent system operators set the market structures and operational policies within their respective regions, typically employing a combination of wholesale energy prices, capacity compensation, and bilateral agreements to meet financial targets and electricity needs. In this way, economics and market prices between different regions can vary significantly, necessitating electric power producers tailor their asset base to market structures in the regions they serve (Exhibit 5).

In *wholesale energy markets*, merchant power plants produce and sell power. Under these arrangements, generation units that are available to produce power are dispatched to serve load in the order of each unit's marginal cost of operations until enough generating capacity has been dispatched to meet existing load requirements. The cost to produce electricity from the final generator sets the wholesale price of electricity that all dispatched units receive.

In *capacity compensation markets* the pricing framework is designed to maintain the reliable operations of the grid. They accomplish this by incentivizing generators to maintain their facilities in optimum operational condition, even during periods where wholesale prices do not provide adequate compensation.

In addition, each market faces different operating requirements and changing grid requirements, often facing one or all of the following risks:

- *Short, steep ramps in peak periods* – occur when the ISO must bring on or shut down generation to meet an increasing or decreasing electricity demand quickly, over a short period.
- *Oversupply risk* – happens when more electricity is supplied than needed to satisfy real-time electricity requirements.
- *Decreased frequency response* – occurs when fewer resources are operating and available to automatically adjust electricity production to maintain grid reliability.

ISO-specific challenges are also varied:

- *California ISO* – California utilities operate in one of the most regulated markets, with the nation's first cap-and-trade program to limit carbon production and a mandate for energy retailers to source 50% of their electricity from renewables by 2030. In addition to the PG&E bankruptcy, several California facilities have filed for bankruptcy or shut down, citing uneconomic power prices.
- *Pennsylvania, Jersey, Maryland Power Pool (PJM)* – maintains both wholesale energy and capacity markets, compensating utilities for actual power production in a wholesale energy market and incentivizing them to keep plants in operating condition even when the wholesale market prices do not provide adequate return. However, demand for electricity in the market outpaces the supply of natural gas, primarily due to a lack of adequate pipeline capacity, so establishing reliable gas delivery is a significant challenge.
- *New York ISO* – runs both wholesale energy and capacity markets and faces significant challenges, such as a highly regulated market that requires it to

produce 50% of electricity from renewable resources by 2030.

- *New England ISO* – has experienced downward pressure on prices from state-subsidized generator projects that reduced market competition. Extreme weather events in recent years also stressed the region's fuel supply infrastructure, causing market prices to reach record highs and increasing the risk of inadequate electrical supply.
- *Electric Reliability Council of Texas (ERCOT)* – unlike other markets, provides no capacity compensation and relies on scarcity pricing (increased energy prices as supply and demand become imbalanced) to provide the additional compensation needed for generators to cover their fixed operating expenses. With significant wind resources, ERCOT's energy prices fluctuate significantly, placing significant pressure on its coal and nuclear assets.
- *Missouri ISO (MISO)* – like other regional ISOs, operates both wholesale energy and capacity markets; however, its capacity market is not as robust as those and other regions.
- *Southwest Power Pool (SPP)* – relies heavily on power purchase agreements with utilities and service providers throughout the region, and the abundance of utilities and bilateral agreements makes the market less transparent than other U.S. power markets.
- *Southeast Electric Region* – is dominated by vertically integrated, regulated electric utilities, as well as bilateral agreements. Its biggest challenge is in its nuclear generating sector, where cost overruns, project delays and project abandonments mean ratepayers bear the burden of paying for industry miscues.

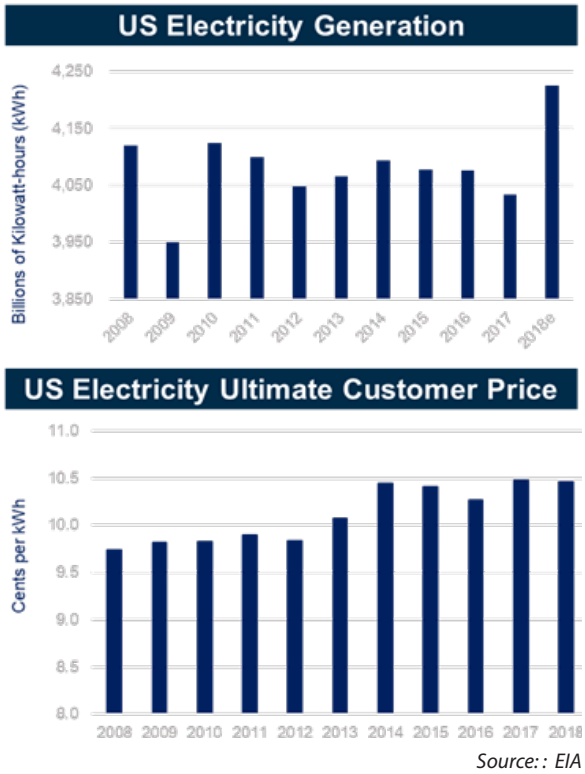
PRICING AND FORECASTS

Pricing Electricity: A Complex Task

The pricing of electricity depends on several factors and the type of customer served (Exhibit 6). For example, prices reflect the costs to build and maintain plants, to generate power, and to maintain the power grid over certain regions. In addition, electricity costs vary by region, reflecting local regulations and unique geographic features that generators must overcome to distribute power (Exhibit 7 on next pg.)

Another factor in pricing electricity is the cost of fuel. Fuel costs vary, often peaking in times of high demand, such as summer, and decreasing in times of lower demand. Likewise, the type of fuel affects the cost to generators.

Exhibit 6: Power generation trends over past decade



Source:: EIA

The need to invest heavily in infrastructure has also affected pricing, since power plants and transmission infrastructure require constant maintenance and new construction and plant conversions require significant capital.

In addition, power plants face the constant cost of meeting regulatory standards, including environmental requirements. Those costs show up in the final pricing of electricity.

Finally, the more difficult it is to distribute electricity to the end user, the higher the pricing, so residential and commercial customers typically pay more. Industrial customers, who usually require more volume of electricity at higher voltages, generally pay a lower rate.

While wholesale prices are set by the day-to-day cost of supplying electricity as demand fluctuates, most retail customers pay a seasonal average, so they don't experience real-time variation of electricity costs.

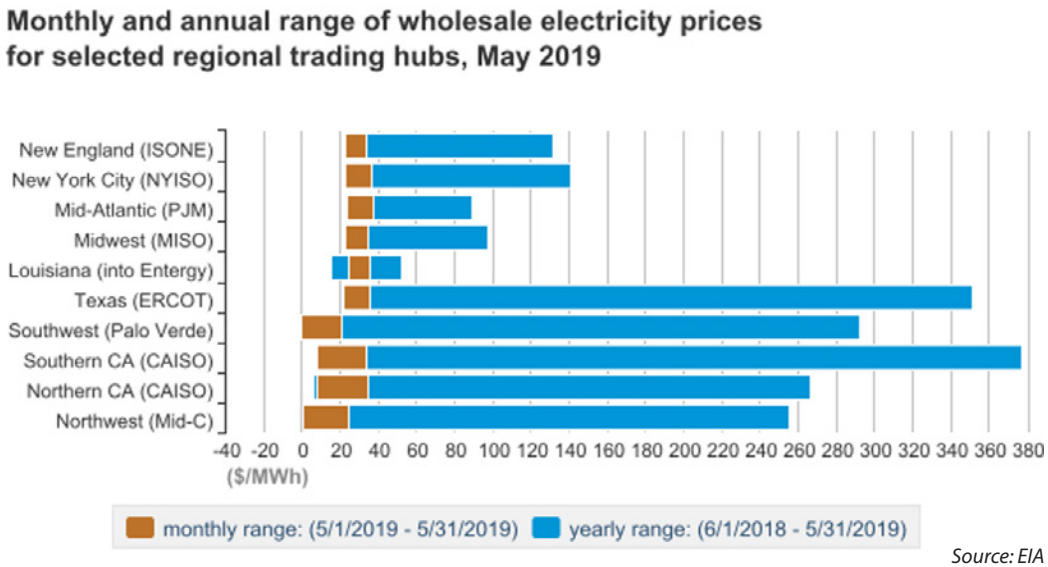
Power Generation and Pricing Trends

Long-term power generation trends have been flat; however, prices have recently declined due to reductions in natural gas and coal costs. Also keeping prices down: a surplus of supply coupled with slowing demand from warmer-than-normal winters.

In 2018, weather-driven demand increased, helping the market experience some price improvement, but pricing pressure remains nationwide and is likely to continue for the foreseeable future.

Continued from p.17

Exhibit 7: Power generation prices by market, 2017-2018.



Source: EIA

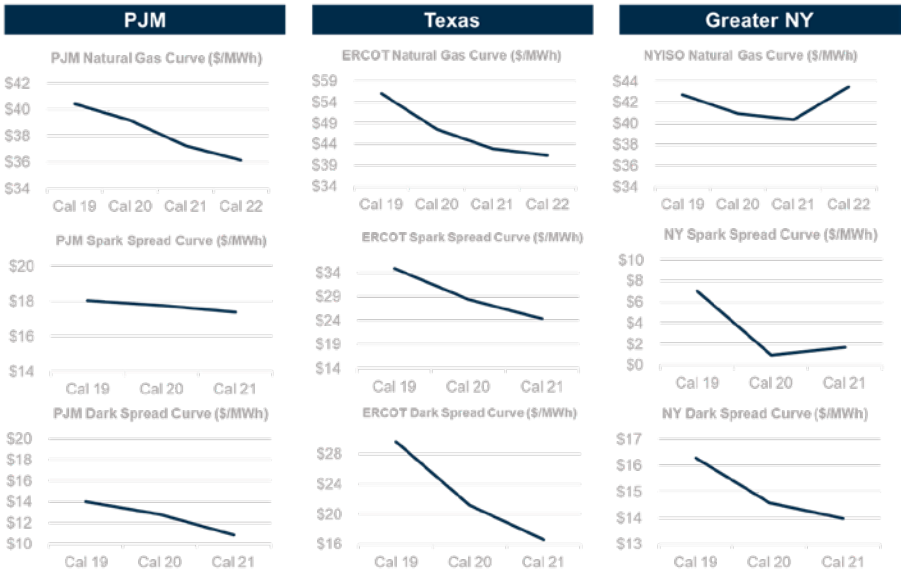
Exhibit 8: Forecasts point to higher natural gas and coal prices in the future.

Commodity Future Price Changes and Forecast

	Price Indexes (2010=100)[1]					Change (%) q/q		Change (%) y/y		Index revision[3]	
	2016	2017	2018	2019f[2]	2020f[2]	2018Q4	2019Q1	2019	2020	2019f[2]	2020f[2]
Energy	55	68	87	82	81	-9.5	-8.0	-5.4	-1.4	-9.6	-4.6
Non-Energy[3]	79	84	85	83	85	-1.5	0.9	-2.1	1.4	-2.4	-2.2
Agriculture	87	87	87	84	86	-2.2	0.9	-2.6	1.7	-3.2	-3.2
Fertilizers	78	74	82	86	88	6.6	-5.4	4.8	1.7	3.6	3.4
Metals and minerals	63	78	83	81	82	-1.0	1.7	-1.9	0.8	-1.2	-0.8
Precious metals[4]	97	98	97	100	103	0.7	6.1	2.6	3.1	4.0	7.8
Memorandum items											
Crude oil ($/bbl)	43	53	68	66	65	-11.9	-6.0	-3.4	-1.5	-8.0	-4.0
Gold ($/toz)	1,249	1,258	1,269	1,310	1,360	1.3	6.1	3.2	3.8	65.1	129.0

Source: World Bank

Exhibit 9: Continued pricing pressure is expected to continue in the foreseeable future.



Source: Bloomberg set defaults on Sub-market and fuel type. Spreads for lowest heat rate. Eastern Rail CSX used for dark spreads.

Commodity Pricing and Supply

Commodities such as energy, metals and agriculture all experienced a significant price change since 2016 (Exhibit 8). Warm winter weather and high levels of natural gas depressed pricing. In addition, record power generation in summers and colder than expected winters drove commodity prices higher.

Unregulated power generation (as is expected under this Administration) is positively levered to higher gas, coal, and to a lesser extent, oil prices.

Future Energy Pricing

Given the outlook for commodity prices, the industry is expected to continue to see pricing pressure into the future, compressing overall operating margins for electric power producers at a time when these same companies need to be investing to modernize their asset base and streamline operations (Exhibit 9).

CHALLENGES FACING THE INDUSTRY

Headwinds for Coal-Fired Plants Continue

Coal dominated the power generation industry and made up 50% of power plant fuel supply until mid-2015. Then in April of that year, natural-gas fired generation surpassed coal for the first time (Exhibit 10).

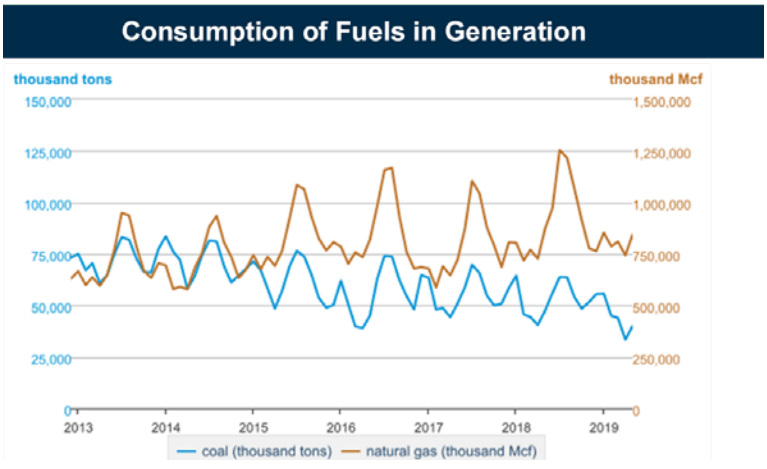
Coal's market share in the power industry will likely continue to decline because of the abundance of low-priced natural gas and the increase in renewable energy.

More than 10% of coal generation capacity, approximately 35 gigawatts, has been retired since 2011, and another 8%, or 24 gigawatts, are forecast to retire between 2016 and 2020, according to Morgan Stanley (Exhibit 11).

Even assuming relaxed environmental policies and regulations applicable to coal under the current administration, the economics of coal will continue to hold back its long-term outlook. Fundamentally, coal cannot compete with natural gas and renewables; companies with gas-heavy fleets and renewables are better positioned for the future.

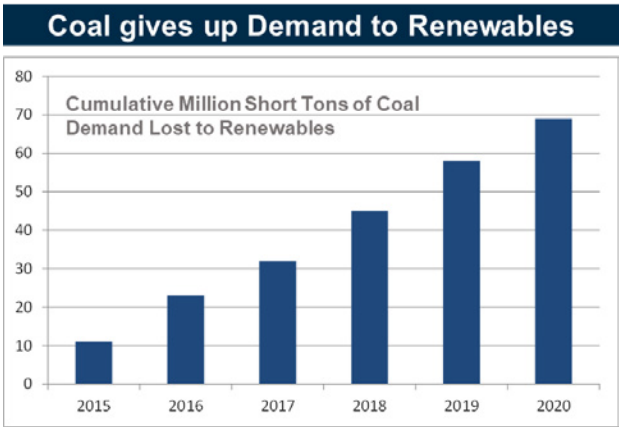
Coal has primarily competed with natural gas to meet "static" electric demand and continues to lose ground. Further, more coal plants now face the end of their useful lives. The average age of coal generators is between 30 and 40 years out of a useful lifespan of 50 to 60 years For that reason, operators face a decision on whether to reinvest or rebuild plants or shift away from coal to meet new generation needs.

Exhibit 10: Natural gas will continue to surpass coal as a fuel supply.



Source: EIA

Exhibit 11: Coal production will continue to decline.



Source: Morgan Stanley Research

Continued from p.19

SUMMARY AND CONCLUSIONS

The U.S. power industry faces unique challenges at the beginning of the 21st century that it didn't have to wrestle with previously. Increasing regulatory requirements, the push for more renewable energy, regional market inefficiencies and unpredictable pricing at various times and places, put pressure on utilities and power companies to invest heavily in new technologies, existing infrastructure and meeting regulatory goals.

The industry's long-term future will unfold with fewer fossil fuel sources, more solar and wind and other renewable energy technologies coming online. In some areas of the country, the power industry must operate under significantly stricter environmental policies. And in many regions, new efficiencies and economic models can help generators and power operators minimize fluctuations in supply and demand.

As utilities, IPPs and transmission and distribution operators invest in new infrastructure or upgrade existing infrastructure, many will face limitations on their ability to raise debt and/or earn an appropriate return on their investment. Primary reasons include an expected lower future revenue profile and a sensitivity by regulators, public utility commissions and customers to rising electricity prices, which in turn, pressures operating margins. These companies may well need to consider ways to rethink or restructure their balance sheet, even as they continue to adapt their business model and align their cost structure. Similarly, as competition and innovation put pressure on electricity prices, OEMs and service companies will face pressure to invest, even as they work to streamline their cost structure in order to be competitive. Getting ahead of this financial pressure through proactive measures, and engaging experts equipped to address these problems, will be necessary to navigate this period of transformation in the energy industry.

SOURCES

"Electric Power Annual," U.S. Energy Information Administration, October 2018.

"2017 State of the Grid," ERCOT, April 2018.

S&P Global Market Intelligence.

Morgan Stanley Research

"Short-term Energy Outlook," U.S. Energy Information Administration, August 2019.

"Annual Energy Outlook 2018," U.S. Energy Information Administration, February 2018.

"Annual Energy Outlook 2019," U.S. Energy Information Administration, January 2019.

"How Does Your State Make Electricity?" by Nadja Popovich, The New York Times, December 2018.

"Regional Transmission Organizations (RTO)/Independent System Operators (ISO)," Federal Energy Regulatory Commission, May 2019.

Federal Energy Regulatory Commission, ABB Velocity Suite.

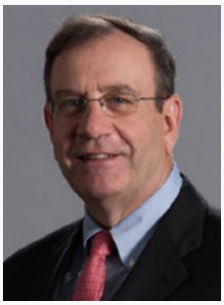
California Energy Commission, staff analysis, November 2018.

ERCOT 2017 State of the Grid, April 2018.

"The Commodity Markets Outlook in Six Charts," World Bank, April 2019.

"Quarterly Mine Employment and Coal Production Report," U.S. Department of Labor, Mine Safety and Health Administration.

ABOUT THE AUTHORS



Ray Dombrowski

Ray Dombrowski is a Managing Director in A&M's New York Office. He has extensive experience in the power industry starting from his undergraduate days at the U.S. Merchant Marine Academy; financing over $5 billion of alternative energy projects and serving as CRO and/or CFO of Ogden (Covanta), Allegheny Energy; MEPCO; leading assignments on behalf of the Unsecured Creditors Committees of Westinghouse and SunEdison; serving as Chair of a hedge fund that traded on the PJM and CAISO markets; as well as serving in advisory capacity for private equity and a number of IPP and IOU concerns.

Charles Moore

Charles Moore is a Managing Director in A&M's Detroit office. He has 25 years of experience in operational and financial restructuring, turnaround consulting, performance improvement and interim management. He has significant experience with power generating assets located in PJM Interconnection, and currently serves as the Chief Restructuring Officer of FirstEnergy Solutions Corp. and FirstEnergy Nuclear Operating Company.

Paul H. Barry

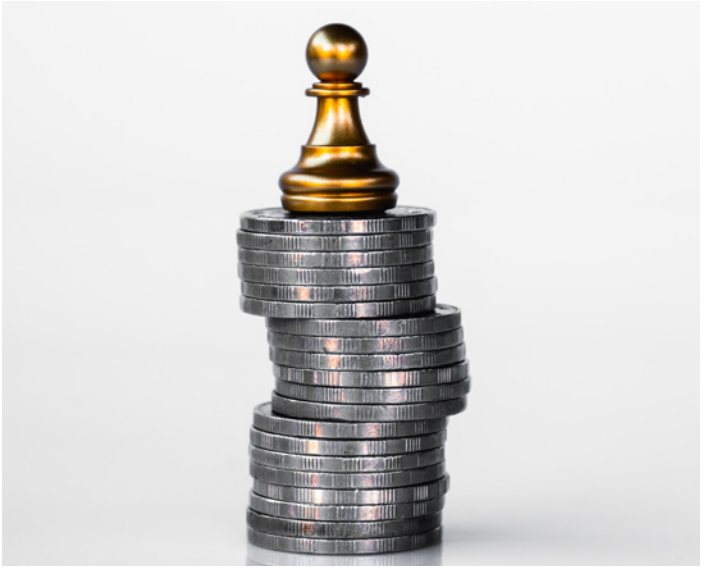
Paul H. Barry is a Managing Director and Co-Head of A&M's North America Corporate Mergers & Acquisitions. Mr. Barry brings over 30 years of experience specializing in origination, development, and execution of global growth initiatives. Prior to joining A&M, Mr. Barry was CEO and co-founder of Public Infrastructure Partners LLC and led the company's operating platform with expertise in acquiring, operating, and maximizing investor returns in regulated and unregulated power markets, midstream gas, and renewables.

Lisa Price

Lisa Price recently joined A&M as a Managing Director in Atlanta. She has extensive experience in the power industry from power plant and maintenance operations at Freeport McMoran, followed by an energy and power sector focus in Investment Banking. At GE, Ms. Price held business development roles at Corporate, China and Energy focused primarily on power equipment She also served as GM and CEO of Global Nuclear Fuels, the nuclear fuels joint venture between GE, Hitachi and Toshiba.

THE NET-SHORT DEBT STRATEGY PARADIGM

BORIS J. STEFFEN, CDBV
GlassRatner Advisory & Capital Group



Disputes between debtors and creditors are common if not ubiquitous in bankruptcy. The nature and scope of these disputes has evolved over time, however, with certain investors no longer motivated simply by the expectation that a debtor will make payments of interest and settle its obligation in full at maturity. Instead, these investors look to profit from establishing a position in a company's debt, equity and derivative securities (i.e., credit default swaps, "CDS") such that they are "net-short" the company's debt, and consequently have more to gain from a decrease rather than increase in its value. The actions taken to implement a net-short debt strategy observable thus far fall into two distinct but closely related categories: the "net-short debt activist" and the "manufactured default" approaches.

CDS Basics

Initially developed as a way for banks to transfer credit exposure and free-up regulatory capital, the use of CDS has evolved as an active portfolio management tool.[1] Similar to insurance, a CDS is a contract in which a buyer of default protection pays a fee, to a seller of default protection on a reference entity, in exchange for a payment by the seller on the occurrence of a predefined credit event.[2] Notwithstanding counterparty risk, CDS therefore serve to mitigate risks by transferring a given risk from one party to another without having to transfer the underlying bond or credit asset. In effect, the position of the default protection buyer, who typically owns the credit asset, is comparable to shorting a bond, while the seller is effectively long.

The terms of a CDS contract are determined via negotiation by the parties. The reference entity is the obligor to which the reference obligation, or underlying credit asset, belongs. The notional amount is the face value of the reference obligation, while the tenor is the period during which protection under the CDS is effective. The default swap premium, or swap spread, calculated as a fraction of the notional amount of the reference obligation,[3] represents the fee the buyer agrees to pay the seller in exchange for transferring the credit risk of the obligation.

Credit events are circumstances that have to take place for a protection buyer to exercise its right to exchange a deliverable obligation to a protection seller and receive a payoff. For corporate entities, credit events include bankruptcy, failure to pay and restructuring. For sovereigns, credit events include repudiation, moratorium and obligation acceleration and default. Restructuring differs from other credit events in that there is no automatic trigger of the CDS. Rather, it is up to the protection buyer or seller to determine how to proceed.[4]

Whether a credit event has occurred is determined by the Determinations Committee ("DC"), comprised of buyers and sellers, for the geographic area in which the contract was written.[5] Any market participant can ask for a determination; however, the scope is limited to credit events that have occurred in the 60 days prior to the request. If the DC finds that a credit event has occurred, the DC then determines whether to hold an auction to establish the market value of the obligations of the reference entity that qualify to be delivered in exchange for payment pursuant to the CDS contract.

When two parties enter into a CDS, the spread is set such that the present value of the swap transaction is zero, with the value of the fixed, or premium leg, and

1 "Understanding Credit Default Swaps," Pimco.com (October 2019), retrieved from https://www.pimco.com/en-us/resources/education/understanding-credit-default-swaps/

2 Arvind Rajan, "A Primer on Credit Default Swaps," in *The Structured Credit Handbook*, edited by Arvind Rajan, Glen McDermott and Ratul Roy (Hoboken: John Wiley & Sons, 2007), 17.

3 George Chacko et al., *Credit Derivatives: A Primer on Credit Risk, Modeling, and Instruments* (Upper Saddle River: Wharton School Publishing, 2006), 152.

4 "A Guide to Credit Events and Auctions," Creditsuisse.com (October 2019), retrieved from https://research-doc.credit-suisse.com/docView?language=ENG&source=emfromsendlink&format=PDF&document_id=803733390&serialid=FWHCx3yCrSE3FoEvAbEKa6fRKhqLoKs0jL1gR5W2Dfs%3D

5 Fabien Carruzzo, Stephen Zide and Daniel King, "Opportunistic Credit Default Swap Strategies," Kramerlevin.com (October 2019), retrieved from https://www.kramerlevin.com/images/content/4/9/v2/49130/Opportunistic-Credit-Default-Swap-Strategies-w-014-1708.pdf

Continued from p.21

value of the contingent, or protection leg, equal.[6] Stated differently, the present value of all CDS premium payments should equal the present value of the expected payoff from the CDS in order for the NPV to be zero for both parties.[7] If the reference entity subsequently defaults, the CDS buyer will receive a payment from the seller. However, as the recovery rate (i.e., degree to which the principal and accrued interest on defaulted debt can be recovered) is typically greater than zero, the payoff will differ from the face value of the obligation. Accordingly, the payoff from a CDS is equal to the face value of the credit asset minus its market value just after default at time *t*, with the market value just after time *t* equal to the recovery rate multiplied by the face value of the bond plus accrued interest. So with a failure to pay or other credit event under a CDS contract, credit protection sellers must pay credit protection buyers the amount of the percentage decline in the par value of the "cheapest to deliver" debt of the reference entity deliverable under the CDS, multiplied by the applicable notional amount.[8]

Overview of Net-Short Debt Activism

"Net-short debt activism" involves the acquisition of a "long" position in a debt instrument such as a corporate bond, in order to assert a default that will result in a profit on a larger "short" position in the reference firm's debt, equity or derivatives.[9] The investor does not seek to work with or support the debtor in restructuring. Rather, the objective of the investor is to force the debtor to accelerate payment.[10] Based on the *Cash America* case, investors have also asserted they are entitled to a *make whole* premium as an alternative to acceleration as covenant defaults are equivalent to an *indirect* optional redemption. Both claims differ from customary disputes where the creditor is trying to enforce its contractual right to payment, or challenge a transaction that may diminish the debtor's ability to pay.[11] Net-short debt activism also differs from that in the equity markets, as bondholders do not vote to approve significant transactions or elect directors.

To implement a net-short debt activist strategy, the investor identifies a transaction it can argue violated an issuer's debt covenants. The investor then creates a position in which it holds both long and short claims in the company's debt, with the long claim smaller than the short, so on balance, the investor is "net-short" the company's debt. While usually comprised of CDS that increase in value on the default of the reference entity, the short leg may also be structured with equity or junior debt. The investor may then assert the default in a letter to the borrower, offering to drop the assertion in exchange for the payment of a fee.[12] If the investor's long position is sufficient (customarily 25 percent of the bond tranche), it may also serve a formal default notice, precipitating litigation.[13]

The Case of Windstream

The litigation between Aurelius Capital Management, LP and Windstream Holdings, Inc.[14] is an illustration of the net-short debt activist strategy. In April 2015, Windstream spun-off and then leased back its copper and fiber assets in a transaction that created Communications Sales & Leasing, Inc., subsequently renamed Uniti Group Inc.[15] Following in October 2017, U.S. Bank National Association filed suit on behalf of Aurelius, who as beneficial owner of more than 25 percent of the senior unsecured notes due 2023 (and who purportedly had purchased CDS worth as much as 10 times the debt it owned)[16] filed a notice of default in September 2017,[17] alleging that the transaction violated the sale and leaseback covenant in the indenture to the notes.[18]

In deciding the case, U.S. District Judge Jesse Furman concluded the spin-off constituted a default and awarded Aurelius approximately $310.5 million, plus interest of $61,347 per day after July 23, 2018.[19] Windstream responded it would challenge the ruling, and announced "The Company believes that Aurelius engaged in predatory market manipulation to advance its own financial position through credit default swaps at the expense of many thousands of shareholders, lenders,

6 Ali Hirsa and Salih N. Neftci, *An Introduction to the Mathematics of Financial Derivatives*, 3 (London: Elsevier, 2014), 380.

7 Yuan Wen and Jacob Kinsella, "Credit Default Swap–Pricing Theory, Real Data Analysis and Classroom Applications
Using Bloomberg Terminal," Bloomberglp.com, retrieved from https://data.bloomberglp.com/professional/sites/10/WhitePaper_Wen.pdf .

8 Carruzzo, Zide and King, "Opportunistic."

9 "CDS market: Beware the net-short-debt activist," Euromoney.com (October 2019, retrieved from https://www.euromoney.com/article/b1b9kgb7fyx0m5/cds-market-beware-the-net-short-debt-activist

10 Roy Zhang, "Sirius Computer Solutions: An Analysis of Net Short Debt Activism Safeguards," Medium.com, retrieved from https://medium.com/@royanderson_1518/sirius-computer-solutions-an-analysis-of-net-short-debt-activism-safeguards-ac519f2dbd1b

11 Steven A. Cohen, Joshua A. Feltman, Emil A. Kleinhaus, and John R. Sobolewski, "Default Activism in the Debt Markets" (memorandum: Wachtell, Lipton, Rosen & Katz, November 16, 2018).

12 Ibid.

13 Joshua A. Feltman, Emil A. Kleinhaus, and John R. Sobolewski, "The Rise of the Net-Short Debt Activist" (memorandum: Wachtell, Lipton, Rosen & Katz, August 1, 2018).

14 Shanthi Rexaline, "The Windstream Plunge, Explained," finance.yahoo.com (Benzinga.com), retrieved from https://finance.yahoo.com/news/windstream-plunge-explained-174236901.html

15 "Communications Sales & Leasing, Inc. Formed Through Spinoff," Uniti.com, https://investor.uniti.com/news-releases/news-release-details/communications-sales-leasing-inc-formed-through-spinoff

16 William D. Cohan, "What Hedge Funds Consider a Win Is a Disaster for Everyone Else," Nytimes.com (May 12, 2019), retrieved from https://www.nytimes.com/2019/05/12/opinion/windstream-bankruptcy-cds.html

17 Debtwire.com, retrieved from https://www.debtwire.com/document-repository/document/BkJSgdVAb

18 Rexaline, "Windstream."

19 Joan Engebretson, "Aurelius Decision Could Trigger a Windstream Bankruptcy, With Implications for Uniti Too," Telecompetitor.com, https://www.telecompetitor.com/aurelius-decision-could-trigger-a-windstream-bankruptcy-with-implications-for-uniti-too/

codere

employees, customers, vendors and business partners. Windstream stands by its decision to defend itself and try to block Aurelius' tactics in court." [20] However, as the ruling effectively cut Windstream off from its $450 million credit facility, with $5.6 billion funded debt and only $6 million cash on hand, it was forced to file for Chapter 11.[21, 22]

Manufactured Defaults

In an unconventional or narrowly tailored credit event, also known as a "manufactured default,"[23] the investor works with the company, agreeing to provide financing on favorable terms contingent on the company voluntarily defaulting on an obligation it is capable of paying. When the company defaults, the investor profits from the default protection provided by the CDS contract it bought to cover the risk of the company's obligation, enabling it to provide financing on favorable terms. The relatively low $1 million failure-to-pay threshold in the standard CDS contract also permits most CDS contracts to be set off without triggering cross-defaults in other debt securities of the company.[24]

To manufacture a default, the investor purchases a CDS on the company from another hedge fund, insurance company or large bank that pays off on the occurrence of a failure-to-pay credit event.[25] The investor then contacts the company and offers to provide it with favorable, low interest financing, conditioned on its defaulting in a manner that triggers payouts on the investor's CDS. The company implements the plan, perhaps by delaying making an interest payment until after the grace period. This default triggers the CDS, causing the counterparty to the investor's CDS to pay a lump sum to settle the contract.

Codere SA: First in the Series

In 2013, Codere SA, an operator of betting parlors and racetracks in Europe and Latin America, undertook an effort to restructure €1 billion of debt after incurring losses over a number of quarters.[26] In the process, GSO Capital Partners LP ("GSO"), a subsidiary of Blackstone Group LP, offered Codere a loan contingent on Codere forgoing an interest payment on one of its obligations until after the associated grace period. This constituted a failure-to-pay credit event with respect to the CDS that GSO had purchased with Codere as the reference entity. In settlement of the CDS, GSO purportedly received a payment of $15.6 million from its CDS protection seller, increasing the returns on its loan to Codere.

Codere's failure-to-pay credit event did not violate the cross-default thresholds of its other debt instruments. Consequently, through the use of CDS, Codere was able to obtain favorable financing, while GSO was able to realize a greater return, absent any harm to the capital structure of Codere altogether. Capital was drawn from the protection sellers in the CDS market and invested in Codere, precluding further degradation of its credit.

The iHeart Restructuring

As part of its efforts to restructure $20 billion of outstanding debt, iHeart Communications Inc. arranged for its wholly owned subsidiary, Clear Channel Holdings, to buy $57.1 million of certain 5.5% senior notes due December 15, 2016.[27] When the Notes matured, iHeart repaid all amounts outstanding except for those owned by Clear Channel. In making this election, iHeart's intention was to avert a springing lien over its assets in

20 "Windstream Files Ch. 11 Following $310M Judgment," Law360.com, retrieved from https://www.law360.com/articles/1132530/windstream-files-ch-11-following-310m-judgment

21 "Windstream Gets Judge's OK To Tap $400M In DIP Funds," Law360.com, retrieved from https://www.law360.com/articles/1133148/windstream-gets-judge-s-ok-to-tap-400m-in-dip-funds

22 Joan Engebretson. Windstream Chooses Bankruptcy Filing Over Appeal of Negative Decision Involving Uniti Group Spinoff." Telecompetitor.com. https://www.telecompetitor.com/windstream-chooses-bankruptcy-filing-over-appeal-of-negative-decision-involving-uniti-group-spinoff/

23 Scott O. Malia. "An Important Milestone.? Isda.org. https://www.isda.org/2019/03/14/an-important-milestone/

24 Carruzzo, Zide and King, "Opportunistic."

25 FinancialTimes.com, retrieved from https://www.ft.com/content/5e23e516-5cdc-11e8-ad91-e01af256df68

26 Carruzzo, Zide and King, "Opportunistic."

27 Ibid.

Continued from p.23

favor of certain creditors that would have been triggered had all of the 2016 Notes been repaid.

While reserving its right to claim the unpaid principal of the 2016 Notes, Clear Channel agreed to forbear exercising its remedies. Concurrently, iHeart sought a declaratory judgement in District Court to establish that the 2016 Notes held by Clear Channel would be viewed as outstanding. As in Codere, iHeart's failure-to-pay did not create a cross-default, as the amount was lower than the $100 million threshold of iHeart's other debt instruments.

On review, the International Swaps and Derivatives Association (ISDA), Americas Credit Derivatives Determinations Committee, determined that iHeart's decision not to repay the principal balance of the Notes held by Clear Channel constituted a failure-to-pay credit event. Consequently, buyers of default protection were entitled to collect on their CDS contracts. In the auction held by ISDA to determine the value of iHeart's obligations, the market value of the obligation that qualified to be delivered in settlement of open iHeart CDS contracts was 35.50 cents on the dollar. On settlement, approximately $154 million was paid out as a result.

Hovnanian's Exchange Offer

In a restructuring substantially financed by GSO, in February 2018, Hovnanian[28] tendered $170 million of its 8% senior notes due November 2019 ("2019 Notes") in exchange for cash of $155 million, $90.6 million of new 13.5% unsecured notes due 2026 ("New 2026 Notes"), and $90.1 million of new 5% unsecured notes due 2040 ("New 2040 Notes"), the lowest trading debt instrument and obligation on which CDS payments would have been expected to be based. Further, GSO gave Hovnanian a 5%, $132.5 million term loan maturing in 2027 (with up to $80 million more available as a delayed draw) to refinance other debt, and a $125 million revolver to use for general purposes and refinance an existing $75 million secured term loan.

The exchange offer required subsidiary K. Hovnanian at Sunrise Trail III ("Sunrise") to agree to buy and hold $26 million of the 2019 Notes tendered. Included in the New 2026 and New 2040 Note indentures was an intentional trigger of a failure-to-pay credit event barring Hovnanian from making the May 2018 interest payment due on the 2019 Notes held by Sunrise. As to why, a default in the amount of $1.04 million would have entitled GSO to receive payments on its approximately $330 million position in Hovnanian's CDS protection contracts, and result in a profit of as much as $230 million[29] but for the litigation brought by protection seller Solus Alternative Asset Management.

Risk-Benefit Trade-Offs

While perfectly legal and potentially highly profitable to the investor, net-short debt activism has not been viewed positively. The assertion that the subject company is in default may precipitate a fall in the market value of the claims and interests of non net-short creditors as well as shareholders.[30] In the case of Windstream, for instance, other bondholders were willing to forgive the company's covenant violation and subsequently attempted to help fend off Aurelius, but in doing so they purportedly incurred huge losses.[31] Further, on Windstream's bankruptcy filing the price of its stock declined by over 60 percent.[32]

Turning to engineered CDS, certain market participants regard the strategy as an innovative source of financing for distressed issuers, while others think of it as a means of CDS market manipulation.[33] Regarding the former, there are no costs to the issuer upfront since it is not a counterparty to the CDS. Further, excepting for transaction costs, the benefits of favorable financing to the issuer, and of a CDS payoff to the protection buyer, are completely offset by the costs incurred by the protection seller. Conversely, though the counterparties may have sufficient expertise to price the risk of their specific positions, engineered CDS have the potential to adversely affect the broader CDS market and other stakeholders of the issuer including its creditors and shareholders.

CDS spreads represent the market's view of an issuer's default risk based on its financial condition, with a larger spread reflecting greater risk of default and vice versa. With an engineered CDS, however, an issuer's default risk is decoupled from its financial condition. The informational asymmetry that results diminishes the relevance and reliability of the spread as an indication of the issuers' default risk. This also impedes the efficiency of the market as a price discovery mechanism and reduces the informational value of the spread to other market participants. The additional risk for the broader CDS market is that the spreads for issuers viewed as likely candidates for the strategy may indicate the risk of an engineered CDS outcome rather than the issuer's fundamental credit risk.

As with net-short debt activism, engineered CDS may have negative consequences for an issuer's creditors,

28 Ibid.

29 Jon Macaskill, "CFTC Intervention Raises Reputation Risks Over Hovnanian Default," Euromoney.com, https://www.euromoney.com/article/b180cxxl9jdk9y/macaskill-on-markets-cftc-intervention-raises-reputation-risks-over-hovnanian-default

30 Zhang, "Sirius."

31 Matt Levine, "Aurelius Broke Windstream's Bonds to Save Them," Bloomberg.com, retrieved from https://www.bloomberg.com/opinion/articles/2019-02-27/windstream-bankruptcy-will-destroy-value-eliminate-profits

32 Cohan, "What."

33 Gina-Gail S. Fletcher, "Engineered Credit Default Swaps: Innovative or Manipulative?" (2019), *New York University Law Review* (forthcoming), Indiana Legal Studies Research Paper No. 403, available at SSRN: https://ssrn.com/abstract=3345276 or http://dx.doi.org/10.2139.

suppliers, employees and shareholders.[34] For unsecured creditors, a CDS engineered to provide a short-term loan to temporarily avoid a default may decrease their chances of being paid anything from the assets of the debtor.[35] For shareholders, the out-of-pocket cash costs and loss of management focus attributable to defending against litigation, such as the action brought by Solus Alternative Asset Management against GSO in response to the default GSO manufactured with Hovnanian, may similarly result in a loss in the market value of their stock.

The Sirius Computer Solutions Net-Short Lender Provision

Sirius Computer Solutions ("Sirius") was acquired in a leveraged buyout by Clayton, Dubilier & Rice in April 2019. The debt issued to finance the transaction totaled approximately $1.2 billion, comprised of a $190 million 1st-lien senior secured revolver, a $750 million 1st-lien senior secured term loan, and $300 million in senior unsecured notes.[36] While otherwise not particularly noteworthy, the credit agreement included the first publicly reported effort of an issuer to insulate itself from net-short debt activism by depriving any lender with a net-short position of its voting and consent rights with respect to loans under the agreement.[37] In particular, the provision provides that:

> …any Lender (other than (x) any Lender that is a Regulated Bank and (y) any Revolving Lender as of the Closing Date) that, as a result of its interest in any total return swap, total rate of return swap, credit default swap or other derivative contract (other than any [such swap] entered into pursuant to bona fide market making activities), has a net short position with respect to the Loans and/or Commitments shall have no right to vote any of its [loans] and shall be deemed to have voted its interest as a Lender without discretion in the same proportion as the allocation of voting with respect to such matter by Lenders who are not [net short lenders].

Further, the provision specifies that a net-short position will be determined using the following rules:

> 1. derivative contracts with respect to the Loans and Commitments and such contracts that are the functional equivalent thereof shall be counted at the notional amounts thereof…;
>
> 2. [notional amounts will be converted to dollars];
>
> 3. [derivatives referencing an index will be disregarded] so long as (x) such index is not created, designed, administered or requested by such Lender and (y) [the borrower's or any other loan party's obligations account for less than 5% of such index]; and
>
> 4. [standard CDS contracts will be deemed short positions if, under such contract] (A) such Lender is a protection buyer and (B) (x) the Loans or the Commitments are a "Reference Obligation", (y) the Loans or the Commitments would be a "Deliverable Obligation", or (z) [the borrower or any other loan party] is a "Reference Entity."

Despite its breadth, the complexities underlying the provision's objective may belie its effectiveness. Starting with how a net-short position is defined,[38] a broad definition may be too limiting, while a reading that fails to account for all approaches to structuring a net-short position may undermine its efficacy. In not discussing the "long" leg of the structure, for instance, the Sirius provision may be over-inclusive in applying to a lender whose position in the borrower extends beyond the subject loan due to its holdings of equity or other debt. At the same time, the provision does not account for short positions in the subordinated debt or equity of the borrower, or more unusual credit derivatives that might incent a lender to push for default. The use of notional amounts to determine net positions may also fail if the payoff on a triggered CDS is larger than the decrease in the value of the loan, which might be true if the loan was purchased at a discount, or some other obligation was the cheapest-to-deliver for CDS settlement purposes.

While silent on the treatment of affiliates, the Sirius provision begs the question whether an affiliate's positions in the issuer's debt, equity or credit derivatives should be examined when determining if a lender is net-short.[39] As with the definition of a net-short position, the difficulty is in achieving the right balance between inclusion and exclusion. By not including lender affiliates, the risk is that a sister company, subsidiary or parent of the lender may hold a net-short position despite that the lender is fully compliant.

Aside from mandatory disclosures and voting restrictions, provisions Sirius might have included but did not, perhaps due to objections from potential lenders, include default time-bars and anti-Cash America provisions.[40] In the Windstream case, the

34 Ibid.

35 *In re* RadioShack Corp., Case No. 15-10197, 550 B.R.700 (Bankr. D. Del. Mar. 12, 2015)(No. 304).

36 Zhang, "Sirius."

37 "Net Short Lender Disenfranchisement: Is the New Anti-CDS Vaccine Safe and Effective?" Milbank.com, retrieved from https://www.milbank.com/images/content/1/1/v2/116063/Client-Alert-6.11.19-Net-Short-Lender-Disenfranchisement.pdf

38 Ibid.

39 Ibid.

40 Steven A. Cohen, Joshua A. Feltman, Emil A. Kleinhaus, John R. Sobolewski, "Debt Default Activism: After Windstream, the Winds of Change," (memorandum: Wachtell, Lipton, Rosen & Katz, June 10, 2019).

Continued from p.25

period between when Windstream completed the spin-off contested by Aurelius (April 2015) and when Aurelius asserted a default (September 2017) was nearly two and a half years. In response, a provision has been introduced that requires notice of any default claim to be given within two years of the date the challenged transaction was publicly reported.

In *Cash America*, the Court found that an issuer's covenant default can be treated as an optional redemption, and that lenders may consequently be entitled to receive a redemption premium from the issuer. Previously, the conventional view was that the only remedy available to a creditor was the acceleration of their debt at par value. However, investors have since brought claims in which they assert a default on debt they have purchased and demand to be repaid at par plus a redemption premium. The response by certain borrowers has been to attempt to include a provision stating that a prepayment premium would never be due on an acceleration of debt

Countervailing Consequences

Although the use of net-short lender provisions may serve to reduce risk for issuers, the practice raises concerns with respect to the liquidity of the credit markets and cost of credit.[41] Net-short lender provisions may reduce creditor incentives to actively enforce covenants, making them less effective. If so, creditors may be less willing to lend, with the result being an increase in borrowing costs. Lender provisions that condition transferability based on the specific characteristics of a particular creditor may also reduce the liquidity of the related instrument, thereby increasing the costs of lending to creditors, and the cost of credit to borrowers. Similarly, a proliferation of net-short lender provisions may cause the credit market to grow wary of CDS, thereby decreasing liquidity and the availability of applicable hedges, while increasing the price of credit.

Key Takeaways

Though predicated on the debtor agreeing to facilitate a prearranged failure-to-pay credit event, in a manufactured default, the investor works with the debtor to provide it with favorable financing, profiting at the cost of CDS sellers. In contrast, a net-short-debt activist, despite owning debt of the borrower, as in Windstream, bets against it in the CDS or some other market, and works to assert a default and accelerate payment, if necessary, through litigation. The outcome has the potential to dilute the credit support for all other creditors, precipitate a drop in the market value of outstanding debt and equity and force the company into bankruptcy.

Codere collaborated with GSO, an independent lender, to engineer a failure-to-pay credit event, while iHeart did so unilaterally between itself and its wholly-owned subsidiary, Clear Channel. Hovnanian was similar to Codere in that its voluntary default appeared constructed to transfer value from the CDS market to itself via favorable financing from GSO. However, as in iHeart, Hovnanian's voluntary failure-to-pay would have been between Hovnanian and its wholly-owned subsidiary, Sunrise. Further, Hovnanian (unlike Codere and, to a degree, iHeart) was not financially distressed despite having to refinance its debt maturing in 2019.

Conclusion

Each of the Windstream, Codere, iHeart and Hovnanian cases represents an evolution in the use of CDS contracts from straightforward default hedge to opportunistic investment. Certain market participants argue such use makes CDS pricing impossible and dissipates liquidity in the CDS market, and that CDS will no longer serve to spread risk. Others counter that the CDS market is able to price the associated risks and that improved risk-reward prospects have resulted in an inflow of new participants that has deepened the liquidity of the market. The ISDA and the Commodity Futures Trading Commission have weighed in with the former, with ISDA updating its Credit Derivatives Definitions to make any failure-to-pay credit event determination subject to a deterioration in the creditworthiness of the Reference Entity. What effect this will have long term remains an open question given the propensity of the CDS market to innovate.

ABOUT THE AUTHOR

Boris J. Steffen, CPA, ASA, ABV, CDBV, CGMG
GlassRatner Advisory & Capital Group

Boris Steffen, CDBV, is a Senior Managing Director with GlassRatner Advisory and Capital Group. An expert in accounting, finance, valuation, solvency and damages analyses, Boris has advised or testified on behalf of numerous privately owned and publicly traded enterprises as well as governmental agencies in the U.S. and abroad. The matters in which he has consulted have involved antitrust and competition policy, appraisal arbitrage, bankruptcy and restructuring, breach of contract, fraud, intellectual property, international trade and arbitration, mergers and acquisitions, securities and utility regulation. Prior to entering the consulting field, Boris worked in finance with Inland Steel Industries, Inc., antitrust with the U.S. Federal Trade Commission, Bureau of Competition and in corporate development with U.S. Generating, Inc

41 "Net Short Lender Disenfranchisement," Milbank.com, retrieved from https://www.milbank.com/images/content/1/1/v2/116063/Client-Alert-6.11.19-Net-Short-Lender-Disenfranchisement.pdf

DISTANCE TO INSOLVENCY

J.B. HEATON
J.B. Heaton, P.C.

Academics and practitioners use option pricing theory to calculate "distance to default" (denoted *DD*), a measure that allows for the calculation of the probability *(P(-DD))* evaluated under the cumulative standard normal distribution that equity will expire worthless.[1] The Merton *DD* depends on a measure of instantaneous solvency, the natural log of the ratio of the market value of the firm's assets to the face value of the firm's debts (or, equivalently, the difference in the logs of the asset market value and debt face value), the drift of the asset market value ("asset drift") and the volatility of the asset market value ("asset volatility").[2]

This article examines the measure of instantaneous solvency contained in the Black-Scholes call option pricing formula[3] and the Merton *DD*: the natural log of the ratio of the market value of the firm's assets to the face value of the firm's debts. I refer to this as the "distance to insolvency," *DI*. Most of the information in the Merton *DD* is contained in *DI* when the firm is not too close to the border of solvency and insolvency. This is fortunate, because *DI* is often easy to calculate from observed market values of debt and equity and the observed face value of debt. By contrast, calculation of the full Merton *DD* is difficult because it requires estimates of asset drift and asset volatility, neither of which are observable for the firm as a whole. Drift in particular is hard to estimate, even for the market as a whole.[4] For firms, especially for firms where *DD* estimates matter, estimates of asset drift are likely to be little more than speculation.

Moreover, by comparison to *DD*, *DI* is a convenient measure of insolvency and, therefore, financial distress, even setting aside the restrictive assumptions of the Black and Scholes (1973) and Merton (1974) models. The natural log of the ratio of the market value of the firm's assets to the face value of the firm's debts is negative for firms that are instantaneously insolvent, zero for firms that are instantaneously on the border of solvency and insolvency (that is, where the market value of assets equals the face value of debt) and positive where the firm is instantaneously solvent. This allows for an intuitive plotting of a measure of insolvency and solvency for firms with different asset and debt levels.

Insolvency Versus Default

Insolvency is a *financial condition*. For example, the United States Bankruptcy Code defines "insolvent" as the "financial condition such that the sum of such entity's debts is greater than all such entity's property, at a fair valuation[.]"[5] Debts are at face value and assets are at market value. Debts include not just contractual debts but any liability on any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured[.]"[6] This includes contingent liabilities for torts inflicted on others, discounted for their probability of adjudication.

1 See, for example, S.T. Bharath and T. Shumway, "Forecasting Default with Merton Distance to Default Model," *Review of Financial Studies* 21(3), (2008), 1339-1369; and C. Jessen and D. Lando, "Robustness of Distance-to-Default," *Journal of Banking & Finance* 50 (2015), 493-505.

2 See, for example, Zvika Afik, Ohad Arad and Koresh Galil, "Using Merton Model for Default Prediction: An Empirical Assessment of Selected Alternatives," *Journal of Empirical Finance* 35 (2016), 43-67.

3 See F. Black and M. Scholes, "The Pricing of Options and Corporate Liabilities," *Journal of Political Economy* 81 (1973), 637-659; and R. Merton, "On the Pricing of Corporate Debt: The Risk Structure of Interest Rates," *Journal of Finance* 29 (1974), 449-470.

4 See R. Merton, "On Estimating the Expected Return on the Market: An Exploratory Investigation," *Journal of Financial Economics* 8 (1980), 323-361.

5 11 U.S.C. § 101(32)(A). The comparison of assets to debts is known as the balance-sheet solvency test. For a discussion of the different legal conceptions of solvency tests, see J.B. Heaton, "Solvency Tests," 62 Bus. Law. 983 (2007).

6 11 U.S.C. § 101(5).

Continued from p.27

By contrast, default is a legal event: the "failure to perform a legal or contractual duty; [especially], the failure to pay a debt when due."[7] This is the concept of default contained in the application of the option pricing framework of Black and Scholes (1973) and Merton (1974) to corporate equity. When the company's assets are insufficient to meet the maturing obligations, the company defaults and the equity (call option) expires worthless. A firm is instantaneously insolvent whenever the market value of assets is below the face value of debt. Default occurs only if the firm is instantaneously insolvent when the firm's debt matures.

Consider the Black-Scholes call option pricing formula defined with terms applicable to analysis of firm equity, assets and debt:

$$E = N(d_1)A = N(d_2)D_F e^{-rT}$$

Where

$$d_1 = \frac{1}{\sigma\sqrt{T}}\left[\ln\left(\frac{A}{D_F}\right) + \left(r + \frac{\sigma^2}{2}\right)T\right]$$

$$d_2 = d_1 - \sigma\sqrt{T}$$

Here, E denotes the market value of the firm's equity at time $t=0$, A denotes the market value of the firm's assets at time $t=0$, and D_F denotes the *face value* of the firm's (assumed zero-coupon) debt that matures at time T. As in the standard representation, r is the annual risk-free rate with continuous compounding, σ is the volatility of returns of the firm's assets, and $N(.)$ is the cumulative distribution function of the standard normal distribution.

Balance sheet insolvency is the financial condition where the market value of assets, A is less than the face amount of the debt, D_F. Inspection of the Black-Scholes formula reveals a measure of (instantaneous) balance-sheet solvency in the term $\ln(A/D_F)$ contained in the definition of d_1. The same term appears in the Merton DD:

$$DD = \frac{\ln\left(\frac{A}{D_F}\right) + [\mu - 0.5\sigma^2]}{\sigma\sqrt{T}}$$

where μ is the expected continuously compounded return on the assets and all other terms are as previously defined. Inspection of the formula for DD shows that, all else equal, DD is larger (the firm is further from default the more solvent is the firm in that instant.

One difficulty with DD is that instantaneously solvent and instantaneously insolvent firms can have the same DD given differences in μ and σ. For example, if A_1 denotes the assets of firm 1 and A_2 denotes the assets of firm 2, with both firms having the same amount of debt D_F, same asset volatility, and where $A_1 < D_F < A_2$ (that is, firm 1 is insolvent while firm 2 is solvent), the firms will have the same DD when:

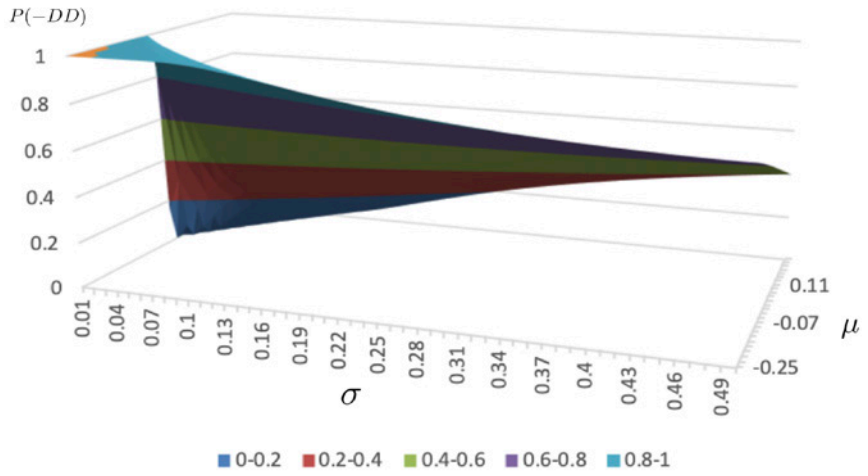
$$\mu_1 = \mu_2 + \frac{\ln\left(\frac{A_2}{A_1}\right)}{T}$$

While this is theoretically sensible because a higher drift can pull an instantaneously insolvent firm out of insolvency by maturity, an error in overestimating the asset drift could easily overstate an insolvent firm's distance to default. If both firms have the same amount of debt D_F, the same asset drift, and $A_1 < D_F < A_2$ (that is, firm 1 is insolvent while firm 2 is solvent), the firms will share the same DD for some values of σ_1 and σ_2.

Because both μ and σ are unobservable and must be estimated, while $\ln(A/D_F)$ is often observable for large public firms (whose bank debt is often traded actively

7 "Default," *Black's Law Dictionary*, 11th ed. (2019).

Exhibit 1: Probability of Default (P(*-DD*)) for T = 1, A = D_F



as well as their bonds), it is likely that $DI = \ln(A/D_F)$ is more accurately estimated in most applications than the other parameters of Merton's DD. Indeed, most of the power of the Merton DD measure comes from DI, especially when DI is away from zero in either direction. To see this, consider DD expanded as:

$$DD = \frac{\ln\left(\frac{A}{D_F}\right)}{\sigma\sqrt{T}} + \frac{\mu\sqrt{T}}{\sigma} - 0.5\sigma\sqrt{T}$$

Suppose $T=1$; then we have:

$$DD = \frac{\ln\left(\frac{A}{D_F}\right)}{\sigma} + \frac{\mu}{\sigma} - 0.5\sigma$$

Exhibit 1 shows the probability of default $(P(-DD))$ evaluated under the cumulative standard normal distribution for a range of σ from 0.01 to 0.50 and a range of μ from -0.25 to 0.25 under the assumption that $T=1$ and $A=D_F$, that is, that the firm is instantaneously on the border between insolvency and solvency. As one would expect, a large negative drift with a low volatility essentially guarantees default for the instantaneously borderline firm, while a large positive drift with low volatility essentially guarantees no default for the instantaneously borderline firm.

Exhibit 2 shows the probability of default for the same range of σ, μ, and T under the assumption that the firm is insolvent with assets equal to one-half of the face value of debt, $A=0.5D_F$. Insolvency swamps the effects of σ, μ, and T for most parameter values. Even with a large positive drift with low volatility, the firm has a high probability of defaulting given its deep instantaneous insolvency.

Exhibit 3 shows the probability of default for the same range of σ, μ, and T under the assumption that the firm is solvent with assets equal to one and one-half times the face value of debt, $A=1.5D_F$. Here, solvency swamps the effects of σ, μ, and T for many parameter

Exhibit 2: Probability of Default (P(-*DD*)) for T = 1, A = ½ D_F

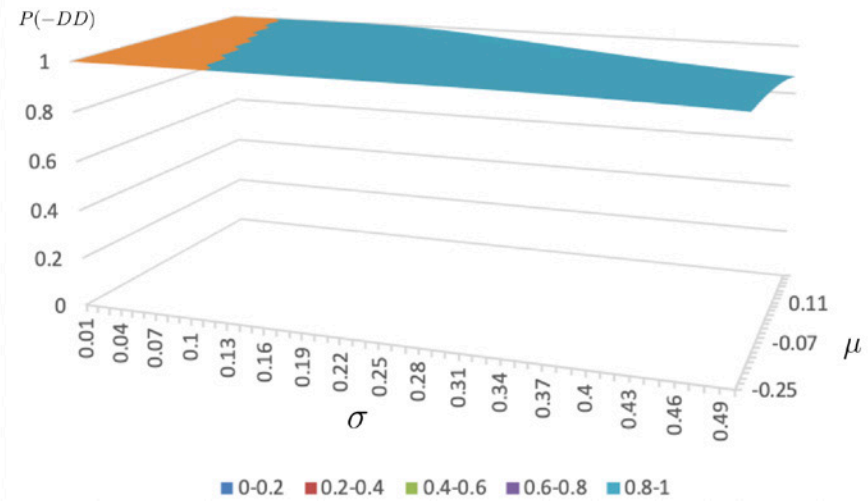
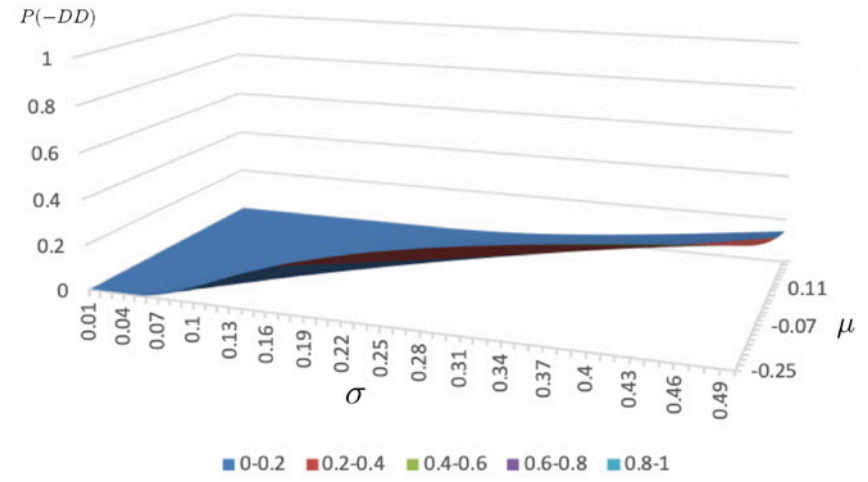
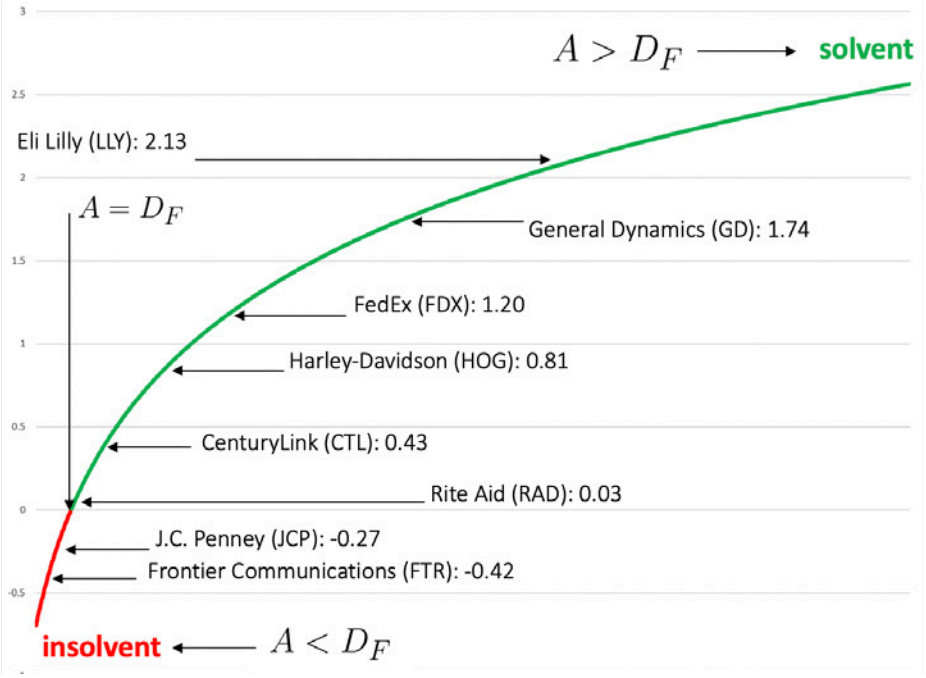


Exhibit 3: Probability of Default (P(-*DD*)) for T = 1, A = 1.5 D_F



Continued from p.29

Exhibit 4: $DI = \ln(A/D_F)$ for Selected Companies as of November 8, 2019



values. A large positive drift and/or high volatility are necessary to drive the firm's probability of default up to significant levels given its strong solvency position at these parameter values.

Model-Free Distance to Insolvency: Some Examples

DI is a convenient measure of firm insolvency even setting aside the restrictive assumptions of the Black and Scholes and Merton models. The natural log of the ratio of the market value of the firm's assets to the face value of the firm's debts is negative when $A < D_F$, that is, when the firm is instantaneously insolvent, zero when $A=D_F$, that is, when the firm is on the border between insolvency and solvency, and positive when $A > D_F$, that is, when the firm is instantaneously solvent. Exhibit 4 plots DI for a selection of U.S. publicly traded companies as of November 8, 2019 (data from Bloomberg). A is calculated by the sum of debt with observable prices (both bonds and bank debt) and market value of equity. The red portion indicates the negative values (where the firm is instantaneously insolvent). The green portion indicates the positive values (where the firm is instantaneously solvent). These are upper bounds as they do not include additional liabilities such as underfunded pensions.

Conclusion

The embedded distance to insolvency measure in the Black-Scholes and Merton DD models, referred to here as DI, is a valuable measure outside the restrictive assumptions of both models. Distance to insolvency differs from distance to default. For firms with publicly traded debt and equity, the distance to insolvency is much easier to calculate than DD which requires estimates of asset drift and volatility. Future research can test whether additional parameters of the Merton DD add predictive power (for default and/or bankruptcy) over the simple measure of insolvency embedded within. DI may also provide a more interpretable (and more predictive) measure of financial distress than other measures, such as the Altman Z-score.[8]

ABOUT THE AUTHOR

J.B. Heaton

J.B. Heaton, P.C.

J.B. Heaton received his J.D., M.B.A., and Ph.D. (financial economics) from the University of Chicago in 1999. He is the founder of J.B. Heaton, P.C. in Chicago, a financial and legal consulting practice. Prior to founding his own practice, he was a partner at Bartlit Beck LLP from 2004 to 2017.

8 See, for example, E. Altman, "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy," *Journal of Finance* 23 (1968), 589-609; and E. Altman, *Corporate Financial Distress: A Complete Guide to Predicting, Avoiding and Dealing with Bankruptcy* (Wiley: New York, 1983).

PURCHASE ORDER FINANCING TO THE DEBTOR IN POSSESSION

SCOTT N. SCHREIBER, *Clark Hill, PC*
GARY EDIDIN, *Franklin Capital Holding LLC*

The lender's dilemma: After months of sputtering along, your borrower has finally exhausted its existing facility and is contemplating filing for bankruptcy to conduct an orderly wind down. Suddenly it receives a reprieve, a long sought-after purchase order for its most profitable product, from its best and most stable customer. Like manna from Heaven, filling this order could be a reflection that your borrower has hit bottom and can begin its turn around, or it's a last gasp effort enabling the borrower to survive long enough to maintain a going concern value and a good customer relationship. But with the existing lender's line completely tapped out and an immediate need for funds to fill the order, what's the solution? Purchase Order Financing (PO Financing).

In PO Financing, the borrower assigns its right and obligations to its customer's purchase order to a PO Lender. The PO Lender purchases the product (for which the customer has issued a PO) from the manufacturer on behalf of the borrower. After the product has been finished (following inspection, shipment, delivery to a U.S. port, delivery to the customer, then ideally acceptance of the product by the customer) the manufacturer is paid by the PO Lender. The product is "sold" to the borrower by the PO Lender and concurrently sold by the borrower to its customer, which issued the PO. Depending on terms of sale between the borrower and its customer, the customer may pay for the product when it is delivered or at some point of time thereafter. If the terms of sale are payment upon delivery, then upon delivery, the borrower issues an invoice to the customer; the customer pays the borrower and the borrower repays the PO Lender for the cost of the product plus interest and the PO Lender's fees. If the terms of sale between the borrower and the customer are for payment for the product sometime after the customer's receipt of the product, the borrower issues an invoice to its customer and an account receivable will have been created. The PO Lender may retain possession of the invoice or assign the invoice to the borrower's working capital lender. If the invoice is assigned to a working capital lender, the PO Lender will be repaid its advances plus interest and fees by the working capital lender. The customer then will pay the invoiced amount to the working capital lender. Alternatively, the borrower will have assigned the invoice to the PO Lender and the customer will pay the invoice according to the terms of sale to the PO Lender. Upon receiving payment from the borrower's customer, the PO Lender deducts its advances, interest and fees and remits the balance of the payment to the borrower.

Since PO Financing can be used for short-term relief within a bankruptcy or a "first date" that can mature into a longer-term relationship after the bankruptcy (if all goes well in Chapter 11), PO Financing should be high on the list of financing solutions for a business debtor considering, or in, a Chapter 11. PO Financing can provide a much-needed lifeline in Chapter 11 and benefit the borrower who has exhausted availability from the existing lender and desperately needs to preserve going concern value in order to maximize the value of its collateral. All the while the PO Lender has comfort knowing that its risk is being mitigated by utilizing all of the protections that a bankruptcy proceeding provides: a Bankruptcy Court Order confirming the transaction, transparency, the ability to enhance its collateral through the Court Order and assurances that both the risks of dealing with a borrower in financial hardship and cost of enforcement is reduced since the borrower is already in a forum where the PO Lender can enforce its rights if the need arises.

1 This article is adapted from Scott N. Schreiber and Gary Edidin, "Purchase Order Financing to the Debtor in Possession," *ABL Advisor* (June 12, 2019), available at https://www.abladvisor.com/articles/16483/purchase-order-financing-to-the-debtor-in-possession

Continued from p.31

The Process, Obstacles and Benefits of Providing PO Financing to the Debtor in Possession

The challenge for many PO Lenders is navigating the several legal hoops that one has to go through to make PO Financing to a Chapter 11 debtor in possession mutually beneficial. The hoops and some of the pitfalls are described below:

The Borrower

The first step is convincing the PO Lender and its existing lender that the profit margins built into selling the product will support PO Financing. Does the manufacturer have access to all raw materials? Are there any risks that the product will not be produced on schedule and on time? Is there a risk of non-payment for the finished product? If the product is being manufactured abroad, does the PO Financing need independent support, e.g., letters of credit? All these issues go into pricing of the PO Financing.

Separately, the cost of paying for the bankruptcy process must ultimately be reflected in the product pricing. And while the borrower may be capable of projecting product pricing information (reflecting the product's salability) absent reorganization expenses, when scrubbing the borrower's projections, the PO Lender must consider if the borrower's pricing still yields sufficient profit margin to pay for the additional costs inherent in a Chapter 11 bankruptcy case?

Since the borrower's customer may be "spooked" by the sudden appearance of the PO Lender especially in this day of credit schemes and the borrower's bankruptcy, the borrower should be prepared to facilitate complete communication between its customer and the PO Lender.

Similarly, the borrower may look at the PO Lender as a potential source for exit financing after it emerges from its Chapter 11. The borrower should carefully examine whether the PO Lender has the ability to be more full-service: Can it provide additional lending facilities, such as factoring or asset based lending, upon the borrower's exit from bankruptcy or is it just a one trick pony?

The Existing Lender

The need for PO Financing is premised on the assumption that the borrower's existing lender has deal fatigue, is unfamiliar with DIP Financing issues, or is unable to provide additional overline or DIP support, and/or does not have the administrative expertise to monitor a PO Financing transaction. More specifically, few lenders have in the house expertise to understand and support international payment methods, shipping documents, and logistics procedures. The PO Lender is not just providing a financing alternative but is adding intrinsic value to the borrower by enhancing its cash flow and/or going concern value, and thus the existing lender's collateral. The existing lender should be prepared to carve out the proceeds generated by the PO Financing from the existing lender's collateral package. That carve-out extends to all rights relating to the purchase order for which the PO Lender is providing financing, the finished product, accounts receivable created by the sale of the finished product and proceeds therefrom. Likewise, the existing lender should fully subordinate their claim to the extent of any advances made by the PO Lender, and its costs.

The PO Lender

The PO Lender needs to ensure that its documents go beyond the protections expected in a traditional relationship; that they protect it as a lender to a debtor in possession with a super-priority, and the ability to seek reimbursement of its advances and fees as a super-priority expense if for some unanticipated reason the whole transaction turns upside-down. PO Lender's counsel must be able to package the DIP proposal and provide full disclosure of relevant information to allow the Court to approve the PO Financing without a contested hearing which will add costs. Counsel must also protect the PO Lender if an alternative lender is introduced to the transaction to make a competing bid to the PO Lender.

This is where knowledge of the bankruptcy process and knowing the line between what's obtainable and what's egregious in the eyes of the Bankruptcy Judge, the Creditors Committee (if one exists) and the United States Trustee comes into play. Since none of those parties are as familiar with PO Financing as the PO Lender and its counsel, it's important to strike a balance between what's fair when providing PO financing to a challenged borrower, and what's unnecessary. The PO Lender typically needs to anticipate how it would dispose of its collateral if the Borrower to default. Where the PO Lender is facilitating a transaction with a debtor in possession, the PO Lender needs to craft its documents to enable it to rely on the Bankruptcy Court, if necessary, to liquidate its collateral, even if for instance the collateral includes licensed goods. And consider whether the appointment of a Trustee under Chapter 11 or Chapter 7, or the automatic stay might affect any of the PO Lender's ability to liquidate its collateral. For instance, if the deal goes sour, the PO Lender may prefer one liquidator over another. The time to negotiate that preference is during the Bankruptcy Court loan approval process, not later.

The PO Lender's documents may provide for all of its fees and costs are paid without further court approval. Whether or not those fees and costs include its attorney's fees, or whether there is a cap on those fees after which court approval is necessary is another topic for negotiation among the parties.

Typical lending agreements provide for a minimum term, or a minimum volume, lest the borrower become liable to pay a fee to the lender. Where those terms are breached as a result of the Debtor converting its case to one under Chapter 7, or simply liquidating, that unpaid fee may become an administrative expense against the debtor's Chapter 11 estate.

Lastly, the PO Lender needs to ensure that it's receiving and reviewing all pleadings and reports filed in the bankruptcy case, including Monthly Operating Reports. The pleadings and report are telling when something is amiss, or about to become amiss in the underlying bankruptcy case.

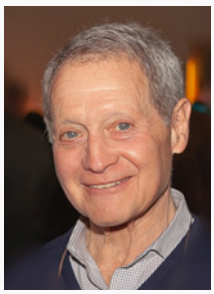
Conclusion

PO Financing to the Debtor in Possession, while risky, can be lucrative, beneficial and the entry to a longer-term relationship with the borrower following its bankruptcy. Navigating the Debtor in Possession Financing Orders requires familiarity with the nuances of the Bankruptcy Code and ensuring that you've anticipated the unexpected.

ABOUT THE AUTHORS

Scott N. Schreiber
Clark Hill, PC

Scott N. Schreiber is co-leader of Clark Hill's Corporate Restructuring & Bankruptcy group. Scott has served as lead counsel to business debtors, secured lenders, creditors, creditors' committees and equity holders in a variety of bankruptcy matters including international insolvency proceedings and out-of-court workouts. He represents clients in supply-chain and transactional matters, such as acquiring assets out of bankruptcies and other distressed situations. Scott has a broad range of experience in Bankruptcy Avoidance Actions.



Gary Edidin
Franklin Capital Holding LLC

Gary Edidin is the Chairman and CEO of Franklin Capital Holding. Mr. Edidin is responsible for strategic planning and managing Franklin's funding sources. Between 1976 and 1998, he was the Chairman of the Banks of Chicago. He has a BS degree from the Wharton School of the University of Pennsylvania and a JD degree from the Law School of the University of Chicago. He also attended the Graduate School of Business at the University of Chicago.

AIRA GRANT NEWTON EDUCATIONAL ENDOWMENT FUND

The mission of the AIRA's Endowment Fund is to further educational programs and funding of research focused on the areas of accounting, restructuring and insolvency including establishments of scholarships; sponsorships and encouragement of research and educational forums; education of judges, court personnel and governmental and other not-for-profit personnel; and providing other projects, materials or educational benefits to the bankruptcy and insolvency community.

Through the generosity of our members, the Endowment Fund has reached a level enabling AIRA to fund a regular scholarship. The AIRA Board of Directors approved its third scholarship funding of $2,500 to Pepperdine University at its January board meeting.

To make a contribution or pledge online, go to https://www.aira.org/aira/endowment_fund. You may also send a check payable to "AIRA Grant Newton Educational Endowment Fund" by mail to AIRA, 221 W. Stewart Avenue, Suite 207, Medford OR 97501. For more information contact AIRA Controller, Sue Cicerone scicerone@aira.org.

Contributors of $200 or more will receive a limited-edition Grant W. Newton bobble head, designed to commemorate Grant's retirement after more than three decades of leadership and service to the AIRA and its education program.

#AC20

36TH ANNUAL BANKRUPTCY & RESTRUCTURING CONFERENCE

Pictured: The Famous Chicago Bean in Millennium Park

JUNE 10-13, 2020

CHICAGO

"Welcome to the windy city..."

Join AIRA at AC20 for 4 days of in–depth education, including two all–day seminars, 3 keynote speakers, and 16 panel presentations on the latest developments and trends in Bankruptcy and Restructuring. Participants can connect with peers and make new contacts during the many networking opportunities and 5 optional excursions that will showcase the best of Chicago!

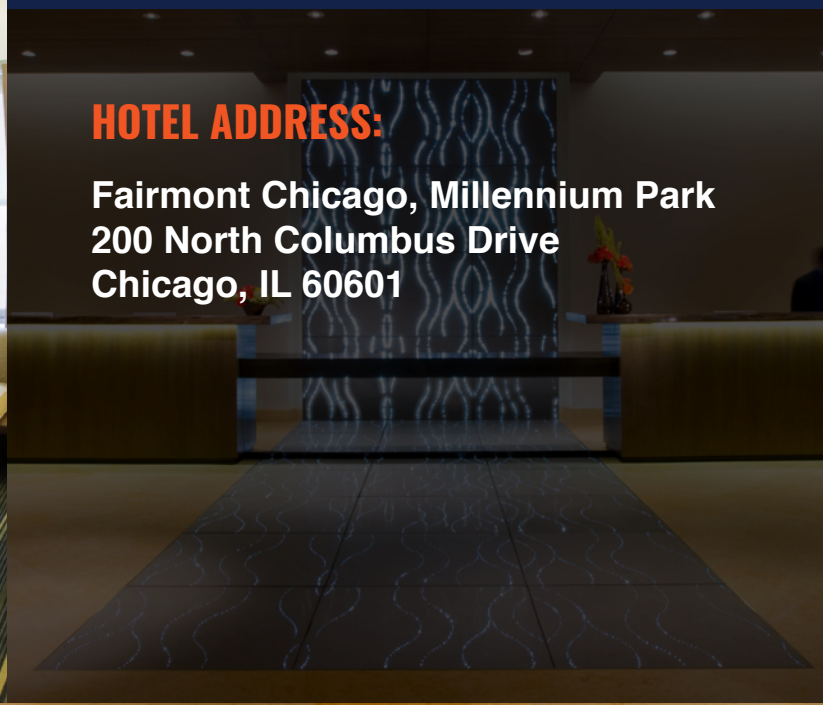
Unpretentious, friendly and cultured, Chicago is known for its skyscrapers, star chefs, sports fans, public artwork and original architecture, and for leafy urban-oasis parks and high-octane music festivals.

CONFERENCE HOTEL
FAIRMONT CHICAGO MILLENNIUM PARK

Yes, we've got location, location, location. Surrounded by 400 acres of green parkland, the Fairmont Chicago is a AAA Four-Diamond luxury hotel in downtown Chicago, steps from Chicago's Magnificent Mile, and just around the block from artsy Millennium Park.

The hotel rooms are spacious and modern, with views of the iconic skyline and Lake Michigan that go on forever.

AIRA's group room rate is $299 single/double. To qualify for this discounted rate, your reservation must be made by May 8, 2020.



HOTEL ADDRESS:

Fairmont Chicago, Millennium Park
200 North Columbus Drive
Chicago, IL 60601

#AC20

BY THE NUMBERS:

- 2 Preconference All-Day Presentations
- 3 Keynote Speakers
- 4 Days of Networking Opportunities
- 16 Conference Sessions

CONFERENCE KEYNOTE SPEAKERS

WEDNESDAY	THURSDAY	FRIDAY
		
Anita Alvarez Managing Director Alvarez & Marsal Disputes & Investigations	**Mark Koulogeorge** Managing General Partner of MK Capital	**Allen R. Sanderson** Senior Lecturer in Economics, University of Chicago

Back by popular demand!

YOUNG PROFESSIONALS RECEPTION

Wednesday, June 10, 5:30-6:30 pm

Immediately before the Opening Reception

CONFERENCE EXCURSIONS

Chicago Architectural Foundation Center River Cruise

Looking for the ultimate Chicago architecture experience? For more than 25 years, the CAC's expertly trained docent volunteers have led the river cruise, sharing fascinating stories behind more than 50 buildings along the Chicago River. Hear how Chicago grew from a small settlement into one of the world's largest cities in less than 100 years. In just 90 minutes, you'll get the best overview of Chicago's architecture and its history.

Tour of the Art Institute of Chicago

Located in downtown Chicago, the Art Institute is one of the world's great art museums, housing a collection that spans centuries and the globe. Join us for a one-hour guided tour, and then have some time to explore the gallery on your own.

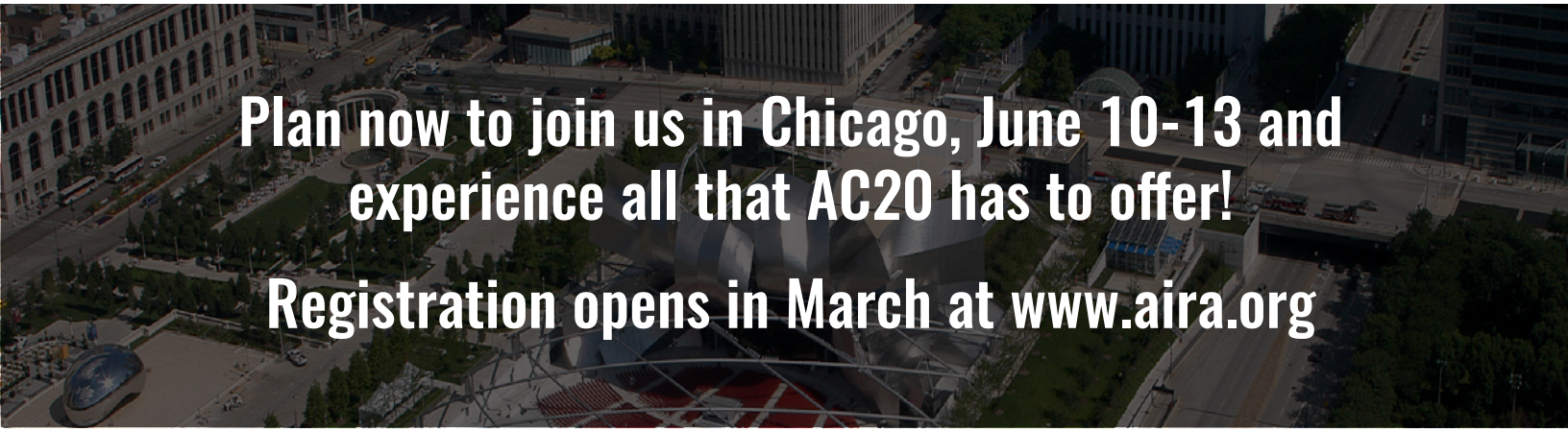
Segway Tour

There's no better way to tour the world-class city of Chicago than on a Chicago Segway! Learn about and see Chicago's top attractions on the most unique tour Chicago has to offer. Throughout the eight-mile, two-hour tour, you'll visit Millennium Park, Grant Park, Buckingham Fountain (where you'll have generous views of both Lake Michigan and the majestic skyline), Monroe Harbor and the Museum Campus that includes the Field Museum, Shedd Aquarium, Soldier Field, and the Adler Planetarium. Next, you're off to Michigan Avenue, home of famous outdoor art installations, statues and monuments, and historic hotels, before heading back to your starting point.

An Evening at Second City

The legendary comedy theater known as Second City has been bringing the funny for over 50 years. Second City opened its doors as a small cabaret theater nearly 60 years ago and has since become the world's premier name in improv-based sketch comedy and education. There are more than a few successful Second City alumni, including Dan Aykroyd, John Belushi, Steve Carell, Stephen Colbert, Tina Fey, Bill Murray, Mike Myers… and many more.

AIRA guests will enjoy dinner at a local restaurant prior to the 8:00 show, ***Do You Believe in Madness?***



MEMBERS ON THE MOVE

Dallas, Texas – BVA Group is proud to announce that Erica Bramer, CIRA, has assumed the role of Managing Partner as of January 1, 2020.

Since joining the firm in 2013, Erica has played an integral role in driving growth for the firm, both as a practitioner and also as a member of the firm's Management Committee. In her role as a client service professional, Erica has advised a myriad of clients on high-stakes complex commercial disputes, restructurings, and valuation engagements. Erica has testified dozens of times as an expert witness on matters of finance, valuation, damages, and solvency. In addition, as a member of the firm's Management Committee, Erica has played an integral role in expanding and diversifying the firm's service offerings.

"Through all her endeavors, Erica's relentless pursuit of excellence has helped to further strengthen the firm's reputation for unparalleled client service," said Bob Manz, a member of BVA's Management Committee. "We look forward to the path ahead."

An Invitation from AIRA Journal

AIRA members and others are invited to submit articles, proposed topics and content-related questions to the AIRA Journal Editorial Board: Michael Lastowski mlastowski@duanemorris.com, David Bart David.Bart@rsmus.com and Boris Steffen bsteffen@glassratner.com. Articles are currently being accepted for upcoming quarterly issues; see AIRA Journal information and Authoring Guidelines at www.aira.org.

To inquire about placing an ad in AIRA Journal contact Michael Stull mstull@aira.org

NEW MEMBERS

Mariya Yastrebova
Berkeley Research Group
New York, NY

Rachael Kuehn
Conway MacKenzie
Chicago, IL

Luca Riva
Alvarez & Marsal
New York, NY

Jeffrey Tirman
Abri Advisors Ltd.
Saint Legier, 1806,

Catherine Moran
Ankura Consulting Group LLC
Denver, CO

Mustafa Kodwavi
Ankura
Nashville, TN

Erik Morandi
Amherst Partners, LLC
Bloomfield Hills, MI

Christina Carpenter
E & Y
San Juan, PR

Steven Golden
Pachulski Stang Ziehl & Jones LLP
Wilmington, DE

Greg Wilkes
Norton Rose Fulbright US LLP
Dallas, TX

Andrew Blanchard
Conway MacKenzie
Houston, TX

Carey Ryan
Wintrust Financial Corporation
Chicago, IL

Pamela LaPlaca
The Claro Group
Austin, TX

David Barmish
SB360 Capital Partners
Needham, MA

Thomas Greene
Newpoint Advisors
Roselle, IL

Aldo Dianderas
Berkeley Research Group
Hasbrouck Heights, NJ

Christopher Sharp
Alvarez & Marsal North America, LLC
Atlanta, GA

Timothy Ahlberg
Conway Mackenzie
Chicago, IL

Samuel Schreiber
Alvarez & Marsal
New York, NY

Alejandro Ramirez Disla
Alvarez & Marsal
Berkeley, CA

Bevery Wong
Alvarez & Marsal
San Francisco, CA

Casey Moran
Grant Thornton LLP
New York, NY

Sam Lee
Ankura
New York, NY

Charlie Dwyer
Alvarez & Marsal
Oakland, CA

Jason Brillant
Ankura Consulting Group
New York, NY

Timothy Tran
The Claro Group
Houston, TX

Zahra Lalani
Conway MacKenzie
Chicago, IL

Greg de Speville
Conway Mackenzie
New York, NY

Harry Bramson
Conway Mackenzie
Atlanta, GA

Quintin Brown
Stapleton Group
Solana Beach, CA

Dean DiTosto
Mackinac Partners
Dallas, TX

Eric Camm
Turning Point
Seattle, WA

Roberto Lopez
Conway MacKenzie
Miami, FL

Raphael Di Napoli
Conway Mackenzie
Miramar, FL

Charlie Tricomi
Greenwich, CT

CLUB 10

Organizations with 10+ professionals who are active CIRAs or have passed all three parts of the exam

AlixPartners, LLP	**77**
FTI Consulting, Inc.	**54**
Alvarez & Marsal	**53**
Ernst & Young LLP	**36**
Huron	**21**
Pension Benefit Guaranty Corporation	**21**
PwC	**20**
Conway MacKenzie, Inc.	**19**
Deloitte	**18**
Ankura Consulting Group, LLC	**17**
Berkeley Research Group, LLC	**16**
KPMG LLP	**15**
Office of the United States Trustee	**14**
BDO USA, LLP	**12**
GlassRatner Advisory & Capital Group LLC	**12**
Protiviti Inc	**12**
SOLIC Capital Advisors, LLC	**11**
EisnerAmper LLP	**10**

BOARD OF DIRECTORS

The Association of Insolvency and Restructuring Advisors is governed by a board composed of up to 40 directors (several former directors continue to serve as directors emeritus). Directors are elected by majority vote at a meeting of the Board, serve for a term of three years (or such less term as the Board may determine or until their successors are duly elected and qualified) and may serve an unlimited number of terms, whether or not consecutive. The majority of the directors on the Board must have a CIRA Certificate; although most are financial advisors, a number of directors are attorneys. New officers assumed their duties at the end of the June Annual Conference and will serve for one year.

PRESIDENT:
BRIAN RYNIKER, CIRA
Ryniker Consultants, LLC

CHAIRMAN:
KEVIN CLANCY, CIRA
CohnReznick LLP

PRESIDENT ELECT:
DAVID BART, CIRA, CDBV**
RSM US LLP

VICE PRESIDENT - CONFERENCES:
DAVID PAYNE, CIRA, CDBV
D. R. Payne & Associates

VICE PRESIDENT - PUERTO RICO:
JOSE MONGE-ROBERTIN, CIRA
Monge Robertin Advisors, LLC

TREASURER:
DAVID BERLINER, CIRA
BDO USA, LLP

AIRA JOURNAL PUBLICATIONS CHAIRMAN:
MICHAEL LASTOWSKI
Duane Morris LLP

LAWRENCE AHERN III
Brown & Ahern

DANIEL ARMEL, CIRA*
Baymark Strategies LLC

ROBERT BINGHAM, CIRA*
Zolfo Cooper

CHUCK CARROLL, CIRA
FTI Consulting, Inc.

MARTIN CAUZ, CIRA
Lexington Health Network

ERIC DANNER, CIRA
CohnReznick LLP

STEPHEN DARR, CIRA, CDBV
Huron

JAMES DECKER, CIRA
Guggenheim Securities, LLC

LEAH EISENBERG
Foley & Lardner LLP

STEVEN FLEMING, CIRA, CDBV
PricewaterhouseCoopers LLP

MICHAEL GOLDSTEIN
Goodwin Procter LLP

S. GREGORY HAYS, CIRA
Hays Financial Consulting LLC

JEAN HOSTY
Piper Sandler & Co.

THOMAS JEREMIASSEN, CIRA
Development Specialists, Inc.

SONEET KAPILA, CIRA*
KapilaMukamal, LLP

ERIC KERWOOD, CIRA
Epiq Systems

KARL KNECHTEL, CIRA
FTI Consulting, Inc.

DENISE LORENZO, CIRA
AlixPartners, LLP

H. KENNETH LEFOLDT, JR., CIRA*
Lefoldt & Co., P.A.

JAMES LUKENDA, CIRA
Huron

KENNETH MALEK, CIRA, CDBV
MalekRemian LLC

KEVIN MCCOY, CIRA
KapilaMukamal, LLP

JENNIFER MEYEROWITZ
Summit Investment Management LLC

EDGAR MOSLEY, CIRA
Alvarez & Marsal

EDWIN ORDWAY, JR, CIRA
Berkeley Research Group, LLC

BEN PICKERING
Ernst & Young LLP

JOHN POLICANO
RPA Advisors, LLC

SUZANNE ROSKI, CIRA, CDBV
Protiviti Inc

ANTHONY SASSO, CIRA
Deloitte CRG

MATTHEW SCHWARTZ, CIRA
Bederson LLP

ANGELA SHORTALL, CIRA
3Cubed Advisory Services, LLC

ANDREW SILFEN
Arent Fox LLP

BORIS STEFFEN, CDBV **
GlassRatner

GRANT STEIN*
Alston & Bird LLP

WILLIAM S. SUGDEN
Alston & Bird LLP

JEFFREY SUTTON, CIRA*
Friedman LLP

JOEL WAITE
Young Conaway Stargatt & Taylor LLP

R. SCOTT WILLIAMS
RumbergerKirk

EXECUTIVE DIRECTOR:

JAMES M. LUKENDA, CIRA

RESIDENT SCHOLAR:
JACK WILLIAMS, CIRA, CDBV
Georgia State Univ. College of Law

EXECUTIVE DIRECTOR EMERITUS:

THOMAS MORROW,

SPECIAL COUNSEL:
KEITH SHAPIRO
Greenberg Traurig, LLP

EXECUTIVE DIRECTOR EMERITUS:

GRANT NEWTON, CIRA

**Director Emeritus*

***AIRA Journal Co-Editor*

AIRA | Association of Insolvency & Restructuring Advisors
221 W. Stewart Avenue, Suite 207
Medford, OR 97501
Phone: 541-858-1665
Fax: 541-858-9187
aira@aira.org
www.aira.org

BECOME AN AIRA MEMBER JOIN THE CIRA PROGRAM

Earn 20 CPE Credits (per Part)

The industry renowned CIRA Certification is proof of an individual's high degree of knowledge, integrity and proficiency across a wide spectrum of skills related to serving clients in situations involving distressed and/or insolvent entities.

3 CIRA COURSES TO CERTIFICATION

3 Financial Reporting, Taxes & Ethics

2 Plan Development

1 Managing Turnaround & Bankruptcy Cases

START THE PATH TO CERTIFICATION TODAY

To become a member and enroll in the CIRA program visit www.AIRA.org