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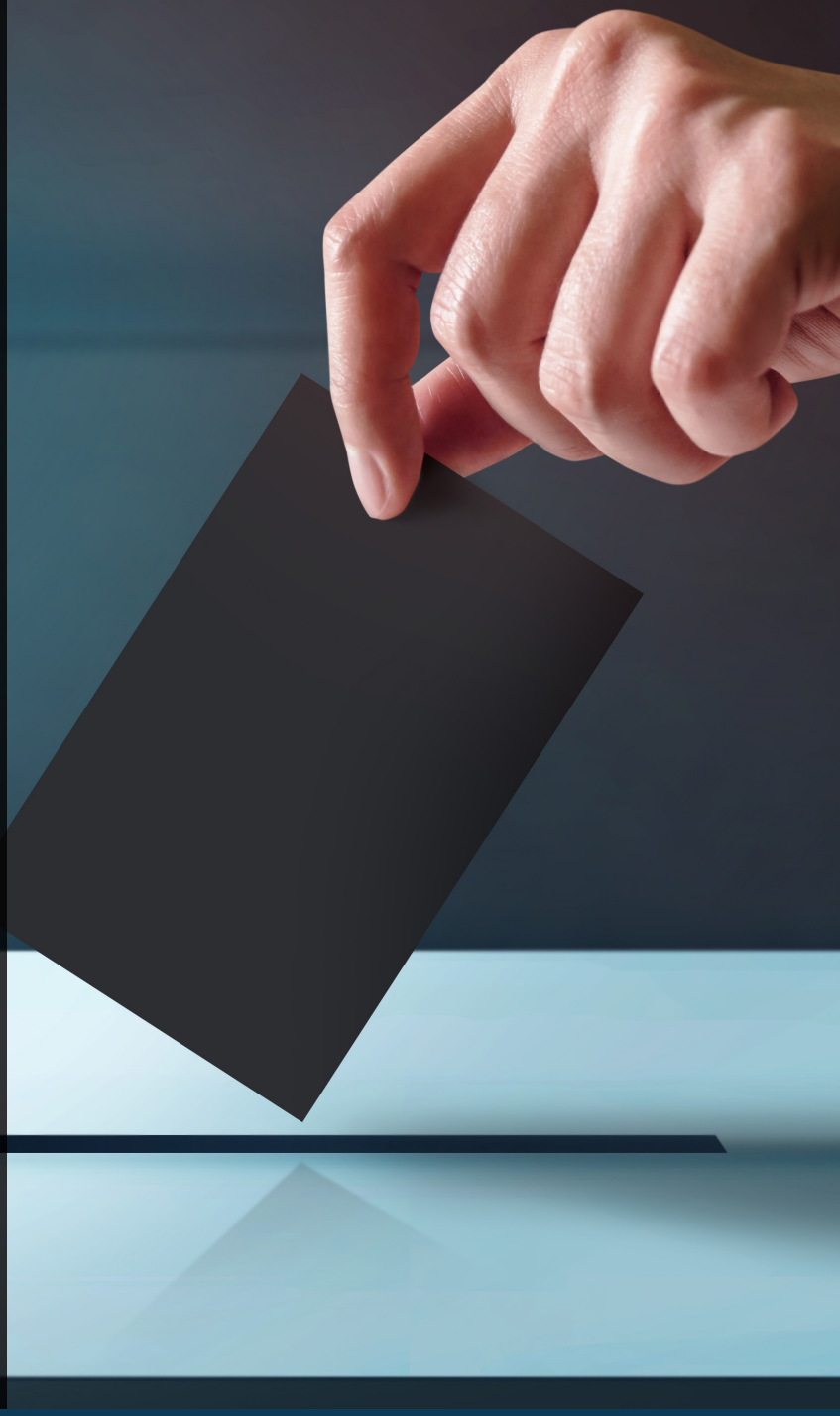
WHAT'S INSIDE



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AIRA Journal is published four times a year by the Association of Insolvency and Restructuring Advisors, 221 Stewart Avenue, Suite 207, Medford, OR 97501.

From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

Greetings to all —

As we enter the fall, several thoughts come to mind…

Community outreach

In November 1992 Queen Elizabeth II, in a speech marking the 40th year of her reign, said, "1992 is not a year on which I shall look back with undiluted pleasure. In the words of one of my more sympathetic correspondents, it has turned out to be an *annus horribilis*."

I think many of us will carry the same sentiments about 2020 into 2021. As if COVID-19 was not enough, both in the U.S. and abroad we have experienced severe weather conditions, hurricanes, floods, fires, and even in New Jersey of all places, a minor earthquake.

The fires on the west coast are, in particular, a matter of both direct and indirect concern. AIRA has many members who reside in areas that have been affected, and we should all be concerned about the longer-term effects of these fires.

It has been hard to miss that Oregon is one of the wildfire centers, particularly the area around AIRA's headquarters, the city of Medford and Jackson County. We are most fortunate that the widespread destruction in the Medford area has not significantly impacted the staff of AIRA. Valda and Grant, Michele, Terry, and Mike and their families have come through without harm to either their health or property. I am grateful for this on their behalf. However, as members of the Jackson County community, they are witness to and are working within their communities to aid those less fortunate.

I understand Rogue Credit Union (https://www.roguecu.org/community/so-fire) is one organization coordinating relief in the area. Should you be so inclined, please consider a donation to further the ongoing relief efforts to the community of which AIRA is a part.

Pursuing our mission

Against this backdrop of climate and health challenges, AIRA, its staff, and membership continue to pursue the Association's objectives of providing education and thought leadership to enhance the skills and ethics of our profession. While I think we all long for the live social contact that accompanies in-person programs, the virtual alternatives have provided timely, convenient, and a safer means for us to continue honing our intellectual skills. The just concluded 9th Annual Energy Summit was very well attended and we anticipate the same for the upcoming 19th Annual Advanced Plan of Restructuring and POR Conference (NYPOR) in November. AIRA is also among the host organizations under ABI's leadership that are currently conducting INSOLVENCY2020 as a substitute for NCBJ's annual conference. AIRA board member and Huron Consulting Managing Director, Steve Darr, CIRA, CDBV, helmed a panel on Subchapter V developments on October 13th as a substitute for the traditional AIRA breakfast panel at the NCBJ conference.

Membership services

Among the benefits of membership in AIRA is one that I perceive has received little attention, but is likely of greater importance in the current environment, as firms seek qualified professionals and qualified professionals work to improve their positions.

The AIRA webpage has a helpful link titled "Career Bank." AIRA maintains a long-standing association with YM Careers™, which manages an extensive database of job openings as well as resumes of those seeking positions. Many of the firms which support AIRA place job postings here. If you are looking for a new position or looking for talent for your practice, you may find your answer through the "Career Bank" link.

Looking ahead

If I may prognosticate a moment, I see us returning to live programs, hopefully by AIRA's next annual conference in June 2021. The planning for the 37th Annual Conference in Newport Beach, California, is already underway. I also foresee that such programs will build on what we have learned in 2020, which means providing greater reach and convenience for the membership as we combine in-person events with virtual access. If this year has taught us anything, it is that we are a group of continual learners who will evolve our practices to keep moving ahead. I look forward to 2021 to be our *anno convaluisset* (year of recovery).

Stay safe and stay well,

Jim

A Letter from AIRA's President

DAVID BART, CIRA, CDBV
RSM US LLP

Fall has arrived, and so has conference season. We are thoroughly engaged in conference planning for all of our fall events as well as the 37th Annual Bankruptcy & Restructuring Conference that will be held June 9-12, 2021 at the Newport Beach Marriott Hotel & Spa. At this point, circumstances permitting, we plan on this being our first live event since VALCON in February 2020. Plan ahead so we can look forward to seeing everyone in person in sunny California.

The upcoming 19th Annual Advanced Plan of Restructuring and POR Conference (NYPOR) will be a virtual event on November 9th and 16th. Note, our sessions are spread over two days. If it is anything like our recent virtual annual conference this past June, we anticipate a great turnout. Don't forget to register. This year's virtual NYPOR will include panels on tax; retail insolvency; the hotel & leisure industry; senior housing, landlords and lenders; the year-in-review; and judicial operations during COVID. Please thank our NYPOR co-chairs Michael Lastowski (Duane Morris LLP) and Brian Ryniker; our entire planning committee; and our sponsors: AlixPartners, CohnReznick, and Duane Morris.

Thank you to everyone who participated in and led our 9th Annual Energy Summit this September. This event went virtual for 2020, spread across two afternoons. We had a terrific turnout. Thank you to our Summit planning committee and our keynote speakers: Ryan Sitton (Texas Railroad Commissioner and co-owner of PinnacleART) and Artem Abramov (Rystad Energy). Special thanks go to our sponsors: Huron Consulting, FTI Consulting, and AlixPartners; our co-hosts: Secured Finance Network Southwest and TMA Dallas/Ft. Worth; as well as our ten panel speakers.

As you probably know, the National Conference of Bankruptcy Judges Conference for 2020 has been converted into INSOLVENCY2020, a joint virtual experience provided by multiple organizations. AIRA's Steve Darr is leading a panel about Subchapter V developments in lieu of AIRA's annual breakfast session at NCBJ.

AIRA's activities stem from you, the membership. Our events, publications, and training programs offer you a chance to learn, to share your experiences, and to meet one another. AIRA offers a place for you, and your staff, to be featured as presenters, authors, teachers, and sponsors to fully engage with your profession. We ask you to step forward and lead the AIRA and the industry by participating in one of our conference planning committees or other roles. Please contact any of the board members, our executive director, Jim Lukenda, or me and we will gladly bring you into the AIRA. There is a role for everyone, and AIRA welcomes your contributions.

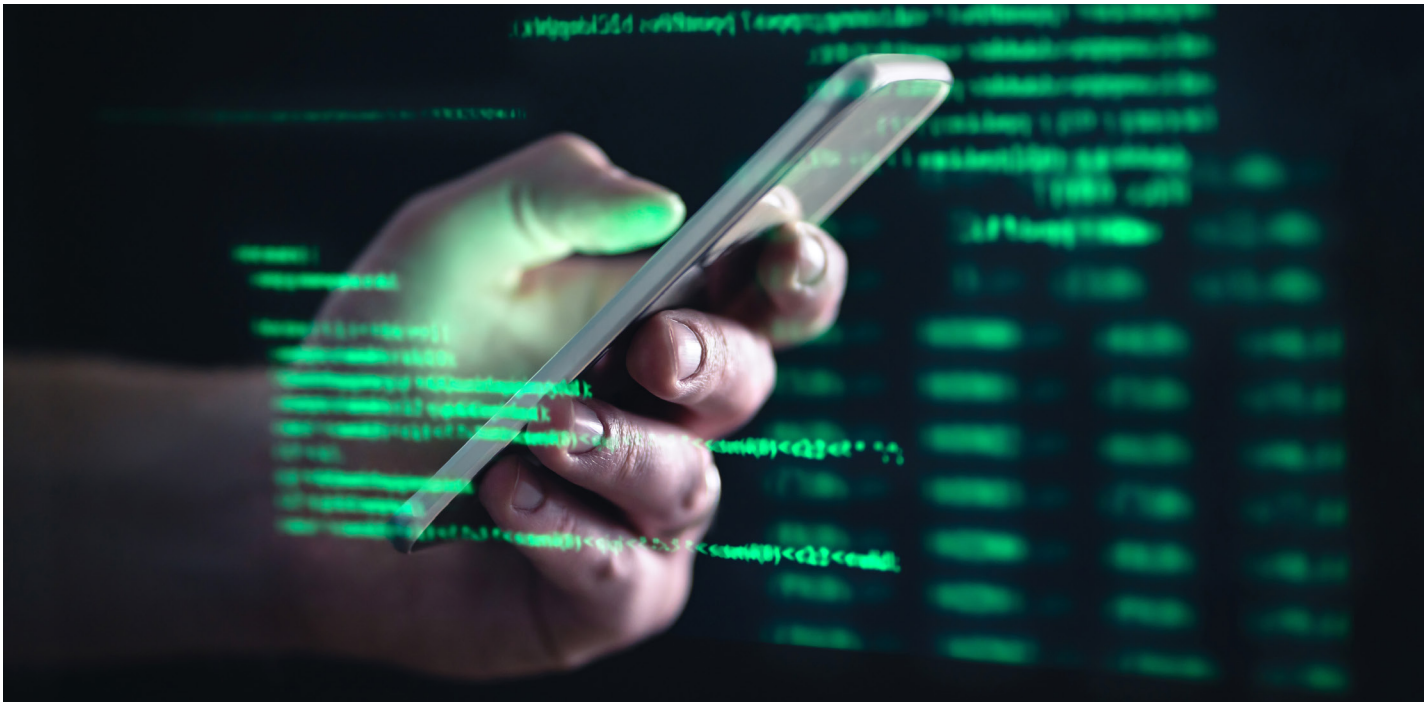
Finally, AIRA continues to provide professional certification and education courses online. Information about AIRA's nearly two dozen CPE offerings is available on the website. CIRA and CDBV training programs are also available online. See the website for details. For more information, please contact Jim Lukenda at jlukenda@aira.org.

I am very excited about the things to come this year. I wish you all the best this fall.

David Bart

CRYPTOCURRENCIES & THE DARK WEB: INSOLVENCY CONSIDERATIONS

REGINA LEE, CIRA, and DAVID WHITE
AlixPartners, LLP



Current Market Conditions

COVID-19 has created economic uncertainty in global financial markets. As a consequence of this volatility, cryptocurrency has become a more common potential source of liquidity and investor safe haven.[1] On October 8, 2020, US Attorney General William P. Barr stated "cryptocurrency is a technology that could fundamentally transform how human beings interact, and how we organize society."[2] On the same day, FBI Director Christopher Wray stated that the FBI sees "first-hand the dangers posed when criminals bend the important technological promise of cryptocurrency to illicit ends."[3] Criminals are always at the ready to exploit the fast-moving pace of technological advancement. The use of custodians to conduct cryptocurrency transactions creates additional risk to investors as opposed to direct transactions. As cryptocurrency custodians fail because of business reasons, fraud, or theft, it is important for investors to understand the risks associated with asserting claims against a bankrupt crypto custodian.

Crypto as Currency

Criminals are always looking for ways to exploit weary investors. Cryptocurrencies are no exception. As these new financial transaction payment methods rapidly gain acceptance worldwide, so too have they become a prime target for hackers and fraudsters. Advances in chip and pin technology, better security protocols and better fraud detection by banks have all made credit card fraud and identity theft far less lucrative than they used to be, turning criminals toward more fertile grounds. Another driver is the rapid deployment of new and often ill-tested cryptocurrency technologies in the race to go to market, often with major vulnerabilities. Cryptocurrency is also being far more widely adopted, further opening up the field of opportunities for fraudsters. Surveys indicate that 36.5 million Americans, or 14.4% of the population, owned cryptocurrency in 2019.[4] The reported reasons for respondents' purchase of cryptocurrency are presented in Exhibit 1.[5]

[1] Haentjens, Matthias, et. Al. (2020). *Disintermediation: Crypto-custodian Insolvency, Legal Risks, and How to Avoid Them*. Retrieved from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3589381.

[2] US Department of Justice, Office of Public Affairs. Justice News Press Release. *Attorney General William P. Barr Announces Publication of Cryptocurrency Enforcement Framework*, October 8, 2020. Retrieved from https://www.justice.gov/opa/pr/attorney-general-william-p-barr-announces-publication-cryptocurrency-enforcement-framework

[3] Id.

[4] Partz, Helen (2019). *Number of Americans Owning Crypto Doubled in 2019: Finder*. Retrieved from https://cointelegraph.com/news/number-of-americans-owning-crypto-doubled-in-2019-finder.

[5] Id.

Exhibit 1: Survey Respondents' Reasons for Owning Cryptocurrency

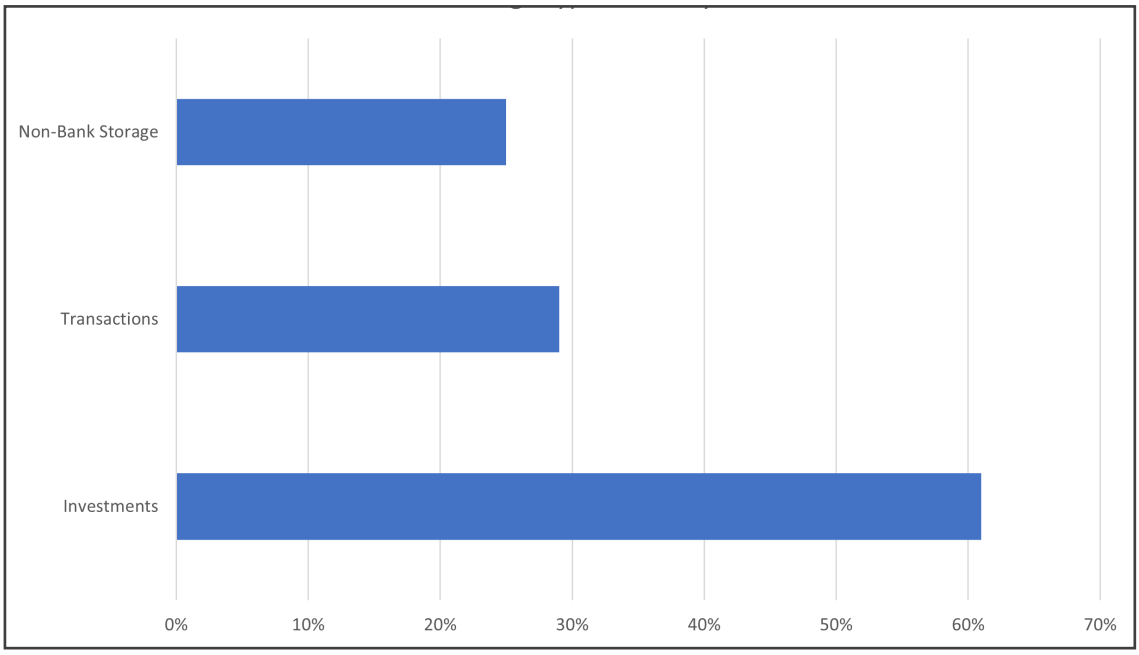
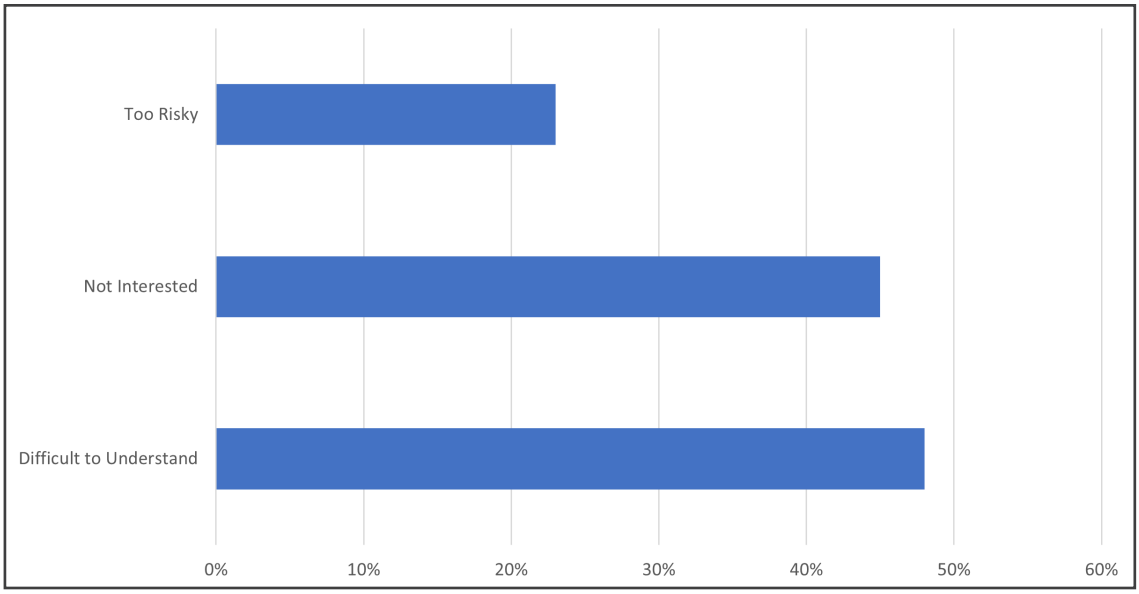


Exhibit 2: Survey Respondents' Reasons for Not Owning Cryptocurrency



Source: Partz, Helen (2019)

In contrast, survey respondents who reported not purchasing cryptocurrency detailed their rationale as shown in Exhibit 2.[6]

Initial Coin Offering Scams

One prime area ripe for exploitation is Initial Coin Offering (ICO) exit scams. Criminals find these very attractive as they can yield very large direct cash payments. Two key targets are cryptocurrency exchanges – where the actual cryptocurrency coins are deposited by investors and then stolen and liquidated for cash, and Ponzi fraud schemes built into many initial coin offerings – where the operators of the ICO entice direct investments in a new crypto-technology and then siphon off investor funds for their own enrichment. Typically, many of these scams are built on wholly non-viable technology disguised to be the next best thing. Some have even been allegedly backed by commodities such as gold bullion or fiat currencies. Through the end of 2019, more than 5,600 ICOs raised over $27 billion as shown in Exhibit 3 on p.8.[7]

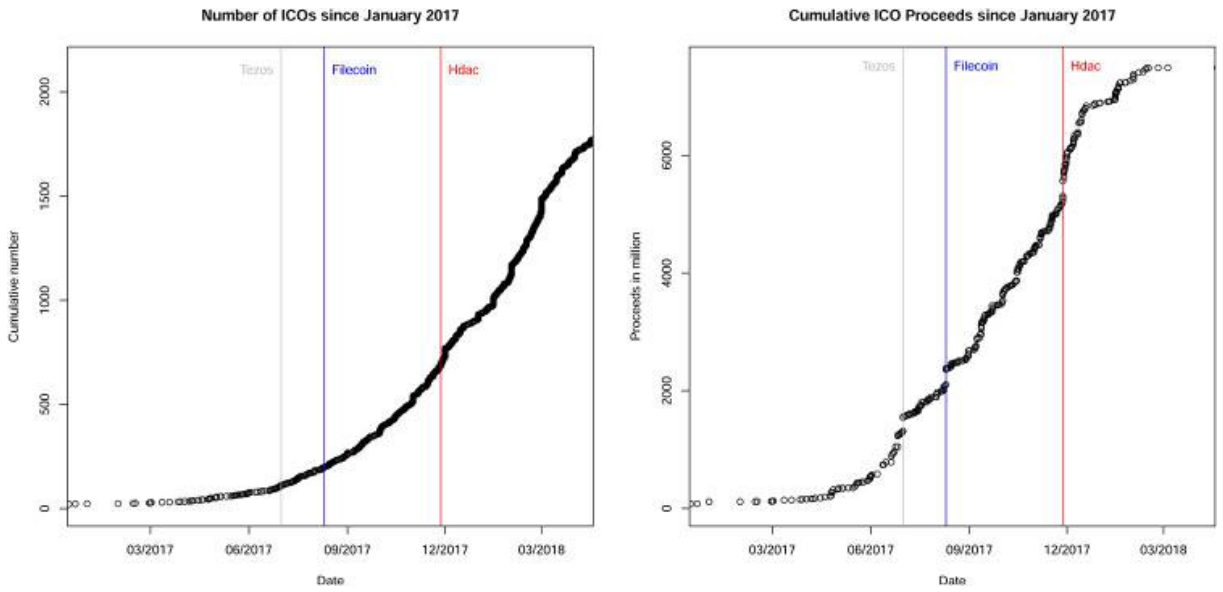
Together, cryptocurrency exchange theft and ICO scams have yielded losses totaling billions of dollars.

[6] Id.

[7] Momtaz PP (2020) Initial Coin Offerings. PLoS ONE 15(5): e0233018. https://doi.org/10.1371/journal.pone.0233018

Continued from p.7

Exhibit 3: Survey Respondents' Reasons for Not Owning Cryptocurrency



Source: Momtaz, PP (2020).

More than 40 ICO scams have been identified,[8] with ten of the most high-profile ICO scams having swindled a staggering $687.4 million from unsuspecting investors.[9] A study prepared by ICO advisory firm Statis Group revealed that more than 80 percent of ICOs conducted in 2017 by number were identified as scams.[10] According to the study, total funding of coins and tokens in 2017 amounted to $11.9 billion, and over $1.5 billion of this funding went to scams.[11] The vast majority went to three large Ponzi scams: Pincoin ($660 million), AriseBank ($600 million) and Savedroid ($50 million), which together equal $1.31 billion.[12] In 2019, scams totaled $8.6 billion in transactions, with three large Ponzi schemes accounting for the majority of the crypto crime.[13] One large Ponzi scheme in China, PlusToken, defrauded more than three million people and totaled more than $2 billion.[14] A correlation between price drops of Bitcoin and the timing of PlusToken cash outs exists, so even those not directly impacted by the PlusToken Ponzi scheme may have been indirectly impacted through devaluation of their Bitcoin holdings.[15]

Cryptocurrency Hacking

Cryptocurrency hacking is equally as lucrative. Last September, hackers reportedly stole $59 million worth of cryptocurrencies from Japanese exchange Zaif, while in Korea there have been at least seven hacks reported in 2019 totaling over $250 million in losses and leading to the bankruptcy of the largest exchange in that country.[16] Another $200 million was stolen from cryptocurrency exchanges through phishing email schemes in 2020 by the CryptoCore Group.[17] Globally, $4.5 billion worth of cryptocurrencies were reported stolen from crypto exchanges in 2019, a Exhibit that is nearly three times the 2018 annual total.[18] Of the $4.5 billion stolen, $4.1 billion related to fraud or misappropriation of funds, and $371 million was lost from exchange thefts and hacks.[19] The cyberfirm Carbon Black reports that roughly $1.1 billion worth of digital currency was stolen across all sources in the first half of this year, with exchanges accounting for 27 percent of these hacks. Even countries that have banned cryptocurrency exchanges and ICOs

[8] Schwienbacher, A. and Hornuf, L. (2018) *Initial coin offerings and fraud cases*. Conference Presentation. Max Planck Institute for Competition and Innovation.

[9] Finance Monthly (2018) *The 10 Biggest ICO Scams Swindled $687.4 Million*. Retrieved from https://www.finance-monthly.com/2018/10/the-10-biggest-ico-scams-swindled-687-4-million/

[10] Cryptocurrency News (2018). *Statis Group Finds That Nearly 80% of ICOs in 2017 Were Scams*. Retrieved from https://cryptocurrencynews.com/statis-group-ico-scams/#:~:text=2018%20Chelsea%20Roh-,Statis%20Group%20Finds%20That%20Nearly%2080%25%20of%20ICOs%20in%202017,held%20in%202017%20were%20scams.

[11] Id.

[12] Id.

[13] Chainalysis (2020). *The 2020 State of Crypto Crime*. Retrieved from https://go.chainalysis.com/rs/503-FAP-074/images/2020-Crypto-Crime-Report.pdf

[14] Orcutt, Mike (2020), MIT Technology Review. *Millions of people fell for crypto-Ponzi schemes in 2019*. Retrieved from https://www.technologyreview.com/2020/01/30/275964/cryptocurrency-ponzi-scams-chainalysis/#:~:text=Cryptocurrency%20scammers%20raked%20in%20%244.3,more%20than%20triple%202018's%20haul.&text=Predation%20by%20Ponzi%3A%20But%20according,the%20elephant%20in%20the%20room.

[15] Chainalysis (2020). *The 2020 State of Crypto Crime*.

[16] Bitcoin.com (2020). *US Charges North Korea-Linked Chinese Nationals for Laundering Over $100 Million in Stolen Cryptocurrency*. Retrieved from https://news.bitcoin.com/north-korea-chinese-cryptocurrency/

[17] Palli, Ishita (2020). *Hacker Group Stole $200 Million from Cryptocurrency Exchanges*. Retrieved from https://www.bankinfosecurity.com/hacker-group-stole-200-million-from-cryptocurrency-exchanges-a-14506

[18] Q42019 Cryptocurrency Anti-Money Laundering Report. Retrieved from https://ciphertrace.com/q4-2019-cryptocurrency-anti-money-laundering-report/#:~:text=Total%20of%20cryptocurrency%2Drelated%20frauds,fraud%20and%20misappropriation%20of%20funds.

[19] Id.

outright have still seen large losses. The Financial Action Task Force (FATF) now requires all member countries to "regulate and supervise cryptocurrency service providers, including exchanges,"[20] and the U.S. Homeland Security department launched a cryptocurrency intelligence program specifically focused on darknet markets.[21]

Mt. Gox Hack Leads to Bankruptcy

The Mt. Gox exchange hack in 2014 was one of the earliest, and still the largest, of the cyberheists. While it is still unclear if this was an inside or outside job, the result was the loss of over 750,000 Bitcoins (BTC) from the company coffers, which brought the exchange into bankruptcy. The proceedings, which were consolidated in Japan, are still ongoing and very few creditor claims have been paid out to date. The case, however, calls out many of the unique legal issues relating to asset recovery in the world of digital currencies. Determination of the applicable law is critical because no standard international rules exist to define the relationship between cryptocurrency customers and custodians.

One of the primary questions in discussion has been whether successful claimants can expect a proprietary remedy in tokens, or merely an unsecured creditor claim for the cash value of the tokens at the time of insolvency. That is, does a token holder have a creditor claim or a property claim in the estate? This question, which is common to any insolvency proceeding involving cryptocurrency tokens, is important as it can have serious financial repercussions for the claimants. The answer, as Mt. Gox demonstrated, turns on the legal classification of the tokens, which differs widely around the globe, as well as on the structure of the relationship between the user and the platform and how the courts choose to characterize that relationship.[22]

Cryptocurrency Under U.S. Law

U.S. securities law does not include cryptocurrency tokens in the definition of "money," but rather treats them as intangibles, a classification that severely restricts their utility as a mainstream payment medium and as an asset that can easily be made the subject of a security interest. Intangibles are also treated as the least negotiable of all UCC forms of property. In Japan, however, the Mt. Gox court held that, under the local Civil Code, tokens are not capable of personal ownership at all.[23] This meant that those with recoverable claims would not be able to recover their tokens back. Instead, they would only be able to recover the pre-filing cash value of those tokens. At the time of the bankruptcy filing in 2014, the Bitcoins had a total value of about $473 million.[24] Since then the value of Bitcoin has increased considerably, putting the present-day value at over seven billion U.S. dollars. The Mt. Gox collapse affected 24,000 creditors, and the company was put into liquidation two months after the filing.[25] This creates a large residual in the estate that could lead to a potential windfall recovery for the owner of Mt. Gox, the very person who was likely instrumental in its failure

[20] Bitcoin.com (2020). *US Charges North Korea.*

[21] Helms, Kevin (2020). *US Develops Cryptocurrency Intelligence Program Targeting P2P Sites, Forums, Darknet Markets.* Retrieved from https://news.bitcoin.com/us-p2p-darknet-markets/

[22] Haentjens, Matthias, et. al. (2020). *The Failed Hopes of Disintermediation: Crypto-custodian Insolvency, Legal Risks, and How to Avoid Them.* Retrieved from https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3589381

[23] Id.

[24] Castor, Amy (2018). *Mt. Gox Trustee Confirms He Sold Off $230 Million in Cryptocurrency.* Retrieved from https://finance.yahoo.com/news/mt-gox-trustee-confirms-sold-165413471.html

[25] Bybit Insight (2020). *How Mt. Gox's "Happily Never After" Could Reach a Fairy Tale Conclusion.* Retrieved from https://blog.bybit.com/insights/how-mt-goxs-happily-never-after-could-reach-a-fairytale-conclusion/

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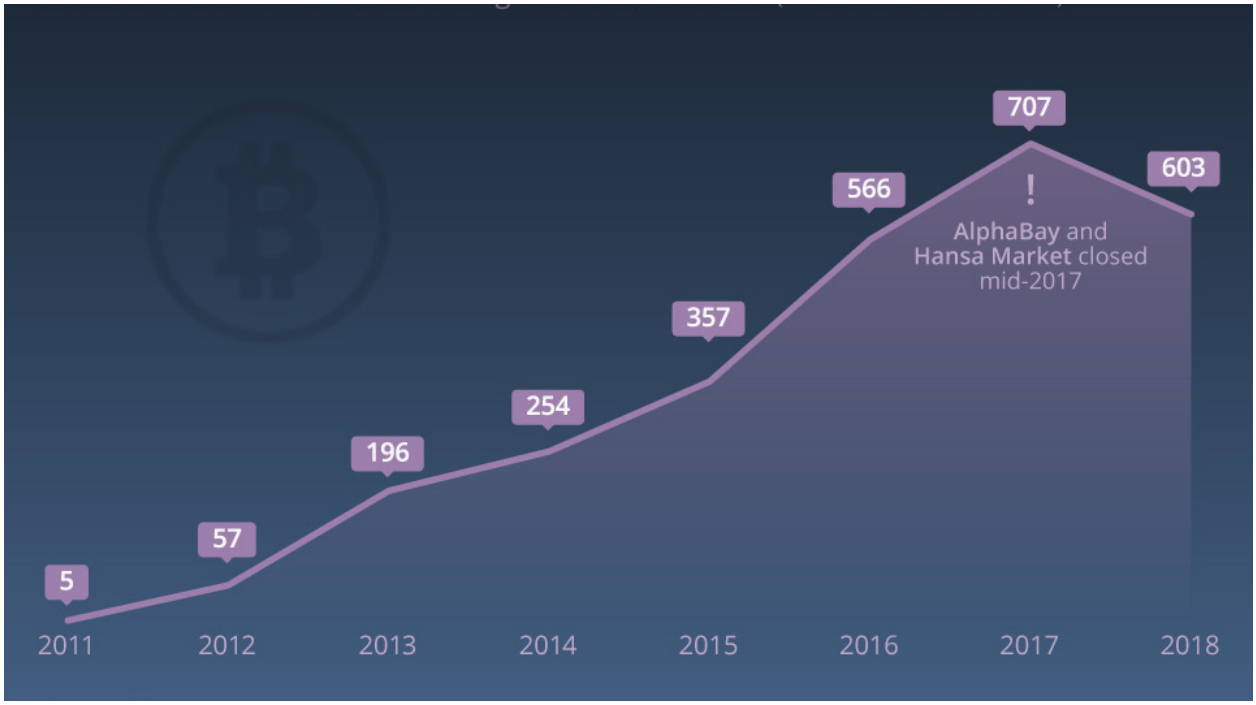
Exhibit 4: Darknet Bitcoin Use is Persistent Despite Busts
Estimated amount of Bitcoin flowing to darknet markets (in million U.S. dollars)



Source: Chainalysis

and who is imprisoned in connection with the event. Fortress created an investment vehicle to purchase Mt. Gox creditor claims at approximately 25% of the market value of Bitcoin, but creditors who preserve valid claims until the trustee makes distributions could end up with a hefty return if they are paid in Bitcoin shares as opposed to the cash value of their investments.[26]

Insolvency Considerations

In addition to novel legal issues around asset classification, there are also a whole host of new technical and logistical issues that arise when an exchange, ICO or wallet holder goes into insolvency. These primarily stem from the digital nature of cryptocurrencies, which raises complex problems that simply are not seen with tangible or secured assets and fiat currencies. One area where this is most evident is bringing assets under the control of the receiver or trustee. This task can always be a challenge. AlixPartners has served as claims agent in the liquidation of assets for the Bernie Madoff Trust since his Ponzi scheme collapsed more than 10 years ago; and bringing all of Madoff's assets under control has been no small task. However, it pales in comparison to gaining control of digital assets that are not only encrypted but may also be scattered around the globe with no associated financial institutions attached to them.

Many investors choose cryptocurrency to bypass governmental oversight and enjoy anonymity; however, this creates significant risk considering insolvency of crypto exchanges. The ownership of cryptocurrency in bankruptcy depends on the applicable laws. The agreement between the investor and the cryptocurrency brokers or agents should be carefully reviewed by the customer as it may govern ownership in bankruptcy. Investors engaging with cryptocurrency brokers who pool crypto assets should realize the higher inherent risk of the pooling. Using segregated blockchain addresses for each investor or investment mitigates some of this risk but does not eliminate the possibility that cryptocurrency assets are commingled among customers and their keys controlled by the broker

Cryptsy Exchange Liquidation

One of the first U.S. cases to bring these issues forward was the Cryptsy exchange liquidation. Cryptsy, a U.S.-based cryptocurrency trading platform, claimed to be hacked in January of 2016 for 13,000 BTC and 300,000 LTC.[27] Since then the founder of the exchange, Paul Vernon, left his residency in Miami, Florida, and is now allegedly hiding out somewhere near Liaoning, China. The exchange was placed into receivership after its customers filed a class action lawsuit for recovery of their losses. After a default judgment of $8.2 million was issued against him for failing to appear, the

[26] Id.

[27] Redman, Jamie (2017). *Vanished Cryptsy CEO "Big Vern" Ordered to Pay $8M in Class Action Lawsuit.* Retrieved from https://news.bitcoin.com/vanished-cryptsy-ceo-big-vern-ordered-to-pay-8m-in-class-action-lawsuit/#:~:text=5-,Vanished%20Cryptsy%20CEO%20'Big%20Vern'%20Ordered%20to%20Pay%-20%248M,company%20Project%20Investors%20(Cryptsy).

defendant confessed through a blog posting that the exchange had been insolvent after $5 million disappeared in June 2014 and that he concealed this fact from customers and regulators.[28] He also admitted to having operated a fraudulent scheme for nearly 18 months while withdrawals were made from profits in its business operating account rather than being funded from safeguarded assets. Unfortunately, this scenario is becoming all too common across hundreds of failed exchanges and fraudulent ICOs.

This case study serves as a good example of the many novel technological challenges faced by the asset recovery and liquidation teams. During its heyday, Cryptsy had a small IT team who ran a full stack of servers needed to manage a vast array of digital wallets. The deposits were comprised of billions of tokens from over 1,000 different cryptocurrencies, each running on its own blockchain software that the receiver had to take control over and manage. The whole environment had to be recreated and assembled in a functional environment. This involved not only engaging a team of IT experts, but also computer forensic experts with blockchain experience to both operate and investigate the hardware and software. Each wallet contained hundreds of thousands of transactions that had to be uncovered, analyzed and assessed for claims settlements. For each account, the entire blockchain history must be analyzed in order to validate its balance. To this end, both the creditors' and the debtors' anonymous public encryption keys first had to be discerned from forensic evidence and records. But these encryption keys only allow for analysis of the blockchain.

Receiver Accessibility

Going one step further, in order to take control of the assets of the debtors, the receiver also had to uncover and take control of the debtors' own private encryption keys as well. Some token holders store these keys on their computers or mobile devices. In such a case, they may be able to be forensically recovered in the absence of cooperation if you have physical access to the devices and they themselves aren't further encrypted or locked. However, many token holders wisely opt to store their digital credentials offline and in secure areas such as in cold USB or even paper wallets. In extreme cases, token holders with significant holdings are reportedly storing their private keys on offline computers locked underground in decommissioned Swiss military bunkers to avoid hacking. In the absence of cooperation, it may be impossible to gain control of keys and their associated assets if they are stored in such unknown or inaccessible places. In the Cryptsy case, some wallets were also corrupt or damaged, and some maliciously destroyed by the debtor.

Recovery of this data, where possible, required an even deeper level of digital forensic expertise. Further, the debtor sought to obfuscate or dissipate assets by destroying computer servers, destroying a database of books and records and their backups, starting a new exchange in China so he could transfer cryptocurrencies to it, and by converting tokens to jewelry and real estate. Unlike traditional funds tracing, tying these tangible assets back to token sales required careful and detailed analysis of digital transactions spread across the many crypto wallets and their associated blockchains. This could only be completed once all the data was safely secured and recompiled.

Liquidating Cryptocurrencies

Other hurdles still abound. Beyond recovery and control, assets may also need to be liquidated before claims can be paid out. Despite what headlines say about the fungibility and demand of popular coins like Bitcoin and Ethereum, not all tokens are created equal. There are a great many alternative cryptocurrencies that have low to medium liquidity and very little demand, making liquidation difficult.

As the Mt. Gox trustee found out—but denied publicly—liquidating large amounts of coin can have significant negative impacts on their market values and require strategic timing. Blockchains, the ledgers that record cryptocurrency transactions, are by design also immutable. Therefore, once you have agreed on a transaction and recorded it, it can never be changed. Doing so corrupts and invalidates the entire ledger. You can subsequently record another transaction about that asset to change its state, but you can never alter or remove the original transaction. This is great for preserving the provenance of assets. For any asset, you can tell where it is, where it's been and what has happened throughout its life.

Unwinding fraudulent conveyances and other reviewable cryptocurrency transactions is technically impossible. Recording a subsequent transaction may be the only viable option, which means that receivers and trustees are being forced to find or produce creative new ways of unwinding needed transactions within the law. This is often akin to fitting a square peg in a round hole with today's jurisprudence, however.

Cryptocurrencies and the Dark Web

In October 2020, the US Attorney General announced the publication of a Cryptocurrency Enforcement Framework. In connection with the release of the framework, FBI Director Christopher Wray stated:

> as this Enforcement Framework describes, we see criminals using cryptocurrency to try to prevent us from 'following the money' across a wide range of investigations, as well as to trade in illicit goods like criminal tools on the dark

[28] Id.

Continued from p.11

web. For example, the cyber criminals behind ransomware attacks often use cryptocurrency to try to hide their true identities when acquiring malware and infrastructure and receiving ransom payments. The men and women of the FBI are constantly innovating to keep pace with the evolution of criminals' use of cryptocurrency.[29]

One place the criminals often hide and seek to monetize their exploits is on the Dark Web. This is a term that has been getting a lot of attention in corporate boardrooms and media outlets as of late. The general preconception of the Dark Web is that it's a seedy underground digital hiding place for drug dealers, assassins, cybercriminals and pedophiles, which isn't far from the truth. For this reason, security researchers and law enforcement agencies have been surveying the Dark Web for years and keep close eyes on what goes on there. Sales through the Dark Web approached $800 million in 2019, representing 0.08%of all cryptocurrency transactions.[30] Exhibit 4 on p.10 details the estimated value of Bitcoin flowing to Dark Web markets.[31]

The Dark Web contains digital markets that aren't necessarily illegal; however, most Dark Web marketplaces are structured to sell drugs, identities, counterfeit goods, weapons, or other illicit products. The Dark Web's digital marketplaces offer the exchange of goods or services for money, often in the form of cryptocurrency. Cryptocurrency for payment offers anonymity to both buyers and sellers. In many instances, as with public cryptocurrency exchanges Dark Web exchanges have resulted in the theft of millions of customer dollars held in escrow by the marketplace administrator.

Dark Web Intelligence

Quite often the Dark Web is the first place that people learn of a data breach or cryptocurrency theft. This has also made it a place of interest for corporate legal, IT security teams and risk managers in the face of fraudulent or suspicious events. According to the rumor mill in cybersecurity circles, stolen data from the Target and Sony breaches potentially sat on the Dark Web for months before making public headlines. However, while Dark Web intelligence may be helpful in defending your organization from cybercriminals, one must have a full understanding of these underground regions of the Internet and an understanding of how malicious actors use it to commit their crimes in order to avoid running afoul of unnecessary risks.

What is the Dark Web?

The Internet is composed of three primary layers: the World Wide Web (or Surface Web), the Deep Web and the Dark Web. The top layer, which is the area that most users are familiar with, represents only a very small fraction of the Internet. It is the roughly 4 percent of the Internet that is easily accessible via any common search engine.

Underneath the Surface Web is the Deep Web, a much larger pool of information that is largely untouched by search engines. No one knows the exact size of the Deep Web, because it is hard to quantify without search engines. Typically, the Deep Web consists of corporate and academic environments that can only be accessed through direct queries. In other words, you need to know precisely what information you're looking for and you often need to have some kind of authorization to obtain the information. Legal research databases and subscription services are common examples, as are corporate intranets.

The third layer is the Dark Web. It's referred to as "dark" because it can only be accessed with special browsers, routers and encryption tools that render all traffic to its sites anonymous. The sites also use tools to hide their IP addresses, which make tracking their location and ownership especially difficult. These two aspects of anonymity are what make the Dark Web suitable as a digital underground. However, they are also what enables anonymous whistleblowing and protects users from surveillance and censorship in authoritarian regimes.

Risks of Dark Web Access

Given the wealth of intelligence that can be gleaned from the Dark Web, it is understandable that corporate security and risk teams are attracted to it. However, counsel must ensure that these teams proceed with due caution in order to avoid what can be very significant risks. Most importantly, impromptu Dark Web reconnaissance can inadvertently expose an organization to greater security risks because of unknown malicious files that can infiltrate the corporate network. Just like other underground black markets, the Dark Web is full of unscrupulous actors who enjoy taking advantage of the unacquainted. If IT staff isn't properly trained nor has the right resources and equipment, they could easily bring that malware and its controllers back home without even knowing it. In fact, connecting to the Dark Web from any corporate network is always ill-advised. It's important to use air-gapped assets that have no way to transfer malicious data into the corporate environment, as well as to use multiple layers of encryption.

Further, gaining access is not for the faint of heart. Not

[29] US Department of Justice, Office of Public Affairs. Justice News Press Release *Attorney General William P. Barr Announces Publication of Cryptocurrency Enforcement Framework*, October 8, 2020. Retrieved from https://www.justice.gov/opa/pr/attorney-general-william-p-barr-announces-publication-cryptocurrency-enforcement-framework

[30] Chainalysis (2020). *The 2020 State of Crypto Crime.*

[31] Feldman, Sarah (2019). *Darknet Bitcoin use is Persistent Despite Busts.* Retrieved from https://www.statista.com/chart/17128/darknet-use-of-bitcoin/#:~:text=Between%202017%20and%202018%2C%20bitcoin's,14%20percnet%20after%20the%20closures.

all content on the Dark Web is immediately accessible. It can take considerable time, expertise and manual effort to glean useful information. It may take a researcher years to establish trust in certain communities and sales forums. Additionally, several criminal forums on the Dark Web utilize a "vouching" system, similar to a private members club, which might require an investigator to associate with criminals or stray into significantly gray ethical territory to gain access to the content. The average systems administrator probably doesn't have the operational skills necessary to pass himself off as a hacker on the Dark Web. Without the requisite skills, reconnaissance is likely to prove fruitless and will open the company up to further danger.

Even if your team was successful in safely gaining access, their activities must be closely monitored to ensure they do not run afoul of any laws. For example, you certainly wouldn't want your employees accidentally viewing child pornography or bringing it onto the corporate network. Also, while it can be tempting to download files pertaining to purported breaches, taking receipt of stolen goods is a felony in the United States (18 U.S.C. § 2315) that can cause legal issues for your team. Beyond that, such activities may disrupt the legitimate work of law enforcement agencies engaged in their own actions. Also, keep in mind that there is no way to confirm who the seller actually is. Purchasing data in such places can subject the company to risks of violating the Patriot Act if it turns out the data is being sold by a terrorist organization and you transfer funds to them.

As tempting as it may be for in-house IT experts to access the Dark Web for legitimate purposes, a better strategy is to engage a reputable security firm to assist with these services. Many firms now offer some level of Dark Web reconnaissance, ranging from manual intelligence gathering to more automated approaches using Web scraping and analytics tools. Further, by integrating and organizing social media, Deep Web public records and peer-to-peer domains, skilled researchers are able to provide a more unified view of their external threats than internal teams can. The use of artificial intelligence and deep learning enables a more valuable exploration and indexing of large unstructured data sources, while enriching the analysis. The result is real-time finished intelligence, safe from the risks of self-gathering.

Conclusion

Cryptocurrency and Dark Web issues have negatively impacted many investors, and every company should be aware of the risks associated with these activities. While the regulatory environment is improving with respect to cryptocurrency, the opaque nature of the investments causes uncertainty about jurisdiction in the event of an insolvency, governing law for fraud events, transparency with transactions, and the counterparties involved, and the Dark Web can make it more difficult to uncover the actors. Both these technologies will undoubtedly continue to disrupt financial payment systems, and criminals will continue to find more and more lucrative ways to exploit these technologies and those who use them. This means that the number of insolvent exchanges and ICOs is only going to grow. In the face of this, it is imperative that our profession continues to evolve both legally and technically at an equal pace. It also means finding the right technical partners with the computer forensic skills and forensic accounting skills needed to resolve the many unique issues raised by digital currencies. Similarly, understanding the potential bankruptcy implications of your investment decisions prior to selecting an investment vehicle is critical for asset protection. Great care must be taken to ensure that qualified professionals are involved when making these decisions.

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4:30 PM – 5:30 PM ET

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This panel will explore important issues facing this industry in view of COVID-19. We will explore current operational factors and options, the effects on near term and longer term outlooks, the impact on values and valuation practices, and current bankruptcy strategies.

Day 2 - Nov 16, 2020

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COVID-19 has had a devastating impact on the senior housing industry, with news outlets reporting that as many as 40% of all COVID deaths in the US occurred in nursing homes. COVID has also had a tremendous financial impact on the industry, and the future of senior housing is now very much uncertain. This panel will explore the unique financial and operational challenges posed by COVID-19 on senior housing from the perspective of lenders, debtors, landlords, financial advisors, CROs, and the Courts.

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5:00 PM – 6:00 PM ET

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UNIFIED LOSS RULES

MICHAEL BARTON
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Mergers and acquisitions activity for the near- and mid-term will likely involve an unusual amount of bargain purchases, including "carve-outs" from consolidated return groups. In such carve-out transactions, subsidiaries are acquired from existing federal consolidated return groups. The Unified Loss Rules contained in Treasury Regulation section 1.1502-36 may disallow all or part of a seller loss, or may result in a step down in the basis of the stock or assets received by the buyer in such transactions.

The Unified Loss Rules may also disallow all or part of a section 165(g)(3) worthless stock deduction and may also apply when a subsidiary deconsolidates from a federal consolidated return group.[1]

The current Unified Loss Rules generally apply to transfers of shares of subsidiary stock on or after September 17, 2008.[2]

This article discusses the current Unified Loss Rules regime at a high level and provides context for the rules.[3] Moreover, the article highlights various elections contained in the regulations that may provide more beneficial outcomes depending on a taxpayer's facts and circumstances.

The Investment Basis System

The Unified Loss Rules are designed to address certain issues that can arise from the application of the regulation section 1.1502-32 investment basis adjustment system. In a consolidated return group, the tax basis of subsidiary stock is generally adjusted by the net change in the tax basis in the assets of the subsidiary.[4] For example, P forms S with $100 on 1/1/X1. During X1, S generates $40 of positive investment basis adjustments (for this example, assume all attributable to generating taxable income). At the end of X1, P's tax basis in the stock of X1 would be $140 ($100 initial basis + $40 of net positive investment basis adjustments).

Purpose of Unified Loss Rules

The Unified Loss Rules have two principal purposes:

1. Non-Economic Loss — The first principal purpose is prevent the consolidated return provisions from reducing a group's consolidated taxable income through the creation and recognition of a non-economic loss.[5] In other words, the mechanism of the consolidated return regulations may create tax basis in subsidiary stock that is non-economic.

For example, P acquires the stock of S for $100. S contains one asset with a basis of $10 and a FMV of $100. S then sells the asset for $100 and now has assets with a basis of $100 (the cash). However, under regulation section 1.1502-32, P's tax basis in the stock of S is adjusted by the $90 gain, resulting in an "outside" tax basis in the stock of $190.[6] If P then sold the S stock for $100, absent the Unified Loss Rules, P would be able to take a $90 non-economic loss on the transaction.

[1] Section 1501 allows an affiliated group of corporations to file a federal consolidated return. Section 1504(a)(2) requires an affiliated group to possess at least 80% of the total voting power and 80% of total value of the stock of a subsidiary. If a subsidiary falls below the 80% vote or 80% value test, such subsidiary will deconsolidate from the consolidated return group. For example, P owns 80% vote and value of S's shares in Year 1. On June 1, Year 2, P sells 1% of the shares of S stock. P would thus own 79% of the shares of S, and S would deconsolidate from the P group effective at the end of the day on June 1, Year 2.

[2] Regulation Section 1.1502-36(h).

[3] The article does not discuss the effects of selling a chain of subsidiaries at a loss.

[4] Exceptions to this rule exist. For example, tax basis in subsidiary stock is only reduced when a net operating loss is absorbed or carried back. Regulation Section 1.1502-32(b)(3)(i).

[5] Regulation Section 1.1502-36(a)(2).

[6] Note that the basis disconformity between "inside" and "outside" tax basis generally remains consistent when subsidiary stock is acquired without a step-up in inside basis. In this case, the basis disconformity amount is $90 both before and after the asset was sold. In general, there is no basis disconformity if the subsidiary was formed or acquired in an asset or deemed asset [*e.g., in a* Section 338(h)(10)] acquisition].

Continued from p.15

2. Duplicated Loss — The second principal purpose is to prevent members (including non-members) of the group from collectively obtaining more than one tax benefit from single economic loss.

For example, P acquires S for $200, and S has one asset, a tract of land, with a FMV and tax basis of $200. In a subsequent year, the value of the land has declined to $160. P sells the stock of S to a third party for $160 – reflecting the $40 decline in the value of the asset. The third party thus acquires stock with a basis of $160 which has an asset with a FMV of $160 and basis of $200. The third party sells the land for $160. As such, the loss is "duplicated" as both P has a $40 loss on the sale of the stock and the third-party has a $40 loss on the sale of the land.

Prior Law

Section 1502 of the tax code contains only one paragraph and essentially grants the Secretary of the Treasury to prescribe regulations to clearly reflect income tax liability for a consolidated return group.

In 1966, the Treasury issued extensive consolidated return regulations, which were substantially revised in 1995. These regulations included former regulation section 1.1502-20, which generally disallowed losses due to the recognition of built-in gains (non-economic losses) and duplicated losses, as described above.

In 1994, Rite Aid Corporation (Rite Aid), sold a subsidiary at a loss. The "duplicated loss" as calculated under regulation 1.1502-20 exceeded Rite Aid's loss, and thus the loss was completely disallowed by the regulations. Rite Aid paid the tax for 1994 exclusive of the loss on the subsidiary, and filed a claim for refund, which the government denied. Rite Aid then sued for a refund. In 2000, The Court of Federal Claims granted summary judgment for the government and found that regulation section 1.1502-20 "is not arbitrary, capricious or manifestly contrary to law."[7]

In 2001, The United States Court of Appeals for the Federal Circuit reversed the Court of Federal Claims holding that the regulation was not within the authority delegated by Congress under section 1502. Specifically, the Federal Circuit held: "(b)ecause the regulation does not reflect the tax liability of the consolidated group, the regulation is manifestly contrary to the statute."[8] This ruling created a great deal of uncertainty by calling into question many other aspects of the consolidated return regulations, including other portions of the 1.1502-20 regulations. To remedy this issue, in 2004 Congress amended section 1502 to include the sentence: ". . . the Secretary may prescribe rules that are different . . . (from those) that would apply if such corporations filed separate returns."

[7] *Rite Aid Corp. v. United States*, 46 Fed. Cl. 500 (2000).

[8] *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed Cir. 2001).

In 2008, the Treasury issued the Unified Loss Rules under 1.1502-36, which were the final replacement for the prior section 1.1502-20 loss disallowance regulations. While the Unified Loss Rules are more comprehensive than the section 1.1502-20 regulations, as stated above, they maintain the goal of eliminating losses relating to duplicated and non-economic losses.

The Unified Loss Rules consist of three principal rules that are applied sequentially: (1) the basis redetermination rule; (2) the basis reduction rule; and (3) the attribute reduction rule.

Basis Redetermination Rule

The first step in the Unified Loss Rules is to determine if there is disparity between different tranches of the subsidiary's stock.[9] For example, P may hold 80 shares of S stock with a $10 gain and 20 shares of S stock with an $8 loss. S might decide to sell the 20 shares and recognize an $8 loss, which could result in a duplicated loss or a non-economic loss.

The basis redetermination rule does not apply if:

- There is no disparity among member's basis in shares of S stock and no member owns a share of preferred stock with respect to which there is unrecognized gain or loss; or
- All the shares held by the group are transferred to one or more non-members, become worthless under section 165, or a combination thereof in one taxable transaction.[10]

If the basis redetermination rules apply, under complex rules, the bases of transferred loss shares may be reduced and the bases of gain preferred and common stock may be increased.[11] In our example above, the basis in the loss shares might be increased under the basis determination rule and the basis in the gain shares might be reduced. Application of the basis redetermination rules cannot alter the overall amount of basis in shares of S held by members of the consolidated return group.[12]

Even if all shares are transferred in one taxable transaction or become worthless under section 165, a consolidated group can still elect to apply the basis redetermination rules if they hold shares with disparate bases.[13]

[9] Regulation Section 1.1502-36(b)(1)(i).

[10] Regulation Section 1.1502-36(b)(1)(ii).

[11] Regulation Section 1.1502-36(b)(2).

[12] Regulation Section 1.1502-36(b)(1)(i).

[13] The election is made in the manner provided in Regulation Section 1.1502-36(e)(5).

Stock Basis Reduction to Prevent Noneconomic Loss

If a transferred share is a loss share after any basis redetermination, then stock basis reduction may reduce the basis in the member's share.[14]

The stock basis reduction rules reduce basis in a transferred share of S stock to prevent non-economic stock loss and thus promote a clear reflection of the group's income. The stock basis reduction rules limit the reduction to the basis in the S share to the amount of net unrealized appreciation reflected in the share's basis of the transfer (the "disconformity amount"). The rules also limit the reduction to basis in the S share to the portion of the share's basis that is attributable to investment adjustments made pursuant to the consolidated return regulations.[15]

Specifically, under the basis reduction rules, basis in the loss shares is reduced, but not below value, by the *lessor* of:

- The share's net positive adjustment; and
- The share's disconformity amount.[16]

Net positive adjustment is the greater of:

- Zero and
- The sum of all investment adjustments reflected in the basis of the share.[17]

A share's disconformity amount is the excess, if any, of:

- The member's basis in the share; over
- The share's allocable portion of S's net inside attribute amount (which is the sum of net operating and capital loss carryovers, deferred deductions, money, and basis in assets other than money, reduced by the amount of S's liabilities).

Let's return to our non-economic loss example:

P acquires the stock of S for $100. S owns one asset with a basis of $10 and a FMV of $100. S then sells the asset for $100 and now has assets with a basis of $100 (the cash). However, under regulation section 1.1502-32, P's tax basis in the stock of S is adjusted by the $90 gain, resulting in an "outside" tax basis in the stock of $190. P then sells the S stock for $100.

Under the basis reduction rules, we would determine the positive investment adjustments (which is the $90 gain from the sale of the asset) and the disconformity amount, which is also $90 ($190 basis less $100 of net inside attributes). In this case, both the positive investment adjustments and the basis disconformity amount are the same, so the lesser of the two is $90. As such, the basis in the S shares would be reduced from $190 to $100 as a result of the stock basis reduction rule, and thus would prevent a non-economic loss on the sale of the S stock.

Attribute Reduction to Prevent Duplication of Loss

The attribute reduction rules reduce attributes of S to the extent they duplicate a net loss on shares of S stock transferred by members in one transaction. This rule is designed to prevent S from using deductions and losses to the extent that the group or its members have either used, or preserved for later, a corresponding loss in S shares.[18]

If a transferred share is a loss share after taking into effect any adjustments under basis redetermination or stock basis reduction, S's attributes are reduced by S's attribute reduction amount immediately before the transfer. In addition, the attribute reduction rules may apply in the case of certain transfers due to worthlessness and certain transfers not followed by a separate return year. [19]

An exception to the attribute reduction rule applies if the aggregate reduction amount in the transaction is less than five percent of the aggregate value of the shares transferred by members in the transaction.

Attribute Reduction Calculations:

S's attribution reduction amount is the lesser of:

- The net stock loss; and
- S's aggregate inside loss.

Net stock loss is the excess of:

- The aggregate basis of all shares of S stock transferred by members in the transaction; over
- The aggregate value of those shares.

Aggregate inside loss is the excess, if any, of:

1. S's net inside attribute amount (which is the sum of net operating and capital loss carryovers, deferred deductions, money, and basis in assets other than money, reduced by the amount of S's liabilities); over
2. The value of all outstanding shares of S stock. [20]

S's attributes available for reduction are:

- Category A – Capital loss carryovers;
- Category B – Net operating loss carryovers;
- Category C – Deferred deductions

[14] Regulation Section 1.1502-36(a)(3)(i).
[15] Regulation Section 1.1502-36(c)(1).
[16] Regulation Section 1.1502-36(c)(2).
[17] Regulation Section 1.1502-36(c)(3).
[18] Regulation Section 1.1502-36(d)(1).
[19] Regulation Section 1.1502-36(d)(1)(i).
[20] Regulation Section 1.1502-36(d)(3).

Continued from p.17

- Category D – Basis of assets other than cash and cash equivalents.[21]

If' S's attribute reduction amount is less than S's total attributes in Category A, Category B and Category C, all of S's attribution amount will be applied to reduce such attributes. However, P may specify the allocation of S's attribution amount among such assets.[22]

Let's return to our duplicated loss example. P acquires S for $200, and S has one asset, a tract of land, with a FMV and tax basis of $200. In a subsequent year, the value of the asset has declined to $160. P sells the stock of S to a third party for $160 – reflecting the $40 decline in the value of its asset. The third party thus acquires stock with a basis of $160, which has an asset with a FMV of $160 and basis of $200. The third party sells the land for $160. As such, the loss is "duplicated" as both P has a $40 loss on the sale of the stock and the third party has a $40 loss on the sale of the land.

S's attribution reduction amount is the lesser of the net stock loss or S's aggregate inside loss. In this case, both amounts are $40. As such, S's basis in the land would be reduced by $40 immediately before the sale to prevent the loss being duplicated by the buyer. As such, the buyer would acquire the shares for $160 and succeed to a stepped-down basis in the land of $160.

Reattribution Election:

P may elect to reduce the potential for loss duplication, and thus reduce or avoid attribute reduction. To the extent of S's attribution amount tentatively computed, P may elect –

- To reduce all or any portion of member's bases in transferred loss shares of S stock;[23]
- To reattribute all or any portion of S's Category A, Category B and Category C attributes, to the extent they would otherwise be subject to attribute reduction; or
- Any combination thereof.[24]

In the example above, P could elect to reduce the basis in the S shares by $40 instead of reducing the basis in the land. In that case, the seller would have no loss on the sale of the S shares (which would have been otherwise disallowed), and the buyer would buy stock for $160 and retain the $200 basis in the land.

Alternatively, assume S had sold the land and recognized a $40 loss that had not been absorbed by the consolidated return group. Without reattribution, the $40 net operating loss would have been reduced under attribute reduction. However, if P elects to reattribute the $40 net operating loss to itself, P's tax basis in the stock of S would decrease by $40 immediately before the sale. P would thus not have a disallowed loss on the sale and would succeed to S's $40 net operating loss.[25]

If S is insolvent within the meaning of section 108(d)(3) at the time of the transfer, S's losses may be reattributed only to the extent they exceed the amount of insolvency.[26]

Additional Attribute Reduction in Certain Cases

In the case of certain transfers due to worthlessness and certain transfers not followed by a separate return year, any of S's Category A, Category B and Category C attributes not otherwise reattributed are eliminated.[27]

For example, P owns the sole share of S. The share is worthless under section 165.[28] In addition, S had disposed of all of its assets. P claims a worthless securities deduction with respect to the shares. The worthlessness is a transfer of the S share, a loss share, and thus is subject to attribute reduction. After application of the basis redetermination and basis reduction rules, P's basis (and thus P's net stock loss) is $75. S has a $100 net operating loss carryforward. Under the general attribute reduction rules, S's attribution amount is $75 [the lesser of P's $75 net stock loss and S's $100 aggregate inside loss ($100 net inside attribute amount over $0 value of S shares)]. S's attributes are reduced by $75, from $100 to $25. In addition, if S remains a member of the group, because S is worthless, its remaining $25 of net operating losses are eliminated. M thus recognizes a $75 worthless securities deduction, S has $0 net inside attributes, and the consolidated net operating loss is reduced by a total of $100.[29] Note that under the insolvency limitation, S's losses could not have been reattributed to P.

If in the previous example S does not dispose of all of its assets, P causes S to be legally dissolved, and the S shares are canceled without consideration. The dissolution of S is similarly considered a transfer, and the results would be the same as above. The result would also be the same if instead of being legally dissolved, S was converted into a disregarded entity.[30]

[21] Regulation Section 1.1502-36(d)(4).

[22] Regulation Section 1.1502-36(d)(4)(ii)(A). The election is made in the manner provided in Regulation Section 1.1502-36(e)(5).

[23] The reduction is allocated among all such shares in proportion to the amount of loss on each share. Regulation Section 1.1502-36(d)(6)(iv).

[24] Regulation Section 1.1502-36(d)(6). The election is made in the manner provided in Regulation Section 1.1502-36(e)(5). Although such elections are irrevocable, they have no effect if there no attribute reduction amount or to the extent S's attribute reduction is less than the amount specified in the election.

[25] Note that the $40 net operating loss may be more valuable to P than to the seller after taking into account the section 382 limitation that would have been imposed if P had sold S with the $40 net operating loss. Moreover, under Regulation Section 1.1502-95(d)(5), P may reattribute to itself all or any part of a section 382 limitation.

[26] Regulation Section 1.1502-36(d)(6)(iv)(B).

[27] Regulation Section 1.1502-36(d)(7)(i).

[28] See "Worthless Stock Losses in Consolidated Return Groups: Tread Carefully," Forrest Lewis. *AIRA Journal*, Vol. 26 No. 5 – 2013.

[29] Regulation Section 1.1502-36(d)(7)(iii) Example (i).

[30] Regulation Section 1.1502-36(d)(7)(iii) Example (ii).

Summary

In history, large events can be triggered by smaller ones. In this case, one US taxpayer, the Rite Aid Corporation, was denied a refund claim by the Internal Revenue Service (IRS), lost at the Court of Claims, and then prevailed at the United States Court of Appeals for the Federal Circuit. This singular tax case threatened to invalidate large swaths of the consolidated return regulations. It took Congress three years to add one sentence to the Section 1502 statute to resolve the regulatory authority issues raised by the Rite Aid case.

In the aftermath of Rite Aid, the Treasury undertook the mammoth project of writing a comprehensive set of regulations to replace the former section 1.1502-20 regulations. In the preamble to the final regulations, the Treasury stated:

> The IRS and Treasury Department recognize that the proposed rules are complex. However, as recognized by commentators and practitioners, the complexity of the rules is a result of the balancing of benefits and burdens arising from the presumptions on which the rules are based.[31]

While the regulations are thus carefully written to prevent non-economic or duplicated losses, the application of the regulations in practice can provide unexpected consequences for both buyers and sellers. As such, both parties should closely consider the effect of the various elections contained in the regulations during stock sale negotiations. Additionally, consolidated return groups attempting to recognize an ordinary loss due to worthlessness of a subsidiary should be cognizant that the worthlessness loss may be partially or completely disallowed. An expert practitioner can apply the Uniform Loss Rules with great precision. An uninformed taxpayer may fall into any number of traps for the unwary contained in the regulations.

[31] https://www.federalregister.gov/documents/2008/09/17/E8-21006/unified-rule-for-loss-on-subsidiary-stock

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HOW CAN LESSONS LEARNED IN ASBESTOS HELP THE OPIOID CRISIS?[1]

JESSICA HOREWITZ and MARC SCOPPETTONE, *Nathan Associates*
HOLLAND SULLIVAN, *Financial Assets Recovery Analytics, LLC*

The opioid crisis in the US has turned our attention not just to those individuals who have struggled with addiction as a result of the over-prescription of opioids, but also towards the societal costs associated with those struggles. Costs that can be attributed to several stages in the supply chain—the unintended consequences of the questionable marketing, prescribing, distribution, and dispensing of opioids. In fact, it is possible that if all costs of the crisis were monetized and all damages paid, the total would be much more than the profits earned or possibly even the revenue generated throughout the supply chain. Some higher estimates have penned the financial effects at more than $1 trillion.[2] Should those damages be paid, would we, as a society, lose pharmaceutical companies? Distributors? Pharmacies? Doctors? We have already seen Insys Therapeutics and Purdue Pharma declare bankruptcy and just in the past two weeks, Mallinckrodt has publicly considered taking that same step.[3]

The litigation surrounding the opioid crisis began as more than 2,000 separate lawsuits comprising more than 2,500 cities and counties, Native American tribes, and individual claimants. These lawsuits targeted opioid manufacturers, pharmaceutical distributors, pharmacy benefits managers (PBMs), pharmacies, and medical care providers. The lawsuits were consolidated into a single multidistrict litigation overseen by a federal judge in the Northern District of Ohio. The Court scheduled bellwether trials for the Summit and Cuyahoga counties in Ohio, which settled on the eve of trial with all defendants except pharmacy defendants. All the remaining suits are pending.[4] The opioid litigation has resulted in the bankruptcies of multiple opioid manufacturers, including Purdue Pharma and Insys Therapeutics, with the potential for additional bankruptcies in the future.[5]

What if a different, wholistic strategy were available? One of the longest-lasting litigations in US history has been those related to asbestos. In 1969, the first personal injury lawsuit alleging asbestos related disease was filed; by the late 1970s, claim filings had picked up speed and the first asbestos related bankruptcy was filed in 1982 (The Johns Manville Corporation).[6] Since then, more than 600,000 individuals have filed personal injury lawsuits due to asbestos exposure, more than 75 companies have declared bankruptcy, and dozens of insurance companies have become insolvent. Lawyers, economists, and conference organizers have seen their entire careers focus on asbestos litigation. While there were early attempts to remove asbestos from the

[1] This article was adapted from "Lessons From Asbestos Can Help Resolve Opioid Liabilities," Law360.com, August 18,2020. Available at https://www.law360.com/articles/1301206/lessons-from-asbestos-can-help-resolve-opioid-liabilities.

[2] NPR, "Your Guide to the Massive (and Massively Complex) Opioid Litigation," Oct. 15, 2019, *available at* https://www.npr.org/sections/health-shots/2019/10/15/761537367/your-guide-to-the-massive-and-massively-complex-opioid-litigation

[3] https://www.fiercepharma.com/pharma/mallinckrodt-considering-bankruptcy-for-its-troubled-u-s-generics-unit-report

[4] A separate state public nuisance claim by the State of Oklahoma against Johnson and Johnson resulted in a nine-figure judgment against Johnson and Johnson. Separately, the Department of Justice has also pursued individual parties for civil and criminal penalties.

[5] Additionally, Mallinckrodt's generic business filed for Chapter 11 bankruptcy.

[6] It is generally stated that Manville was the first asbestos related bankruptcy https://www.asbestos.com/companies/johns-manville/#:~:text=Johns%20Manville%20was%20the%20first,use%20of%20the%20bankruptcy%20law. However, there is some ambiguity as to whether Unarco's July 29, 1982 asbestos related bankruptcy filing pre-dates Manville's 1982 filing.

traditional (individualized) tort system,[7] it has mostly been left up to individuals, law firms, corporations, and insurance companies to litigate and settle claims as they arise.

Management of asbestos liability has become a significant source of activity for some defendant companies. In-house counsel specialists are often needed to manage the litigation (which can range from a few claims a year to thousands), outside counsel coordination, claims management, and insurance negotiations. Litigation can impact day-to-day operations and may be a significant expense, impact acquisitions and divestitures, distract management, and depress company value. While many defendants have used bankruptcy to mitigate the impact of asbestos liability, others have remained in the tort system intending to "manage" the liability. However, other asbestos defendant companies have sought solutions outside the courts.

A few asbestos defendants have attempted corporate restructuring as a method to "wall off" the ongoing operations of the company from the legacy of asbestos. In order to do so, a new corporate entity is created, and the liability is assigned to the new entity. The value of the asset depends on expected future liability (estimated by an economist or actuary), an estimate of any expected insurance asset that can offset the liability (estimated by an insurance coverage expert and taking into account the solvency of the insurance program), a possible infusion of cash (or other asset) by the original parent, and an ability to leverage timing and smart investments to maximize the asset value. This new "runoff" company can be a wholly owned subsidiary or (better yet) an independent entity so the parent is free from the asbestos overhang. Under ideal circumstances, the liability, asset, and investment estimates are reasonable and close to the actual experience and the new entity can run off the asbestos liabilities through their end (expected in the 2050s). If the estimates are too conservative, the runoff entity could complete the asbestos claim lifecycle and have assets remaining or if the estimates are too aggressive, the runoff entity could become insolvent.[8]

How could corporate restructure be a solution for the companies in the opioid supply chain?

At first glance it seems that the supply chain for opioids is more complex than that of asbestos, but that is not necessarily the case. Even in the asbestos framework, there were manufacturers, distributors, designers, and installers (somewhat parallel to pharmaceutical manufacturers, distributors, retailers and prescribers). In the asbestos litigation, however, each entity in each step in the supply/exposure chain became a defendant without distinction as to their role (a distributor was sued for the same asbestos fibers as the company that specified or produced the final asbestos-containing-product) but damages (other than punitive) were limited to the number of individuals diagnosed with asbestos-related disease.

Over time, as mesothelioma gained visibility with only one known cause,[9] claims have grown to a level far higher than originally anticipated. Plaintiff law firms responded by establishing infrastructure to support ongoing asbestos litigation efforts, and defendant companies matched plaintiff firm efforts with comparable defense strategy and spend. A litigation that was expected to be relatively short lived has persisted and even flourished for decades. Depending upon the length of time over which opioid litigation persists, a similar pattern may emerge, i.e. diminishing claim numbers offset by increasing claim values.

Asbestos litigation has been further complicated by joint and several liability: a total award made to an individual would ideally be divided among all responsible parties, but if any entity in the chain were insolvent, the remaining parties would take on the share of those unable to pay. This same situation is applicable in the case of opioids: damages can arise from many sources, with any remaining (solvent) entity in the supply chain taking on the responsibility of those exiting the tort system, a domino effect that could be devastating to healthcare.

If our goal, as a society, is to continue to have functional and innovative pharmaceutical companies, we will need any resolution to the opioid crisis to preserve the solvency and functionality of the companies in the supply chain, lest we risk losing the firms most skilled at drug research, innovation, treatment development (and who could argue with that in the COVID-19 world?), and efficient and functioning systems for drug distribution and dispensation. The corporate restructure technique could be a means to maintain that goal in the face of a tsunami of litigation.

In order to restructure opioid-involved companies, a methodology for estimating their liabilities must be available. There are many potential sources of damages arising from opioids:

- Municipality Claims
- State Attorneys General Claims
- Individual Claims

[7] The Georgine case would have turned asbestos personal injury cases for a group of large defendants into a class action was decertified by the Supreme Court in 1997, and the FAIR Act would have prohibited asbestos personal injury claims from being brought against individual defendants and created a centralized (national) fund to compensate victims.

[8] Absent an arms-length transaction with both parties' legal and actuarial representatives offering defensible opinion letters, the risk of additional liability exposure does exist.

[9] Idiopathic mesothelioma is observed, but rarely identified when even a tangential link to asbestos exposure can be made.

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- Insurance Company Claims (for reimbursement of unwarranted opioid prescriptions)
- Securities Claims
- Department of Justice ("DOJ") Contingency Claims
- Hospital claims (arising from the undue allocation of hospital resources toward opioid patients)
- Future claimants (babies born to addicted mothers)
- Insurance claimants (those who purchased insurance at rates above what they would have been but for the cost of caring for addicts and covering unnecessary opioid prescriptions)
- SEC investigations
- Investigations of healthcare professionals
- Congressional and other inquiries
- Derivative lawsuits against directors of company

While this list seems daunting, there have been some estimates (or estimation methodologies) for many of these potential sources of damage in the opioid litigation that has proceeded to date. For example, market-wide estimates could then be parsed to each entity involved in the supply chain (possibly by market share[10]). Others may be based on statutory provisions that nonetheless are readily estimable using company-specific data. Thus, there are reliable methods upon which to compute damages by a company.

If the claims could also be adequately quantified, it seems that opioid companies could take advantage of a restructuring that separated the opioid business from the non-opioid business. Through a properly structured transaction with a third party, an opioid company could achieve finality from contingent liabilities through a true sale. Just as in the context asbestos-related transactions, the seller and purchaser will both require legal and actuarial opinions from their respective advisors. While every transaction requires bespoke structuring, typically the selling entity can sell either a legacy subsidiary or ringfenced vehicle containing both funding and liabilities to a third party. After such a transaction, the selling company no longer retains any exposure to the described contingent liabilities on its balance sheet and maintains no control or ongoing involvement in any litigation, settlement, or other resolution of claims going forward. This approach is the only alternative to bankruptcy that achieves complete finality from exposure to contingent liabilities.

[10] Market share in opioids is thoughtfully computed as morphine milligram equivalent (MME) rather than unit sales to control for the varying potency of different products.

By allowing companies a clean separation of past liabilities from ongoing operations, a fair and equitable resolution to opioid liabilities can be achieved while maintaining the innovation and dynamism of America's pharmaceutical industry.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm or its clients, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

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THIRD-PARTY RELEASES? – NOT SO FAST!

An Update on Releases and Warnings on Common Related Pitfalls

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In a previous article "*Third-Party Releases? – Not So Fast!*", members of the Lowenstein team wrote regarding the changing trends and heightened scrutiny of nonconsensual third-party releases across jurisdictions in a post-Enron world.[1] At the time that article was published, three circuits–the Fifth, Ninth, and Tenth Circuits–had been labeled "Prohibition Circuits," that is, those that generally held nonconsensual third-party releases are barred by the Bankruptcy Code without exception.[2] The remaining jurisdictions, labeled "Permissive Circuits," generally permitted nonconsensual third-party releases under certain conditions set forth by case law within the circuit.[3] Although none of the circuits entirely switched perspectives over the past five years, courts have been active and vocal in this area, and parties have been creative in finding new ways to present these releases to the court. This article examines significant case law updates, as well as common pitfalls which practitioners should be aware of when analyzing "release" issues on behalf of their clients.

With limited exception, nonconsensual third-party releases are still rejected across the board in the Prohibition Circuits.[4] These courts have held steadfastly to the premise that nonconsensual third-party releases violate section 524(e) of the Bankruptcy Code and must be barred in all circumstances. Even these jurisdictions acknowledge, however, that third-party releases may be permitted when they are consented to by all parties granting the release.

That being said, the Ninth Circuit has begun to dance around the idea of permitting third-party releases in certain specific instances. First, the Ninth Circuit acknowledged that because section 524 does not apply to cases arising under Chapter 9 of the Bankruptcy Code, nonconsensual third-party releases may be permissible in the reorganization of a municipality under Chapter 9.[5] This decision should *not* be viewed as a sea change in the Ninth Circuit's mindset, as the Ninth Circuit has limited the releases to cases arising under Chapter 9, and Bankruptcy Courts in the circuit still routinely acknowledge that nonconsensual third-party releases are not permitted in Chapter 11.[6]

Even more recently, the Ninth Circuit has strayed from related holdings in other Prohibition Circuits by holding that a third-party exculpation clause that is "narrow in both scope and time" does not violate section 524(e).[7] In *Blixseth v. Credit Suisse*, the Ninth Circuit permitted the exculpation of the debtors' largest creditor,[8] which

[1] Michael S. Etkin & Nicole M. Brown, *Third-Party Releases? – Not So Fast! Changing Trends and Heightened Scrutiny*, AIRA Journal, Vol. 29, No. 3, 2015.

[2] *Id.* at 23, 25.

[3] *Id.* at 25.

[4] Cases in the Prohibition Circuits still overwhelmingly rely on the case law cited in our 2015 article for the proposition that nonconsensual third-party releases are invalid in light of section 524(e) of the Bankruptcy Code, and therefore are never permissible. *See e.g.*, *Dragnea v. Dragnea (In re Dragnea)*, 609 B.R. 239, 251 (Bankr. E.D. Cal. 2019) (citing *Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401-02 (9th Cir. 1995), and *Am. Hardwoods, Inc. v. Deutsche Credit Corp. (In re Am. Hardwoods, Inc.)*, 885 F.2d 621, 624-27 (9th Cir. 1989)); *Webster Capital Fin., Inc. v. Newby*, No. 12-2290-EFM, 2013 U.S. Dist. LEXIS 19703, at *17 (D. Kan. Feb. 14, 2013) (citing *In re W. Real Estate Fund*, 922 F.2d 592, 600-01 (10th Cir. 1990)); *In re Patriot Place, Ltd.*, 486 B.R. 773, 822-23 (Bankr. W.D. Tex. 2013) (citing, for example, *In re Vitro SAB de CV*, 701 F.3d 1031 (5th Cir. 2012), and *In re Pac. Lumber Co.*, 584 F.3d 229 (5th Cir. 2009)).

[5] *See, e.g.*, *DeCampo v. Potts*, 836 F.3d 1134, 1143 (9th Cir. 2016) (noting, but not making any determination, that because Chapter 9, unlike Chapter 11, does not incorporate section 524(e), section 105 *might* authorize a bankruptcy court to confirm a plan that adjusts or discharges debts owed by non-debtor third parties).

[6] *See* Memorandum Decision – Confirmation of Debtors' and Shareholder Proponents' Joint Chapter 11 Plan of Reorganization, at 24-25, In re PG&E Corporation, No. 19-30088-DM, (Bankr. N.D. Cal. June 17, 2020), ECF No. 8001 (noting that the releases were permissible only because they are consensual, and section 524(e) and Ninth Circuit case law prohibit nonconsensual third-party releases).

[7] *Blixseth v. Credit Suisse*, No. 16-35304 (9th Cir. June 11, 2020). The *Blixseth* court acknowledged that its decision reached the opposite conclusion from the Fifth Circuit in *Pacific Lumber*. *Id.* at 19, n. 7.

[8] The *Blixseth* Court noted that exculpation could only cover parties "closely involved" in drafting the plan. Because the creditor "had the ability to single-handedly disrupt the entire confirmation process but had become a plan proponent through its direct participation in the negotiations that preceded the adoption of the Plan." *Id.* at 13.

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narrowly focused on the creditor's potential negligent actions (not willful misconduct or gross negligence) relating only to the plan approval process.[9] As we have previously noted, releases and exculpation differ in that releases offer protection for preconfirmation liability, while exculpation protects against liability for acts or omissions in connection with the bankruptcy case.[10] The Ninth Circuit found, consistent with Third Circuit Courts, that "by its terms, 524(e) prevents a bankruptcy court from extinguishing claims of creditors against non-debtors *over the very debt discharged through the bankruptcy proceedings*," and because exculpation does not deal with such debt that is otherwise being discharged in the bankruptcy, 524(e) does not apply a bar to these kinds of releases for third parties.[11]

In the Permissive Circuits, which have applied heightened scrutiny to third-party releases post-*Enron*, courts continue to uphold the general proposition that nonconsensual third-party releases should be permitted sparingly. Courts generally consider the following five factors when determining whether a plan may include third-party releases: (a) identity of interests between debtor and non-debtor releasee; (b) substantial contribution to the plan by third party; (c) necessity of the release to reorganization; (d) overwhelming acceptance of plan and release by creditors; and (e) payment of all of substantially all of the claims of creditors and interest holders granting the release.[12]

Although the court in *In re Metromedia Fiber Network, Inc.*, acknowledged certain circumstances where non-debtor releases may be approved,[13] subsequent decisions within the Second Circuit routinely focus on the requirement, as noted in *Metromedia*, that nonconsensual third-party releases should only be granted in rare and unusual circumstances.[14] For example, in *In re Aegean Marine Petroleum Network Inc.*, the Court upheld the Second Circuit's stringent standard and discussed, at length, refusal to permit nonconsensual third-party releases without showing that the releases are necessary to the reorganization, adding that permitting such releases would turn third-party releases into "participation awards."[15] In *Aegean*, like many other cases, the debtors' plan proposed releases for non-debtors based on their contribution to the reorganization efforts during the pendency of the bankruptcy case.[16] The Court discussed, at length, the impermissibility of these clauses and the Court's unwillingness to grant them absent a connection between the benefit and the claims released:

[9] The court specifically noted that the exculpation provision "does not affect obligations relating to the claims filed by creditors and discharged through bankruptcy proceedings, as it exclusively exculpates actions that occurred during the bankruptcy proceeding, not before." *Id.* at 12.

[10] It should be noted, however, that some courts do not pay much attention to the distinction and often refer to exculpation as a release. Etkin & Brown, *supra*.

[11] *Blixseth*, at 14 (emphasis added).

[12] *In re Tribune* Co., 464 B.R. 126, 186 (Bankr. D. Del. 2011) (citations omitted).

[13] *Deutsche Banke AG, London Branch v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 142 (2d Cir. 2005) ("Courts have approved nondebtor releases when: the estate received substantial consideration …; the enjoined claims were 'channeled' to a settlement fund rather than extinguished…; the enjoined claims would indirectly impact the debtor's reorganization 'by way of indemnity or contribution'…; and the plan otherwise provided for the full payment of the enjoined claims.") (internal citations omitted).

[14] *See, e.g.*, Transcript of Record at 95, *In re Aegean Marine Petroleum Network Inc.*, No. 18-13374-mew (Bankr. S.D.N.Y. Mar. 26, 2019) ("[T]hird party releases are not a merit badge that somebody gets in return for making a positive contribution to a restructuring, they are not a participation trophy, they're not a gold star for doing a good job on your homework. Doing positive things, even important positive things in a restructuring case is not enough under *Metromedia*.").

[15] *Id.*

[16] *Id.*

> This notion–this interpretation of *Metromedia* that I get to appoint myself as the arbiter of whether somebody gets a gold star on their report card for the quality of the work that they do, and the payment for that comes at the expense of other people by releasing their third-party claims is wrong. It's 100 percent wrong. I will never approve it. I will never adopt it. You don't get a release just because you did your work. You have to show that there's something about the particular claim that you want released that has to be barred in order to make this reorganization workable. And you have to show that it's fair for me to take that person's claim away from them in light of what they're getting this case. That's not what you're saying. What you're saying is this was a hard case, these people did a good job, give them a bonus, not out of the pockets of the Debtors but out of the pockets of a bunch of third parties. That's not right.[17]

The Third Circuit has also seen several developments since *Washington Mutual*. Although a Permissive Circuit, courts within the Third Circuit also claim to permit nonconsensual third-party releases only in "exceptional" circumstances. In *In re Millennium Lab Holdings II, LLC, et al*, the Third Circuit found its "exceptional" case, and permitted the nonconsensual third-party release of certain non-debtor shareholders in exchange for $325 million.[18] The Court repeatedly emphasized that it was not expanding bankruptcy court authority and that the holding of the case is "specific and limited."[19] Nonetheless, the court confirmed a plan containing nonconsensual third-party releases, based on the fact that granting the releases was "do or die," and they "were heavily negotiated" and "necessary to the entire agreed resolution."[20] Notably, the Court found that absent the releases and payment that was provided in exchange, "liquidation, not reorganization, would have been [the debtors'] sole option. Restructuring in this case was possible only because of the release provisions."[21]

While most courts permit *consensual* third-party releases, the debate continues across jurisdictions about what constitutes consent. For example, while some plans require the creditor to affirmatively "opt-in" to a release, others will consider a creditor to have consented to the third-party release if the creditor has not opted *out* of the release, submitted a ballot to accept or reject the plan, or otherwise objected to the release provision in the plan. What actually constitutes consent is beyond the scope of this article, but is a nuance of which practitioners should beware.

Importantly, a practitioner's analysis does not begin or end at the releases contained in a proposed plan, even though those provisions require significant analysis in their own right. In fact, parties are often tempted to act as proponents, and seek expedited approval of a

[17] *Id* at 60-61

[18] *In re Millennium Lab Holdings II, LLC, et al*, 945 F.3d 126, 130-31 (3d Cir. 2019).

[19] *Id.* 140.

[20] *Id.* at 131-32.

[21] *Id.* at 137.This case leaves open the question of whether a nonconsensual third-party release could be permitted in a plan of liquidation, as opposed to reorganization. Other circuits have acknowledged that third-party releases are questionable in a liquidation scenario. *In re Berwick Black Cattle Co.*, 394 B.R. 448, 461 (Bankr. C.D. Ill. 2008) ("The rationale for granting third-party releases is far less compelling, if it exists at all, in a liquidation than in a reorganization.").

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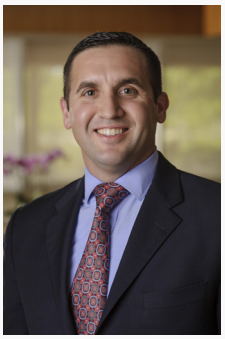

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plan that appears to assign "all claims" to a liquidating or litigation trust in hopes of avoiding fees and administrative expenses and preserving value for the larger creditor body. *Not so fast!* Practitioners must also be diligent in avoiding release-related pitfalls in many aspects of a Chapter 11 case, such as in plans, 363 sales, structured dismissals, and settlements.

It is *crucial* that practitioners take a step back and think critically about, for example, (i) whether the specific language used to release or assign those claims encompasses all potential claims without leaving any behind, and (ii) the law of the jurisdiction in which the claims will be brought. Failing to follow either of these steps could release third parties merely because there will not be a party with standing to bring the claims. Whether the releases are accomplished intentionally by the debtors is *almost* irrelevant; instead, focusing on avoiding these pitfalls and potential for ambiguities is key.

When structuring a plan that assigns claims to a liquidating or litigation trust, the parties must think critically about the precise language and evaluate both the explicit and the implied. This calls for careful crafting and reviewing by all parties in interest. Courts differ on the specificity required to assign claims to a liquidating trust, for example. Think you can use a catchall to assign *all* claims and causes of action belonging to the debtor? *Not so fast!* Many courts find that wholesale assignment provisions *do not* permit the bankruptcy court to confer standing to bring these actions on the trustee/assignee.[22] Conversely, provisions that are too narrow or specific risk leaving causes of action behind with the debtors' estate,[23] which, if not discovered in time, could mean there is no entity, counsel, or funds, available to bring these claims for the benefit of creditors. The practical result is a *de facto* release for the third party–with no party to bring the action against them, the claims are released. This risk is especially high when a committee or other creditors are not given a sufficient opportunity to investigate potential claims and causes of action prior to the assignment or plan approval.

Another important factor to consider is the law of the particular jurisdiction. Some jurisdictions *never* allow certain claims to be assigned. For example, the Delaware Limited Liability Company Act prohibits certain third parties from bringing derivative actions relating to a limited liability company under Delaware law.[24] Again, assignment of these claims without considering the law of the jurisdiction could lead to an unfortunate result for creditors–unintentional third-party releases.

The moral of the story is that every case is different, factually and jurisdictionally. Practitioners cannot get complacent when analyzing these issues; it is critical to think carefully and creatively about the specifics of each and every case, including about what is *not* being said, to bring the case to the finish line with the best outcome for your client and highest possible recovery for the creditor body. You just might provide a party with an unintentional, and nonconsensual, third-party release if you do not.

[22] *See, e.g., Gavin Solmonese, LLC v. Shyamsundar (In re AmCad Holdings, LLC)*, 2016 U.S. Bankr. LEXIS 2420 (Bankr. D. Del. June 14, 2016); *Fairchilds Liquidating Trust v. New York (In re Fairchild Corp.)*, 452 FB.R. 525 (Bankr. D. Del. 2011); *Shandler v. DLJ Merc. Banking, Inc. (In re Insilco Techs., Inc.)*, 330 B.R. 512 (Bankr. D. Del. 2005).

[23] *See Sun Microsystems Inc. v. Hynix Semiconductor Inc.*, 534 F. Supp. 2d 1101 (N.D. Ca. 2007) (Claims outside time period were not assigned and court could not provide standing to pursue).

[24] *See* 6 Del. C. § 18-1002; *In re Citadel Watford City Disposal Partners L.P.*, 603 B.R. 897, 907 (Bankr. D. Del. 2019) (holding that litigation trustee lacked standing to bring derivative action against debtor LLC assigned to litigation trust by a creditors' committee pursuant to Chapter 11 plan because creditors' committee lacked standing); *In re HH Liquidation, LLC*, 590 B.R. 211, 285 (Bankr. D. Del. 2018) (holding that official committee of unsecured creditors had no standing to bring breach of fiduciary claims on behalf of debtor LLC); *In re PennySaver USA Publishing, LLC*, 587 B.R. 445 (Bankr. D. Del. 2018) (holding that Chapter 7 trustee lacked standing to sue on behalf of LLC because LLC's creditors also lacked standing).

FROM DELAWARE TO THE CAYMAN ISLANDS:

The New Frontier for Fair Value Share Appraisal Opportunities

PAUL MADDEN
Harneys

Fund managers wishing to invest in appraisal opportunities have a new jurisdiction to consider. Cayman Islands share appraisal litigation is on an upward trajectory, where the statutory regime is similar to Delaware, yet in many ways more favourable to dissenters; where discounted cash flow (DCF) or other income-based company valuation methodologies still prevail, and where fair value has been determined to exceed merger price.

Delaware's Popularity?

The 2017 decisions of the Delaware Supreme Court in *DFC Global*[1] and *Dell*[2] may, according to some market participants, have all but sounded the death knell for Delaware share appraisal arbitrage.

At a recent corporate law conference in New Orleans, one panel member proclaimed this would be the final year that share appraisal litigation would feature as a topic. The statement was met with by applause from some in the room, if not the fund managers, valuation experts and litigators.

An analysis of *DFC Global* and *Dell* is beyond the scope of this article. The key point is that following those decisions, the general position in Delaware appears to be that merger price will generally be afforded significant, if not dispositive, weight in appraisal actions to determine the fair value of shares held in a public company which have been expropriated from minority shareholders following a robust, arms-length sales process.

This is unwelcome news for would-be arbitrage investors.

It should therefore come as no surprise that the number of appraisal actions coming before the Delaware courts in recent years mirrors our perceptive panellist's forecast. In 2016, a total of 85 appraisal cases were determined by the Delaware Courts. In 2017, that number fell to 62. In 2018, it fell again to 26. Last year, there were just 11. Whilst there may of course be additional policy and/or legal considerations informing the reasons behind this trend, the trend itself is clear.

Unlike Delaware, Cayman Islands law generally adopts a "loser pays" regime on costs. Further, dissenters can seek payment of a 'baseline' interim sum at the commencement of the litigation.

Fair Value in the Cayman Islands

The Cayman Islands is a procedurally attractive, user-friendly, and sophisticated jurisdiction that is becoming increasingly well-versed in heavily contested appraisal litigation.

The Cayman Islands equivalent to Section 262 of the Delaware General Corporation Law can be found in Section 238 of the Companies Law, which provides that *"a member of a constituent company incorporated under this Law shall be entitled to payment of the fair value of his shares upon dissenting from a merger or consolidation."*

By way of overview, the principles governing the meaning of fair value in the Cayman Islands can broadly be stated as follows: Fair value is intended as a form of compensation, reflecting an economic exchange of the rights and obligations attaching to the shares, for cash; fair value applies both to the dissenters and to the company; excluded from the assessment of fair value are the benefits and burdens of the merger transaction itself; "fair" adds the concepts of just and equitable treatment, and flexibility, to "value"; minority

[1] *DFC Global Corp. v. Muirfield Value Partners, L.P.,* 172 A.3d 346 (Del. 2017).
[2] *Dell, Inc. v Magnetar Global Event Driven Master Fund Limited* 177 A.3d 1 (2017) (Del. 2017).

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shareholdings are to be valued as such (although that does not necessarily mean that a discount must always be applied); and it is the shares themselves that are to be valued, not a pro rata share of the going concern (although, as will be seen, the *methodology* used to value the shares has, to date, always centred around an analysis of the value of the going concern).

Fair Value Determinations: The Picture So Far

As the Grand Court expressly noted in *Nord Anglia*, so far there is no precedent in the Cayman Islands for placing primary or sole reliance on the market price in any of them. Instead, the methodology adopted by the Court has always taken into account valuation conclusions arrived at by reference to the value of the relevant going concern.

Four recent decisions are of note. In the first decision, DCF was afforded a 75% weighting (with market price afforded 25%). In the second, DCF was afforded a 100% weighting (as agreed by the parties). In the third, DCF was afforded a 50% weighting (with market price afforded 50%). In the fourth, DCF was afforded a 40% weighting (with merger price afforded 60%).

Advantages

There are additional advantages for investors engaged in Cayman Islands share appraisal litigation. The three most obvious examples are the costs regime, the interim payments regime, and the rate of interest to be paid to the dissenters upon the determination of fair value.

Costs

Unlike in the US, where the parties are responsible for their own legal fees irrespective of the outcome of the proceedings, the starting point in the Cayman Islands is that the losing party pays the costs of the prevailing party.

While there some nuances, broadly speaking the successful dissenters will in the ordinary course be able to recover their reasonable legal and expert fees.

Interim Payments

It is now settled that the Cayman courts have jurisdiction to award interim payments within the context of Section 238 proceedings.[3] This means that dissenters are entitled to receive advance payment on account of the fair value sum that is ultimately determined by the Court to be payable to them.

Unlike in Delaware, therefore, dissenters need not be kept out of the money whilst the fair value proceedings run their course, creating a "war chest" in effect. This is obviously advantageous from a cash flow perspective. Taken together with a costs regime, payment of a 'baseline' fair value sum in advance of judgment significantly de-risks the investment from the outset.

Interest

Under Section 238, dissenting shareholders are to be paid a fair rate of interest. To date, the approach taken by the Cayman Islands courts in ascertaining a fair rate of interest is consistent with the practice in Delaware. This is reflected by the Grand Court's decision, affirmed by the Court of Appeal in *Shanda*,[4] in which the Judge adopted a midway point between the rate of interest representing the return that a prudent investor could have made on unpaid appraisal monies, and the rate of interest that the company would have had to pay in order to borrow the equivalent sum.

Looking Forward

It Is likely that share appraisal proceedings will be featuring more prominently in the Cayman Islands. This is perhaps unsurprising given that this complex area of law is, at least compared with the Delaware jurisprudence, still in its infancy. Further, determinations of fair value will always be highly fact sensitive.

While there is undoubted overlap between the jurisdictions, there are also significant differences, and this is never more evident than the types of Cayman Islands incorporated companies availing themselves of the Cayman Islands merger regime. To date, the vast majority of these companies have been listed in the US but have their centre of operations in the People's Republic of China. Cayman Islands appraisal litigation has seen arguments deployed, and in certain instances accepted by the Cayman Islands courts, regarding the US market's perception of such companies. In any event, given the Grand Court's continued application of the DFC valuation methodology, the landscape for share appraisal litigation remains wide open.

[3] *In re Qunar* (Unreported, 20 June 2018; CICA No 23 of 2017, on appeal from FSD 76 of 2017 (RPJ)).

[4] *In re Shanda Games* (Unreported, 25 April 2017; FSD 14 of 2016 (NSJ)).

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HUMAN RESOURCES LEVERS TO DRIVE TRANSACTION VALUE

REHAN FAROOQ and JOHN SCHULTZ
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Historically, an uncertain business climate precipitates a surge in business activity. As companies emerge from the COVID-19 crisis, we anticipate pent up demand for merger and acquisition (M&A) activity that will resume as leaders seek to lower operating costs, face consolidation or rethink ways to maintain market share and achieve growth targets.

CFOs are tasked with maximizing the value of any transaction. In addition to maintaining focus on cash management,[1] the CFO should also be leading cost reduction initiatives in anticipation of M&A activity. One area the CFO should not overlook in these efforts is human resources (HR). Often, the HR function is viewed only through the lens of payroll, leading to missed savings opportunities. In fact, finance leaders have multiple levers at their disposal to maximize transaction value and reduce costs associated with HR.

Who's on the Team? Strategies to Optimize Your Organization

Changes to the employee roster are inevitable during a transaction, but those changes must be strategic and aligned with business objectives. COVID-19 has placed renewed focus on what is truly critical to business continuity; these roles must be retained and appropriately incentivized. For this group, consider an incentive and retention program so the business can remain operationally efficient while minimizing the risk of losing critical employees. In addition to the overarching program, consider retention bonuses for roles critical to realizing synergies that are key to a transaction's value proposition.

On the other hand, some employees' roles may not be necessary in the 'new normal,' or may overlap across the combined business; different strategies are more appropriate for this group. Providing a Volunteer Early Retirement Program (VERP) and pausing Secondment Programs are recommended initial actions to rapidly create value. In addition, pay special attention to severance policies – those must be contemplated as you develop your new as-is business case.

Always consider your contractor footprint or the proverbial "shadow workforce." Every time you end or postpone discretionary projects, you are sending a message to employees, including contractors, who in many cases sit in key roles. If they are not sufficiently engaged or feel alarmed, they will leave, taking valuable knowledge and expertise with them.

Be careful about instituting blanket hiring freezes as they give the appearance of a massive house-cleaning and lay-offs. Implementing a hiring strategy that remains focused on acquiring critical capabilities is a better strategy. Build protocols to ensure that management reviews and approves all new hires, as most separation committees want to see their weekly hiring progress as they begin filling new roles for the organization.

When deciding on appropriate strategies to manage your employee footprint, you must cut through the clutter:

- Which employees are truly critical? Where would turnover be most costly or disruptive?
- If you are in the midst of an event, do you have permission to communicate with critical employees to assess capabilities and align strategies? Most organizations (i.e., sellers) will not allow external parties (i.e. buyers) to directly engage with their employees. Often, these agreements must be jointly worked out between a subcommittee that

[1] See COVID-19 checklist for CFOs at: https://www.alvarezandmarsal.com/insights/navigating-impacts-covid-19-alvarez-marsals-management-guidelines-cfos

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is empowered to make recommendations on employment matters. Having a full list of tools at your disposal to properly incentivize and attract critical employees and consistently and fairly deal with others is vital.

- Incentives won't trump engagement. Be prepared to engage impacted functions and teams; allow them the opportunity to be a part of the process of creating a new, unified organization.
- Transactions take time and endurance. Consider incremental goals to maintain motivation and tie concrete incentives to measurable goals and outcomes.

The CFO should be ready to provide guidance to functional leaders on how to creatively manage their employee rosters and rewards packages, and data, systems and platforms in a way that creates value and positions the business for growth.

What's the Benefit? Rethinking Total Rewards Strategies

The total employee cost, including base compensation and fringe benefit programs, should be reviewed to identify cost reduction opportunities. Retirement plans can also be a source of significant savings and should not be overlooked. Before amending employee contracts, CFOs should work closely with their legal department to ensure they comply with regulatory mandates, especially for companies operating under international jurisdictions or that have union workers.

Compensation

Finding savings opportunities in broad-based compensation is a highly analytical exercise. During most transactions, CFOs set a compensation strategy that reflects the needs of the business and maintains market competitiveness. This includes benchmarking against peers and developing a comprehensive approach to short-term incentives, long-term incentives and total compensation.

Access to benchmarks and actuarial data will greatly assist in this process. Benchmarking analysis includes reviewing compensation data for comparable organizations to see if your organization is at, above, or below market ranges. In tandem with this external benchmarking exercise, internal benchmarking where employee compensation for similar jobs is compared can help identify outliers and determine if current salary levels are justified. Additional metrics such as total HR spend per employee can be developed to further understand operational inefficiencies. These metrics should also be benchmarked externally. Combined, these analytical outputs provide management with additional information that enable "right-sizing" their departments without breaking a process, negatively impacting employee engagement or destabilizing operations.

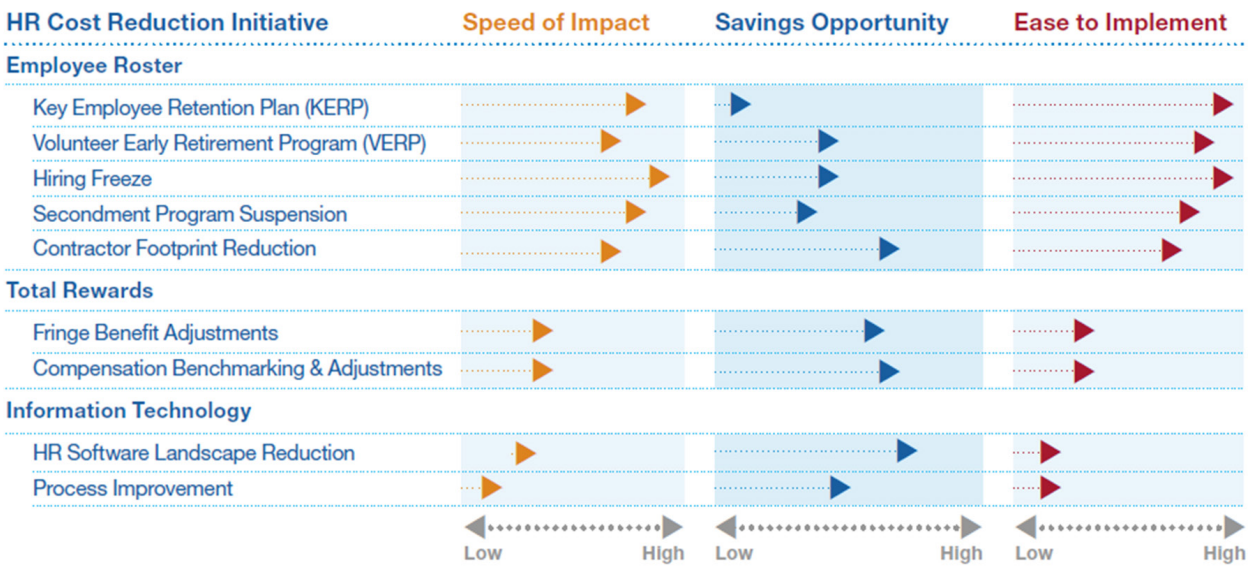
Benefits Plans

Health and welfare plans are not all created equal. Each plan has underlying assumptions around cost sharing and mitigation that should be reviewed and challenged. To implement cost reduction opportunities, you may need to select new providers, or stand up new plans. Health and welfare benefit program changes often rely on the expiration of legacy contracts in order to switch to a lower cost provider; however, some fringe offerings can be reassessed on shorter notice. For example, time off policies (e.g. vacation, sick, holiday, etc.), can be condensed into a single bucket with a uniform accrual calculation. The terms of these benefit programs, such as rules around carryover allowances, can also be altered to reduce the company's financial liability, but any changes need to be done keeping an eye on state law requirements, which vary state to state.

Consider the effective date of your transaction. Will changes to benefits require open enrollment? Will they require employees to live in a state of ambiguity and conduct two enrollments? Can you receive reports on current selections and share them with the new benefits providers? From our experience, drastic benefits changes can cause more unease – if the business demands it, there must be a strong communication plan with town halls, access to leadership, benefits coordinators and materials to take home. If the effective date is mid-period, consider the impact to legacy balances to HSA, FSA, 401(k) and deductibles. These are real issues that must be discussed and pondered to ensure employees are upright.

Simplifying the System - What Platform Wins?

Transactions present an opportunity to build a platform for growth. Every employee will touch your future HR system, either for personal data, employee events, time entry, payroll and/or training. CFOs should understand the baseline costs of all their "people" systems and recognize data as a valuable source of value creation. Picking the right system and tools will enable operational efficiency; picking the wrong one will destroy value, create a "manual headache," perpetuate unsustainable data flows, and create permanent reliance on expensive solution experts. Use the transaction as an opportunity to identify inefficient processes and systems and create a basic understanding of their costs to determine



Choose the appropriate HR levers to balance the required speed, savings and ease of implementation required.

opportunities for improvement. At a minimum, clients typically focus on automating their payroll, timekeeping, and learning management/training functions.

Data is the lifeblood of today's business. To enhance the material value that CFOs can realize from investments, consider how the existing application landscape and business processes accept new employee populations. Key HR processes such as onboarding, annual enrollment, payroll, performance reviews, and compensation changes should be top of mind as you contemplate making changes to the HR suite of software.

The Bottom Line

CFOs looking to capitalize on the expected increase of M&A activity should not underestimate the value that can be unlocked from the HR function in terms of both cost reduction opportunities and optimization of organizational structures. Successful transactions leverage HR as an enabler to position the company for growth. CFOs who don't overlook the contributions that HR can make will be rewarded with greater deal-value that only strengthens the organization's future position.

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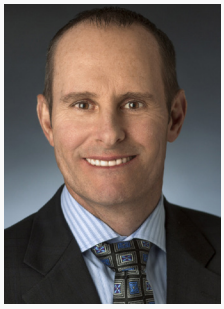

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THE ALTMAN Z SCORE DOES NOT PREDICT BANKRUPTCY

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Among insolvency practitioners, the Altman Z Score ("AZS") enjoys a reputation as a valuable indication of bankruptcy risk. That influence has allowed the AZS to play a role in court decisions on financial distress.[1] This article shows that the AZS does not work. In a large sample of U.S. publicly traded firms from 2000-2019, the AZS has no ability to classify firms accurately into those that will and will not file for bankruptcy in the next one or two years. The measured correlation between AZS and bankruptcy incidence is zero. The false positive rate of AZS is 98%. That is, a firm with a "bad" AZS has less than a 2% chance of going bankrupt. This makes the AZS unreliable for predicting bankruptcy.

Altman's work was part of an effort in the late 1960s to use financial ratios to predict bankruptcy. Researchers hypothesized that financial ratios that provided advanced warning of financial distress ought to, if effective, predict when firms will file for bankruptcy and when they will not. Early work by Tamari (1966),[2] Beaver (1966, 1968a, 1968b)[3] and Altman (1968)[4] found that firms that filed for bankruptcy protection had worse financial ratios, on average, than those that did not. Altman's (1968) analysis became the best-known ratio-based bankruptcy prediction model. Altman found that five financial ratios could, in a particular statistical model, separate bankrupt from nonbankrupt firms in a pre-selected and balanced sample with an equal number of bankrupt and nonbankrupt firms. Altman's ratios are (1) working capital/total assets; (2) retained earnings/total assets; (3) earnings before interest and taxes/total assets; (4) market value equity/book value of total debt; and (5) sales/total assets.

From the start, however, accounting and financial researchers recognized that the Altman method did not actually predict bankruptcy. As just one critic, Johnson (1970),[5] put it, Altman Z-scores are only "largely descriptive statements devoid of predictive content ... Altman demonstrates that failed and non-failed firms have dissimilar ratios, not that ratios have predictive power. But the crucial problem is to make an inference in the reverse direction, i.e., from ratios to failures." Altman had not developed a way of determining whether a company was likely to go bankrupt, but instead whether a certain kind of statistical analysis known as discriminant analysis could, when presented with a set of bankrupt firms and a set of "matched" firms known not to go bankrupt, use financial ratios to sort the firms into their correct categories of bankrupt or not. For this purpose, the statistical analysis is powerful. The error noted by early academic critics was the inference that Altman suggested: that the same ratios can be used to predict whether a given firm *not already known to be bankrupt or not* would go bankrupt.

That is, while discriminant analysis can distinguish bankrupt from non-bankrupt firms when the number of each kind of firms is approximately the same and the non-bankrupt firms have been selected because they were healthy and not distressed, this is practically never the question of interest in a real-world bankruptcy prediction problem. In the real world, the question is whether a firm that appears to be in some amount of financial distress is likely to go bankrupt. Users of the AZS fall into Altman's error, confusing the probability of having bad financial ratios *given* that a firm filed for bankruptcy versus the probability of filing for bankruptcy *given* that the firm has bad financial ratios. As shown below, predicting that a given firm with bad financial ratios or a bad Altman "Z" score will go bankrupt is a bad prediction rule. In the real world, most all firms with bad financial ratios (and Altman scores that predict bankruptcy) do not go bankrupt.

Data and Findings

All data is from Bloomberg Terminal. Bloomberg provides calculations of the AZS in the function "AZS."[6] For each year 2000 to 2017, I download data for all Russell 3000 firms as of the last trading day of each calendar year. I remove financial companies from the sample since Altman has described Z Score

[1] See, for example, *Gernandt v. SandRidge Energy Inc.,* No. CIV-15-1001-D, 2017 WL 3219490, at *2 (W.D. Okla. July 28, 2017) ("During this time, SandRidge's Z-Score was 0.12[.]"); *Power Integrations, Inc. v. Fairchild Semiconductor Int'l, Inc.*, No. 09-CV-05235-MMC, 2017 WL 2311249, at *2 (N.D. Cal. May 26, 2017) ("Further, Power Integrations has submitted evidence that ONs 'Altman Z-Score,' a 'standard method by which to predict future bankruptcies', was, as of April 2017, 1.60, which places ON 'in Distress Zones' and 'implies bankruptcy possibility in the next two years'"); *In re Empresas Inabon, Inc.,* 358 B.R. 487, 506 (Bankr. D.P.R. 2006) ("Robert Morris parameters and ZScore reflected a 'highly real risk' operation. The Altman ZScore was negative, minus 3.3").

[2] Tamari, M. 1966. Financial Ratios as a Means of Forecasting Bankruptcy. *Management International Review*, 6(4), 15-21. While not directly addressing Altman's work, Tamari's work showed sensitivity to the problem addressed here.

[3] Beaver, W.H. 1966. Financial Ratios as Predictors of Failure. *Journal of Accounting Research*, 1966, 71-111; Beaver, W.H. 1968a. Alternative Accounting Measures as Predictors of Failure. Accounting Review, 43(1), 113-222; Beaver, W.H. 1968b. Market Prices, Financial Ratios, and the Prediction of Failure. *Journal of Accounting Research*, 6(2), 179-192.

[4] Altman, E.I. 1968. Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy. *Journal of Finance*, 23(4), 589-609.

[5] Johnson, C.G. 1970. Ratio Analysis and the Prediction of Firm Failure. *Journal of Finance*, 25(5), 1166-1168. See also Moyer, R.C. 1977. Forecasting Financial Failure. *Financial Management*, 6(1), 11-17.

[6] Inclusion as a function in Bloomberg Terminal is evidence of the continuing demand for the AZS among even the most sophisticated financial market participants. This article shows that demand to be unjustified, at least on predictive ability.

Table 1			
Occurrence	AZS < 1.81	1.81 < AZS < 2.99	2.99 < AZS
Full Data Set	4,621	4,320	16,501
Bankrupt w/in 1 Year	46	8	5
Not Bankrupt w/in 1 Year	4,575	4,312	16,496
Bankrupt w/in 2 Years	115	26	24
Not Bankrupt w/in 2 Years	4,506	4,294	16,477

Table 2				
Occurrence	Min AZS	Median AZS	Mean AZS	Max AZS
Full Data Set	-117.6	3.9	5.0	8,050.9
Bankrupt w/in 1 Year	-8.9	0.9	1.0	22.0
Not Bankrupt w/in 1 Year	-117.6	3.9	5.0	8,050.9
Bankrupt w/in 2 Years	-13.8	1.2	1.1	22.0
Not Bankrupt w/in 2 Years	-117.6	3.9	5.0	8,050.9

as not appropriate for such firms and since some firms are considered "too big to fail." I also remove public utilities because, with rare exceptions mostly in California, these are not subject to bankruptcy. I remove real estate companies as well, including real estate investment trusts, because they hold substantial debt against assets. I also remove firms with no reported debt. All of these deletions should increase the power of the AZS to predict bankruptcy if it has predictive power.

I obtain bankruptcy dates for 2001 through 2019 from three sources: (1) Bloomberg Terminal; (2) the UCLA-LoPucki Bankruptcy Research Database,[7] and (3) searches on sec.gov. I also obtain total debt, price, return, index return, and equity market cap as of the year end date for each firm from Bloomberg Terminal. The final dataset contains 25,442 firm-year observations. There are 165 bankruptcies within two years of a given firm-year and 59 within one year. That is, just 0.65% of the firm-years are associated with a bankruptcy within two years and just 0.23% within one year, reflecting the serious "class imbalance" problem in bankruptcy detection: far more firms do not go bankrupt than do. This class imbalance problem is at the heart of the practical uselessness of AZS for predicting bankruptcy.

Table 1 sets out the distribution of AZS in the sample. The AZS thresholds are AZS < 1.81 for "distressed" firms predicted to go bankrupt, 1.81 < AZS < 2.99 as a gray zone where prediction is said to be difficult, and 2.99 < AZS which classifies firms safe from bankruptcy. Inspection of Table 1 is sufficient to prove that the AZS lacks the ability to distinguish firms that will go bankrupt within one or two years and those that will not. Fully 18% (4,621/25,442) of the dataset has AZS below the distress threshold, but 98% of those firms (4,506/4,621) do not file bankruptcy within 2 years; 99% of those firms (4,575/4,621) do not file bankruptcy within 1 year. **Table 2** presents additional data on the distribution of AZS in the sample. While the median, mean, and max AZS are lower for firms that go bankrupt, the minimum AZS are associated with firms that do not go bankrupt within one or two years. The correlation coefficient for AZS and a 0-1 indicator for bankruptcy within 2 years is -0.0055 and for 1 year is -0.0034. Both coefficients are effectively zero.

The likeliest explanation for the inability of AZS to predict bankruptcy is that financial ratios based on accounting data ignore market evidence of financial distress. Only one AZS variable - (4) market value equity/ book value of total debt - contains any direct market evidence. By contrast, published finance research (see, for example, Campbell, Hillscher, and Szilagyi (2008))[8] identifies several market-based variables that are related to financial distress: (1) the ratio of debt to the sum of market value of equity and total debt (an approximation, potentially poor however, to the ratio of book debt over the market value of assets); (2) a measure of the firm's year-to-date deviation from the market return; (3) the natural log of stock price; and (4) volatility of stock returns. In a statistical (probit model) estimation for one- and two-year bankruptcy, the AZS is statistically insignificant, while (1) the ratio of debt to the sum of market value of equity and total debt, (2) a measure of the firm's year-to-date deviation from the market return, and (3) the natural log of stock price are all reliably significant (volatility is not). Significantly greater accuracy is possible with variables that are more

[7] See https://lopucki.law.ucla.edu/.

[8] Campbell, J.Y., J. Hillscher, and J. Szilagyi. 2008. In Search of Distress Risk. *Journal of Finance*, 63(6), 2899-2939.

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informative of market indications of deep insolvency.[9] But the AZS is useless as a predictor.

Conclusion

Despite its difficulty, accurate bankruptcy prediction would be of value in a number of contexts. Potential creditors do not want to lend money they will not be able to collect, and their prospects for collection - both as to amount and timing - will depend in part on whether the company is likely to file for bankruptcy around the time the debt is due. Existing creditors want notice as early as possible that a borrower is at significant risk of filing for bankruptcy. Credit analysts and credit rating agencies must have the ability to employ reliable bankruptcy predictors, lest they deem a company creditworthy that files for bankruptcy embarrassingly quickly after their pronouncement. Shareholders of all varieties, from long-term investors to high-frequency traders, and from longs to shorts, take positions that may be bear more or less bankruptcy risk than they otherwise believe. Others with exposure to a company – vendors, tort claimants (such as those wronged by dangerous chemicals or utility-caused wildfires), and employees and communities – all have good reasons to want early and accurate warnings of company bankruptcies that impact them. The Altman Z-Score, however, is unreliable.

[9] See, for example, the variables identified in Heaton, J.B. 2019. Simple Insolvency Detection for Publicly-Traded Firms. *Business Lawyer*, Vol 74(3), 723-734.

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EXPERT PITFALLS — AND WAYS TO AVOID THEM[1]

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This article summarizes a panel discussion on various issues regarding the use of experts in litigation. The lawyers raised a set of questions about the role of experts from their perspective as litigators, and the experts on the panel together with the lawyers led the discussion. The article presents the views of the litigators on the panel, which the experts clarified but need not have agreed with certain perspectives about their role in litigation.

I. EXPERT RETENTION

■ **Attorneys should not wait until after fact discovery is closed to find an expert.** Intended testifying experts should be hired as soon in the litigation process as possible. For example, one of the litigators on the panel asked if the expert should help shape the "winning theory of the truth" and help structure discovery efforts to support the litigation thesis. The attorney also may need help with mandatory preliminary disclosures under rule 7026. Attorneys do not want to be in a situation where fact discovery is closed, and they lack the necessary data or other information to support the opinion they would like the expert to be able to give. If third party discovery is necessary to obtain such information, it can take a long time; and if third-party discovery is required from foreign entities, it can take an especially long time. Start early.

■ **Experts should be able to defend the basis for their opinions and assumptions.** While an expert should not be an advocate, the expert must be able to defend the basis for his opinions. Nothing is more crucial to the case. Attorneys should talk through the main issues with prospective experts before retention, and then develop a relationship with the expert so that he or she can defend his or her findings and assumptions.

■ **Attorneys should pick an expert who is an effective communicator in court.** It doesn't matter if the expert knows more about the subject matter than anyone in the world or has written the definitive papers on the subject at hand, if she or he cannot explain the subject matter and his or her opinions to the trier of facts. Storytelling can be just as important as the opinions, analyses, and results, especially in jury trials.

■ **Attorneys must be due diligence experts.** An example is a case where an expert stated that he has a graduate degree from a prestigious university. It turns out that the expert did not graduate from this university at all. His degree was from an affiliated professional organization. The judge overseeing the case noted that the matter would go to weight and not admissibility. *(Mastr Adjustable Rate Mortgages Trust 2006-OA2 et al v. UBS Real Estate Securities Inc.)*

■ **Attorneys need to be aware of any skeletons in the closet**. Explore the prospective expert's prior testimony on issues that relate to those likely to be the subject of expert testimony in the case. Has the expert taken positions that cannot be distinguished? Do not assume that sealed and confidential materials will not make it out. In addition, publications, presentations, and other engagements should be scrutinized and reviewed.

Likewise, experts should be forthcoming about potential issues/inconsistencies that may arise in a case.

- One example is an expert being targeted for unrelated prior experience in industries or with companies that have a negative stigma. This could include previous engagements for the tobacco industry, for instance. Although the effectiveness of this kind of approach is uncertain, this tactic may be more prevalent in a jury trial.

■ **In a multi-party case, attorneys should sign on to the expert engagement.** In a case with several parties having a common interest, it is more economical and often tactically more sensible to utilize a single expert; but, do not assume that the party hiring the expert will still be in the case come trial. In the event one party settles, all remaining parties may continue to rely on and call that expert at trial.

■ **In a multi-party case, attorneys should be careful before calling more than one expert to testify about the same thing.** Calling multiple witnesses to testify on the same topic may lead to inconsistencies in testimony.

Good examples:

- *TOUSA* – Experts worked hand in glove with counsel. There were 3-4 reports that all reflected back on one another with no contradictions.

[1] This paper was submitted with materials for a panel presentation at VALCON2020, February 26-28, 2020. Reprinted with permission.

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- *Chemtura* – Debtors called a soup-to-nuts valuation expert at plan confirmation; UCC called an industry expert who supported key but narrow points of the debtors' witness.

II. EXPERT PREPARATION – PRE-TRIAL

■ **Attorneys should consider hiring additional support for the team and the expert.** Even the best testifying expert does not necessarily have the skills, capacity, and staff necessary to provide all of the support the case may require. One way of addressing this issue is to hire a "consulting expert" who will typically take pressure off the expert by assuming responsibility for supporting counsel with the development of expert strategy, identifying key documents, preparing for expert and fact witness depositions, creating trial exhibits and other demonstratives, and ensuring start-to-finish quality control. In addition, consulting experts can be used to prepare preliminary analyses or test alternative methodologies that will not then be subject to discovery in expert deposition.

■ **Witnesses should not let the attorney write their report.** Rather, the witness should guide the team/attorneys and obtain whatever is needed to prepare the report. Attorney should provide the witness with full access to discovery (either directly or by requesting documents) and the witness should communicate any such discovery needs to the attorneys.

- Attorneys also need to keep the witnesses on track as to deadlines and submission responsibilities. There have been instances of experts going to the movies and even foreign countries at the last minute.

■ **Attorneys should make sure the testifying expert has done enough work to credibly present the case.** To be sure, financial experts almost always are supported by teams who do a substantial amount of the legwork. But it is not effective advocacy for the testifying expert not to be able to explain an aspect of or a source cited in the expert report because someone on the "team" did the work. Ultimately, the witness needs to own the work and be intimately familiar with the details. This can be a concern with inexperienced experts and sometimes academic experts.

- An example is a case in which the expert designed and conducted a consumer survey but later admitted in deposition to having no training in survey design methods and no experience with surveys. The opposing side put forth a *Daubert* motion. In addition to precluding and identifying the expert to be unqualified. The presiding judge found the expert's methods and results to be demonstrably unreliable, starting with the questions in the survey, the execution of the survey, and the interpretation of the results. *(The State of New York and City of New York v. United Parcel Services.)*

■ **In a case with multiple experts, attorneys should be cognizant of cross-reliance among the work of experts.** Attorneys should consider how interconnected the work of the experts is. How might an error or flaw in the work of one expert affect the opinions of the other experts? Additional preparations may be to include alternative scenarios or approaches that can be divorced from relying on other experts.

- There have been instances where a portion of an expert's report is stricken and the cascading effect is to render large portions of other experts' reports null and void, potentially including the estimation of damages. This could be partially warded off by employing multiple methods for estimating damages based on varying data sources and calculations.
- An example is a case in which an expert's loss causation analysis and results were a vital component for another expert to estimate loss causation damages. The presiding judge found the loss causation expert's work to have no reliable basis as the expert failed to properly control for the variable under review and did not demonstrate clean benchmarks. The opposing side's motion to exclude was granted – the collateral damage was to strike the corresponding opinions of the damages expert. *(Federal Housing Finance Agency v. Nomura Holding America, Inc, et al.)*

■ **Attorneys should make sure the expert is fully prepared for the deposition.** Do not assume that the other side is simply interested in hearing the expert's story, setting up an exclusion motion, and "locking in" the expert's testimony. Experienced litigators often view the expert deposition as the best time to launch a full throttle assault on the witness. They understand that in that setting, there are only upsides and if the expert is not fully prepared, they can obtain enough admissions that their trial cross-examination is already in the can.

■ **Witnesses must stay in their lane.** The witness should know their expertise and stick to it. It is not necessary to make the factual case or try to "win" at the deposition.

■ **Witnesses should not speculate and should beware of the hypothetical.** Whether at the deposition or trial, the witness should never guess. If the witness does not understand the question or the question is vague, misleading, or assumes a fact that is not true, the witness may ask for the question to be rephrased. If a witness is asked a question they don't know the answer to or is presented with an unfamiliar document, sometimes "I don't know" or "I haven't seen this document before" are sufficient and appropriate answers.

■ **Attorneys need to be prepared to defend against Daubert or equivalent motions.** The opposing side will do everything possible to disqualify an expert or at least strike portions of his or her report and testimony.

- As an example, a veteran expert was found not to be qualified to proffer certain opinions in a case due to a lack of specialized knowledge of the subject matter. The expert's exposure to the topic was only through acting as an expert witness – there was no direct or hands-on experience either through research and publishing or practical involvement in the industry. *(Securities and Exchange v. Fabrice Tourre.)*

■ **Attorneys should make sure the expert has a basic understanding of the entire case, and not just an exhaustive understanding of the aspect he or she is testifying on.** Do not assume the expert's testimony will be narrowly confined to the contents of his or her expert report. If at deposition or at trial the expert is required to answer a key question in the case, he or she must have an understanding of the basic facts of the overall case. Not every judge will strictly enforce the "beyond the scope of direct" objection. As Tom Stoppard famously observed, Rosencrantz and Guildenstern died because, as bit characters, they didn't understand the overall plot of *Hamlet*. Avoid that fate.

III. EXPERTS AT TRIAL

■ **Attorneys must know their expert.** When prepping experts, the attorney should make sure he or she understands how the expert thinks and tailor questions accordingly. It does not go over well if the attorney's own expert does not understand the question the attorney is asking.

■ **Attorneys and experts must know their audience.** It is good practice for the attorney to observe the judge and educate the expert as to the way the judge conducts his or her courtroom and his or her experience with the specific type of expert testimony that is being presented. For example, Judge Isgur (Hon. Marvin Isgur, Southern District of Houston) will start doing calculations in real time, on the bench, so the expert should be prepared to assist in that process. Some judges will require experts to respond to their direct questioning with yes or no answers while others allow some latitude. Providing these types of insights to your expert can help avoid anxiety before and during testimony.

■ **Attorneys should not ask the proverbial question they do not know the answer to.** Doing so can ruin an otherwise effective examination or cross-examination.

■ **If using technology or carrying out any type of demonstration, attorneys and witnesses should make sure it is well rehearsed.** Remember anything that can go wrong, probably will.

■ **Attorneys should be careful that demonstrative exhibits are not capable of being easily edited to serve the purposes of the other side.** It is a highly effective trial technique to take a magic marker and turn the other side's demonstratives into the centerpiece for your own case.

■ **Attorneys should try to make points through the content of their questions on cross-examination but should not expect to make their case through the testimony of the other side.** Attorneys should not try to make their case through the mouth of the expert on the other side, but should be cognizant of the opportunity to use cross-examination to make their point and potentially preview closing argument. Nonetheless, attorneys should be fearful and humble in examining the other side's experts at trial. There is a reason why the other side chose their expert and why he or she is being paid big bucks. The attorney's goal is to score whatever points he or she is certain can be achieved and to get the other side's expert off the stand.

■ **Attorneys should monitor potential conflicts of interest**. Questions regarding an expert's unpaid invoices and large accounts receivables may raise questions of potential bias.

Valuation Meets the Amazing Kreskin: VALUING CONTINGENT ASSETS AND LIABILITIES[1]

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I. INTRODUCTION

Balance sheets and financial reporting rely on Generally Accepted Accounting Principles ("GAAP") that follow relatively imprecise rules for reporting contingent and unliquidated liabilities and assets. Bankruptcy courts and courts applying insolvency laws generally, such as the uniform fraudulent transfer statutes, do not apply GAAP, but only use a GAAP balance sheet as a starting point.[1]

The definition of insolvency is referred to generally as the "balance sheet" test. *HomePlace of American, Inc. v. Salton, Inc. (In re Waccamaw's HomePlace)*, 325 B.R. 524, 529 (Bankr. D. Del. 2005).

> To label it a "balance sheet" test may be a misnomer. Financial statements prepared in accordance with [GAAP] do not record assets at fair market value. Instead, they are recorded at the historical, original purchase cost and reduced each year by an estimate of depreciation. Within the contemplation of § 101(32) "property" may include assets not even listed on the balance sheet. Debts are recorded only to the extent that they are known and quantifiable; many nonrecorded liabilities usually surface in an insolvency analysis. [T]he balance sheet is only the starting point in the analysis.

Travelers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.), 180 B.R. 389, 405 n.22 (Bankr. D. Del. 1996), *rev'd in part on other grounds*, 134 F.3d 188 (3d Cir.), *cert. denied*, 523 U.S. 1138 (1998); *Lids Corp. v. Marathon Inv. Partners, L.P. (In re Lids Corp.)*, 281 B.R. 535, 540 (Bankr. D. Del. 2002) ("This standard for solvency is typically called the 'Balance Sheet Test.'"...However, this may be a misnomer because the Balance Sheet Test is based on a fair valuation and not based on [GAAP], which are used to prepare a typical balance sheet."); *Sierra Steel, Inc. v. Totten Tubes, Inc. (In re Sierra Steel, Inc.)*, 96 B.R. 275 (Bankr. 9th Cir. 1989) (GAAP inapposite to solvency calculations).

II. CASES HARMONIZE SOLVENCY CALCULATIONS UNDER STATE AND FEDERAL LAW

Comments by the Uniform Law Commission show that the definition of "insolvent" in both the Uniform Voidable Transactions Act (UVTA) and the Uniform Fraudulent Transfer Act (UFTA) derives from the Bankruptcy Code's definition of insolvent in section 101(32)(A). Further, UVTA and its predecessors direct judges to apply and construe its provisions to "effectuate its general purpose to make uniform the law with respect to the subject of this chapter among states enacting it." UVTA § 13; UFTA § 11; *see In re Hinsley*, 201 F.3d 638, 643 (5th Cir. 2000) (interpreting provisions of UFTA by relying on interpretations of similarly worded Bankruptcy Code provisions). Similarly, the uniform act instructs that "the principles of law and equity, including the … law relating to … insolvency, supplement its provisions." UVTA § 12. "To accomplish this requirement, the court takes into account existing case law and evaluates how courts have analyzed the statutory interpretation question presented here." *Waller v. Pidgeon*, 2008 U.S. Dist. LEXIS 44238, *15-16, 2008 WL 2338217 (N.D. Tex. June 5, 2008). These and many similar authorities guide courts to borrow from other states' decisions under UVTA, UFTA as well as the Bankruptcy Code to address similar fact patterns.

An analysis of (a) contingent liabilities and (b) the provisions of UVTA or UFTA may intersect where a creditor holding a contingent liability seeks to avoid a transfer. Under both UVTA and UFTA, a creditor can avoid a "transfer or obligation to the extent necessary to satisfy the creditor's claim." UVTA § 13; UFTA § 11; *see Am. Sur. Co. of N.Y. v. Conner*, 251 N.Y. 1 (1929). This federal-state harmony also means that the Bankruptcy Code's and UFTA/UVTA's definition of "creditor" will confer standing on a creditor with contingent claims. Where a creditor with contingent claims attempts to avoid a transfer, a court may need to determine the present value of the contingent claim. *See Burkhart v. Genworth Fin., Inc.*, No. 2018-0691-JRS (Del. Ch. Jan 31, 2020) ("[A]llowing creditors with unmatured claims to bring claims under the Act may require the court to undertake the challenging exercise of assessing the present value of such claims.").

III. DETERMINING WHETHER A LIABILITY IS CONTINGENT

Valuing liabilities and assets of unknown value requires distinguishing between "contingent" and "unliquidated." A decision from the *In re All Media Properties, Inc.* bankruptcy case serves as the touchstone for much of the law on whether a liability is contingent or is merely unliquidated. 5 B.R. 126 (Bankr. S.D. Tex. 1980), *aff'd* 646 F.2d 193 (5th Cir. 1981). The *All Media* court referenced pre-Code practice when it held that contingent liabilities include those that become payable only upon the occurrence of an extrinsic event reasonably contemplated by the company and its creditor:

> Under § 59b of the Act, a claim was not necessarily rendered contingent as to liability merely because

[1] This paper was submitted with materials for a panel presentation at VALCON2020, February 26-28, 2020. Reprinted with permission.

> it was unmatured. For example, in *Matter of Myers,* 31 F. Supp. 636 (E.D.N.Y. 1940) the court held that a holder of notes could properly be a petitioning creditor even though some of the notes were not due until after the involuntary petition was filed, because the obligation was "absolutely owing" at the time of the filing. ….Where no additional act or event need have occurred before liability attached, then liability was considered to be non-contingent. *In re Trimble Company*, 339 F.2d 838, 844 (3rd Cir. 1964).

Id. at 132; *see also id.* at 133 ("The court concludes that claims are contingent as to liability if the debt is one which the debtor will be called upon to pay only upon the occurrence or happening of an extrinsic event which will trigger the liability of the debtor to the alleged creditor and if such triggering event or occurrence was one reasonably contemplated by the debtor and creditor at the time the event giving rise to the claim occurred."). (emphasis added.)

Courts across the country summarize the *All Media* test as a "trigger" test: "[C]ourts have applied the "triggering event" test to determine whether a debt is contingent." *Imagine Fulfillment Servs., LLC v. DC Media Capital, LLC (In re Imagine Fulfillment Servs., LLC)*, 489 B.R. 136, 148 (Bankr. S.D. Cal. 2013) (applying chapter 13 precedent to a chapter 11 case) ("[A] creditor's claim is not contingent when the `triggering event' occurred before the filing of the chapter 13 petition.")

Contingent claims therefore do not include unmatured claims, unliquidated claims, and disputed claims. *See All Media*, 5 B.R. at 133. ("just because a claim is unliquidated, disputed or unmatured apparently does not mean it is contingent."). Courts recognize this distinction and routinely differentiate contingent claims from those that are unmatured, unliquidated, or disputed. *See, e.g., In re Covey*, 650 F.2d 877, 881, n. 6 (7th Cir. 1981) *In re Turner*, 32 B.R. 244 (Bankr. D. Mass 1983) (same); *In re First Energy Leasing Corp.*, 38 B.R. 577, 581 (Bankr. E.D.N.Y. 1984) (citing *In re Chateaugay Corp.*, 944 F.2d 997, 1004 (2d Cir. 1991)).

In additional to contingent liabilities, a company may have contingent assets. That is, a company may acquire rights to payment after the occurrence of a triggering liability event. These contingent payment rights should be considered as assets of the company. *See R.M.L.*, 92 F.3d at 156. Under the *R.M.L.* decision and other decisions, the valuation method for contingent assets mirrors the valuation method for contingent liabilities, and both sides of the balance sheet must be taken into account. For example, *Mellon Bank, N.A. v. Metro Communications., Inc.*, 945 F.2d 635, 648 (3d Cir. 1991), holds that the balance sheet analysis has to incorporate both the liability and any offsetting asset related to the liability—such as an intercompany guaranty and a right of contribution should be valued as pairs. *See id.*

IV. THE CONTINGENT LIABILITY DECISION MATRIX

Decisions from a variety of jurisdictions inform the proper valuation of contingent claims. *See, e.g., In re Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988) ("the asset or liability must be reduced to its present, or expected, value before a determination can be made whether the firm's assets exceed its liabilities"); *see also Basic, Inc. v. Levinson*, 485 U.S. 224, 229 (1988) (adopting a valuation test from *SEC v. Texas Gulf Sulphur*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969), that materiality of a contingent corporate event is determined by balancing probability of event occurring against its anticipated magnitude); *Smith v. Commissioner*, 198 F.3d 515, 525 n. 40 (5th Cir. 1999) (deciding issues under the Internal Revenue Code) ("Discounting a contingent liability by the probability of its occurrence is good economics and therefore good law.") (quoting *Covey v. Comm. Nat. Bank of Peoria*, 960 F.2d 657, 660 (7th Cir. 1992)).1 The *Xonics* decision, now renowned and accepted by bankruptcy courts almost without exception, held that a company must value its contingent liabilities for the purposes of solvency:

> It makes no difference whether the firm has a contingent asset or a contingent liability; the asset or liability must be reduced to its present, or expected, value before a determination can be made whether the firm's assets exceed its liabilities. *See, e.g., Syracuse Engineering Co. v. Haight*, 97 F.2d 573, 576 (2d Cir. 1938) (L. Hand, J.); *In re Ollag Construction Equipment Corp.*, 578 F.2d 904, 909 (2d Cir. 1978); *In re Fulghum Construction Co.*, 7 B.R. 629, 632-33 (Bankr. M.D. Tenn. 1980), *aff'd*, 14 B.R. 293 (M.D. Tenn.1981); *In re Hemphill*, 18 B.R. 38, 48-49 (Bankr. S.D. Iowa 1982). […] Occasionally one finds the flat statement that "contingent or inchoate claims of the bankrupt are not included as part of the bankrupt's property." *Allegaert v. Chemical Bank*, 418 F. Supp. 690, 692 (E.D.N.Y.1976). This is the equally untenable opposite extreme from valuing them at their face amount.

Valuation opinions err when the opinion adopts a company's estimate of a liability or asset without more. In *Tronox Inc. v. Kerr McGee Corp. (In re Tronox Inc.)*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013), the fairness opinion used to inform the board of directors' approval of the transaction drew this criticism:[2]

> After four pages of caveats and conditions, Houlihan's opinion was that "the fair value and present fair saleable value of the Company's assets

2 A court commits reversible error by excluding liabilities from the insolvency calculation merely because the liability is contingent or because the debtor disputes the claim. *See e.g., In re Sierra Steel, Inc.*, 96 B.R. 275, 279 (9th Cir. B.A.P. 1989); I*n re Tronox Incorporated*, 503 B.R. 239, 313 (Bankr. S.D.N.Y. 2013); *see also In re Ollag Construction Equipment Corp.*, 578 F.2d 904, 909 (2d Cir. 1978).

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> would exceed the Company's stated liabilities and identified contingent liabilities." However, as to the critical issue in this case – the amount of Tronox's contingent liabilities – Houlihan simply took Kerr-McGee's number and used it. As stated in the Houlihan "solvency opinion," *"The term 'identified contingent liabilities" is defined to mean "the stated amount of contingent liabilities identified to us and valued by responsible officers of the Company, upon whom we have relied without independent verification; no other contingent liabilities have been considered."*

503 B.R. at 287 (emphasis added).

The *Covey v. Comm. Nat'l Bank* decision provides an excellent hypothetical of how to value contingent liabilities from the debtor's perspective. 960 F.2d at 660. Building a demonstrative from a company's obligations under an upstream guarantee, the Seventh Circuit states:

> The Bankruptcy Code requires us to assess things from the debtor's perspective. Consider a simple case. Debtor issues its note for $10 million. It has assets of $5 million, secured debt of $2 million, and no other debt. From the creditor's perspective this note is worth somewhat less than $3 million. (Collection is costly and uncertain.) Together, Debtor's creditors place a value of less than $5 million on its commitments. Nonetheless, Debtor is insolvent. Against assets of $5 million, there are claims of $12 million. Now turn the $10 million note into a guarantee of a parent corporation's $50 million debt, coupled with a probability of 20% that Debtor will be called on to pay. The two commitments are economically equivalent: $10,000,000 = $50,000,000 × 0.2. The creditor will treat each instrument as worth a little less than $3 million. There is no reason not to treat the promises identically from Debtor's perspective too. Each commitment renders the firm insolvent by creating aggregate claims exceeding its assets. If we use net assets as the maximum value of a contingent liability, it follows that no contingent liability ever renders any firm insolvent. A $5 million note issued by a firm with $4 million in assets propels the firm into insolvency, but a $5 *billion* guarantee by the same firm, on which the beneficiary is 99% certain to draw, would not: instead of multiplying $5 billion by 0.99, the court would multiply $4 million by 0.99. Yet all would concede that, from the debtor's perspective, the guarantee is more costly than the unconditional note.
>
> (Consider: What happens if the firm unexpectedly receives an enormously valuable patent shortly after issuing the note or the guarantee? Which of these instruments will the equity owners more regret signing?)

Id.

a. The Good Faith Estimate Method

Under the first valuation method (the "Good Faith Estimate Method"), a bankruptcy court may consider the debtor's good faith estimate of the liability at the time of the transfer. *See Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L. (In re R.M.L.)*, 92 F.3d 139, 156 (3d Cir. 1996) ("[A] court looks at the circumstances as they appeared to the debtor and determines whether the debtor's belief that a future event would occur was reasonable.") (citing *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

This method relies heavily upon the company's credibility. A bankruptcy court may modify the company's valuation of contingent assets, if the court disputes the reasonableness of the company's forecasts:

> Far from "hindsight" or "*post-hoc*" analysis, a court looks at the circumstances as they appeared to the debtor and determines whether the debtor's belief that a future event would occur was reasonable. The less reasonable a debtor's belief, the more a court is justified in reducing the assets (or raising liabilities) to reflect the debtor's true financial condition at the time of the alleged transfers.

R.M.L., 92 F.3d at 156.

Several bankruptcy courts outside of the Third Circuit have embraced the Good Faith Valuation Method:

> [The] use of hindsight gives a false picture of the company in 1994 and early 1995 and is inappropriate.
>
> The court concludes that the fair value of a contingent liability is properly determined by multiplying total debt guaranteed by the probability that the debtor would be required to make good on the guarantee. [*Covey v. Comm. Nat. Bank of Peoria*,] 960 F.2d at 659–60. The court further concludes that this evaluation must be made as of the date of the valuation and without the benefit of hindsight. Based upon the evidence adduced, the probability that WRT would be called under the Tricore guaranty was *de minimus*.

WRT Creditors Liquidation Trust v. WRT Bankruptcy Litig. Master File (In re WRT Energy Corp.), 282 B.R. 343, 400 (Bankr. W.D. La. 2001); see also *Jimmy Swaggert Ministries v. Hayes (In re Hannover Corp.)*, 310 F.3d 796, 802 (5th Cir. 2002) (addressing a solvency valuation) ("Second, its adoption [referring to a valuation argument based on hindsight] would, by permitting the exercise of judgment in hindsight, conflict with basic economics and with Fifth Circuit caselaw."); *Official*

Asbestos Claimants' Comm. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.), 274 B.R. 230, 262 (Bankr. E.D. La. 2002) ("Under the present circumstances in which the court is attempting to determine the amount of future asbestos liabilities for determining B & W's solvency as of July 1, 1998, *the court cannot use hindsight* and can only determine whether the predictions by B & W were reasonable under the circumstances existing at the time they were made. Applying that standard, the court concludes that B & W's estimates were reasonable and thus the plaintiffs have failed to carry their burden of proving that B & W was insolvent.") (emphasis added); *see generally* Israel Shaked and Robert F. Reilly, *A Practical Guide to Bankruptcy Valuation*, 50 (ABI, 2d ed., 2017) ("The analyst's use of hindsight in the bankruptcy valuation is typically discouraged. Judicial finders of fact seem to adopt the so-called `known or knowable principle' with regard to the analyst only using information that was knowable as of the defined valuation date.") (cited in *Weinman v. Crowley (In re Blair)*, 588 B.R. 605, 622–23 (Bankr. D. Colo. 2018)).

b. The Hindsight Method

Under the second valuation method (the "Hindsight Method"), a bankruptcy court may consider events subsequent to the time of valuation in lieu of the Good Faith Estimate. The National Association of Certified Valuators and Analysts publication has stated that the Hindsight Method provides the benefit of accuracy:

> Some courts have allowed hindsight to be used when it is available to value…later resolved disputed liabilities…. [T]he benefit of using hindsight in situations where the disputed liability has become fixed by the time that a transaction is challenged is accuracy. In the case of a disputed liability that existed at the time of the transaction—as compared to a contingent one—all the facts giving rise to the claim had already occurred. All that remained was the final resolution of that claim—by settlement, by arbitration, or by a judgment from a trial court. If a final resolution has occurred, one must wonder what reason there might be to make an expert make a "prediction" about the amount of the claim. Allowing the use of hindsight relieves all parties, including the expert, from having to make a theoretical determination of fair value, thereby removing at least one variable of uncertainty in the overall insolvency analysis.

Valuing Contingent or Disputed Assets and Liabilities at pp. 5-6, *quoted* in *Allonhill, LLC v. Stewart Lender Servs. (In re Allonhill, LLC)*, 2019 Bankr. LEXIS 1304 at *155-156, (Bankr. D. Del. April 25, 2019).

Numerous decisions endorse the use of post hoc information to inform retrospective valuations. The Tenth Circuit Court of Appeals, in *Gillman v. Scientific Research Prods., Inc. (In re Mama D'Angelo, Inc.)*, determined that a court may consider subsequent developments in valuing liabilities:

> We are mindful of the authority to the effect that fair valuation ordinarily must be made from the vantage of a going concern and that subsequent dismemberment should not enter into the picture. *See 2 Collier on Bankruptcy* 101.32 (1995); *Cissell v. First Nat'l Bank of Cincinnati*, 476 F.Supp. 474, 484 (S.D. Ohio 1979) (a company's assets must be valued at the time of the alleged transfer and not at what they turned out to be worth at some time after the bankruptcy intervened); *Mutual Sav. & Loan Ass'n v. McCants*, 183 F.2d 423 (4th Cir. 1950). But we "may consider information originating subsequent to the transfer date if it tends to shed light on a fair and accurate assessment of the asset or liability as of the pertinent date." *In re Chemical Separations Corp.*, 38 B.R. 890, 895-96 (Bankr. E.D. Tenn. 1984). Thus, it is not improper hindsight for a court to attribute current circumstances which may be more correctly defined as current awareness or current discovery of the existence of a previous set of circumstances. In this case, even Scientific's witnesses acknowledge a current "discovery" or "awareness" of circumstances then in existence: "most of the problems were inherent with the original construction of the plant which, you, would have been there as of [the] day we moved into the plant," and management had "stuck millions upon millions of dollars fruitlessly into this facility." Circumstances did not change between July and the November shut- down date; it simply took management a few months to "discover" and became "aware" of those circumstances that existed beginning in July.

55 F.3d 552, 556 (10th Cir. 1995); *see also Payne v. Clarendon Nat'l Ins. Co (In re Sunset Sales, Inc.)*, 220 B.R. 1005, 1016–17 (B.A.P. 10th Cir. 1998) (hindsight proper to value assets by referring to price paid for assets in bankruptcy sales and adjusting the value upward to account for depreciation of the assets between valuation date and sale date, where debtor was deemed on its "deathbed" at the time of the transfers); *Canney v. Fisher & Strattner, LLC (In re Turner & Cook, Inc.)*, 507 B.R. 101, 109-110 (Bankr. D. Vt. 2014); *SEC v. Antar,* 120 F. Supp. 2d 431, 434, 443-44 (D.N.J. 2000); *In re W.R. Grace & Co.*, 281 B.R. 852, 869 (Bankr. D. Del. 2002) ("The Tenth Circuit summed the governing principle up, holding that the courts 'may consider information originating subsequent to the transfer date if it tends to shed light on a fair and accurate assessment of the asset or liability as of the pertinent date. Thus, it is not improper hindsight for a court to attribute current circumstances which may be more correctly defined as current awareness or current discovery of the existence of a previous set of

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circumstances.'") (quoting *D'Angelo*, 281 B.R. at 556); *Campana v. Pilavis (In re Pilavis)*, 233 B.R. 1, 7-8 (Bankr. D. Mass. 1999).

V. DISTINGUISHING CONTINGENT LIABILITIES FROM UNLIQUIDATED LIABILITIES

Cases distinguishing the *Xonics* opinion make a further, finer distinction that merely disputed or undetermined claims are *not* contingent claims—justifying the use of the Hindsight Rule. In *In re W.R. Grace & Co.*, 281 B.R. 852, 869 (Bankr. D. Del. 2002), the district court defined the approach used in both *Xonics* and *R.M.L.* as the "Probability Discount Rule." 281 B.R. at 858 ("discounting a contingent liability by the probability of occurrence is good economics and therefore good law, for solvency") (quoting *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d at 650).[3] However, the *W.R. Grace* court rejected the application of the Probability Discount Rule to its solvency analysis in a fraudulent transfer action to value asbestos claims as of the time of the debtor's divestiture of its most profitable business unit.

Citing the *Antar* decision, the *W.R. Grace* court determined that no probability discount should be applied to the now known or estimated claims whether or not asserted at the time of the transfer. *See* 281 B.R. at 863. The court also cited *In re Howdeshell of Ft. Myers*, 55 B.R. 470 (Bankr. M.D. Fla. 1985), where the court noted that project completion costs had to be included at their actual amount—not their estimated amount—and rejected the debtor's plea of intervening unforeseen events, noting that the unanticipated increase was merely "an inaccurate estimate of the true cost as it, in fact, existed at the relevant time." *Id.* The court applied the Hindsight Rule to the insolvency calculation noting that the claims were now asserted and estimated in the bankruptcy case using epidemiological and statistical experts. No probability discount should apply to value non-contingent claims as of the date of the transfer. *Id.* at 864.

3 Each of the *Xonics, R.M.L.* and *Covey v. Commercial Nat'l Bank of Peoria* cases involved estimates of indemnity of guaranty claims that had not been triggered. 281 B.R. at 865.

VI. CONCLUSION

The two primary valuation methods for contingent liabilities—the Good Faith Estimate Method and the Hindsight Method—can be applied to both unliquidated and contingent claims that depend on the occurence of a triggering event. However, the Hindsight Method applies more readily to unliquidated claims and the Good Faith Estimate Method fits more aptly to truly contingent claims. Understanding the variations in the two methods and the distinction between contingent and unliquidated claims can make the difference between winning and losing.

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The VALCON2020 Panel*

The topic of this article was presented at VALCON2020, February 27, 2020, by the following panel:

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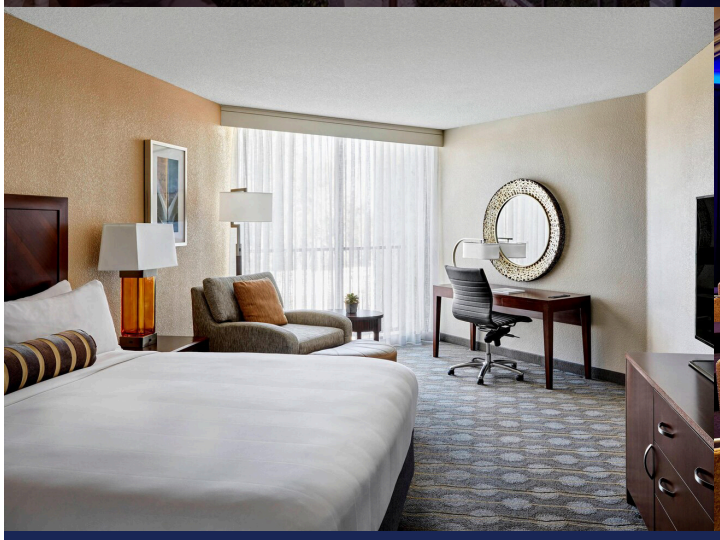
Moelis & Company

*The opinions expressed in this article are those of the author and may not represent the views of other panel members or their firms.

SAVE THE DATE: JUNE 9-12, 2021

37TH ANNUAL BANKRUPCTY & RESTRUCTURING CONFERENCE

Newport Beach, CA - Newport Beach Marriott Hotel & Spa



More information coming in early 2021!

AlixPartners and the Restructuring Community Mourn the Loss of Bob Dangremond

AlixPartners is saddened to report that our colleague and friend, **Bob Dangremond**, passed away on Friday, August 28th.

Bob joined AlixPartners in 1989, helping to build the firm's restructuring practice. In addition to being a Managing Director, he served as Vice Chairman of AlixPartners from 2009 to 2012, and Senior Adviser until 2016. Bob was instrumental in growing AlixPartners in both the US and Europe, having co-led the firm's US and European restructuring practices. He also served on the boards of TMA and INSOL.

Bob held interim management roles in many notable cases, including: Forstmann & Company (President and CEO); Harnischfeger (CRO); Mirant (CRO; named by TMA, "Most Effective Restructure of a Company within a Chapter 11 Reorganization"); Refco (CEO and CRO; earned Bob a headline in the New York Post: "Refco Installs Fixer"); Unisys (Treasurer); and Zenith (CFO and CRO; Bob's role was reported in *Wall Street Journal* and *Chicago Tribune*).

Bob is remembered by colleagues and friends for his patience, mentorship, and fantastic sense of humor.

MEMBER ON THE MOVE

Boris J. Steffen, CDBV, and Province, Inc. recently announced Boris has joined the firm as a Managing Director. With over 30 years' experience as a financial advisor and expert witness to holders of interests and claims on matters of accounting, finance, valuation and solvency, he has consulted in over $100 billion of mergers, acquisitions and restructurings across a spectrum of industries including aerospace, asbestos, auto, batteries, biotechnology, cable networks, chemicals, media, oil & gas, pharmaceuticals, power, retail, semiconductors, software, steel and telecom.

As such, his practice has included Special Litigation Committee service, acting as the independent accounting expert in post-closing working capital disputes, evaluating asset acquisitions and serving as an expert witness with respect to issues including the interpretation of accounting principles, allocation of costs, specificity of merger synergies, actual and constructive fraudulent transfers, and fair value, including before the Delaware Court of Chancery.

PRESS RELEASES

WILMINGTON, DE (September 24, 2020) -- Gavin/Solmonese LLC announced today that it has hired **Doug Wolfe, Esq.**, long-time General Counsel of a leading distressed-debt hedge fund strategy firm, to serve as a Managing Director in the firm's Corporate Recovery practice. Based in New York City and a member of the New York Bar Association, Doug specializes in complex debt restructuring with specific expertise in off-market transactions for distressed and bankrupt companies.

In his 14 years with the hedge fund, Doug oversaw more than a billion dollars of investments and successfully completed thousands of difficult-to-finance transactions with investors and funds in New York and across the country. His involvement in major cases, including the Madoff bankruptcy and that of Tribune Co., has earned him peer recognition and professional achievement industry-wide. Doug has helped negotiate and implement investments across the capital structures of distressed companies and has actively participated on Creditors' Committees, Equity Committees, and as Chairman of Post-Confirmation Litigation Committees. He has also presented on several American Bankruptcy Institute panels on the topic of claims trading.

COHNREZNICK WINS 2020 TMA TURNAROUND OF THE YEAR AWARD

New York, NY – August 13, 2020 – CohnReznick LLP, one of the leading advisory, assurance, and tax firms in the United States, announced that **Cynthia Romano** and **Chris Creger** of its Restructuring & Dispute Resolution practice have been awarded the prestigious Turnaround Management Association (TMA) 2020 Turnaround and Transaction of the Year Award. The award recognized their success as Chief Restructuring Officer in the turnaround and sale of Allentown, Pennsylvania-based Coordinated Health (CH). The award was won for the Middle Market category.

Cynthia Romano, Global Director of CohnReznick's Restructuring and Dispute Resolution practice, was hired as Chief Restructuring Officer (CRO) in April 2019. Over the course of eight months and having made the decision to restructure out of court, the team of Cynthia Romano, Chris Creger, and Joonam Hwang triaged cash, turned around operations, and monetized assets to create cash runway and return the company to positive EBITDA while convincing 800 secured and unsecured creditors to stand still without court protection.

Competitive and timing pressures ultimately made a sale the most attractive long-term solution for stakeholders and the turnaround made the transaction feasible. Lehigh Valley Health Network (LVHN) was selected after a comprehensive process. The CRO team worked with CH management, creditors, and, ultimately, LVHN to create and return significant value to all stakeholders, bolster this nationally ranked practice, and preserve 1,300 jobs.

CLUB 10

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

AlixPartners, LLP	**80**
FTI Consulting Inc.	**63**
Alvarez & Marsal	**54**
Ernst & Young LLP	**33**
Berkeley Research Group, LLC	**18**
Huron	**16**
Ankura Consulting Group, LLC	**16**
Conway MacKenzie, Inc.	**15**
Deloitte	**15**
PBGC	**15**
PricewaterhouseCoopers LLP	**13**
B. Riley Advisory Services	**13**
BDO USA, LLP	**13**
KPMG LLP	**12**
Office of the U.S. Trustee	**12**
SOLIC Capital Advisors, LLC	**10**

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