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AIRA Journal

WHAT'S INSIDE

AIRA Announces New Distinguished Fellows Program for Long-Standing Members with Exceptional Contributions to the Industry, see p.15

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NEW OWNERSHIP
FOR SALE | FOR LEASE

From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

As 2020 evolved, the AIRA experienced a heightened interest in CIRA and other programs focused on preparing professionals for the anticipated increase in distressed situations arising from COVID-19 related economic and social disruptions.

As time has played out, while there are significant areas of distress, government relief efforts and the general strength of the economy appear to have held off much of the economic wreckage that was initially anticipated.

In their February 1, 2021 survey report, William Blair & Company, L.L.C., who follows the consulting industry, reported that respondents to their fourth quarter 2020 survey expected more moderate demand for services compared to earlier in 2020, when almost 90% anticipated increased activity over previous periods by as much as 10%. In their latest survey, Blair reports 29% experienced increased demand of 5% or greater in 2020. These results are mirrored in a recent report on bankruptcy filings from Epiq AACER, who reported the overall number of chapter 11 filings in 2020 were the lowest since 1986. However, 2020 did see an increase in commercial chapter 11 filings of 29% over those in 2019.

As with so much that happened in 2020, comparisons of what actually came to pass and what may still be anticipated have provided a window for the turnaround and restructuring industry to gain some new perspectives. Professionals should be as prepared as possible for our next set of assignments in 2021. As a result of actions taken to meet the COVID-19 economic challenges, there have been changes in U.S. bankruptcy law and procedures that impact our clients and our assignments. Among those changes are new quarterly fee requirements of the Office of the U.S. Trustee, modifications to chapter 11 as contained in the Consolidated Appropriations Act, and new chapter 11 periodic reporting requirements that become effective for non-small business chapter 11 cases filed on or after June 21, 2021. I encourage members to keep an eye on the "Membership Alerts" tab on the AIRA website where we will endeavor to bring such changes to your attention as quickly as possible.

Changes are also occurring in our AIRA office. It is with a sense of sadness from me, and happiness for her, that I report Terry Jones, our Director of CIRA and CDBV programs, retired in early February. Since joining AIRA in 2001, Terry has been an institutional point of contact for AIRA's certification programs. She became the name, and if not the actual, then the figurative face of AIRA, to a significant portion of our membership. Terry's efforts have maintained the orderliness and integrity of the program, shepherding so many of our members through CIRA/CDBV courses, testing and certification. On behalf of the staff, the membership, and especially, Grant Newton, Tom Morrow, and myself: Terry, thank you for your skills, effort, and friendship these past 20 years…and enjoy your retirement!

Terry Jones

Another excellent series of articles follows. Stay safe and stay well.

Jim

A Letter from AIRA's President

DAVID BART, CIRA, CDBV

RSM US LLP

To AIRA's membership and supporters:

Welcome to 2021. As a new year begins, we look forward to a 2021 where we hope to be able to resume live activities at some point. AIRA is moving forward with programs, whether virtual or live, and planning for an active year ahead.

STAFF DEPARTURES – On behalf of the board and the membership, congratulations to Terry Jones on her retirement from AIRA. Terry was the Director of AIRA's CIRA & CDBV Programs for 20 years. Terry worked closely with Jim Lukenda, so please see Jim's letter in this issue of the *AIRA Journal* for more information. Terry, thank you from everyone for your many years of service!!

AIRA DISTINGUISHED FELLOWS PROGRAM – I am very excited to announce the new AIRA Distinguished Fellows program. AIRA's board of directors conceived this new program as a way to recognize the significant contributions AIRA's senior members have made to the art and science of corporate restructuring and to AIRA. Recognition as an AIRA Distinguished Fellow is intended as an academic and professional honor for those members who exemplify the highest level of excellence in professional practice and whose contributions have left a significant positive legacy to our profession and to AIRA. Members who are in good standing for at least ten years are eligible for nomination by any AIRA member, with endorsement referrals. The inaugural class of AIRA Distinguished Fellows will be inducted at the June 2021 annual conference. Thereafter, AIRA plans to announce a new class of Distinguished Fellows each June. The nomination process will be open throughout the year. Please see the website for more information.

EVENTS – AIRA's **37th Annual Bankruptcy & Restructuring Conference (AC21)** is scheduled for June 9-12, 2021 at the Newport Beach Marriott Hotel & Spa. As I write this letter, we are still hopeful that circumstances permitting, the annual conference will be our first live event since VALCON in February 2020. Please be aware that the annual conference may convert to a remote virtual environment due to the ongoing pandemic and/or employer responses that continue to severely limit travel. If the conference converts to a virtual program, it will be presented in a manner similar to our 2020 virtual annual conference, and our sessions will be spread throughout the month of June. Please watch the AIRA website and your AIRA member emails for further information.

Don't forget that **VALCON 2021** is scheduled in May 2021 and will be held virtually over the dates of May 5-13. Please see AIRA's website for more details.

Thank you to everyone who participated in the **16th Annual NYIC/AIRA Joint Bankruptcy and Restructuring Event** in January 2021. NYIC and AIRA provided a wonderful virtual event and had many participants and sponsors from across the country.

BOARD OF DIRECTORS – Finally, I want to thank our departing AIRA board members for their devotion to the organization and their many contributions. Thank you to John Policano, Martin Cauz, and Michael Goldstein for your service to AIRA. And we are pleased to welcome Gregory Fox, who joins AIRA's board of directors from Goodwin Procter in New York City. We look forward to working with you, Greg.

Stay healthy, and I wish you, your colleagues, and your families all the best in 2021.

David Bart

HOW THE AIRLINE INDUSTRY IS RESPONDING TO COVID-19'S CRIPPLING PUNCH

DAVID MILLER, CIRA, CDBV; JAMES CLARKE, and MICHAEL RUTNER
Alvarez & Marsal

INTRODUCTION

The airline industry faces a long, arduous path to recovery in the wake of the unprecedented disruption to passenger travel caused by the coronavirus pandemic. In early 2020, the COVID-19 virus quickly spread around the globe, devastating demand for air transportation and compelling governments to mandate travel restrictions. As airlines ramped down their business, most of them had no more than two or three months of liquidity, according to the International Air Transportation Association (IATA), but have since secured loans, bailouts and other funding options, while numerous international carriers have filed for bankruptcy protection. The crisis, which came suddenly, is global in nature with uncertain duration and consequently the recovery will likely be painfully slow, even with the relatively expeditious regulatory approval of several vaccines.

In the U.S., approximately 750,000 people work in the airline industry and another 500,000 work in the aerospace manufacturing sector. As a result of the crisis, approximately 32,000 employees have been furloughed or laid off in the U.S. as of October. While the $15 billion airlines received from the second stimulus package requires furloughed workers be reinstated, employees will again be at risk when the funding runs out. (As of publication, a third and possibly final round of stimulus grants and loans being ironed out by Congress could provide another $14 billion in aid for the airline industry.)

Contributing to the economic toll, many consumers won't be able to fly for some time due to unemployment and the new work-from-home protocols (which are likely to stay in place for the foreseeable future). Coming after many profitable years for U.S. airlines and significant balance sheet repair during the last decade, COVID-19 and its resulting impact on air travel will significantly affect the sector for years to come.

Travel and hospitality remain among the hardest hit sectors of this pandemic. Both industries involve high levels of social interaction and will likely only recover when the virus subsides to the point that people feel comfortable flying, dining out and staying in hotels. Until that happens, the broader travel and entertainment sectors are facing the grim reality of unprecedented business disruption.

While carriers have taken immediate steps to cut costs, Alvarez & Marsal (A&M) expects a phased recovery as the industry initially seeks bailouts, raises capital and substantially reduces flying schedules, aircraft fleets, and finally turns to longer term relief through restructuring and consolidation.

COVID-19'S IMPACT WAS SWIFT AND DEEP, FORCING IMMEDIATE ACTION

As the global aerospace industry is facing the greatest calamity in its history, it may suffer many years of sustained disruption and will require significant financial and operational restructuring to survive.

While the industry very successfully recovered from the financial recession of a decade ago, there have been warning signs in recent years that global profits and traffic were slowing and had passed their collective post-recession peak. From 2017 to 2019, the sector experienced a decline of net profits from $38 billion to $26 billion. In 2019, annual growth in passenger traffic rose by mere single digits, hinting at a slowing of what had previously been a very long, strong cycle tracing back to the end of the global financial crisis. As a result, several low-cost carriers filed for bankruptcy in 2019 and some larger, established airlines like Jet Airways in India also sought court protection.

When the pandemic hit, airlines immediately began to strategically cut costs by furloughing employees, encouraging early retirements, retiring aircraft and

Exhibit 1: Fewer global destinations have closed to international tourism in recent months.

70% PERCENTAGE OF WORLDWIDE DESTINATIONS WHICH HAVE EASED COVID-19 RESTRICTIONS	**27%** PERCENTAGE OF BORDERS CLOSED IN NOVEMBER 2020
65% PERCENTAGE OF BORDERS CLOSED IN JUNE 2020	**54%** PERCENTAGE OF BORDERS CLOSED OR PARTIALLY CLOSED IN NOVEMBER 2020

Source: UNTWO, December 2020.

deferring aircraft rents. Further, they have been forced to take historic actions to ameliorate their losses, such as severely cutting capacity, trimming executive compensation, and shifting passenger capacity to cargo capacity in some cases by removing passenger seats in passenger aircraft. Unfortunately, in most cases these decisions have proven largely insufficient, and industry players continue to seek opportunities to cut expenses. By late third quarter, American Airlines, United Airlines and JetBlue warned they could eventually lay off more than 70,000 employees combined, while Delta Air Lines and Southwest announced that they were working to avoid layoffs through voluntary retirements. However, Delta later warned it will follow suit with massive layoffs of its own, and American told its employees in February 2021 to expect 13,000 furloughs once the second stimulus package runs out. A third round of aid could prevent or delay a massive layoff.

In the meantime, carriers have been burning cash at an alarming rate. Airlines have reduced the $10 billion-a-month of burn in late March to approximately $5 billion per month in the third quarter of 2020 yet are expected to continue burning cash through Q2 of 2021. In June 2020, airlines' collective cash burn was $61 billion with an estimated loss of $39 billion, according to IATA. (The International Air Transport Association said airlines will likely have burned through more than $77 billion during the second half of 2020.) The organization now forecasts year-over-year industry passenger revenues will fall a staggering $500 billion in 2020. Additionally, the International Civil Aviation Organization (ICAO) expects air travel to remain well below pre-COVID levels through the end of 2024, even by its most optimistic scenarios. The industry's total losses in 2020 are projected to be $118 billion, according to IATA, with demand down 61% from 2019; that compares to a healthy profit of $26 billion in 2019.

In addition to cost cutting, airlines have sought to maintain liquidity through government aid or raising capital through debt issuances, secondary equity issuances, and sale leasebacks of owned aircraft. In the U.S., carriers raised a remarkable $47 billion of debt and equity capital through the end of the second quarter (excluding the Cares Act payroll and loan programs and significantly large sale leasebacks completed by carriers such as United and Delta) and recently there have been signs by the larger U.S. carriers to raise more capital in 2021. Globally, governments have made more than $180 billion available to help airlines weather the crisis, mainly in the form of loans, loan guarantees and wage concessions. However, the aid has been unevenly distributed by global region, with the U.S. airlines receiving the equivalent of 25% of such assistance and European airlines receiving about 15%.

According to the trade group Airlines for America (A4A) and its member companies, travel bans, passenger fears and a global recession are driving a sustained decline in demand. At a glance, these economic shocks are creating a historic crisis for the industry:

Travel Restrictions — In June 2020, 65% of countries were completely closed to international tourist traffic, and over 95% had some travel restrictions in place (Exhibit 1). By November, many countries, including the U.S., had relaxed some international travel restrictions, but more than two dozen countries still observe the strictest level of travel ban. Europe has lifted restrictions for intra-European travel, and while other countries have followed suit, a few, such as France and Germany imposed new country-wide lockdowns at the end of 2020 after facing a second wave of the pandemic. In January, the European Commission adopted a position that all non-essential travel should be strongly discouraged. And while restrictions have been loosening since the Spring of 2020, overall international passenger volume was still down over 60% versus 2019, evidence of travelers' continued reticence to fly. Domestically, travel was down 58% in January 2021 while international air travel was down 63%.

Evaporating Demand — As passenger fears over travel safety have intensified, global net revenue bookings have fallen dramatically, dropping 90% in the U.S. at the outset of the pandemic and remaining nearly 60% below their pre-crisis levels.

Continued from p.7

Global Impact — While the downturn began in Asia, it quickly became a global phenomenon, striking every major travel region and evincing only modest recovery since March 2020.

Macroeconomic Recession — The virus is causing a sharp global economic downturn of the broader economy, contributing directly to lower industry demand.

Uncertain Future — The impacts of the COVID-19 pandemic continue into 2021, and travelers may be reluctant to book flights until the crisis and its associated risks are resolved (and even for a period of time thereafter).

CAPACITY AND PASSENGER TRAFFIC DECREASED INSTANTLY AND REMAIN LOW

Demand for travel and aircraft capacity plunged swiftly at the outset of the pandemic crisis and has not yet recovered (Exhibit 2). A sharp decrease in air travel is still evident as year-over-year bookings for future flights have dropped from about a 7% year-over-year gain in January 2020 to approximately a 79% year-over-year decline in June (and near that level in July), which still represented a modest improvement from the nadir of a 89% year-over-year decline in mid-April.

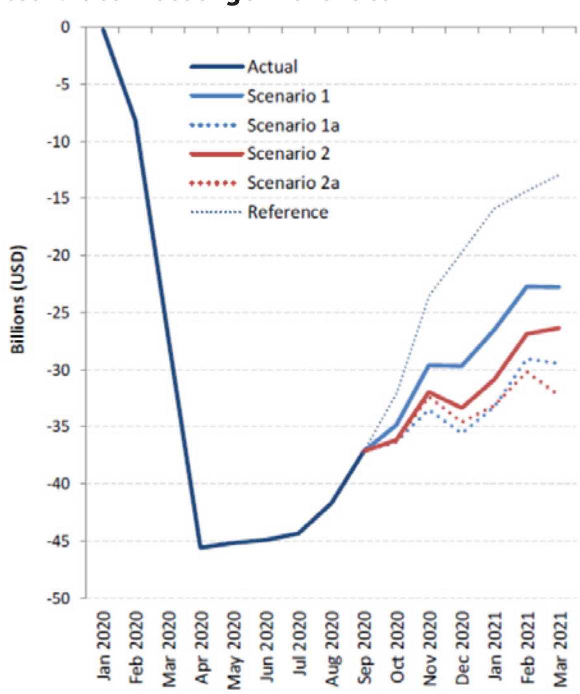
Across almost all metrics, capacity and demand reached unprecedented lows during this crisis. Global impacts include:

- Year-over-year demand in China declined to negative 87% five weeks into the crisis but is down only 3% today, while European capacity remains down 75% from a year ago. And while U.S. capacity improved by November to 28,000 flights per day, that level of flying remains a fraction of the roughly 110,000 daily flights before the crisis.[1]
- By January 2021, year-over-year U.S. domestic passenger volumes were down 58% and international flights down 63%.[2]
- The weekly average number of passengers processed through TSA checkpoints daily reached a trough of 95,000 during the week of April 11-17. Since then, passenger volume recovered slightly to 665,000 in July and surpassed 1 million passengers during key weeks around the holidays before falling back down to approximately 700,000. In comparison, the pre-COVID weekly average was about 2.4 million passengers.[3]
- While the decline of demand for future U.S. air travel seems to have plateaued in June, passenger traffic is still down about 66% and revenue has decreased 61% from pre-pandemic levels.[4]
- Nearly 40% of the U.S. aircraft fleet remains idle. At the peak of the crisis in May, 52% of the fleet was grounded. The largest portion of idle aircraft are

[1] ARC Travel Demand, arccorp.com; Airlines for America (A4A), airlines.org. November 2020.
[2] A4A, January 2021.
[3] Transportation Security Administration, tsa.gov. November 2020.
[4] ARC Travel Demand, November 2020.

Exhibit 2: Passenger demand and revenues will be depressed for some time.

Forecasted Global Passenger Revenues



Scenarios depend on the duration of the pandemic, degree of consumer confidence, and economic conditions:

- **Baseline: counterfactual scenario, in which the COVID-19 pandemic does not occur, that is, originally planned or business as usual**
- **Scenario 1: two (2) different paths (similar to Nike swoosh- and W-shaped)**
- **Scenario 2: two (2) different paths (similar to U- and L-shaped)**
- **Reference: information only, based on latest airline schedules (similar to V-shaped)**

Source: ICAO estimates based on ICAO ADS-B, OAG, ICAO-ICM MIDT, ICAO LTF, ICAO RCA, IATA Economics, and IMF Economic Outlook.

larger widebody and older aircraft, such as B777s and in the case of Delta, MD80 and MD90s.[5]

Airlines are taking significant steps to reduce capacity, relegating entire fleets to long-term storage or part-out programs. For example, British Airways, the largest operator of 747-400s, grounded its entire 747 fleet of 31 planes in July because of the pandemic, four years earlier than it had planned.

A CURRENT SNAPSHOT OF THE INDUSTRY AND WHERE IT'S HEADING

When the impact of the 9/11 attacks hit the airline sector, it took the industry four years to recover to its pre-9/11 revenue. Throughout that time, capacity lagged behind pre-crisis levels. By contrast, following the global financial crisis that began in 2008, the industry only took one year to recover. How long the current shock will impact carriers until they are able to return to 2019 revenue levels is yet to be seen, but it is theorized that this particular impact is so devastating that it could take much longer than a year or two to resolve (Exhibit 3).

Passenger traffic will likely return slowly, with high paying business travelers lagging the return of vacationers and those visiting friends and family. Business travel and entertainment expenses are often cut in a crisis and are unlikely to quickly return to pre-pandemic levels once the crisis is over.

We expect that the post-pandemic recovery of the airline industry will be long and will play out in two or more phases before the sector fully recovers. Below are some highlights of how we anticipate the recovery to unfold over the next few years. Note that this overview is predicated on a number of factors, including how long it will take for passengers to feel safe flying again.

Overall effect of COVID-19 on the industry: Through 2020, IATA estimates the industry's year-over-year loss in passenger revenue is over $500 billion, an unprecedented blow for the sector. In October, the organization provided an even grimmer outlook for 2021 as it lowered its industry revenue projection for the year by 25%, saying it expects total revenues to be negative 49% compared to 2019 levels. As a result, it is likely that there will be a number of airlines that will be forced to restructure, liquidate or merge all or parts of their operations with more stable or larger airlines.

A&M has modelled traffic scenarios for different industry segments and geographic regions and envisions different recovery scenarios for narrow-body and wide-body aircraft, and substantial impacts on the aerospace supply chain.

Restructuring landscape and supply chain impacts: During this ongoing recovery period, we expect to see a multi-phased response in the aviation industry, characterized by bailouts and initial capacity reductions to be followed by deeper restructurings, insolvencies and structural changes in capacity.

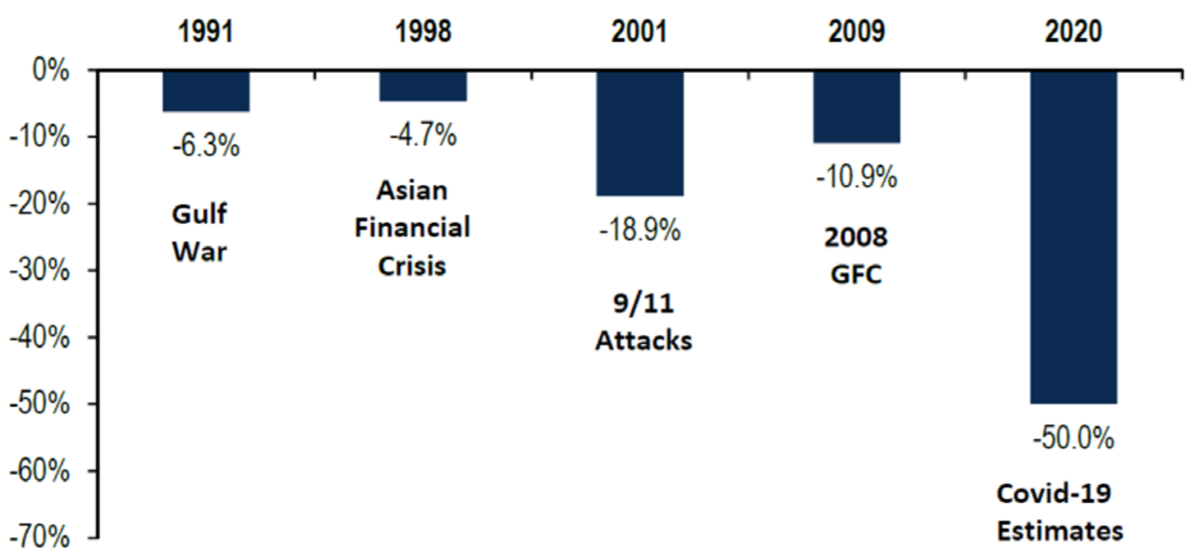
Suppliers are also expected to experience a potential wave of restructuring and insolvencies, and those that are prepared to sustain lost revenues, excess inventory and potential defaults are far more likely to survive the ongoing turbulence.

Impact on production and maintenance, repair and overhaul (MRO) volumes: Several senior aerospace industry executives have informed A&M that they are focused on minimizing cash outflow and beginning to

5 masFlight, masflightbigdata.com, November 2020.

Exhibit 3: Airlines have weathered shocks to the sector, but none so deep as the present crisis.

Largest U.S. Carrier Capacity Reductions Year-over-year



Source: BofA Global Research, IATA

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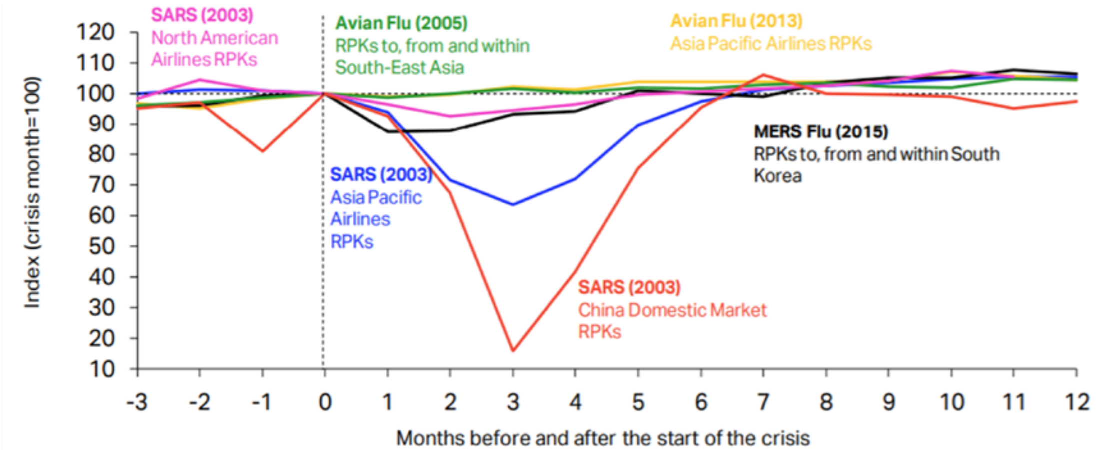
Exhibit 4: Recovery from the impacts of COVID-19 will be longer than previous outbreak crises.

Impacts of Past Disease Outbreaks on Aviation



Source: IATA – COVID-19 Updated Impact Assessment.

plan for restructuring. Despite having a record pre-pandemic backlog, manufacturers have needed to slash production rates, indicating the depth of the demand slump that is now directly affecting the supply chain.

By comparison, however, spending on aircraft for defense has shielded demand in the near term, though it is uncertain whether continued disruptions in the commercial sector and related supply chain will bleed over into the broader manufacturing sector.

In sum, the road to recovery for the industry depends on many factors, including the public's sentiment about air travel, how soon effective vaccines can be distributed, and how deep the supply chain disruptions ultimately impact the sector and whether these disruptions can be easily overcome.

RECOVERY TIME AND THE FUTURE FINANCIAL IMPACT

IATA predicts that the financial impact on the industry will be long and painful, anticipating that 2020 will be the worst year in the history of the industry for airlines. In October, it estimated that the sector will experience $130 billion in losses and $500 billion in total passenger revenue losses. Significant sector losses will continue (though to a lesser extent) in 2021 (Exhibit 4).

By contrast, during the 2003 SARS outbreak, passenger demand took approximately 6 months to return to pre-SARS levels. However, as a deeper secular economic recession is expected to follow the COVID-19 crisis, unemployment and the loss of discretionary income may affect more of the population. Additionally, the altered business traveler behavior may have a more profound effect on the global airline sector and related verticals, and IATA has thus extended its prediction for the industry's recovery to not occur until 2024.

SCENARIO MODELING INDICATES HOW DIFFERENT REGIONS AND ROUTE TYPES MAY RECOVER

Traffic recovery scenarios are expected to be very different depending on the region and types of flights. Not all regions are recovering. For example, while China's domestic routes have been restored, long-haul flights across Asia are still mostly nonexistent.

To gain insight into the potential shape of the recovery, A&M modelled traffic and capacity by revenue passenger kilometres (RPKs) and available seat kilometers (ASKs) to determine possible recovery scenarios for the industry in light of the global crisis (Exhibit 5).

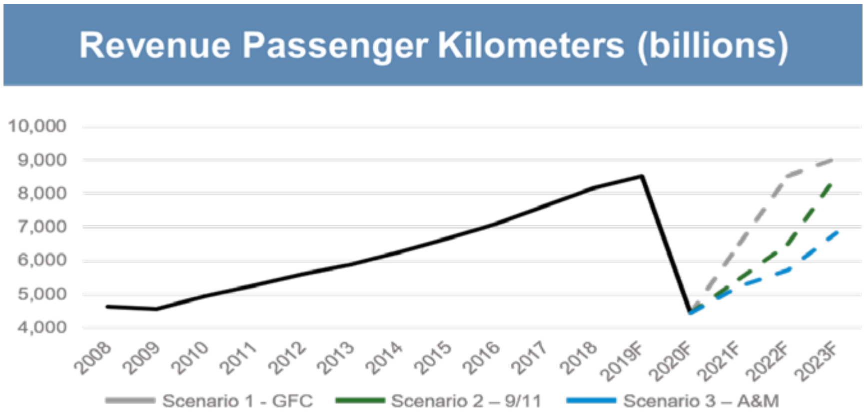
Under the RPK scenario modelling, A&M looked at major global traffic routes, comparing recovery curves following the global financial crisis of the mid-2000s, the 9/11 attacks and the current pandemic crisis. This model overlaid the current IATA estimated reduction in traffic of 48% through the rest of 2020 and beyond. In comparing the different scenarios, recovery was quicker (more 'V-shaped') after the 2008 financial crisis, but much slower (more 'U-shaped') after the 9/11 attacks. The model expects the post-COVID-19 recovery to be longer, returning to pre-crisis levels by 2022 or 2023. A significant driver of recovery will be the broad distribution of recently approved vaccines for COVID-19.

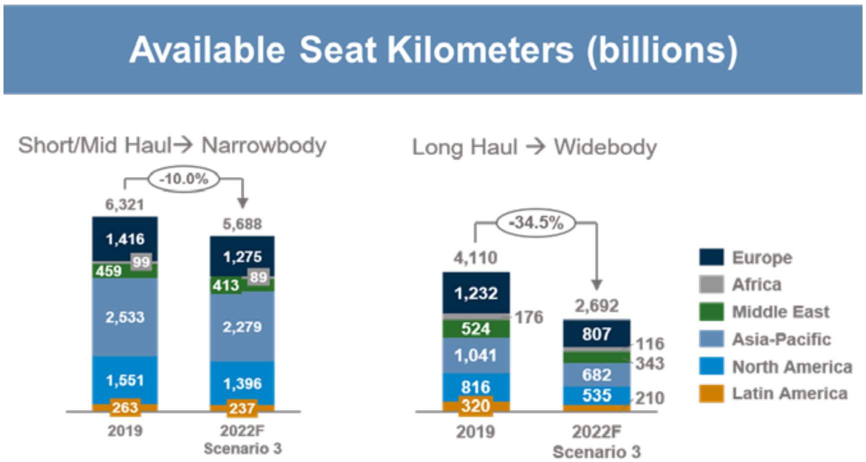
The model also predicts a faster recovery of short-haul and intra-regional traffic as restrictions are lifted, but a slower recovery for long-haul traffic to a revised lower peak as significant capacity reductions and prolonged suppressed passenger demand are expected. A&M expects 2023 passenger demand to still be about 20% below pre-pandemic levels.

The ASK scenario model looks at impacts on capacity and activity, which vary by region and fleet types, and appear to be in line with current OEM production

Exhibit 5: Recovery will differ based on region, route type and size of aircraft.

Traffic and Capacity Model Scenarios by Region and Route Type



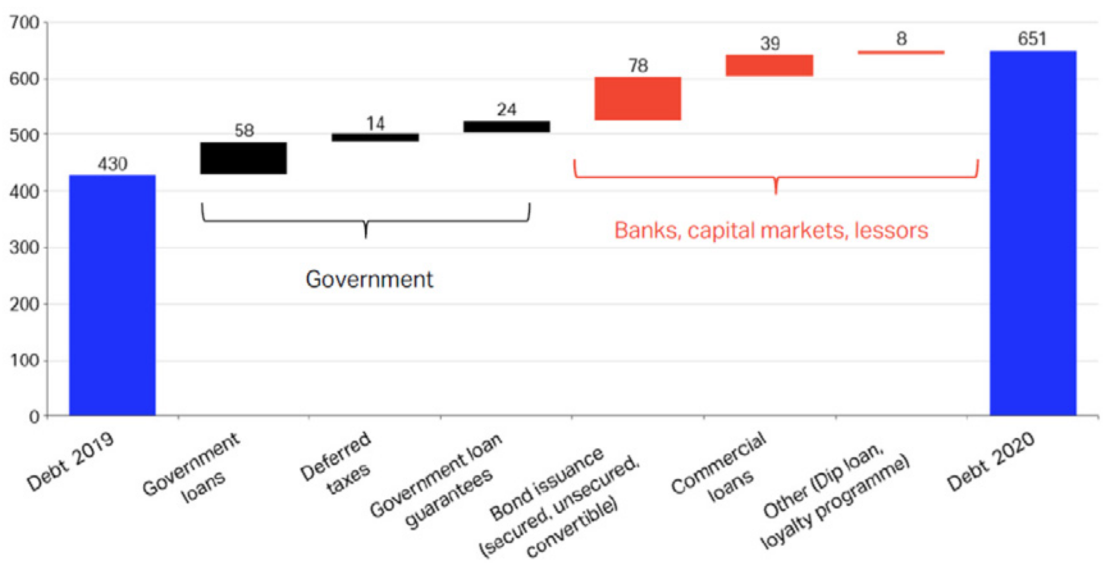


Source: Boeing – Commercial Outlook Assessment; www.icao.int, A&M Analysis.

Exhibit 6: Airlines are using all available resources to increase liquidity.

Sources of Airline Liquidity

Airlines took on an additional $125B in new debt, $78B in bond issuance, $39B in commercial loans and $8B in other loans and programs.



Source: IATA, November 2020.

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expectations. Specifically, short-haul capacity levels are expected to recover further and faster, especially in the Asia Pacific region and in North America. Europe and the Middle East are expected to take longer based on their relatively higher reliance on long-haul fleets and routes.

AIRLINES ARE SEARCHING EVERYWHERE FOR CASH

Following the immediate pandemic lockdown and facing travel restrictions and a long, slow recovery, airlines have quickly and creatively acquired needed liquidity, raising $123 billion in government aid with $67 billion to be repaid as of October 2020 (and subsequently increased further). In addition to government grants and loans, airlines have tapped the debt markets as well as issuing highly dilutive equity and engaging in sale-leaseback transactions on core fleet types, indicating the industry will likely be in recovery mode for some time (Exhibit 6).

These efforts to manage liquidity will leave U.S. carriers more leveraged, reversing years of debt reductions for the sector. Total debt across the industry is projected to increase 44% from the end of 2019 to the end of 2020. Standard & Poor's has already lowered its credit rating on every U.S. carrier to account for their weakened financial positions and the heightened risk in this crisis. As a result, airlines will soon have no choice but to begin reducing debt, and further equity issuances are expected to help rebalance stressed capital structures.

Through December 2020, governments have or are executing more than $140 billion in confirmed bailouts or assistance measures for airlines globally, according to Ishka Advisory, which focuses on airline credit health. Unconfirmed reports, and allocations deemed likely, suggest the total tally could increase to about $161 billion in the near-term.

AIRLINES WILL RESTRUCTURE, IF THEY HAVEN'T STARTED ALREADY

In order to stabilize the industry, the U.S. government initially provided $50 billion in taxpayer-funded aid to carriers, including $25 billion in grants and loans to cover wage and benefit expenses through September 30, 2020. To participate in the aid programs, airlines have been required to provide compensation to the government in the form of equity, stock, warrants or other forms of payment and have been prohibited from engaging in any involuntary pay cuts, layoffs, or furloughs until at least September 30. Other conditions included maintaining a baseline number of flights and clarifying the process for customer refunds. The second round of stimulus aid arrived in December, giving airlines a total of $15 billion that will pay employees through March 2021 and carry many of the same restrictions as in the previous aid package. A third, proposed stimulus package would provide approximately $14 billion, if approved.

Relief and recovery for carriers in the industry will most likely require them to significantly restructure their businesses and right-size in order to stabilize themselves during the pandemic's economic impacts and aftermath. Significant government aid, as valuable as it has been, is insufficient for carriers to become profitable again.

After the profound impact on the balance sheets of airlines due to industry bailouts, equity funding, and debt is assessed, carriers will likely begin restructuring in the next year or two in order to return to long-term stability. Lufthansa has already embarked on a plan to reduce its fleet by 13% and is considering cutting up to 22,000 jobs. United Airlines, which received a $3.5 billion grant and a $1.5 billion payroll protection loan, has furloughed 13,000 employees as of mid-October 2020 and may need to lay off more.

As more airlines begin paring and resizing operations, we expect the restructuring to unfold in multiple phases:

Phase 1 — Government bailouts and fleet rationalization: Throughout 2020 and into early-2021, we expect carriers to continue to accept a number of high-profile government bailout packages and phase out older aircraft or ground parts of their fleets. OEMs are expected to continue to cancel or postpone deliveries from suppliers. Across the sector, companies will likely seek shorter term cost cutting and adjust their working capital strategies, such as enacting furlough schemes and payment deferrals.

Phase 2 — Insolvency, restructuring and M&A: Globally, there were 25 airlines that ceased operating in 2020 according to Ishka (this was less than the numbers in 2018 and 2019, which totalled 26 and 35 respectively). Airlines are expected to be able to assess the "new normal" within the industry by 2021 in order to get a sense of their own projected recovery rate and the overall improvement of global travel demand. Once the new market conditions become clearer, we expect additional insolvencies and mergers and acquisitions over the medium- to long-term. There may also be a second wave of restructurings as airlines adapt to the changing market conditions.

Phase 3 — Full recovery, altered landscape: At the point when the COVID-19 pandemic is safely in the past, possibly due to the widespread adoption of effective vaccines, the airlines that are able to manage their operations during the next 12-24 months will nonetheless face new and longer-term challenges resulting from the crisis.

As their balance sheets may have been materially burdened by additional leverage, reduced networks and smaller fleets, airlines may need to consider additional restructurings and bankruptcies, as well as further strategic M&A and industry consolidation in order to create greater efficiencies and to "rescue" weaker carriers.

In all likelihood, airlines will use their alliances (One World, Sky Team, Star Alliance) to forge additional partnerships, though this may require addressing the current Open Skies limitations as they relate to foreign carrier ownership.

CONCLUSION

Carriers and OEMs across the sector are restructuring their companies to meet the unparalleled disruption caused by the COVID-19 crisis. Their initial actions to cut expenses and stop cash outflows, while undoubtedly necessary, are not solely enough to sustain their operations in the longer term. Industry executives will need to consider flexible restructuring plans that can respond to varying degrees of operational impact in order to mirror changes in demand.

Beyond restructuring, airlines will need to develop plans to amortize the massive debt burdens that they have incurred in order to weather this crisis and develop plans to divest themselves of government obligations they may have incurred due to bailout funds that they received.

While the race for effective medical treatments for COVID-19 is mainly out of their hands, airlines will need to address passengers' health and safety concerns by communicating any health safeguards they establish, whether on the ground (airports) or in flight, in order to reassure passengers that it is relatively safe to travel by air. Ultimately, it will be the passengers' fears that will drive much of their demand, which makes the timing of flying recovery and return extremely difficult to predict.

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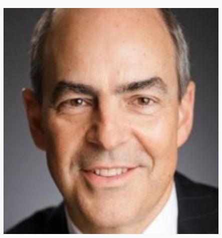

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Mr. Clarke has more than 33 years of senior management and transaction experience in finance, planning and strategy, general corporate finance and structured asset finance, risk management and restructuring, with area focus in commercial aviation and logistics. He has developed with financial partners (as principal and advisor) over $10 billion of long-term, enterprise and equipment capital in all economic cycles and company growth phases. Mr. Clarke's airline and leasing industry experience includes: Chief Financial Officer of Eastern Airlines, LLC, SVP and Chief Financial Officer of Aloha Airlines, Inc., Chief Financial Officer of Air Lease Corporation, and other top-level engagements in the industry. He can be reached at **jclarke@alvarezandmarsal.com**.

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AIRA Announces Distinguished Fellows Program

The new AIRA Distinguished Fellows Program was created by AIRA's Board of Directors to recognize significant contributions to the art and science of corporate restructuring.

Purpose of Distinguished Fellows Program

- To provide a senior-level status that recognizes AIRA member achievements and contributions to the field of corporate restructuring and to AIRA.
- To distinguish AIRA members who exemplify the highest level of excellence in professional practice and whose contributions have left a significant positive legacy to the profession and the organization.

Nomination Process

Elevation to the status of AIRA Distinguished Fellow is by invitation only through a nominating process which includes:

- Submission of completed forms by any AIRA member, and
- Approval by AIRA's Board of Directors.

AIRA members who meet the following criteria are eligible to be nominated. At the time of nomination, a nominee must:

- Be an AIRA member in good standing for at least 10 years, and
- Have made contributions to the art and science of corporate restructuring and to the AIRA that may be deemed outstanding by AIRA's Board of Directors.

Recognition of Fellows

Upon approval, new Distinguished Fellows will be inducted at the AIRA Annual Conference or at AIRA's New York Plan of Reorganization Conference, and their designation will be included on AIRA's website.

Additional information about AIRA's Distinguished Fellows Program and nomination forms are available at www.aira.org.

REPORT FROM THE FRONT LINES: COVID-19 M&A LITIGATION IN DELAWARE

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Many high-profile transactions impacted by the COVID-19 pandemic have fallen apart between signing and closing, resulting in litigation – often in the Delaware Court of Chancery – focused on whether the buyer had an obligation to close. Buyers backing out of transactions generally have asserted the failure of the to-be-acquired company to operate in the ordinary course of business and the occurrence of a "material adverse change" or "material adverse event" ("MAE"). Sellers generally have disputed that COVID-19 caused the failure of closing conditions, and have sued for specific performance of buyers' obligations to close or for damages. On November 30, 2020, the Delaware Court of Chancery – the nation's top business court where many of these "broken-deal" cases are pending – issued its first post-trial opinion in a COVID-19-related broken deal case, finding for the buyer in *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*, C.A. No. 2020-0310-JTL, including on the ground of the seller's failure to comply with the sale and purchase agreement's ordinary course covenant. As the remaining pending broken-deal cases are tried, the resulting decisions are likely to further shape the broken-deal legal landscape and guide ordinary course, MAE, and M&A contract trends.

This report summarizes learnings from these cases, including key arguments, challenges, and practical insights. Specifically, it discusses (1) ordinary course clauses; (2) MAE clauses; (3) COVID-19 related changes in law; (4) post-COVID-19 M&A contract trends regarding MAE and ordinary course clauses; (5) financing contingencies; (6) remedies; (7) timing issues; (8) expert discovery; and (9) selection of litigation counsel.

ORDINARY COURSE CLAUSES

Ordinary course clauses generally. M&A agreements typically include a covenant by the seller providing that, during the period between the signing and closing, the acquisition target will be operated "in the ordinary course" of business. Ordinary course clauses allocate risks and incentives between the parties, particularly with respect to decisions within the target's control regarding the conduct of its business, including in response to external changes. Ordinary course clauses ensure that the business the buyer is acquiring at closing is essentially the same as the one it contracted to buy. And ordinary course clauses may help to mitigate the "moral hazard" problem, *i.e.*, ensure the seller does not take actions to compromise the target's business before the buyer assumes ownership. From a seller's perspective, ordinary course clauses can protect the target (and seller) from the risk of a decline in value caused by strict restrictions on its conduct or changes in operation.

Ordinary course clauses vary in language. Some ordinary course clauses restrict the target to operating "consistent with past practice." Some are absolute, whereas others are qualified, for example, permitting deviations from the ordinary course that are immaterial, permitting deviations that would not cause an MAE, or requiring that commercially reasonable efforts be taken to operate in the ordinary course. Ordinary course clauses also commonly require that the target make affirmative efforts to preserve value or relationships between signing and closing.

COVID-19-related issues. In broken-deal cases in the COVID-19 environment, where the target's way of doing business has changed in response to the pandemic, compliance with ordinary course covenants has emerged as a heavily disputed matter. A key, threshold issue is the standard by which to assess the seller's actions and inaction during the period between signing and closing. This implicates several questions: Is the relevant inquiry whether the target's post-COVID operations were commercially reasonable and, if so, what does commercially reasonable mean? Is the standard whether the target's actions were consistent with operation of similar businesses in the post-COVID environment, *i.e.*, consistent with current industry standards? Or should the target's actions be measured against its own past practice, or against past industry practice? And if past practice is the standard, should the court look to past practice at the time of signing the agreement, or past practice in times of crisis? If an approach has never been taken before (or has never been taken to such an extreme degree), can it ever be part of the ordinary course and consistent with past practices? How can a target operate consistently with past practice if it has never operated in a pandemic?

For example, in the *AB Stable v. MAPS Hotels* case, Vice Chancellor Laster of the Delaware Court of Chancery raised the following inquiry at the outset of the case:

> The real question is whether an ordinary course covenant means ordinary course on a clear day or ordinary course based on the hand you're

dealt. In other words, if you have flooding, is it the ordinary course of what you do consistent with past practice when you are in a flood, or is it ordinary course on a clear day when there hasn't been any rain? Here, we obviously have a colossal and viral-based rainstorm.

But that's really the question: Are people doing things that are ordinary course when one is in a pandemic, and is that what the contract contemplates? Or, differently, as the defendant casts it, is this really a clear-day type provision where you have to deliver in the condition that they were when you signed?

The applicable standard in any given case, and the answer to these questions, may depend on the specific contract language at issue and the specific actions taken. In particular, buyers have focused on the presence, or absence, of an efforts qualifier, which they have argued is determinative of the applicable standard.

Another key issue that has emerged is buyer consent. Ordinary course covenants often permit targets to depart from ordinary course operations with the consent of the buyer. Agreements may require that such consent be in writing, but may state that, on request, the buyer may not unreasonably withhold it. Some ordinary course clauses include a list of specific actions that may be taken only with the buyer's consent. Buyers have argued that the reasonableness of targets' responses to COVID-19 is not relevant where sellers have failed to seek their consent. On the other hand, sellers have argued that buyers' consent need not have been sought where the actions in question were reasonable, such that buyers could not reasonably have withheld consent if asked.

Post-COVID-19 precedent. Several of these issues were addressed in the November 30, 2020 post-trial opinion in the *AB Stable v. MAPS Hotels* case, which concerned a dispute over the purchase of fifteen luxury hotels for $5.8 billion. The Delaware Court of Chancery held: "Buyer proved that due to the COVID-19 pandemic, [the target] made extensive changes to its business. Because of those changes, its business was not conducted only in the ordinary course of business, consistent with past practice in all material respects. The Covenant Compliance Condition therefore failed, relieving Buyer of its obligation to close." As a result, the Court found for the buyer and denied all relief sought by the seller, including specific performance.

In that case, prior to closing, the target had implemented drastic changes to the hotels' operations after the onset of COVID-19, including closing two of the Hotels, limiting operations at the other thirteen hotels, and cutting employee headcount. The agreement at issue included an ordinary course covenant from the seller that, until closing, absent buyer's prior written consent, the business of the target "shall be conducted only in the ordinary course of business consistent with past practice in all material respects." The ordinary course covenant was absolute, meaning that it did not contain a qualification that the seller need only make certain prescribed efforts (such as "commercially reasonable efforts") *to try* to operate the target in the ordinary course of business. The seller failed to seek the buyer's consent to the operational changes at the hotels. In the wake of this opinion, we expect that disputes over ordinary course covenants will be front and center in the remaining pending broken-deal cases, scheduled to be tried this year.

MAE CLAUSES

MAE clauses generally. MAE clauses reflect a bargained-for allocation of risk between buyer and seller of adverse changes affecting the target between signing and closing, and they are commonly positioned as closing conditions in M&A agreements. An MAE clause may condition closing on the absence of an MAE in the target's business and may permit a buyer to terminate an agreement if the target has experienced a change of circumstances – an event or occurrence – that

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materially alters the basis for the transaction between signing and closing.

Basic definition. The specific language and scope of what constitutes an MAE varies, but generally the basic definition refers to an event, change, or effect that is, or reasonably would be expected to be, materially adverse to the business, results of operation, or financial condition of the target.

Carve-outs. Most MAE definitions include a series of exceptions or "carve-outs" – *i.e.*, events, changes, or occurrences that the parties have agreed do not constitute an MAE and will therefore not excuse the buyer's performance. Carve-outs have increased in scope and number in recent years. While carve-outs vary by agreement in number, scope, and specificity, common carve-outs include general changes in economic, political, and industry conditions, changes in law, changes in GAAP, and changes caused by public announcement of the transaction. Carve-outs may also include "force majeure events," "acts of God," "acts of war or hostilities," and "natural disasters." Some MAE clauses include specific exclusions for "epidemics," "pandemics," "public health crises," or similar terms. By negotiating carve-outs for known risks that could have a material adverse impact on the target's business, sellers can seek to transfer the risk of such occurrences to buyers.

Carve-back-ins. Some MAE definitions also specify exceptions to the exceptions, or "carve-back-ins" – *i.e.*, language qualifying carve-outs as inapplicable if the event, change, or occurrence described is disproportionately adverse to the target as compared to other similarly-situated companies or companies in the same industry. For example, an MAE definition may provide that an effect arising from a change in political conditions will not constitute an MAE unless such change disproportionately impacts the target as compared to its peers. Carve-back-ins are sometimes placed within specific, enumerated carve-outs; other times they are placed at the beginning or end of all the carve-outs. By negotiating carve-back-ins, buyers can seek to clarify that they do not bear risks that are target specific or that may uniquely impact the target. As a practical matter, buyers may deem negotiating carve-back-ins to be especially important in deals with numerous and broad MAE carve-outs.

Dual-prong MAE definitions. Some MAE definitions specify that an MAE can be based on an adverse change that prevents the seller or target from performing its obligations under the agreement or from consummating the transaction (in addition to an adverse change on the target's business, results of operation, or financial condition). For dual-prong MAE definitions, carve-outs are sometimes only applicable to the prong related to an MAE on the target's business.

COVID-19-related issues. In the context of COVID-19, buyer claims that the target has suffered an MAE under the parties' agreement in broken-deal cases are requiring courts to determine issues such as the impact of COVID-19 on targets, the expected durational significance of performance downturns attributable to COVID-19, whether the effects of COVID-19 fall within carve-outs, and whether COVID-19 has disproportionately impacted targets' businesses such that carve-back-ins apply.

In cases where targets have been clearly devastated by COVID-19, the focus in litigation is centered on application of the carve-outs and carve-back-ins, if any. Where MAE definitions do not include express carve-outs for pandemics or the like, parties have disputed whether more general carve-outs – such as carve-outs for changes in economic and industry conditions, changes in law, and "natural disasters" – encompass the downturn in target business resulting from COVID-19.

Where MAE definitions include carve-back-ins, parties in COVID-19 broken-deal cases have disputed the proper benchmark for evaluating whether the target has been disproportionately impacted and what the relevant "industry" for comparison purposes should be. Where MAE definitions do not include carve-back-ins, parties have disputed whether a buyer can nevertheless seek to avoid a general carve-out (such as an industry change carve-out) on the ground that the effect was disproportionate and therefore not general.

More fundamentally, in the COVID-19 MAE cases, sellers and buyers are litigating disputes about the kinds of risks that MAE clauses are designed to shift. In these cases, parties have disputed whether it is appropriate to invoke policy-based rationales regarding the purpose of MAE clauses or whether to adhere to a more textualist approach. In certain cases, parties have focused on the rationales for including MAE clauses in transaction agreements. In others, parties have focused on the language of the agreement at issue, including whether or not there is language regarding particular risks or events.

In the COVID-19 broken-deal cases, buyers declining to close M&A agreements have tended to cite the occurrence of an MAE as one of several grounds for relief from performance. Alongside MAE claims, buyers have brought other contractual claims, such as violations of ordinary course covenants; breaches of provisions regarding material customers, suppliers, and contracts; breaches of financing provisions; and breaches of information access provisions governing sellers' obligations to permit buyers' access to targets' records, books, properties, and information. Buyers have also pursued common law claims alongside MAE claims, including fraud claims.

Pre-COVID-19 MAE precedent. Although MAE clauses generate a great deal of litigation activity, the only post-trial finding by the Delaware Court of Chancery that an MAE occurred and that a buyer's termination of an M&A agreement was valid on that basis was in *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL. In that case, in October 2018, Vice Chancellor Laster found the buyer Fresenius had validly terminated a merger agreement governing its purchase of target Akorn because of Akorn's failure to comply with covenants and the existence of an MAE. Vice Chancellor Laster's 246-page decision, affirmed by the Delaware Supreme Court, is the necessary starting point that must be considered by any parties litigating an MAE and related issues.

Post-COVID-19 MAE precedent. In the *AB Stable v. MAPS Hotels* case discussed above, although the Court held that the buyer was relieved of its obligation to close based on the ordinary course covenant breach, the Court found that the occurrence of an MAE on the target's business did not provide a separate and additional ground for the buyer to exit the deal. There, the buyer alleged that the business of the to-be-acquired hotels suffered an MAE due to the onset of COVID-19. The Court concluded that "[e]ven assuming that [the target] suffered an effect that was both material and adverse, the cause of that effect was the COVID-19 pandemic, which falls within an exception to the MAE Definition for effects resulting from 'calamities.'" The Court clarified that "[b]ecause the Ordinary Course Covenant does not incorporate MAE language, the fact that [the target] did not suffer a Material Adverse Effect does not dictate the outcome under the Ordinary Course Covenant," even though the operational changes at the hotels were also related to COVID-19. In other pending broken-deal cases, the agreements at issue do not contain carve-outs for "calamities," and parties are expected to litigate whether COVID-19 is covered by other general carve-outs.

Substantive decisions from the Delaware Court of Chancery generally remain forthcoming in the other COVID-19 broken-deal cases. In the meantime, a recent decision from the English High Court has been tracked by M&A litigators. In October 2020, the English High Court issued preliminary rulings on MAE clause interpretation in *Travelport Ltd. vs. WEX Inc.*[2020] EWHC 2670. In that case, the buyer WEX asserted an MAE due to COVID-19 to exit a $1.7 billion deal to buy two travel payment providers, arguing that the pandemic carve-out did not apply because the targets were disproportionately impacted. Much of the decision concerned the meaning of the term "industries" in the MAE definition's carve-back-in. The court agreed with WEX that the benchmark for disproportionate impact against which the targets' performance should be compared should be the broader "business to business" payments industry rather than the narrower "travel payments industry," as sellers had argued. "Industry," the court noted, "is a broader word; in its natural and ordinary meaning one would see it as capturing a group of participants in a broad sphere of economic activity. In advised or careful use it tends to connote scale and a high level of generality. Thus it is used to cover such areas as the steel industry, the automobile industry or the IT industry." In addition, the court found that it was an "oversimplification" to characterize the deal as "just a purchase of a travel payments business," noting "the objective purpose of the transaction was that this was not a deal with a single purpose[;] … [t]he present, predominant and known value was in travel; but the acquisition carried with it future value in other markets."

COVID-19-RELATED CHANGES IN LAW

A key issue that has emerged in ordinary course and MAE litigation in the COVID-19 broken-deal cases is the role of stay-at-home orders, quarantines, travel restrictions, public health guidance, and other government responses to the pandemic. In the context of ordinary course claims, even in cases where ordinary course covenants do not have exceptions for changes in law, sellers have argued that any failure to operate in the ordinary course should be excused where changes in applicable law or public health and safety guidance required such actions. This raises the question whether, if an operational change is mandated by COVID-19-related government orders, does that make it contractually permissible, as some sellers have argued and buyers have disputed? Buyers have argued that, even if certain operational changes made in response to COVID-19 are reasonable or mandated by law, this does not excuse a seller's deviation from the ordinary course. As with many broken-deal issues, resolution may be driven by the precise language of the parties' agreement.

Government responses to the pandemic have also been raised in the context of MAE claims. As mentioned above, some agreements contain carve-outs from the definition of an MAE for conditions, events, or circumstances attributable to changes in law. Depending on how "changes in law" is defined in the applicable contract, it could be construed to encompass COVID-19 government response measures. In the broken-deal cases with such carve-outs, parties have engaged in discovery regarding whether the target's business downturn was caused by the government's COVID-19 response measures, including stay-at-home and quarantine orders, or by the pandemic itself, including customers' fear of getting sick. In addition, as a legal matter, where there is a "changes in law" carve-out and where the buyer is relying on the pandemic itself as an MAE, parties have debated whether evidence of a downturn in the target's business caused by government

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actions in response to COVID-19 is relevant to the question whether an MAE has occurred. In each case, resolution of these questions is specific to the particular language of the contract in question and the particular facts underlying the buyer's claims of an MAE.

POST-COVID-19 M&A CONTRACT TRENDS RE: ORDINARY COURSE AND MAE CLAUSES

We are seeing important changes in ordinary course and MAE clauses in M&A deals announced since the onset of COVID-19 that relate to several of the disputes that have emerged in the broken-deal litigation. In particular, M&A contracts generally expressly discuss risks related to pandemics and COVID-19 specifically.

In ordinary course covenants, since spring 2020, M&A contracts have frequently included COVID-19-related exceptions to the target's obligations to operate in the ordinary course of business. These exceptions could permit departures from ordinary course operations where, for example, extraordinary actions are needed to address COVID-19-related health and safety issues, business disruptions, or government orders. Some agreements condition application of the exceptions on the target's consultation with the buyer or the reasonableness of the actions taken. Some agreements also expressly define ordinary course of business to include the target's post-COVID-19 response measures and operations.

For example, in the publicly-available agreement for the acquisition of Portola Pharmaceuticals by Alexion Pharmaceuticals, announced in May 2020 and completed in July 2020, the ordinary course clause contained an express COVID-19 exception that

> . . . during any period of full or partial suspension of operations related to the coronavirus (COVID-19) pandemic, the Company may, in connection with the coronavirus (COVID-19) pandemic, take such actions as are reasonably necessary (A) to protect the health and safety of the Company's or Company Subsidiary's employees and other individuals having business dealings with the Company or Company Subsidiary or (B) to respond to third-party supply or service disruptions caused by the coronavirus (COVID-19) pandemic; provided, further, that following any such suspension, to the extent that the Company or any Company Subsidiary took any actions pursuant to the immediately preceding proviso that caused deviations from its business being conducted in the ordinary course of business consistent with past practice, to resume conducting its business in the ordinary course of business consistent with past practice in all material respects as soon as reasonably practicable.

With respect to MAE definitions, since spring 2020, M&A contracts have generally contained express carve-outs for pandemics, epidemics, public health crises, or similar events, and most contain carve-outs for COVID-19 specifically. COVID-19 is often defined to include any mutations or second waves. Several contracts also include carve-outs for COVID-19-related government measures, such as stay-at-home orders, quarantines, and social distancing guidelines. Some more seller-friendly deals specify that COVID-19 carve-outs are excluded from disproportionate carve-back-ins.

For example, in the publicly available agreement for ConocoPhillips' acquisition of Concho Resources, announced in October 2020, the MAE definition includes a carve-out for "pandemics (including the existence and impact of the COVID-19 pandemic)," and excludes from the disproportionate carve-back-in "any Effect arising from, resulting from or related to COVID-19, COVID-19 Measures or the November 3, 2020 United States federal elections."

FINANCING CONTINGENCIES

The failure of third-party financing has emerged as another key issue. Whether as an express contractual matter, or as a practical matter, availability of financing is often tied to the relief available to a seller in the event that the buyer does not consummate a transaction. Courts will need to determine who bears the risk of the failure of financing, what obligations buyers have to secure backup financing, and what remedies are available to sellers when financing fails. Resolution of these issues will likely turn on the specific financing provisions and deal structures at issue.

In instances where anticipated third-party financing has become unavailable, buyers may point to withdrawal of financing by lenders as excusing their obligations to close, whereas sellers may point to the same withdrawal as merely triggering buyers' obligations to find alternative financing. While some agreements provide that a buyer's obligation to consummate a transaction is contingent on its ability to obtain the financing contemplated at signing, many do not, and some contain clauses expressly disclaiming any financing condition. Even where agreements do not expressly condition specific performance on the funding of financing, if a buyer requires financing to fund the purchase price, and the buyer's sponsor or parent has not provided a full equity backstop, and third-party financing has become unavailable, a buyer may argue that as a practical matter it cannot consummate the transaction without the necessary financing. So, depending on contract terms and deal structure, where requisite financing is not available, buyers may claim that specific performance should be deemed impracticable, or even impossible. In certain cases, however, depending on the circumstances giving rise to the unavailability of financing, sellers may argue that buyers cannot invoke these practical difficulties where they have behaved inequitably or inconsistently with their contractual obligations, and may nonetheless be required to close.

One way parties sometimes allocate the risk of the failure of financing is by providing for payment of a "reverse breakup fee" (reverse in the sense that it is payable to the seller, not the buyer) if the buyer fails to consummate the transaction because of failure to obtain financing and it has been unable to prove the existence of an MAE or other violation of contractual provisions that would permit it to terminate the agreement. A buyer may or may not find it more attractive to pay the breakup fee than to consummate the acquisition, depending on the difference between the fee and the purchase price and taking into account any diminution in the target's value caused by COVID-19, costs associated with any alternative financing needed to close, any risk of damages liability beyond the fee, and any litigation risks and costs.

In some instances, a seller may accept receiving the breakup fee and retaining the target company, especially where sale to a different buyer for a comparable price is likely. In other situations where the seller is less sanguine about its possibility of finding another buyer who will pay a comparable price, the seller may press the argument that the buyer is required to find alternative financing, or it may even try to find alternative financing on its own. Not all financing is alike, though, and buyers may argue there are no viable alternatives available and they cannot be forced into a lending relationship to which they never agreed. In addition, if a target's business is suffering because of COVID-19, this could make finding alternative financing difficult. Whether or not buyers can prevail on such arguments or can pay a reverse break-up fee in lieu of closing is a context-specific inquiry that depends on specific contractual language.

In certain COVID-19 broken-deal cases, sellers have invoked the prevention doctrine in relation to disputes concerning the failure of financing. Under the prevention doctrine, a party cannot rely on the failure of a condition to excuse its performance when its own conduct materially caused that condition's failure. For example, in *Snow Phipps Group, LLC v. KCAKE Acquisition Inc., et al.*, C.A. No. 2020-0282-KSJM (Del. Ch. Oct. 16, 2020), where the seller alleged that the buyer intentionally scuttled financing, Vice Chancellor McCormick denied the buyer's motion to dismiss the seller's specific performance claim, reasoning: "I agree with [seller's] argument that the prevention doctrine potentially forecloses [buyer] from avoiding specific performance due to the lack of debt financing."

REMEDIES

Although the remedies available to sellers and buyers vary and depend on what claims are brought, in the COVID-19 broken-deal cases, the remedies sought have included claims to specific performance and/or damages by sellers, and claims by buyers for declaratory judgments that terminations were proper.

Specific performance. Specific performance is often the favored remedy of sellers in broken-deal cases. Under the common law, to be entitled to specific performance, a seller must prove by clear and convincing evidence that "(1) a valid contract exists, (2) he is ready, willing, and able to perform, and (3) that the balance of equities tips in favor of the party seeking performance." *Osborn ex rel. Osborn v. Kemp*, 991 A.2d 1153, 1158 (Del. 2010). Agreements sometimes expressly speak to the availability of specific performance or modify the default common-law standard: for example, agreeing to the availability of specific performance as a remedy on the ground that money damages would be inadequate, or not to assert the defense that money damages are an adequate remedy. As discussed above, however, the availability of specific performance may depend on the availability of third-party financing needed to close. In addition, because specific performance is an equitable remedy, its availability may be affected by equitable defenses such as laches and unclean hands where a contract does not modify the default common law standard.

Monetary damages. Sellers have generally sought damages as an alternative to specific performance. Agreements may have provisions governing the extent to which damages are available. The amount of damages for certain breaches may be liquidated by agreement, for example, with a reverse breakup fee. Other agreements provide for a "cap" on damages, that is, that the damages awarded may not exceed a certain amount. Certain sellers have also sought compensatory damages as a supplement to specific performance in the form of, for example, disbursement of the buyer's deal deposit and other compensation they argue is necessary to make the seller whole. In addition, certain buyers have even asserted their own claims for damages, including attorneys' fees and litigation costs.

Declaratory relief. Declarations of rights have been sought by both sellers and buyers in broken-deal cases. Buyers have generally requested declarations that they are relieved of their obligations to close or were justified in terminating agreements based on the occurrence of an MAE, ordinary course covenant violations, or other breaches. Sellers have sought declarations that all conditions to closing have been satisfied and that a buyer's refusal to close breached the parties' agreement. The specifics of these requests often depend on the parties' agreement and the particular facts at issue.

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TIMING ISSUES

Expiration dates for third-party financing, or other drop-dead dates in agreements, can drive the overall timing of broken-deal cases and result in extremely expedited trial schedules.

For example, in one case, *Forescout v. Ferrari Group Holdings, L.P., et al.*, which relates to a dispute concerning Ferrari-affiliate private equity firm Advent International's acquisition of cybersecurity company Forescout Technologies, Vice Chancellor Glasscock initially set trial just one week out, requiring the parties to take document, fact, and expert discovery, and prepare for trial, in a matter of days. Through a stipulation of the parties, the trial was ultimately moved six weeks later to a date chosen by the Court that would have permitted it to render a decision before the third-party debt financing "drop-dead" date. Although the drop-dead date subsequently became moot, the Court declined to reschedule the trial, which was to be conducted via Zoom. In those seven weeks, with a $2 billion transaction at issue, the parties took dozens of remote depositions, exchanged numerous expert reports, filed multiple motions to compel, and reviewed hundreds of thousands of documents, all while simultaneously learning the case and preparing for trial. Shortly before trial, the parties settled, with Advent receiving a half-billion-dollar discount off the original purchase price.

In the *AB Stable v. MAPS Hotels* case discussed above, Vice Chancellor Laster presided over a week-long full merits trial by Zoom just four months after the case was filed. In the lead-up to trial, hundreds of thousands of documents were produced and reviewed, twenty-six expert reports were submitted, forty-nine depositions taken, numerous discovery motions briefed, and pre-trial briefs filed.

On the other end of the spectrum, in *In re Global Business Travel Share Purchase Agreement Litigation*, which relates to disputes concerning investments by affiliates of Carlyle and GIC in the American Express Global Business Travel service, Vice Chancellor Slights denied the seller's motion to expedite, on the basis, among others, that an accelerated schedule could adversely affect the health of the participants, thereby eliminating specific performance as an available remedy.

Highly expedited cases like the first two above are best handled by sophisticated trial counsel. A litigation team that is focused from the beginning of the engagement on what arguments and evidence will matter at trial is an advantage. Lawyers with experience in these cases can get up to speed very quickly, identifying the key facts and legal issues within a few days, and developing an effective plan of attack from the outset.

EXPERT DISCOVERY

The COVID-19 broken-deal cases have involved a wide range of experts, including valuation experts, industry experts, M&A deal and contract experts, and financing experts, as noted in the table on the next page. Given the fact-intensive issues and heavy focus on expert discovery in these cases, proper expert selection, analysis, preparation, and management is especially important. This process starts with getting up to speed quickly and identifying the operative legal and factual issues early on to enable the trial team to identify, early in the case, the subject matters requiring presentation of expert testimony.

SELECTION OF LITIGATION COUNSEL

When a deal is broken and leading to litigation, the first instinct might be to use litigation counsel from the same firm as the transaction lawyers to litigate it, on the theory that the transaction firm is already on the scene, it will have a shorter learning curve, there will be easier communications between transaction lawyers and litigation counsel at the same firm, and that firm will have a greater investment in defending the client's position. But there are multiple pitfalls inherent in this "one-firm" approach.

Issue	Type(s) of Expert	Topic(s)
MAE	Valuation Economic Industry	• impact of COVID-19 on target's operational and financial performance; • target's post-COVID-19 performance as compared to past performance; • materiality of impact of COVID-19 on target's business; • whether carve-out conditions such as changes in law contributed to target's downturn; • diminution in value experienced by target as a result of COVID-19; • outlook for recovery and expected durational significance of COVID-19's effects on target; and • whether target disproportionately impacted by COVID-19.
Ordinary Course	Industry	• how target responded to COVID-19; • how conduct of target's business since COVID-19 compares to target's past practice, industry past practice, and/or current industry practice; • materiality of target's departures from ordinary course of business; and • reasonableness of target's COVID-19 response measures.
M&A Contract	M&A transactions Deal economics Customs and practices of M&A practitioners	• industry custom and practice regarding, and economics of, MAE clauses, ordinary course covenants, and other key terms; • trends in MAE clauses and ordinary course covenants in comparable M&A agreements.
Financing	Corporate finance Industry	• availability of third-party financing for deals; • costs and risks associated with financing options.

First, the corporate lawyers close to the deal, and their litigation partners at the firm, are subject to natural unconscious biases that make it difficult for them to exercise the kind of independent judgment required of litigation counsel in high-stakes cases like these. These biases include:

- *Anchoring bias*: a cognitive bias towards an initial estimate or starting point;
- *Confirmation bias*: a person's strong views about what documents mean and why they did a good job;
- *False consensus bias*: a person's belief that their own interpretation based on what they intended and thought they did is the only sensible interpretation; and
- *Self-protection bias*: the tendency to offer theories and strategies that protect the firm as well as the client, when they are not necessarily best for the client, which may constitute an ethical conflict.

Using independent counsel as trial counsel eliminates these biases and permits a fresh look at the facts and circumstances of the case. Deal counsel may be too close to the transaction to see the greater issues and themes that have developed as time has elapsed. And the significance of COVID-19 may have decreased as the target company developed effective ways to deal with the crisis, making it necessary to gather and analyze additional context and develop a more robust theme for trial.

Second, with the "one-firm" approach, the transaction partners may have too much influence over key litigation decisions, such as who from the deal team should testify, whose opinion is most important, whether the other side's positions have merit, and what is the best approach for presenting the client's case to a mediator, arbitrator, or judge. A client may be better served with an independent litigator who can more easily say, "No offense, but that construction of the wording makes no sense," or "Your position goes against current law and we need to find a way to resolve this quickly." Reframing the work of the transaction lawyers can be a delicate conversation to have under the best of circumstances, and more likely to proceed well if done by lawyers from a separate firm. Ultimately, the natural tendency to support the work of one's colleagues raises the potential for biased decisions – the opposite of what a client needs when defending a lawsuit. In the words of Nobel-prize winning psychologist Professor Kahneman,

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the ideal advisor is "a person who likes you and doesn't care about your feelings."

Third, the transaction lawyers and their firm may be motivated by self-protection. Whether they even realize it or not, there is an almost inevitable tendency to offer litigation theories and strategies that protect the firm as much as the client — when in fact the firm's and the client's interests are not truly aligned. Litigation counsel can face internal pressure to justify the deal language, the negotiations, the documents, and the advice given by their deal partners, especially when the deal lawyer is the partner who literally put work on that litigator's desk.

Litigation counsel must be unconstrained in telling the transaction partners the contract has flaws, the strategy must be repositioned, or the terms are ambiguous and it is important to rethink what the parties meant. Using independent counsel makes these conversations easier (or in some cases, *possible*) and frees up the advocate to make the tough strategic decisions required throughout the litigation. Independent counsel will ask the tough questions, and make sure they get answered. This is essential not only for proper case development overall but for the "tough" witness preparation that should take place before witnesses testify at deposition and trial. Witnesses, and case outcome, benefit from strong witness preparation by unbiased trial counsel.

Fourth, where lawyers' representation of the client is constrained by concern for their firm or their partners who are deal counsel, this can be an ethics violation because it amounts to a concurrent conflict of interest. A concurrent conflict of interest exists if "there is a significant risk that the representation of one or more clients will be *materially limited* by the lawyer's responsibilities to another client, a former client or a third person or by a *personal interest of the lawyer*." ABA Model Rule of Professional Conduct 1.7 (emphasis added). A competing "personal interest of the lawyer" includes risks to the lawyer's partners or to his or her firm. Such conflicts may extend to the firm as a whole. ABA Model Rule 1.10.

When litigation and transaction counsel are from one firm, there are multiple ways in which representation of a client may be "materially limited." As discussed above, this can happen when the lawyer pursues litigation strategies that favor the deal lawyers or their firm. It can also happen when a deal lawyer is to appear as a fact witness. There are any number of specific facts about the background and negotiation of the deal that could be the basis of testimony, although they may be hard to anticipate at the beginning of a case. The actions that the transaction firm took, or failed to take, can easily become a focus of discovery and testimony leading to arguments for counsel disqualification. In some instances, the transaction lawyer may even be deemed litigation counsel, for example, by conducting an investigation before any litigation is filed. This too may provide grounds for disqualification.

Using litigation counsel from the transaction lawyers' firm may put the client's privileged communications at risk. Like any other case in which counsel is playing a witness role, managing the scope and content of the transaction lawyers' testimony to avoid waiver of privileged communications is extremely important. Parties may not use privileged information as a sword

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Diane is a partner whose practice is devoted to complex commercial litigation. She has substantial experience in derivatives and other financial matters, and was named to LawDragon's List of 500 Leading Plaintiffs Financial Lawyers in 2019 and 2020. She has been named a Southern California Super Lawyer in Business Litigation ten years in a row. In 2020, Diane defended Advent International in one of the first broken-deal cases of the COVID-19 era, a dispute concerning its acquisition of Forescout Technologies. Diane is recognized nationally for her unique skill in creating and executing innovative solutions for her clients.

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Using litigation counsel from the transaction firm can also negatively impact credibility, as it may suggest the trial lawyer has a personal stake in the litigation. Litigators from the same firm as transaction counsel may also be hesitant to aggressively question their partners, or even put them on the witness list, although that may be needed for a successful result. In contrast, use of independent litigation counsel tends to enhance the transaction counsel's, and the client's, credibility, because it gives the appearance that someone who is removed from the transaction is asking transaction counsel the hard questions and fearlessly seeking the truth.

Finally, the one-firm approach may materially limit litigation counsel's representation of the client when called on to give advice about the scope of settlement or about the possibility the case will settle. The risk is heightened when the transaction firm has a direct financial interest in the outcome as a result of, for example, a success fee or kicker contingent upon closing the challenged transaction. The litigation attorney then has a financial interest as a partner of the transaction firm in the outcome of the dispute, including such factors as when and for how much the dispute is resolved.

HOW THE COVID-19 PANDEMIC HAS IMPACTED THE COMMERCIAL REAL ESTATE LANDSCAPE[1,2]

JAHN BRODWIN, JOSH HERRENKOHL, INGRID NOONE, and GLENN BRILL
FTI Consulting

This article presents insight and intelligence from senior personnel at FTI Consulting and a joint research initiative conducted by FTI and Real Estate Fund Intelligence (REFI), in conjunction with REFI's July 2020 Global Investors Virtual Summit. It contains a summary and analysis of results from a survey of 64 U.S.-based, commercial real estate investment professionals, including fund and investment managers, REITs, and other institutional investors. The survey was conducted over a two-month period in 2020.

INTRODUCTION

COVID-19 has created challenges for the commercial real estate market in the U.S. that have not been seen since the 2008 global financial crisis. While the 2008 crisis was the direct result of credit and liquidity fiascos, the pandemic has had a direct, powerful impact on the demand for space, put pressures on supply chains, caused massive job losses, disrupted travel, and devastated consumer confidence. As a result, 2020's commercial real estate (CRE) marketplace has been characterized by rising vacancy rates in the office sector, delinquent rents in the retail sector, more distress in hospitality, and falling property prices overall, especially in major cities across the country.

But because the pandemic's impact has varied dramatically across property types in some cases and between urban and suburban markets, there have been some bright spots. For example, industrial, warehouse and suburban multifamily sectors have outperformed expectations, as more consumers shopped online and flocked to residential life outside major cities with an eye toward steering clear of the virus. Now, the promise of a vaccine in late 2020/early 2021 has the CRE markets on standby, and the recovery is likely to look very different than the one that followed the 2008 financial meltdown.

The financial crisis of 2008 was a very different situation from the COVID-19 crisis. In 2008, there was doom and gloom and little expectation that things would recover quickly. And then, of course, it was followed by one of the longest bull runs in modern history.

IMMEDIATE REACTION

In 2020 the pandemic swiftly shut the door on transactions, with most deals stalled or stopped. A few transactions continued, mostly in the industrial and life sciences sectors and in others where buyers risked losing deposits. There is anecdotal evidence that some transactions that were in negotiations when the COVID shutdown hit were later resurrected at prices 10% or more lower.

Yet in the ensuing months, the various real estate asset classes have experienced mixed results summarized as follows:

- ***Industrial***: This segment of the market has not taken a break.
- ***Retail:*** Retail is a different story and much more problematic, as it was facing unprecedented challenges before COVID. With the significant number of large retailers that are filing for bankruptcy, the pain has been amplified and accelerated. When big box retailers file for bankruptcy, they often have the opportunity to cancel leases. This creates a domino effect on other retailers that rely on foot traffic created by the larger box retailers.
- ***Office:*** Most of the real estate is leased on a long-term basis, so office real estate is traditionally a lagging indicator of the marketplace and therefore generally easy to predict. However, in the longer term (two-to-three years out), we believe this will be a zero-sum game, as a) more office workers will work remotely and the fewer people occupying office space will demand more square footage per head; and b) select suburban office properties will be winners in the short-to-midterm as they become the "spokes" to the urban office "hubs." On a longer-term basis, though, it is predicted employees and employers will gravitate back to urban centers; however, it is unclear what rental concessions will be needed to reinvigorate this market.
- ***Multifamily:*** Large cities are going to suffer in the near-to-midterm. Rents will get repriced, not so much in the form of headline rents, but rather in free rent and other incentives.

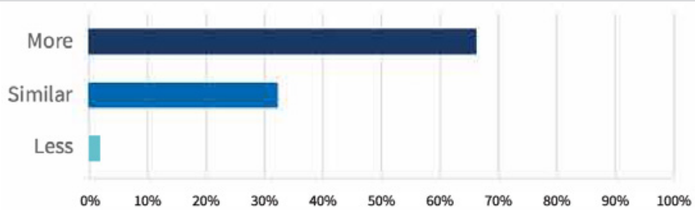
[1] This article was originally published as a paper, "How the COVID-19 Pandemic Has Impacted the Commercial Real Estate Landscape in the Short and Long Term," in conjunction with REFI's July 2020 Global Investors Virtual Summit. The AIRA thanks FTI Consulting for its kind permission to republish this material in *AIRA Journal*.

[2] Statements in this article represent the views of the authors and do not represent the views of the firm.

There is a lot of optimism about Industrial, which makes sense given that ecommerce will continue to be a highly significant trend; however, there is a lot of pessimism around Office. Multifamily was middle of the road but largely dependent on geography; metropolitan multifamily will likely experience continued distress in the near term.

The virtual landscape has also impacted how investors and sponsors interacted with each other, no longer relying on in-person meetings and conferences to communicate. In the 2020 survey by REFI and FTI,[3] sixty-six percent of respondents reported speaking with investors more frequently than they did in 2019; an additional 32% said the amount of speaking with investors was similar to the last year:

How often are you speaking with your investors (or are your sponsors speaking to you) now versus 2019?



Overall, the virtual commercial real estate landscape has left some commercial real estate players looking back to the global financial crisis to evaluate how best to respond to the market volatility.

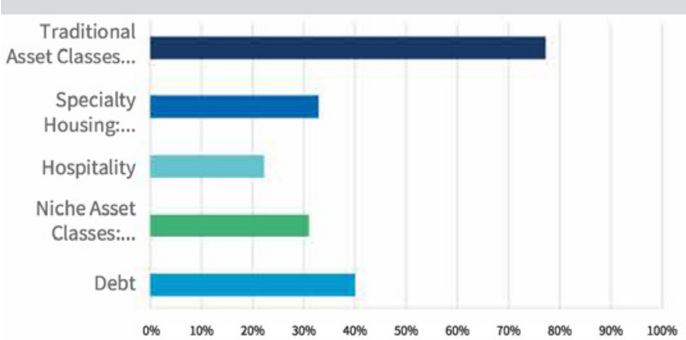
INVESTMENT OUTLOOK

In the Short Term

When assessing short-term investments, the REFI-FTI survey found 77% of respondents are attracted to traditional asset classes; less than half that number indicated attraction to investing in each of the other categories: debt, specialty housing, niche asset classes, or hospitality:

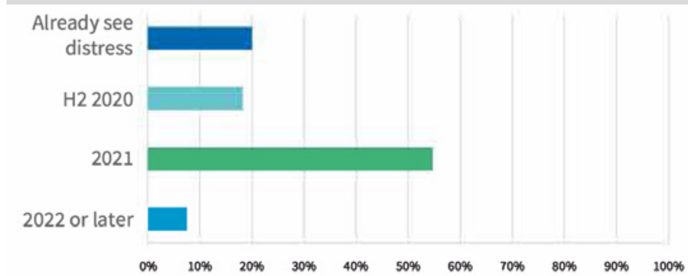
[3] See note on the REFI-FTI survey at the beginning of this article on p. 26.

What types of assets are you attracted to invest in the short-term?



We are already seeing distress. There is a significant amount of capital available for investment and many are waiting for someone else to dip a toe in the water and start investing again. This was evidenced by 54% percent of survey respondents indicating they believe 2021 will be characterized by a great deal of distress in the real estate market, 20% said they were already seeing distress, and 18% expected to see it before the end of 2020.

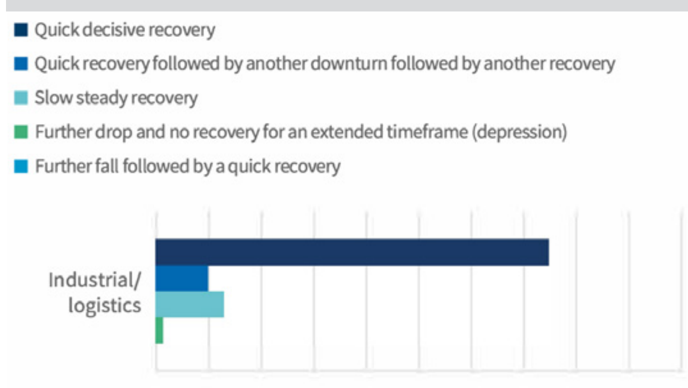
When do you expect to see distress? (Foreclosures, bankruptcies, etc.)



Outlook by Asset Class

While trying to take advantage of market distress, we observe here that commercial real estate professionals remain conscious of how the COVID-19 pandemic may impact investments in the asset class. The survey results show varied expectations about the recovery across commercial sectors. The areas where we see expectations of a V-shaped recovery – most notably industrial, suburban multifamily, and single home residential – reflect the thinking that when 2021 rolls around, there will be a vaccine and then everything will get back to normal:

What is your general expectation for the shape of the recovery from pre-Covid 19 to post-Covid-19 for the following types of asset valuation: Industrial/Logistics?



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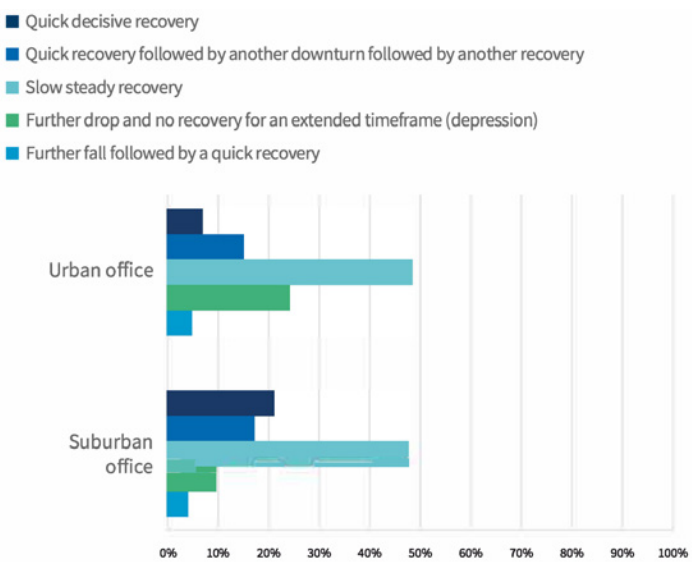
Overall, commercial real estate professionals see the industrial sector – which has remained relatively stable throughout the pandemic – as bouncing back the quickest. Seventy-five percent of respondents predict a V-shaped recovery for this asset class. For most asset classes, the majority of respondents believe the recovery will take one of two paths: a slow and steady U-shaped recovery, or an L-shaped scenario with further drop and no recovery for an extended period.

However, looking deeper into other traditional asset classes, we observe:

- There were mixed levels of optimism for short-term investment across multifamily and office, with respondents saying suburban locations may experience a quicker bounce back than urban locations. Across the office sector, a U-shaped recovery was also what the majority of respondents predicted for both the urban and suburban asset classes.
- Seven percent of respondents expect to see a V-shaped recovery in urban office, far less than the 21% that are expecting to see it in the suburban office market.

What is your general expectation for the shape of the recovery from pre-COVID-19 to post-Co-19 for the following types of asset valuation: Urban office; Suburban office?



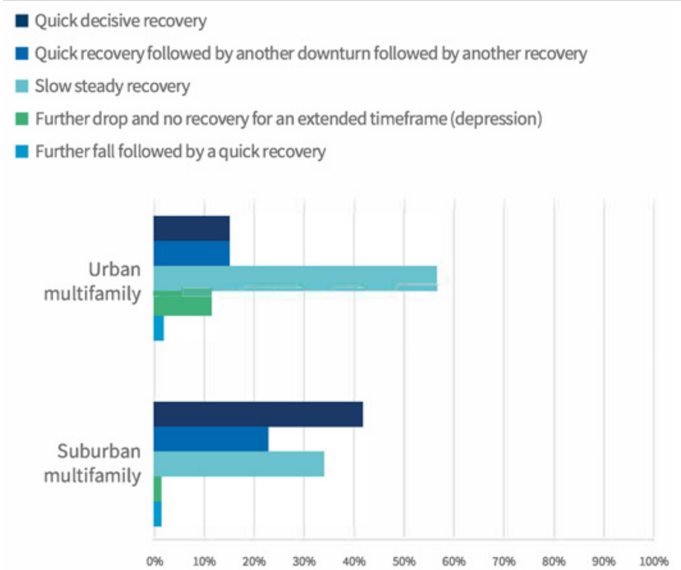
Regarding the office market, we note that there has been a resurgence of companies that are traditionally in gateway cities renting additional office space in suburban markets to accommodate employees that don't want to come into a dense city – they don't want to take public transportation; they don't want to be in a crowded elevator.

Many refer to this as a hub (city) and spoke (suburb) concept. The bigger question is whether this hub-and-spoke concept is here to stay or will run its course in the next couple of years as employees become more comfortable returning to gateway cities. History has shown over and over again that amnesia will eventually set in. However, the trend toward more full- or part-time remote work was already in motion before COVID-19, and perhaps COVID-19 accelerated this movement by many years. On the other hand, the densification trend will likely throttle back as employees will not want to be shoulder-to-shoulder with their coworkers, resulting in a zero-sum game in a few years.

When looking at the multifamily sector, there is also a discrepancy between urban and suburban markets among respondents.

- Fifty-six percent believe there will be a U-shaped recovery in urban multifamily assets, slightly above the 33% in the suburban multifamily.
- Fifteen percent of respondents see a quick recovery (V-shaped) in urban multifamily, with 41% seeing this in suburban multifamily.

What is your general expectation for the shape of the recovery from pre-Covid 19 to post-Covid-19 for the following types of asset valuation?



There is much less optimism for short-term recovery across various types of in-person retail, with 1% of respondents expecting a quick revival of high street retail and mall shopping.

- For shopping malls, 70% predict an L-shaped recovery with a further decline and sustained downturn.

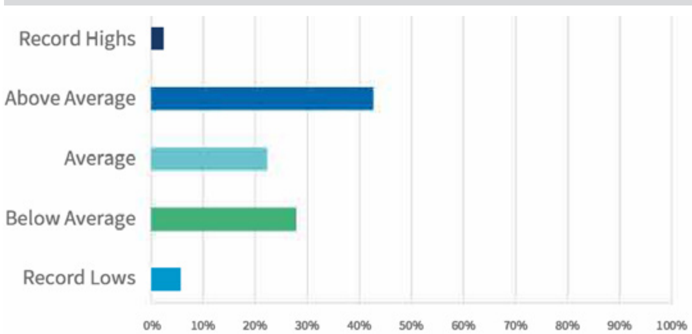
- Respondents were slightly more optimistic about neighborhood shopping, with 16% of respondents expecting a V-shaped recovery and 58% foreseeing a slow, steady U-shaped recovery.

One asset class projected to make a slower rebound is the hospitality sector, given the limits on both domestic and international travel due to the pandemic. Seventy-five percent of respondents predict a U- or L-shaped recovery for hospitality assets. With worldwide acceptance of proptech companies such as Airbnb (which use technology dedicated to the real estate industry), there is a strong likelihood that the number of traditional hotel rooms will contract for the foreseeable future. One bright exception might be a new genre of hotel concepts focused on the needs of digital nomads, who use telecommunications technologies to earn a living and conduct their life in a nomadic manner.

2021 WILL OUTPACE 2020

Outside of how real estate managers will assess investments in different asset classes, transaction volume will be significantly higher in 2021 given the lack of activity for most months in 2020. Forty-two percent of the survey respondents believed at the time of the survey that 2021 transaction volume would be above average if there were a cure or vaccination by the end of 2020 or early in 2021:

Where do you expect to see 2021 transaction volume assuming we have a cure/vaccination by the end of 2020?



Recently, we are starting to see some transactions, distressed and otherwise and, in our opinion, this is definitely going to continue. The fourth quarter of 2020 might surprise us in a good way with some level of transaction volume, and it is a sure bet 2021 is going to outpace 2020.

Acquisitions directors spend half of their lives trying to look good and half of their lives trying not to look bad: at the moment, everyone is trying not to look bad. We are waiting for one or two credible investors to kick-start transaction activity and show us where the market has bottomed out.

Institutional investment in real estate is also something that commercial real estate managers are closely monitoring, with 87% of respondents thinking there will be more or similar amounts of institutional investment in 2021 compared to what took place in 2020.

LONG-TERM INVESTMENT OUTLOOK

Commercial real estate's historic long-term viewpoint must provide some sense of stability for interested investors. With other asset classes being more turbulent due to market volatility, institutional investors may remain keen on making long-term investments.

Institutional investors have the capital and fortitude to play the long game and weather the storm. This will create significant opportunity, but also widen the divide between the larger and smaller players. That said, everything gets reframed if there is no cure or more

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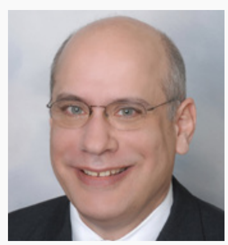

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Continued from p.29

effective roll out of vaccines, because at the end of the day, if this pandemic keeps dragging on and on, the cracks in the foundation will continue to grow.

Of the office sector, it is likely that in the next few years many office workers are going to realize they don't need to be in the office every single day. There are many companies that are going to allow their employees to work two or three days a week in the office and the balance of the week offsite. Furthermore, since it will likely be a long time before we can go back to having people sitting three feet apart, some companies are going to need more space and others are going to need less space: over time, we will find a new equilibrium.

For the entire commercial real estate market, the long-term view remains positive, knowing that distress creates opportunities for both buyer and seller. Without a crystal ball to predict the short-, medium- or long-term horizon, market leaders continue to compare the current situation to how the market recovered after the global financial crisis.

It is likely we will end up seeing a lot more turnover and a lot more consolidation. We also expect there will be many more ups and downs with a W-shaped recovery before there is an elongated up. At the end of the day, however, real estate is more stable than equities, which tend to experience much bigger peaks and valleys. And so, real estate continues to be a good hedge for many investors looking to manage risk – real estate is not going to dissolve.

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

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

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

CONSERVING CONSERVATORSHIP

ANNE EBERHARDT
Gavin/Solmonese LLC

In early 2008, responding to a rash of unhealthy behaviors, Britney Spears' father swept into action, placing the former Mouseketeer into conservatorship. Later that year, responding to a global financial crisis, Richard Lockhart III, the Director of the Federal Housing Finance Agency, took similar action, placing into conservatorship the government-sponsored enterprises, or GSEs, known colloquially as Fannie Mae and Freddie Mac.

Twelve years later, the "Free Britney" movement staged protests outside government buildings, hoping to garner support for ending her conservatorship. And in the weeks between the November 2020 election and the inauguration of President Biden, a drama likewise unfolded within Washington's corridors of power, as Mark Calabria, the current Director of FHFA, similarly sought to end to the conservatorships of Fannie Mae and Freddie Mac.[1]

Yet despite the extensive public theater, both conservatorships survive to this day. If 2008 was the Year of Conservatorship, 2020 was the Year of Conserving Conservatorship.

The GSEs' conservatorships, along with the entire housing finance infrastructure, were built, and occasionally refurbished, during times of profound economic and social turmoil. Since its inception with the Great Depression, the nation's housing finance system has been asked to accomplish many goals, among them:

- Increase home ownership, especially among underserved communities.
- Help Americans build wealth through home ownership.
- Keep financial markets stable and liquid.
- Keep mortgages affordable.
- Support home price growth.
- Contribute to geographic and social mobility by keeping the mortgage market liquid.
- Keep 30-year-fixed rate mortgages available as the predominant mortgage choice for homeowners.
- Price securities backed by residential mortgages to reflect their underlying risks.
- Don't price securities backed by residential mortgages to reflect their underlying risks.
- Promote competition in the market for home mortgages.
- Protect home owners from predatory lenders in the home mortgage market.

No housing policy could realistically accommodate all of these goals, yet because home ownership occupies an almost sacred space in the American imagination, those policymakers entrusted with minding the housing finance apparatus cannot entirely ignore these issues and policy drivers. A national housing finance system must balance the interests of the citizenry with the exigencies of the market.

It should not be surprising, given all the misery unleashed into the world in 2020, that policymakers would avoid radically transforming a conservatorship that was, more or less, addressing the issues it was designed to address.

THE HISTORY OF HOUSING FINANCE

During the Great Depression, in an effort to stimulate the economy through home construction, the federal government initiated its support for homeownership by creating the entities that form the foundation of our current housing finance apparatus: Fannie Mae, the Federal Home Loan Bank system, and the Federal Housing Administration, or FHA.[2]

In 1938, Fannie Mae was chartered as a government corporation with the purpose of operating a secondary market to purchase loans guaranteed by FHA. That mission was broadened after the Second World War with the creation of the Department of Veterans Affairs, when Fannie Mae was further authorized to purchase VA-guaranteed mortgage loans.

In 1968, as part of the war on poverty and the implementation of President Lyndon Johnson's "Great Society" programs, the Department of Housing and Urban Development was created, splitting Fannie Mae into two entities: Fannie Mae, which continued its secondary market operations, and the Government National Mortgage Association, or Ginnie Mae, which assumed the administration of the portfolio of mortgage loans expressly insured by the federal government.

In 1970, Fannie Mae transitioned to a shareholder-owned corporation with a government charter, becoming authorized to acquire mortgage loans that were not insured by the federal government. This was

[1] Fannie Mae's formal name is the Federal National Mortgage Association, and Freddie Mac's is the Federal Home Loan Mortgage Corporation.

[2] Much of this section is summarized from the U.S. Department of the Treasury Housing Reform Plan, Pursuant to the Presidential Memorandum Issued March 27, 2019, September 2019, pp. 4-5, https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf (accessed January 30, 2021).

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also the year Congress established Freddie Mac in order to provide competition to Fannie Mae.

At that time, most mortgage loans were made by financial institutions and other private sector entities, which bore the risk of loan defaults. By the mid-1980s, the portion of mortgage debt guaranteed by the GSEs and other federal guarantors began to increase as a share of outstanding mortgage debt. In 2018, mortgages guaranteed in one form or another by the federal government, whether through the GSEs, FHA, the VA, or Ginnie Mae, accounted for about 63 percent of total mortgage debt outstanding, according to data from the Federal Reserve (see graph, p.33).

THE SUBPRIME DISASTER

Most observers blame the proliferation of subprime mortgages for the 2008 financial crisis. As chartered, the GSEs were required to avoid subprime mortgages, with limited exceptions that were meant to support initiatives intended to expand homeownership to certain specified underserved communities. FHA and Ginnie Mae hold the primary responsibility of providing support for low- and moderate-income families whose mortgages cannot be supported through traditional underwriting.

Partly in response to changes in the tax code, partly in response to reforms following the savings and loan crisis of the 1980s, and partly as investors sought more sophisticated methods to manage risk, securitization of residential mortgage debt swelled in the 1990s.

The GSEs faced increasing competition from private financial institutions entering the securitization market because of the increased demand for mortgages, the primary "raw material" of the residential mortgage-backed securitization "factory."

Meanwhile, banking laws and regulations issued under the Basel II Accord provided recommendations to strengthen the level and quality of capital that banks were required to hold, given the financial and operational risks they faced. Capital buffer requirements dictated the types of securities that would fulfill the tiered requirements for capital adequacy. Although the U.S. government did not expressly guarantee the GSEs' mortgage-backed securities, the new international banking rules treated them as if they were of the same quality as that of U.S. Treasury securities. This perceived guarantee created almost unlimited demand for GSE MBS as banks across the globe sought to bolster their balance sheets with the GSEs' MBS.

Because the GSEs had a ready market to sell virtually any security they created, this had the consequence of expanding the demand for subprime mortgages as the competition for mortgages between the GSEs and private label securitizers intensified.

For years, the GSEs' regulator, then known as the Office of Federal Housing Enterprise Oversight, warned Congress of the GSEs' unsafe behavior, but the GSEs' lobbying machines usually were able to fend off calls for increased regulation by wrapping themselves in the flag of home and hearth. It was extremely difficult to find any legislators willing to attach their names to something that its opponents would inevitably call the "Destroying the American Dream Act."

Perhaps not entirely coincidentally, expanded securitization had the added benefit of increasing the bonus pool for the GSEs' management teams, making many of them multi-millionaires, lending credibility to critics who argued that the GSEs were able to reap the benefits during the good times, while forcing taxpayers to pick up the tab for the losses once the party ended.

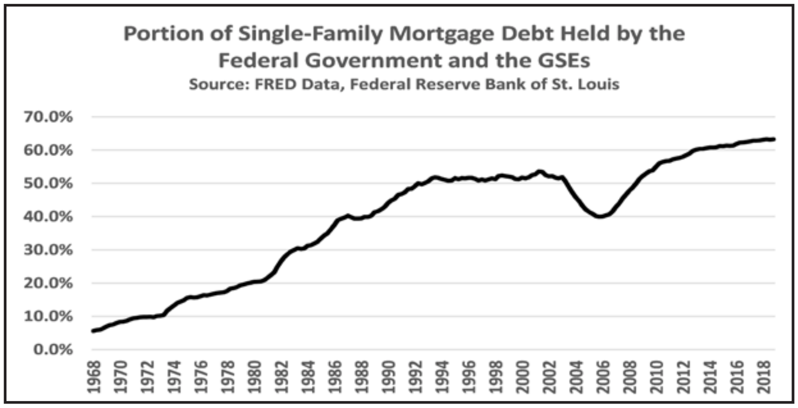
In 2007, panic in the financial markets set in as subprime lenders began filing for bankruptcy and an increasing number of homeowners grew delinquent on their mortgage payments, threatening the ability of the MBS to deliver the returns their investors required.

By the summer of 2008, it was like a global game of chicken, with investors holding GSE MBS – many of them the world's largest financial institutions – practically daring the U.S. government not to guarantee them. Ultimately, rather than allow the destruction of America's credit-worthiness, Treasury Secretary Henry Paulson swerved first, averring that well, yes, while they're not *officially* guaranteed, we will, um, right, you know, make sure that the GSEs' MBS are fully supported by *essentially* the full faith and credit of the U.S. government.

CONSERVATORSHIP

In late July 2008, Congress passed the Housing and Economic Recovery Act of 2008, establishing FHFA as a more robust regulator for the GSEs, and within a few weeks, FHFA Director Lockhart placed Fannie Mae and Freddie Mac into conservatorship.

The GSEs' conservatorships are governed by the terms of the Senior Preferred Stock Purchase Agreement, or PSPA, under which the Treasury Department promised to provide the GSEs an amount of up to $100 billion each, following any quarter in which they reported a deficit in their balance sheets. While this amount may



seem a trifle now that we are accustomed to economic stimulus packages denominated in the trillions, at the time, $100 billion seemed like a number that just might be sufficient to restore calm to the global financial markets.

It is important to recognize that the PSPAs were structured not as loans, but as preferred equity. In exchange for the capital infusions Treasury offered under the PSPAs, the GSEs were required to make quarterly dividend payments on an annual basis of 10 percent (12 percent if not paid in cash), meaning that a PSPA draw of $10 billion would require annual cash dividends of $1 billion. And while there was a mechanism within the PSPAs to redeem, purchase, or retire the Senior Preferred stock, dividends were never considered to be interest or loan repayments.

In exchange for its commitment of liquidity to the GSEs, Treasury received Senior Preferred shares, the right to periodic commitment fees, and a warrant to purchase 79.9 percent of the GSEs' common stock – just under the percentage that would have required Treasury to consolidate the GSEs' financial statements into the government's financial statements. And to be clear, there were approximately zero policymakers who were interested in bringing the GSEs' almost $6 trillion of unconsolidated debt into the Federal balance sheet, which at the time held "only" about $12 trillion in debt.

THE GAAP GAP

The terms of the PSPAs did not provide for "liquidity, as needed." Instead, the Treasury pledged to plug any gap produced in the GSEs' financial statements prepared according to generally accepted accounting standards – or GAAP. This curious feature resulted in GSE draws from Treasury because of GAAP deficits caused by accounting entries, such as writedowns for estimated loan losses, the elimination of deferred tax assets, and timing differences in recording gains and losses in their derivatives portfolios, that had no immediate cash flow effects on the GSEs' ability to meet their obligations.

Almost immediately, both GSEs began drawing heavily, and by May 2009, fearing that $100 billion might not be enough, the newly installed Obama administration amended the PSPAs to increase the amount of liquidity promised to each GSE to $200 billion.

By the end of the third quarter of 2009, Fannie Mae had drawn $45 billion and Freddie Mac $51 billion, and fearing that even $200 billion would not be enough, Treasury again amended the PSPAs to allow each GSE to draw $200 billion plus all the deficits they would incur through the end of 2012.

By the end of 2011, Fannie Mae had drawn almost $112 billion, and Freddie Mac had drawn about $71 billion. As the housing market began to stabilize and even improve a bit in early 2012, the GSEs increased their guarantee fees, helping to improve their financial performance. But with annual dividend requirements of $11.2 billion for Fannie Mae and $7.1 billion for Freddie Mac – earnings figures they had never achieved prior to the financial crisis – fears began to mount that the GSEs would be forced to draw from Treasury in order to make their 10 percent dividend payments back to, well, Treasury, creating a kind of "dividend death spiral" that would eventually deplete the remaining funding commitment to the GSEs.

Accordingly, in August of 2012, the PSPAs were once again amended, requiring the GSEs to pay to the Treasury Department all of their net worth each quarter, except for a specified capital reserve amount to enable them to absorb short-term and non-cash flow GAAP losses.

TERMINATING CONSERVATORSHIP

By almost any measure, conservatorship seems to have contributed to the stabilization of the financial markets following the 2008 crisis and to have provided at least some support to many homeowners, helping them remain in their homes by allowing lenders to work with them to modify the terms of their mortgages. Importantly, the GSEs retained their access to the capital markets, and the U.S. dollar retained its position as the world's reserve currency.

Still, it is difficult to believe that the architects of conservatorship intended it to last indefinitely, and in

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fact, current FHFA Director Mark Calabria contends that, as one of those architects, it never was so intended.

During the Obama administration there *were* several bi-partisan attempts to introduce legislation to reform the GSEs and to address conservatorship, but as the economy stabilized and housing prices began to return to their pre-crisis levels, housing reform lost much of its urgency, and none of the bills ever came to a vote in either the House or the Senate.

FHFA implemented significant structural reforms while under the leadership of former Congressman Melvin Watt, appointed by President Obama in 2014 as the Director of FHFA. Director Watt led the initiative to complete a standardized securitizing platform to be used by both GSEs, while maintaining a primary focus on maximum home retention policies and credit availability.

Meanwhile, nothing is ever simple, including attempts by dedicated civil servants to stabilize the nation's housing system. In response to the August 2012 "third amendment" to the PSPA, often called the "Net Worth Sweep," several large investors in the publicly-traded equity of the GSEs filed multiple lawsuits against Treasury and FHFA, challenging the government's authority to "sweep" all the GSEs' earnings.

With the election of President Trump in 2016 and his announcement that Steven Mnuchin would lead the Treasury Department, many GSE watchers expected that given Mnuchin's background in mortgages and the lending industry, GSE reform would become a signature issue of the Trump administration. However, there was a catch. FHFA was still helmed by Director Watt, whose term would not expire until January of 2019.

Once Director Watt's term ended, the Trump administration didn't waste any time moving forward with its program of GSE reform. On March 27, 2019, President Trump issued a Presidential Memorandum directing the Treasury Secretary to

> …develop a plan for administrative and legislative reforms to achieve the following housing reform goals: (i) **ending the conservatorships** of the Government-sponsored enterprises…upon the completion of specified reforms; (ii) facilitating competition in the housing finance market; (iii) establishing regulation of the GSEs that safeguards their safety and soundness and minimizes the risks they pose to the financial stability of the United States; and (iv) providing that the Federal Government is properly compensated for any explicit or implicit support it provides to the GSEs or the secondary housing finance market.[3] (Emphasis is mine.)

Less than two weeks later, on April 9, 2019, Mark Calabria assumed his position as the Director of FHFA, stating, "I enter this office with a sense of urgency. The foundations of our mortgage finance system remain vulnerable, and we must not let this opportunity for reform pass."[4]

Director Calabria immediately rolled up his sleeves, making significant alterations to the scorecards FHFA had issued for the previous seven years to measure the GSEs' performance toward meeting the requirements of conservatorship. Significantly, Director Calabria added to the scorecard the goal of preparing for a transition out of conservatorship.

In September 2019, Treasury issued its Housing Reform Plan, recommending substantial changes to the role of the federal government and the GSEs in the housing finance industry, preventing future taxpayer-funded bailouts, promoting increased market competition, and of course, ending the conservatorships.

The plan to release the GSEs from conservatorship appeared to be proceeding apace when in early February of 2020, FHFA announced that it had engaged the investment banking firm Houlihan Lokey "to assist in the development and implementation of a roadmap to responsibly end the conservatorships of Fannie Mae and Freddie Mac…" They would be further asked to consider "business and capital structures, market impacts and timing, and available capital raising alternatives" for the GSEs.[5]

THE CURRENT CRISIS AND CONTINUING CONSERVATORSHIP

And then came COVID-19.

As the lockdowns were implemented in response to the pandemic, unemployment skyrocketed, plunging the country into another economic catastrophe. During these worst of times, it certainly didn't seem like the best of times to be discussing radical changes to the GSEs or to their conservatorships. The known unknowns, as well as the unknown unknowns, have certainly accumulated during the past year, and the only certainty is that there is none, particularly with respect to how much forbearance homeowners will need and the effects all this will have on the GSEs' financial performance. As of this writing, the GSEs reported astonishingly good results during the first three quarters of 2020, with income from mortgage refinancings and home prices reaching near record highs. Nevertheless, at some yet-to-be-determined point in time, there is almost certain to be financial pain once generous (and mandated) forbearance terms reach their inevitable limit.

3 U.S. Department of the Treasury Housing Reform Plan, Pursuant to the Presidential Memorandum Issued March 27, 2019, September 2019, pg. 1. https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf (accessed January 30, 2021).

4 Federal Housing Finance Agency News Release, Dr. Mark Calabria Sworn In as Director of the Federal Housing Finance Agency, April 15, 2019, https://www.fhfa.gov/Media/PublicAffairs/Pages/Dr-Mark-Calabria-Sworn-In-as-Director-of-the-Federal-Housing-Finance-Agency.aspx (accessed January 28, 2021).

5 Federal Housing Finance Agency News Release, FHFA Hires Financial Advisor, February 3, 2020, https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Hires-Financial-Advisor.aspx (accessed January 28, 2021).

Throughout the COVID-19 crisis, while supporting the GSEs' role in helping borrowers remain in their homes and continuing to extend moratoria on home foreclosures, Director Calabria and Secretary Mnuchin believed there was much that could be done to reform the GSEs without congressional help, and they continued to pursue a strategy for ending conservatorship, or at least for significantly altering its structure.

As if there weren't enough obstacles to their efforts to end conservatorship, in June of 2020 one of the investor lawsuits received a boost when the U.S. Supreme Court handed down its decision in *Seila Law v. the Consumer Financial Protection Bureau*, ruling that the single-director structure of the CFPB was unconstitutional. The decision heartened the GSE investor plaintiffs challenging the 2012 Net Worth Sweep because it seemed to indicate the Supreme Court would be sympathetic to their arguments in the *Collins v. Mnuchin* case. In that case, the Fifth Circuit Court of Appeals handed down a decision in June of 2019 that FHFA's structure was unconstitutional, in part because of *its* single-director structure. The Government's appeal of the Fifth Circuit's decision was heard by the Supreme Court on December 9, 2020, and a decision is expected in June of this year.

Should the Court rule that FHFA's structure is unconstitutional, it would mean that the President has the right to appoint FHFA's director, who would no longer be protected by a five-year term. And if that is the Court's ruling, most observers believe it is a near certainty that President Biden will choose to replace Mark Calabria with a Director who is not as likely to be as enthusiastic about ending conservatorship.

While it could be argued that during the first half of January the Executive branch of government was occupied with far more pressing issues than GSE reform, on January 14, 2021, less than a week before President Biden's inauguration, the Treasury Department announced another change to the terms of the PSPA. Treasury would no longer sweep the GSEs' earnings. Instead, the GSEs would be allowed to retain their earnings to build equity consistent with the requirements set forth by FHFA in its December 2020 Final Rule on Enterprise Capital. The Rule stipulated that the GSEs should hold capital in an amount deemed sufficient to "facilitate their ability to operate through a severe downturn" and that collectively, the GSEs should hold more than $280 billion in risk-based capital. The January 14 announcement was, in other words, essentially a reversal of the 2012 Net Worth Sweep, as well as a giant pause button on the requirement for the GSEs to pay dividends to Treasury.

Of course, no changes to the PSPAs are set in stone; the PSPAs can be amended at any time by Treasury Secretary Janet Yellen or any future successor. In theory, Congress could also intercede and modify the GSEs' charters and create legislation to release them from conservatorship, although that seems unlikely in the present climate.

The very purpose of conservatorship is to implement critical reforms that will produce a stronger and more resilient housing finance system. This is not just a free market goal but also a social goal. And therein lies much of the predicament facing policymakers when confronting GSE reform. Fannie Mae and Freddie Mac were always weird animals: stockholder-held, SEC-listed, publicly-traded companies, but chartered to serve a social purpose – not fully public, but not completely private either. Instead of being taken into bankruptcy for restructuring or liquidation, they were placed into government-supervised conservatorships, where they have remained for more than a dozen years.

And once again, the GSEs have been asked to step in to help mitigate the damages that an entirely free housing market would almost certainly extract from homeowners. Those whose mortgages are held by the GSEs are being assured that they will be offered forbearance and mortgage modifications, and it is FHFA, as the GSEs' conservator, that is directing the GSEs to take those initiatives.

Will the GSEs need to draw on their PSPAs once again? Fannie Mae's remaining PSPA commitment is $113.9 billion, while Freddie Mac's is $140.2 billion. FHFA and Treasury are now committed to allowing the GSEs to retain capital, with no obligation to pay dividends to Treasury. But there's still a lot of uncertainty. No one knows how much longer this pandemic will last or how bad its long-term consequences will be.

It would be foolish to engage in any kind of prognosticating after all we've recently been through. Almost no one predicted Brexit, Donald Trump's presidency or the COVID-19 pandemic and its accompanying economic damage. Still, it is difficult to imagine President Biden mustering the enthusiasm to end the GSEs' conservatorships. And there just might be something to be said for conserving the GSEs' conservatorships during a time of continuing crisis. Just ask Jamie Spears, who continues to control the purse strings of his daughter's vast entertainment empire.

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CHAPTER 11 BANKRUPTCY AND IRS FORM 8937: REPORT OF ORGANIZATIONAL ACTIONS AFFECTING BASIS OF SECURITIES

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In a typical single-debtor Chapter 11 bankruptcy reorganization, secured creditors acquire majority ownership of the reorganized corporation pursuant to the bankruptcy plan of reorganization.[1] In most cases, prior equity holders receive no equity in the reorganized corporation; however, in some bankruptcy reorganizations prior equity holders receive new equity in the reorganized corporation.[2] In either case, the reorganization may trigger a Form 8937 filing requirement for the reorganized corporation.

REQUIREMENT TO FILE A FORM 8937 PURSUANT TO A CHAPTER 11 RECAPITALIZATION

Many corporate actions can trigger the requirement for the corporation to file a Form 8937, Report of Organizational Actions Affecting Basis of Securities. Such actions include corporate distributions in excess of earnings and profits, certain merger and acquisition transactions, and exchanges of stock-for-stock or stock-for-debt, as described further below.

The Form 8937 requirement arises under section 6045B and Reg. section 1.6045B-1, and stems from Congress' expansion of tax basis reporting requirements in 2008 legislation.[3] Section 6045B requires corporate issuers of certain securities to report information to the IRS and its shareholders following certain actions that affect the security's basis. Congress enacted the provision to improve tax compliance resulting from the proper determination of the basis of securities.

For example, a corporation that exchanges all of its outstanding notes for corporate stock in a Chapter 11 reorganization treated as a recapitalization generally must file a Form 8937. The form would serve to inform the prior note holders regarding their basis in the shares of stock received in exchange for their notes, and would make the same basis information available to brokers (if any) that hold such stock for customers. If prior equity holders also receive new equity in the reorganized corporation, the Form 8937 will also apprise the prior equity holders of the basis in the shares of the stock received in exchange for their prior equity interests, and would again make the same basis information available to brokers.

The filing requirement only applies upon certain "organizational actions" taken by an issuer of a "specified security."[4] We will next discuss the organizational action and specified security concepts in turn.

ORGANIZATIONAL ACTION

Only organizational actions that affect the basis of all holders of a security or class of a security trigger the section 6045B reporting requirements.[5] Organizational actions generally subject to the reporting requirement include:

- Distribution of cash or stock in excess of current and accumulated earnings and profits.
- Certain mergers and acquisitions.
- Exchange of notes for stock, or stock for a different class of stock.
- The issuance of a debt instrument in a recapitalization, including a recapitalization resulting from a significant modification or a bankruptcy reorganization.
- Nontaxable stock split or reverse stock split.

Certain actions generally do not trigger the reporting requirement, including:

- Distribution of money or stock not in excess of current and accumulated earnings and profits.
- The issuance of a debt instrument.
- The distribution of stock to someone exercising a previously granted right to purchase stock.

[1] A bankruptcy reorganization of this sort, involving exchange of debt for equity of a corporate debtor, may qualify as a recapitalization under Internal Revenue Code ("IRC") section 368(a)(1)(E) (an "E Reorganization"), and may also qualify as a reorganization under IRC section 368(a)(1)(G) (a "G Reorganization"). Parties to E Reorganizations and G Reorganizations generally qualify for tax-free treatment with respect to exchanges of stock or securities in the reorganization. By contrast, no exchange of debt for equity of a corporate debtor typically occurs in a Bankruptcy Code section 363 asset sale. Nonetheless, a section 363 asset sale may also qualify as a G Reorganization. All references herein to "section" or "Reg. section" refer to the IRC and the regulations promulgated thereunder, unless a specific reference is made to the Bankruptcy Code.

[2] For example, in the American Airlines bankruptcy, former equity holders received new equity in the reorganized company. *In re AMR Corporation, et al., Case No. 11-15463 (SHL), (Jointly Administered),* (Bankr. S.D.N.Y.).

[3] Section 403 of the Energy Improvement and Extension Act of 2008, Div. B of Pub. L. No. 110-343, 122 Stat. 3765 (Oct. 3, 2008) (the "2008 Act"), amended the broker reporting rules in section 6045. As amended by the 2008 Act, section 6045(g) generally requires a broker, when reporting the sale of a covered security to the Internal Revenue Service, to report the customer's adjusted basis for the security. The 2008 Act also added two new sections to the IRC: (1) section 6045A, which requires a broker transferring certain securities to report basis and other information to the receiving broker; and (2) section 6045B, which requires an issuer of certain securities to file a Form 8937 to describe the issuer's actions that affect the basis of the security.

[4] Section 6045B(a)(1); Reg. section 1.6045B-1(a)(1).

[5] *See* Section 6045B(a)(1); Reg. section 1.6045B-1(a)(1).

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SPECIFIED SECURITY

Specified securities include any stock and certain debt instruments issued by an entity classified as a corporation, whether foreign or domestic.[6] Debt or equity interests issued by entities classified as partnerships for federal income tax purposes are not specified securities.[7] Also, a security classified as stock by the issuer is treated as stock for purposes of section 6045B.

Specified securities generally include: (1) stock, (2) debt instruments, (3) options on specified securities or on financial attributes of specified securities, warrants and certain stock rights, and (4) securities futures contracts.[8]

ADDITIONAL RULES FOR FORM 8937 FILINGS AND CONTENT

Form 8937 must be filed by the earlier of: (1) 45 days after the date of the event affecting the specified security's basis,[9] and (2) January 15 of the year following the calendar year of the event affecting the security's basis.[10]

If the corporation makes Form 8937 publicly available in the manner prescribed by the regulations, along with the name, address, phone number and email address of the person required to file the return, then the corporation need not file the information return or furnish statements to the holders.[11] The regulations state that this can be accomplished if the issuer posts Form 8937 in a readily accessible format in an area of its primary public website dedicated to this purpose and keeps the return accessible to the public for ten years on its primary public website or that of any successor organization.[12]

S corporations frequently make distributions that are treated as reductions to stock basis rather than as taxable dividends. An S corporation is deemed to satisfy the reporting requirements if the required information is included in the Schedules K-1 that are included with its tax returns when filed on a timely basis.[13] Accordingly, the S corporation does not need to report separately under section 6045B.

6 Reg. section 1.16045-1(a)(14). *See generally* Sections 6045B(d) and 6045(g)(3)(B). The Form 8937 filing requirement applies to both domestic and foreign issuers of securities. However, the Form 8937 filing requirement does not apply where all the holders of the security are exempt recipients, as defined in Reg. section 1.6045-1(c)(3)(i)(B). Reg. section 1.6045B-1(b)(5).

7 *See* Reg. section 1.16045-1(a)(14). *See also* Sections 6045B(d) and 6045(g)(3)(B).

8 *See* Reg. sections 1.16045-1(a)(14), -1(m) and -1(n).

9 In the case of a bankruptcy reorganization, the event affecting the specified security's basis is typically the effective date of the plan of reorganization, not the confirmation date of the plan.

10 Section 6045B(b)(2).

11 This is generally the case for large bankruptcies. See, for example, a Form 8937 made publicly available relating to the American Airlines bankruptcy at https://americanairlines.gcs-web.com/static-files/f402c28b-be48-4b23-9948-f86eb01b62cf.

12 Section 6045B(e); Reg. section 1.6045B-1(a)(3).

13 Reg. section 1.6045B-1(c).

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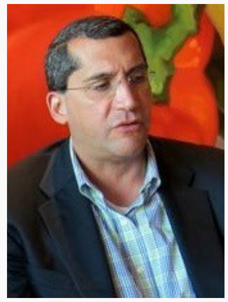

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A corporate issuer that, prior to the reporting due date, cannot determine the quantitative effect of an organizational action on basis may make reasonable assumptions regarding the relevant facts. However, for this purpose, the corporation must treat a payment that may be a dividend consistently with the corporation's treatment of the payment for purposes of determining whether it is a dividend.[14] Under the rules relating to dividend treatment, for purposes of furnishing Forms 1099-DIV to report the taxable (dividend) portion of

14 Reg. section 1.6045B-1(a)(2)(ii). *See also* section 6042(b)(3); Reg. section 1.6042-3(c).

the distribution, a corporation is required to treat the entire distribution as a taxable dividend unless it can establish the amount that is not a dividend. Accordingly, if the entire amount of a distribution is reported as a taxable dividend, section 6045B reporting would not be required (because the distribution would not impact basis). If the corporation later determines that a portion of the distribution is not a dividend, it should amend its Forms 1099-DIV and provide the section 6045B information within forty-five days of determining the correct facts.[15]

In some cases, a corporation may believe that a portion of a distribution is a taxable dividend but might not know the amount with certainty. In these cases, it is appropriate to make a timely filing under section 6045B and amend it later when the correct information becomes available. As noted above, the corporation may make reasonable assumptions about facts that cannot be determined before the due date.[16] The corporation must file a corrected return within 45 days of determining facts that result in a different quantitative effect on basis from what the corporation previously reported.[17]

CONCLUSION

Taxpayers emerging from bankruptcy reorganizations should consider whether the Form 8937 filing requirement applies to them, bearing in mind the Form 8937 filing deadline is the earlier of: (1) 45 days after the date of the reorganization, and (2) January 15 of the year following the calendar year of the reorganization.

15 Reg. sections 1.6045B-1(a)(2)(ii) and 1.6045B-1(g), Example 2(iii).
16 Reg. section 1.6045B-1(a)(2)(ii).
17 *Id.*

SOLVENCY OPINIONS AND CONCERNS ABOUT FRAUDULENT CONVEYANCE IN LEVERAGED TRANSACTIONS

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The many considerations related to solvency opinions can be quite complicated. Yet these analyses are often required as a condition for consummating sizeable recapitalizations and other risky corporate transactions. A solvency opinion may serve as the means (1) to address the possibility that the transaction could be alleged to be a fraudulent conveyance at some point in the future and (2) to provide comfort to fiduciaries responsible for approving such transactions. This discussion describes each of the three financial tests that are the components of the fraudulent transfer analysis. And, this discussion presents considerations and procedures that (1) enhance the analytical support for the solvency opinion and (2) bolster its usefulness to the intended user.

INTRODUCTION

Independent financial advisers are often asked to issue solvency opinions in order to provide an assessment of a debtor company's solvency as of the date of a proposed leveraged transaction.

For instance, a debtor company board of directors may often request that a solvency opinion be procured as part of its due diligence process for certain corporate transactions. Should the board of directors approve a proposed transaction, the solvency opinion (1) provides support for the decision and (2) provides evidence of actions taken in order to fulfil the board's fiduciary duty of care should the transaction be challenged in a fraudulent conveyance claim.

Examples of corporate transactions that may benefit from the preparation of a solvency opinion include, but are not limited to, the following:

1. Leveraged dividend recapitalizations
2. Equity security redemptions
3. Leveraged asset purchases
4. Substantial liability payments

When financial advisers refer to a solvency opinion, they are typically referring to the performance of several tests to determine whether the conditions indicative of a fraudulent conveyance as presented in Bankruptcy Code Section 548 exist as of a specified date. Therefore, the solvency opinion, in this context, is essentially a preemptive fraudulent conveyance analysis.

The three generally accepted tests—and the associated conditions—for fraudulent conveyance and for the related solvency opinions include the following:

1. The *balance sheet test* considers whether the total fair value of the debtor company assets is greater than the total amount of the debtor company liabilities.
2. The *cash flow test* evaluates whether the debtor company will be able to pay its debts and other financial obligations as they become due. The period analyzed is generally from the transaction date through the maturity date of any transaction related debt.
3. The *capital adequacy test* considers whether the debtor company has the capital needed to meet its operating expenses, capital expenditure requirements, and debt repayment obligations during the first few quarters after the proposed transaction.

The analysis of reasonably equivalent value is typically included when analyzing a transaction for fraudulent conveyance purposes. However, it is not typically included as a separate analysis when conducting a pretransaction solvency opinion. This subject is beyond the scope of this discussion.

In a bankruptcy context, the notion of solvency is limited to an analysis of assets and liabilities. However, in the context of this discussion, the terms "solvency opinion" and "solvency analysis" will refer to an analysis of a debtor company that is performed prior to a proposed transaction and includes the performance of the three aforementioned fraudulent transfer tests.

THE BALANCE SHEET TEST

The balance sheet test indicates whether, at the time of the transaction, the total fair value of the debtor company assets is greater than the total amount of debtor company liabilities.

First, the analyst typically considers the highest and best use of the debtor company assets. The highest and best use analysis indicates the appropriate premise of value for the valuation aspects of the analysis. A typical premise of value conclusion is value in continued use, as part of a going-concern business enterprise.

Second, the analyst typically estimates the fair value of the debtor company assets, including (1) financial assets, (2) real estate and tangible personal property, and (3) intangible assets.

Third, the analyst estimates the amount of debtor company liabilities including all (1) current liabilities, (2) long-term liabilities, (3) contingent liabilities, (4) disputed claims, and (5) any liabilities attributable to the proposed transaction (i.e., transaction debt).

Fourth, the analyst compares the fair value of the debtor company total assets to the amount of the debtor company total liabilities. The debtor company is considered to have "passed" the balance sheet test if the fair value of the total assets exceeds the amount of the total liabilities.

Contingent Liabilities and Disputed Claims

Disputed claims and contingent liabilities can be particularly tricky in a balance sheet test analysis. This is because these liabilities are not usually readily identifiable and may or may not be disclosed in debtor company financial statements or other information provided by the company management.

A contingent liability is an obligation that requires a triggering event to occur before the debtor company is required to pay a specified amount to a creditor. However, a disputed claim involves a dispute about the amount associated with a claim after the events spawning the claim have already occurred.

These types of liabilities are not always obvious. Therefore, a financial adviser should conduct appropriate due diligence to ensure that contingent liabilities and disputed claims are accurately reflected in the analysis.

A significant factor in estimating the amount of a contingent liability or disputed claim—and its impact on the debtor company—is the uncertainty surrounding:

1. the occurrence of a triggering event in the case of a contingent liability or
2. the outcome of a dispute in the case of a disputed claim.

In both instances, financial advisers may typically apply a probability weighting that is reflective of the chances of a certain outcome occurring.

THE CASH FLOW TEST

The cash flow test is designed to consider the debtor company's ability to pay its financial obligations (including any new debt related to the proposed transaction) as they mature.

The starting point for the cash flow test analysis is typically a set of earnings or cash flow projections developed by the company management. The length of the projection period should typically be equal to the repayment period for any new debt related to the proposed transaction.

The financial adviser may use the financial projection to estimate the debtor company's net cash flow, after taking into account the financing and operating obligations as well as capital investment and working capital needs of the company.

The cash flow test is considered "passed" if the debtor company is expected to have the ability to meet its financial obligations and remain in compliance with any debt covenants in each year of the projection period.

THE CAPITAL ADEQUACY TEST

The capital adequacy test (sometimes called the "reasonable capital test") indicates whether the debtor company is engaged in a business or transaction for which it has an adequate amount of capital. The capital adequacy test evaluates the debtor company's ability to meet its (1) operating expenses, (2) capital expenditure requirements, and (3) debt repayment obligations.

The goal of the test is to evaluate the likelihood that the company will survive potential business fluctuations over several quarters following the closing of the proposed transaction.

The capital adequacy test involves an analysis of short-term sources and uses of funds, typically for the next four to six quarters following the transaction date.

Typically, the capital adequacy test will have an appearance very similar to the cash flow test and should also include the same or similar scenario and sensitivity analyses as well as stress testing.

The capital adequacy test is "passed" if the analysis indicates that the company is expected to have sufficient cash on hand to pay its:

1. operating expenses,
2. capital expenditures, and
3. debt repayment obligations.

As part of the cash flow test and capital adequacy test, the financial adviser generally performs scenario analyses, which may include sensitivity and stress testing, in order to more rigorously assess risks associated with the proposed transaction. This can also be used as a tool to give fiduciaries and managers insight into how the proposed transaction could affect the company under various operating conditions.

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SCENARIO ANALYSES

The terms "scenario analysis" and "sensitivity analysis" are sometimes used interchangeably. However, for purposes of this discussion, a distinction can be made. While a scenario represents a possible future environment or set of circumstances within which the debtor company could find itself operating, the sensitivity analysis is related to the observed outcomes achieved by changing the financial variables of the scenario.

Often, a scenario analysis is deterministic in nature. That is to say that it has single point estimates for key inputs and outcomes determined by the parameter values.[1]

However, scenario analyses can be stochastic in nature with one or more random variables, and can be used to estimate the probability of outcomes within a forecast. An example of a stochastic analysis is a Monte Carlo simulation. While certain elements of this discussion may be applicable to deterministic and stochastic scenario analyses, the focus of this discussion is on deterministic scenarios.

A very basic deterministic scenario analysis will include the base case scenario and a sensitivity analysis of the base case. However, certain situations may call for a more rigorous analysis, which could include sensitivity analyses and stress tests related to several types of scenarios.

Scenarios can be grouped into several broad categories, including the following:[2]

- ***Single event scenarios*** are relatively straightforward and are usually not the types of events that would result in a chain of successive events.
- ***Multi-event scenarios*** are the result of multiple factors that cause a chain of successive events due to causal linkages between various factors.
- ***Reverse scenarios*** are developed by determining what set of conditions will lead to a specified financial result. This type of analysis can be especially challenging because such an analysis involves a comprehensive understanding of the risk dynamics of the subject debtor company.
- ***Historical scenarios*** are based on actual historical events. The advantage of the historical scenarios is that the short-, medium-, and long-term effects of the event can be observed. Further, the effect of the event on specified risk factors and the relationships between risk factors can be studied. Based on this study, the financial adviser can make proper adjustments when developing scenarios that assume similar events occur in the future.
- ***Synthetic scenarios*** involve hypothetical circumstances that have not been observed but could occur at some point in the future. An example of a synthetic scenario would be the development of a breakthrough technology.

No matter the type of scenario, care should be taken to consider and understand the types of operational disturbances, both internal and external, that could cause such scenarios. Internal and external factors can be grouped into economic, industry, and company-specific categories. Any combination of factors can be used as the event catalyst or the basis for a scenario.

Scenario Development Considerations

Management-prepared financial projections are typically the starting point of a scenario analysis in the context of a solvency opinion. It is the financial adviser's responsibility to assess the reasonableness of the financial projection starting point.

The financial adviser should understand the narrative behind the financial projections and the relationships between the assumptions and variables that drive the projections. When developing scenarios, the financial adviser applies this knowledge to ensure that changes to the financial variables:

1. correctly flow through the model and
2. accurately reflect the relationships between cash flow drivers.

The due diligence related to the financial projections also helps the financial adviser to be able to recognize additional scenarios that should be analyzed in order to provide a robustly supported solvency opinion.

The following illustrative questions are financial-projection-specific inquiries that may provide perspective and may aid the financial adviser in identifying aggressive or conservative bias within the financial projections:

1. What is the functional use or purpose of the financial projections?
2. How experienced is the company management team in preparing financial projections?
3. When were the financial projections prepared?
4. How does the current projection reconcile with historical projections?
5. Who prepared the financial projections?
6. What was the process for developing the projections?
7. How comprehensive are the projections and the supporting documentation?

[1] *Stress Testing and Scenario Analysis* (Ottawa, Canada: International Actuarial Association, July 2013), 3.
[2] Ibid., 12–16.

The reasonableness analysis encompasses the evaluation of many factors and requires the understanding of the interrelationships of these factors, while also considering the impact of outside influences on the company-specific risk elements.

The financial adviser should typically develop a thorough understanding of the mechanics of the company's projection model—as well as the story supporting the projection—before moving forward with the scenario analysis.

The financial adviser can then develop one or several scenarios based on economic, industry, or company-specific factors identified during the due diligence process. While general economic and industry data are typically readily available, a financial adviser should consult with company management in order to understand how and what data was used to develop the projection.

There are many company-specific risk factors that can be informative when included in scenarios for the cash flow test and capital adequacy test. Debtor company management may be a valuable resource for assistance in identifying the company's unique areas of risk and the potential impact on financial performance.

Debtor company management can alert financial advisers to the implications surrounding areas of company-specific risk such as the following:

1. Geographic concentration
2. Customer concentration
3. Key person dependence
4. Supplier concentration
5. Technology or other intellectual property obsolescence
6. Lack of product diversification
7. Unique exposure to changes in laws or regulations
8. Potential or existing litigation
9. Strained supplier relations
10. Strained employee relations
11. Plant and physical capacity constraints

SENSITIVITY ANALYSIS

After developing several scenarios, the financial adviser may run sensitivities of all or certain scenarios to observe the outcomes resulting from incremental changes in the financial variables. A sensitivity is the effect of a set of alternative assumptions regarding a future environment or scenario.[3]

[3] Ibid., 4.

For example, when a financial adviser uses the company management projections as a starting point and then adjusts the variables to reflect small changes in the execution of management's plan, then they have created a sensitivity analysis.

By reviewing the outcomes to various sensitivities, the financial adviser should be able to observe the responsiveness of the cash flow to relatively small changes in the financial variables within the framework of a given scenario.

STRESS TESTING

A stress test is a projection of the financial condition of a company under a specific set of severely adverse circumstances that may be the result of one or several risk factors resulting in severe consequences that can extend over months or years. The likelihood of the stress test condition is typically not likely, yet plausible.[4]

Examples of stress tests scenarios include, but are not limited to, natural disasters, terrorist attacks, political instability (revolution, regime change, expropriation), regulatory changes, economic depression, company fraud, and war.

SUMMARY AND CONCLUSION

Solvency opinions are typically prepared in the context of a proposed transaction when a corporate board of directors or other intended user requires:

1. evidence of actions taken to fulfil their fiduciary duty and
2. comfort that a proposed transaction is not expected to directly cause the insolvency of the company.

A financial adviser should be sure to conduct proper due diligence and apply the appropriate analytical procedures in order to develop a defensible solvency opinion.

[4] Ibid.

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Ryan is a vice president with Willamette Management Associates. His practice includes valuation consulting and financial advisory services comprising solvency analyses, fairness opinions, transaction pricing and structuring, and valuation analyses for tax planning and compliance. Ryan has over 15 years of experience providing assistance and thought leadership to corporate decision makers in order to help them solve problems and make informed decisions. Ryan has served clients across a broad range of industries. He regularly assists corporate boards of directors, private equity firms, owners of closely held enterprises, and fiduciaries with their financial advisory needs.

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A PRIMER ON TRANSFER PRICING FOR RESTRUCTURING PROFESSIONALS: SITUATION ANALYSIS

ARA STEPANYAN
Keystone Strategy

Transfer pricing can be a useful tool and source of information for turnaround and restructuring professionals. Although the practice of transfer pricing is most closely associated with tax planning and compliance, restructuring professionals stand to benefit from using the wealth of information and data provided in transfer pricing studies.

In particular, restructuring professionals typically need to identify the particular business units, subsidiaries, and/or locations that are most and least profitable, identify the reasons for the financial results, and propose strategies accordingly. But such work relies to a large extent, often unbeknownst to most restructuring professionals, on the correctness of transfer pricing. Incorrect transfer pricing produces inaccurate financial results, which, in turn, may lead to erroneous turnaround and restructuring strategies.

This article provides a brief overview of the concept of transfer pricing, summarizes the pertinent transfer pricing regulations, and discusses how restructuring professionals can avail themselves of information available in transfer pricing studies, including details about each entity's functions, assets, markets, and risks, and more importantly, validation of the intercompany prices and resulting entity-level financial results. In addition, a three-step due diligence process is included for restructuring professionals who wish to take advantage of transfer pricing analysis. This approach complements situation analysis and provides the information and data necessary for better-informed turnaround and restructuring strategies.

WHAT IS TRANSFER PRICING?

Corporate turnaround and restructuring takes place for reasons ranging from financial duress resulting from poor management, marketplace changes, or adverse or unforeseen circumstances, to preparation for a sale, merger, or other ownership change, to a need to alter the supply chain for such purposes as streamlining, increasing resiliency, avoiding tariffs, and/or outsourcing, insourcing, or co-sourcing. In each and every instance of turnaround and restructuring, transfer prices must accurately reflect the existing situation to prevent skewing the financial results.

So, what are transfer prices? Transfer prices are the prices that a company sets for transactions among its own affiliates, such as those involving the movement of tangible goods, the use of intangible property (e.g., patents, trademarks, copyrights, and other intellectual property), the provision of R&D and other services, and intercompany funding operations. Each company typically has a policy for determining the transfer prices paid by its buying subsidiaries to its selling subsidiaries. Such policies are typically based on target prices, margins, or markups.

Transfer prices determine the revenue for the selling subsidiaries and the cost for the buying subsidiaries and thus play an important role in assessing and managing the profitability of subsidiaries. For example, if a company's head office charges only the direct cost of services it provides to a subsidiary, then the subsidiary may appear artificially more profitable whereas the head office will appear artificially less profitable. As a consequence, a naive situation analysis that takes the established transfer prices (direct cost in this example) as a given without further examining their economic justification and correctness may lead to an erroneous

[1] This article was previously published in *Journal of Corporate Renewal*, October 2020; republished with permission.

conclusion that the head office operations might need to be restructured.

Another way to look at transfer pricing is to imagine a global pool of profit (or loss) earned by a multinational enterprise (MNE) as a whole. How should that global profit (or loss) be distributed within the MNE to all the entities that comprise it? The answer is that the allocation of profit must take place in accordance with the relative levels of value (or "profit uplift") being generated by the different entities at their locations.

Transfer pricing most often involves MNEs, although it also comes up in domestic-only situations among MNE affiliates located in different U.S. states. When establishing transfer prices, practitioners take a close look at the functions and risks involved with the operations of every entity comprising the MNE, and ensure that the transfer prices are set such that the resulting profit allocation is aligned with value creation.

For example, an entity doing full-fledged manufacturing must earn an amount in excess of another entity doing contract manufacturing, and those amounts must be consistent among the MNE's entities performing similar functions around the globe. Thus, the correct measurement of the profitability of the MNE entities first requires assessing the reasonableness of the MNE's transfer prices. As stated earlier, relying on incorrect transfer prices for situation analysis may lead to misguided turnaround and restructuring strategies. Conversely, getting transfer prices "right" is critically important for a meaningful situation analysis.

TRANSFER PRICING REGULATIONS

Because the shifting of taxable income by means of transfer pricing erodes tax revenue available to governments, corporate income tax regulations in more than 130 countries require that MNEs justify and document the compliance of their transfer prices with the transfer pricing regulations. The latter are based on the arm's-length standard, which requires that transfer prices be equivalent to the market prices at which related buying and selling entities would interact if they were independent entities, rather than parts of the same firm.

For the most part, transfer pricing regulations closely follow the guidelines issued by the Organization for Economic Co-operation and Development (OECD).[2] The most recent update to the OECD guidelines, in 2017, introduced a new standardized approach to transfer pricing documentation, which recommended that MNEs annually prepare the following three reports:[3]

- **Master File.** This report includes information about an MNE's global business operations, organizational structure, main geographical locations, business activities of the group's subsidiaries, significant value drivers, group intangibles, financing activities, and tax positions.
- **Local File.** This report supplements the information contained in the master file and includes detailed information specific to each of the MNE's local country subsidiaries, including transfer pricing policies, related-party agreements, related-party transactions, the resulting financial positions, and an analysis and determination of the arm's-length nature of the results.
- **Country-by-Country Report.** This report, which covers the entire MNE and is essentially an accounting overview, includes business and financial information for the MNE's operations in each tax jurisdiction, such as number of employees, revenue (both related- and third-party), profit before income tax, income tax paid, assets, etc. It is meant to provide tax authorities with a centralized view of key MNE statistics by jurisdiction and enables them to conduct high-level risk assessments and identify targets for tax audits.

In the United States, this triad of reports is not specifically required. However, to avoid penalties in case the Internal Revenue Service (IRS) audits and adjusts transfer prices, corporate taxpayers are encouraged to prepare "contemporaneous" transfer pricing documentation that includes information complying with most of the OECD's requirements for the master file and local file reports.

The required information similarly includes an overview of the business, a description of the intercompany transactions, a description of the organizational structure of related parties engaged in the transactions, a description of the method selected to evaluate transfer prices along with an explanation of why it was selected, a description of the other methods that were considered and an explanation of why they were not selected, and an explanation of the economic analysis used to develop transfer prices.[4]

Often, the transfer pricing documentation also includes what is referred to as a value-chain analysis (VCA), which describes value creation by location. Many tax authorities have come to expect such an analysis to enable them to understand "the big picture" of a business. For the same

2 oecd.org/tax/transfer-pricing/ (http://oecd.org/tax/transfer-prici ng/).

3 Most countries have adopted the OECD guidelines or some version thereof in their local tax regulations.

4 irs.gov/pub/irs-a pa/penalties6662_e.pdf (http://irs.gov/pub/irs- apa/penalties6662_e.pdf).

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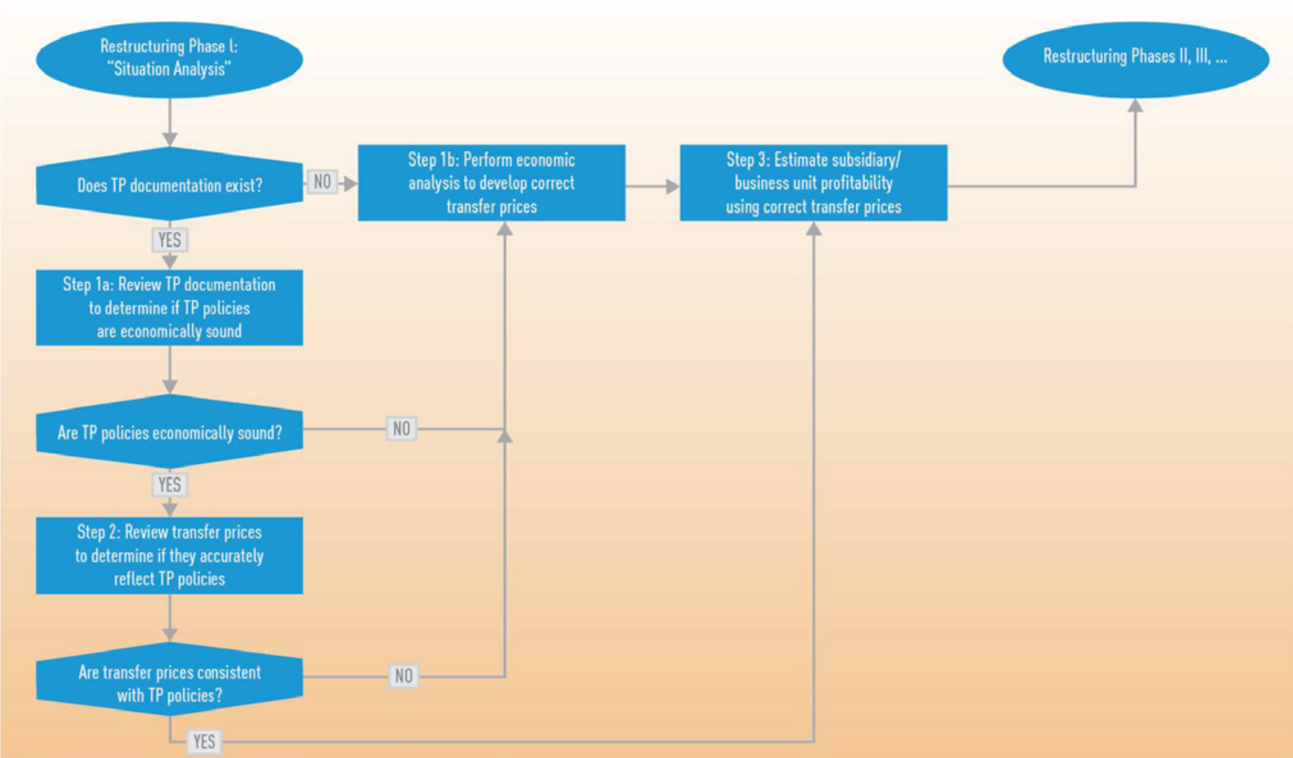
Exhibit 1: Transfer Pricing Flowchart for Situation Analysis



reason, a VCA is likely to be beneficial to restructuring professionals.

ALIGNING RESTRUCTURING WITH TRANSFER PRICING

Restructuring professionals would gain considerable useful information and data by tapping into and aligning their work with transfer pricing. A three-step due diligence approach shown in Exhibit 1 is proposed to incorporate transfer pricing in the situation analysis.

The first question to ask is simply if up-to-date transfer pricing documentation exists. This would take the form of a detailed documentation study for every major location that covers the most recent fiscal year. If documentation exists, as indicated in Step 1a, restructuring professionals would gain pertinent information by reviewing it to ascertain the MNE's transfer pricing policies, which directly affect the financial results of the parent company and all subsidiaries. It would be helpful to have the following questions in mind when reviewing transfer pricing documentation:

- What are the functions performed by each entity?
- What are the risks borne by each entity?
- What are the differences among the various entities?
- Does the range of comparable profits for each entity make economic sense given the descriptions of functions and risks?
- Do the financial results for each entity as shown by actual profit margins or markups make economic sense given the descriptions of functions and risks?
- Are the results consistent across entities with similar functions and risks?
- At which locations are profits either as expected, extraordinary, or below expectations given the functions and risks?
- If a troubled company, can the particular business units or locations experiencing difficulties be isolated?
- Does the MNE utilize valuable intangible assets to attempt to drive extraordinary profits?
- Are the intangible assets located at the correct locations given their profit contributions?
- What information exists to show that extraordinary profits or losses are due to intangibles, company management, market, or other circumstances, or alternatively to transfer mispricing?
- Is there value at any location that is mispriced or not put to work efficiently?

If transfer pricing documentation does not exist or the quality of the provided documentation is questionable, as indicated in Step 1b, restructuring professionals should conduct an independent economic analysis. The purpose would be to ensure that the allocation of revenues and costs across the MNE group subsidiaries is economically sound before proceeding with entity-level profitability assessment.

As previously explained, the soundness of the allocation of revenues and costs depends largely on whether transfer prices have been set such that they are equivalent to arm's-length prices. The economic analysis could take the form of the standard transfer pricing study under pertinent regulations, with a particular focus on the questions posed earlier.

Assume next that the review of transfer pricing documentation, whether already in existence or newly created, leads to a conclusion that the MNE's transfer pricing policies are reasonable. The next step, as indicated in Step 2, is to examine transfer prices and entity-level financial outcomes to ensure that they reflect the established transfer pricing policies accurately. It is not unusual to observe transfer prices and outcomes that are inconsistent with transfer pricing policies due to errors introduced during the implementation process.

For example, if a manufacturing subsidiary of an MNE sells goods to a distribution subsidiary and the transfer pricing policy states that the distributor should earn a 3% return on sales, then the transfer prices must be set such that the distributor indeed earns a 3% profit margin. Reviewing the consistency of transfer prices with transfer pricing policies often requires a granular-level understanding of intercompany transactions at the product level, along with product-level financial records and detailed cost accounting information.

As indicated in Step 3, only after the MNE's transfer prices have been reviewed and the allocation of revenues and costs across the group subsidiaries validated as economically defensible can restructuring professionals use the subsidiary-level profitability data to conduct the situation analysis and identify potential restructuring strategies. In other words, restructuring professionals will have a more informed basis for the identification of such strategies with the benefit of a transfer pricing analysis and confirmation that transfer prices have been set correctly.

CONCLUSION

Restructuring professionals stand to benefit from knowing if the financial data and results they are examining are reflective of correct intercompany pricing, since skewed financial results may lead to using the wrong turnaround and restructuring strategies. In addition, restructuring professionals can take advantage of the information provided in transfer pricing documentation about a company's functions, assets, markets, risks, and expected profits by location to better understand what drives the profits or losses of the various component entities.

In fact, complete and thorough transfer pricing documentation should contain substantial information and data about business segments and their absolute and relative performance. Restructuring professionals can also consider altering the transfer prices in line with arm's-length requirements to make sure that internal pricing correctly incentivizes and rewards the various business segments based on value generation. The three-step due diligence process described in this article can be useful by complementing the situation analysis and providing information and data necessary for better-informed turnaround and restructuring strategies .

The author thanks Dr. Steven Felgran for his useful suggestions and contributions to this article.

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Ara Stepanyan is a principal with Keystone Strategy in Boston and a member of the firm's Economics and Technology Advisory practice. He has more than 15 years of experience guiding senior management and attorneys through high stakes litigation, corporate restructurings, and complex economic issues involving domestic and international tax and transfer pricing matters. He has also provided investigative consulting services in connection with corruption and fraud-related investigations. Stepanyan holds a PhD in economics from Rice University and an MPA from Harvard Kennedy School.

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Harney Partners, a corporate turnaround and restructuring advisory firm, is pleased to announce the promotion of **Erik White, CIRA**, to Managing Director. In this expanded leadership role, White will continue to focus on providing financial and operational advisory services to companies in transition and distressed situations, while driving firm growth strategies and client delivery enhancement.

From Fortune 500 to lower middle market, White has supported a broad range of companies across multiple industries. He has demonstrated experience in a variety of financial advisory roles, including Chief Restructuring Officer. His expertise includes evaluating business plans, developing financial models for recapitalization and restructuring, monitoring bankruptcy initiatives, identifying cost saving strategies, and negotiating exit financing.

Prior to joining Harney Partners, White has held strategic finance and restructuring roles at a global business advisory firm and with a hedge fund. A member of AIRA and a Certified Insolvency & Restructuring Advisor, he holds an M.B.A. from the University of Michigan, with a concentration in Operations Management. White graduated from Princeton University with a B.S.E. in Operations Research and Financial Engineering.

CLUB 10

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