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WHAT'S INSIDE

38TH ANNUAL BANKRUPTCY & RESTRUCTURING CONFERENCE ("AC22")

JUNE 8-11 & 14,15 | CLEVELAND, OH

AC22 DETAILS ON PP. 59-63

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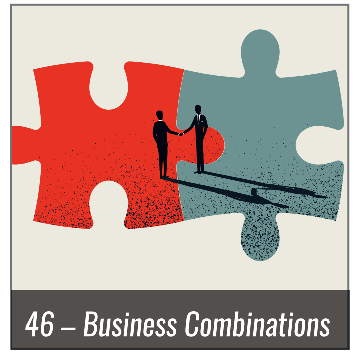

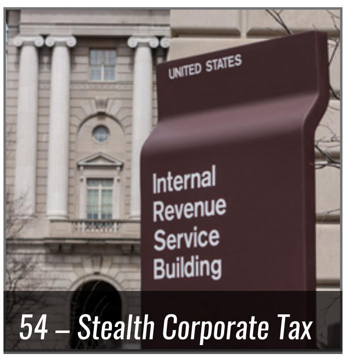
UNITED STATES
Internal
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From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

The year seems to have just started and already we are almost halfway through. As I am drafting this brief note, the live and in-person AC22 Cleveland conference is approaching. My sense is that our membership is ready to meet, learn, and network in person come June 8-11. It is not too late to register. The conference will be preceded by an in-person CIRA 1 class session on June 6 and 7, as well. These are great opportunities to enhance your professional credentials, meet continuing education requirements, and see professional friends and colleagues.

With the annual conference comes transition in the Association's leadership. Mike Lastowski's term as AIRA President concludes in June as he replaces David Bart as AIRA Chairperson, and David Payne assumes the mantle of AIRA President for 22-23. Mike's quarterly letter follows as well as a salutation from David Payne.

In addition to expressing my thanks to all three, David, Mike, and David, for all they have done and continue to do for the Association, I also take this opportunity to recognize other transitions this June.

At AIRA's board meeting in March, the board approved the election of Denise Lorenzo as President Elect and Boris Steffen to succeed Denise as Association Secretary.

On the board front, a number of AIRA's long time board members are concluding their terms. I gratefully acknowledge the contributions to AIRA and our profession by Larry Ahern, Greg Fox, Tony Sasso, Matt Schwartz, Will Sugden, and Joel Waite during their terms as AIRA board members. Thank you for your service, gentlemen.

Joining the AIRA board in June are Michael C. Sullivan, a managing director with Deloitte Turnaround & Restructuring and Kenneth J. Enos, a bankruptcy and restructuring partner in Young Conaway Stargatt & Taylor. Welcome Mike and Ken.

With those notes above, I leave you with another excellent series of articles for your consideration.

Stay safe and stay well.

Jim

A Letter from AIRA's President

MICHAEL R. LASTOWSKI
Duane Morris LLP

Dear AIRA members and supporters:

Many thanks to all of you for your continued support of AIRA. At our calendar year, I would like to provide a brief update on changes in leadership and to remind you all of the opportunity to attend our annual conference and to otherwise participate in AIRA.

LEADERSHIP - I want to welcome and congratulate our new AIRA president, David R. Payne of D.R. Payne & Associates. David is a longstanding member of AIRA who has made many contributions to AIRA as a member of the board of directors. As a member of a small firm whose practice lies outside of the major markets, David has always provided valuable perspectives to our board during discussions relating to planning and strategies. Dave will assume his office at our Annual Bankruptcy & Restructuring Conference (AC22). I want to thank David for assuming his new responsibilities, and I look forward to working with him during the coming year.

At AC22, I will assume the role of Chairman, a position currently held by my friend David Bart of Baker Tilly US LLP. David deserves many thanks for all that he has done for AIRA. Many of you may have noticed the *AIRA Journal* consistently includes a robust collection of articles on a wide variety of issues. David, together with Boris Steffen of Province, Inc., is largely responsible for the *AIRA Journal's* content. Finally, while he was AIRA president, David created the AIRA Distinguished Fellows Program, which was designed to recognize the contributions of senior members of AIRA to the restructuring profession. I know that David will continue to contribute to AIRA and we will all benefit from his dedication to our association.

THE ANNUAL CONFERENCE - AC22 will take place from June 8 through June 11, 2022. The program will be a live event and will take place in Cleveland, Ohio. The Conference presents an excellent opportunity to reconnect with friends and acquaintances post-pandemic in a host city which many of us have yet to explore. I want to extend my special thanks to the AC22 Conference Co-Chairs, Hon. (Ret.) Judith K. Fitzgerald of Tucker Arensberg, P.C., Daniel A. DeMarco of Hahn Loeser & Parks LLP, and John Creighton of AlixPartners, and to our Judicial Chair, the Honorable Jerrold N. Poslusny, Jr., D. N.J. Together with our Planning Committee, they have assembled a group of nationally recognized speakers who will address the issues and challenges facing restructuring professionals today. Many thanks to these speakers and to our many sponsors. Those sponsors are identified on the AIRA website. Your and their support are critical to the success of AC22. Please attend and register online. I hope to see many of you in Cleveland.

OPPORTUNITIES - I encourage each of you to take advantage of the many writing and speaking opportunities which AIRA provides. We are interested in original content and in republishing articles from other professional organizations. Please let us know if you are interested in writing an article or if you would like us to republish an article. In either event, please reach out to me at mlastowski@duanemorris.com or Boris Steffen at bsteffen@provincefirm.com.

I also encourage you to take advantage of the many opportunities to participate in our conferences. Opportunities include both speaking and joining a conference planning committee. If you are interested in participating in any of our conferences, please reach out to one of our board members, all of whom are identified on our website.

Finally, AIRA continues to offer professional certification and educational courses online. AIRA's website provides information about our CPE offerings. CIRA and CDBV training programs are also available online. For further information, contact our Executive Director, Jim Lukenda, at jlukenda@aira.org.

Once again, I thank you for all of your support and I hope to see you at AC22 and other future AIRA events.

A Letter from AIRA's President-Elect

DAVID R. PAYNE, CIRA, CDBV
D. R. Payne & Associates

On behalf of the AIRA, I want to thank outgoing president, Michael Lastowski, for his leadership and service in navigating the organization through the second year of our COVID separation that commenced immediately following VALCON 2020. I am looking forward to the interpersonal aspects of AIRA's 38th Annual Conference, June 8-11 in Cleveland.

I am honored to serve the organization and to serve as successor to a professional such as Michael who has such a distinguished legal career and has been a tremendous supporter of the AIRA. The diversity of professionals and firms within AIRA is a real testament to the foresight of our organization compared to years ago when I first joined as a member of AIA in the late 1980s. As a smaller market, smaller firm practice with three women directors/CIRA's not including myself, the AIRA has played an instrumental role in guiding DRPA's practice development and staff training. I look forward to promoting further diversity, equity and inclusion for AIRA and the restructuring and insolvency community.

I also want to thank Grant and Valda Newton for taking such a personal interest in Ann Payne's and my career pathways over the past thirty plus years and for entertaining our children at numerous conferences and board meetings. I am committed to emphasizing the principles aspired to by Grant and the AIRA, including competency, objectivity, leadership, communication, listening to adverse opinions/positions, and consensus/resolution building, to name a few.

The 2022/2023 fiscal year provides several AIRA platforms to reconnect with colleagues and obtain in-person continuing education, including:

- Annual Energy Conference, Dallas September 15, 2022
- NCBJ Annual AIRA Breakfast Program, Post Confirmation Trust Governance, Orlando, October 21, 2022
- Annual Advanced Restructuring & POR Conference, New York, November 14, 2022

I look forward to working with Michael as the incoming chairman and serving as president under the direction of Jim Lukenda, executive director and the Board starting in Cleveland on the shores of Lake Erie and ending on the shores of Newport Beach for our 2023 conference.

RECENT TRENDS IN CORPORATE DEBT AND REORGANIZATIONS: LAYING THE GROUNDWORK FOR FUTURE LARGE CHAPTER 11 CASES OR JUST MORE RUNWAY?

CORINNE BALL, BRETT BARRAGATE, LEWIS GRIMM, HEATHER LENNOX, DAN MOSS, and KEVYN ORR
Jones Day

Executive Summary

After commercial Chapter 11 filings soared to their highest levels in more than a decade in 2020, the numbers gradually came back to Earth in the latter part of 2020 and, in 2021, fell well below annual averages. The primary driver of this reversal was twofold: swift and robust central bank intervention around the world and readily available and affordable capital from banks, private equity, and hedge funds. Companies were able to amass liquidity by tapping into existing lines of credit, undertaking major capital structure reconfigurations, and leveraging previously unencumbered assets in order to finance existing debt obligations and maintain operations during the pandemic. While this has temporarily abated anticipated increases in restructuring activity, increased interest rates, uncertainty regarding the pandemic's impact on market demand, inflation, and government intervention will all factor into whether restructuring trends return to more "normal" historical ranges or continue their current below-average trajectory.

Future restructuring trends will likely turn on, among other things, whether high-yield issuances remain steady or continue to slow in the coming year and whether liquidity remains readily available and affordable. These macro and micro factors will likely impact the ability of many borrowers to afford existing debt and limit borrowers' optionality in the future and could prompt an increase in court-supervised restructurings.

2020: Peak Year of Restructuring

Chapter 11 Filings Reach Historic Highs

During 2020, bankruptcy filings reached their highest levels since the 2009 financial crisis.[1] Ninety-two companies with liabilities in excess of $500 million filed for bankruptcy.[2] This number constituted an 88% increase from 2019, and a 272% increase over the national annual average since 2005.[3] Sixty companies with liabilities exceeding $1 billion filed Chapter 11, representing a 170% increase over the annual average between 2005 and 2020.[4] Chapter 11 filings peaked in July 2020 after three consecutive months of record numbers of filings.[5] Fifty-one companies with liabilities exceeding $1 billion filed from January 1 to June 30, while only nine restructured in the final six months of 2020.[6] For companies with liabilities exceeding $500 million, only 22 filed for Chapter 11 from approximately July 1 to December 31, a substantial drop from the 70 filings in the first half of the year.[7] The second half of 2020 therefore experienced a more rapid recovery than that following the Lehman Brothers filing in 2009.[8] Indeed, by October 2020, monthly bankruptcy filings returned to historical averages[9] (Exhibits 1-3).

1 2021 Review Mid-Year Report, BankruptcyData.com, https://info.bankruptcydata.com/midyear2021-0.
2 According to BankruptcyData.com.
3 *Id.*
4 *See* Trends in Large Corporate Bankruptcy and Financial Distress: Midyear 2021 Update, Cornerstone Research, 1, https://www.cornerstone.com/Publications/Reports/Trends-in-Large-Corporate-Bankruptcy-and-Financial-Distress-Midyear-2021-Update.
5 Eight or more companies with assets exceeding $1 billion filed for chapter 11 in May, June, and July 2020. The previous record of eight filings was set in May 2009. *Id.* at 2.
6 *See* BankruptcyData.com, *supra* note 2.
7 *Ibid*.
8 *See* Cornerstone Research, *supra* note 4, at 2.
9 *Id.* at 3.

Exhibit 1: 2020-2021 Chapter 11 Filings > $500 Million in Liabilities[10]

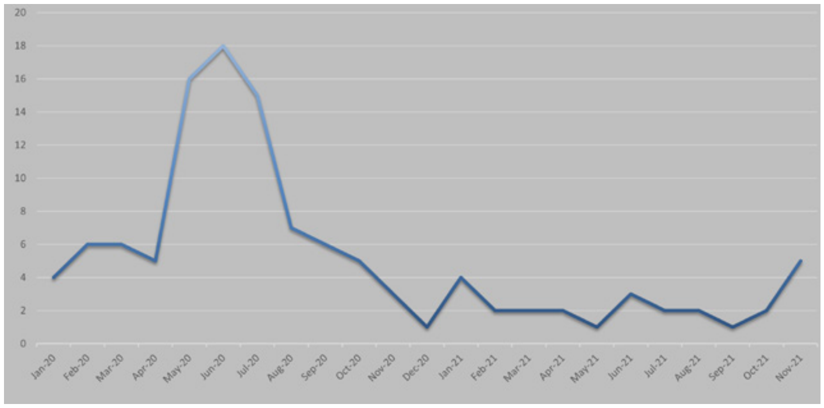
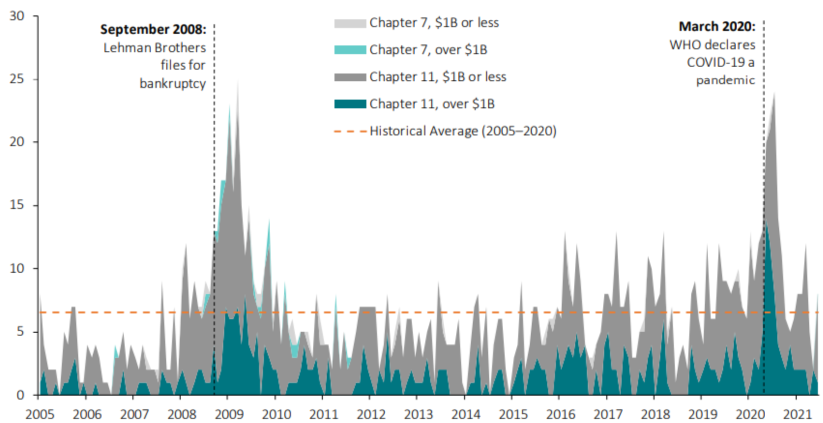


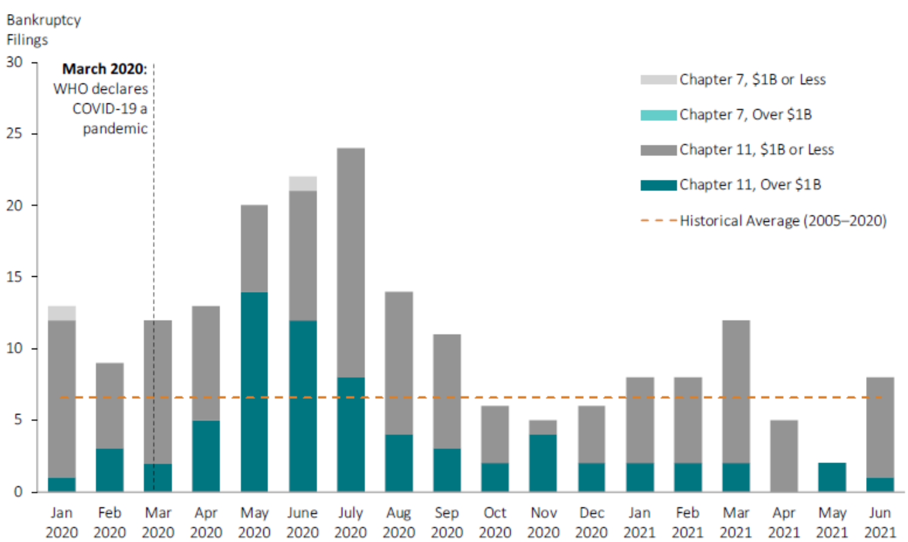
Exhibit 2: Monthly Chapter 7 and Chapter 11 Bankruptcy Filings, 2005–1H 2021[11]



Source: BankruptcyData

Note: Only Chapter 7 and Chapter 11 bankruptcy filings by companies (both public and private) with over $100 million in assets are included. For companies where exact asset values are not known, the lower bound of the estimated range is used. Asset values are not adjusted for inflation. Lehman Brothers filed for bankruptcy on September 15, 2008. The World Health Organization (WHO) declared COVID-19 a pandemic on March 11, 2020. Years are labeled at January 1.

Exhibit 3: Monthly Chapter 7 and Chapter 11 Bankruptcy Filings (Recent Trends), 2020–1H 2021[12]



Source: BankruptcyData

Note: Only Chapter 7 and Chapter 11 bankruptcy filings by companies (both public and private) with over $100 million in assets are included. For companies where exact asset values are not known, the lower bound of the estimated range is used. Asset values are not adjusted for inflation. The World Health Organization (WHO) declared COVID-19 a pandemic on March 11, 2020.

10 *See* BankruptcyData.com, *supra* note 2 (data retrieved Nov. 19, 2021).

11 Cornerstone Research, *supra* note 4, at 2.

12 *Id.* at 3.

Continued from p.7

Exhibit 4: Top 10 Chapter 11 filings in 2020 by liability size ($ in millions)[13]

Company name	Sector	Liabilities
The Hertz Corporation	Industrials	19,590
Frontier Communications Corporation	Communications	17,513
Intelsat S.A.	Communications	14,717
Chesapeake Energy Corporation	Energy	9,095
McDermott International, Inc.	Energy	7,105
Valaris plc	Energy	7,094
Mallinckrodt plc	Healthcare	5,283
Neiman Marcus Group Ltd LLC	Retail and consumer	5,154
California Resources Corporation	Energy	5,085
J.C. Penney Company Inc.	Retail and consumer	4,917
		95,553

Source: Reorg Research, Debtwire, Capital IQ

Exhibit 5: Nonfinancial Corporate Debt Securities and Loans Outstanding, January 2008-March 2021[19]

Source: FRED Economic Data

Note: GDP levels and nonfinancial corporate debt securities and loans outstanding are reported on a quarterly basis and are seasonally adjusted.

The Hardest Hit Industries: Retail and Energy

COVID-19 triggered Chapter 11 filings by distressed companies that otherwise would have eventually restructured, albeit at a later date. In fact, all but one of the top 10 largest companies (by total liabilities) to seek Chapter 11 protection in 2020 were on distressed watch lists before the start of 2020.[14] This trend manifested primarily in the retail and energy industries, with half of the 20 largest bankruptcies filed in 2020 by companies in these sectors.[15] In terms of liabilities, The Hertz Corporation represented the largest restructuring in 2020, with nearly $20 billion in liabilities at the time of the filing (Exhibit 4).

The Commensurate Rise of Corporate Debt

The nonfinancial corporate debt-to-GDP ratio increased from 46.5% in the fourth quarter of 2019 to 57.1% in the second quarter of 2020.[16] Additionally, high-yield and investment-grade spreads relative to Treasury yields spiked 205% and 297%, respectively, in March 2020 over their levels in January 2020 and then slowly returned to January 2020 spreads by December 2020.[17] Investment-grade and high-yield bond issuance increased following the initial government relief efforts, and by June 2020 were 30% above historical levels.[18] This high rate of bond issuance was likely based on the perception that the rapid spike in demand following the end of the pandemic would offset any risk attendant to providing a lifeline to distressed companies. However, the lower revenues and earnings of these companies forced them to use these proceeds both to fund operating losses and to service existing debt (Exhibit 5).

2021: Valley of Restructuring

Restructuring Falls Below Historic Averages

In the first half of 2021, nine companies with liabilities exceeding $1 billion filed for Chapter 11, constituting a 50% decrease from 2020 and six fewer filings than the same period in 2019.[20] Similarly, as of December 2021, nearly 30 companies with liabilities in excess of $500 million filed for bankruptcy during 2021, a precipitous drop from the 92 filings in 2020. It is also approximately 50% below the corresponding number of filings in 2019.[21] Private companies constituted nearly 80% of Chapter 11 filings in the first half of 2021, a significant departure from the annual average of 39% between 2005-2020.[22] Conversely, only 12 publicly traded companies filed for bankruptcy in the first half of 2021, the lowest number since 1980[23] (Exhibit 6).

The average size of the 20 largest bankruptcies in 2021 was 88% smaller than filings that occurred in 2020.[24] When measured by total assets, 2021 experienced fewer bankruptcy filings compared to 2020, with the top two filings, Seadrill Limited and Washington Prime Group, both occurring in the first half of the year.[25] Only the Seadrill bankruptcy would have made the list of the top 20 largest bankruptcies in 2020.[26]

Overall, 2021 experienced a lower level of restructuring activity than anticipated, and that was largely attributable to central bank policies around the world and substantial available liquidity from banks, private equity, and hedge funds. In the United States alone,

13 Turnaround and Restructuring 2021 Outlook, PWC, 5, https://www.pwc.com/us/en/services/deals/library/bankruptcy-outlook.html.
14 *See* Cornerstone Research, *supra* note 4, at 6.
15 *See* PWC, *supra* note 13, at 3.
16 *See* Cornerstone Research, *supra* note 4, at 9.
17 *Id.*
18 *Id.*

19 *See id.*
20 *See* Cornerstone Research, *supra* note 4, at 3.
21 *See* BankruptcyData.com, *supra* note 2.
22 *See* Cornerstone Research, *supra* note 4, at 1.
23 *See* 2021 Transactions Year in Review, *supra* note 1.
24 *Id.*
25 *See* Cornerstone Research, *supra* note 4, at 6.
26 *Id.*
27 BankruptcyData.com, *supra* note 2 (data retrieved Jan. 6, 2022).

Exhibit 6: Business Bankruptcies Cumulative Comparison by Year

Congress enacted more than $5 trillion in financial relief measures since the onset of the pandemic, including almost $800 billion in Paycheck Protection Program loans to various businesses. The Federal Reserve, in concert with other central banks around the world, has also utilized powerful monetary policy measures, such as lowering the target federal funds rate to a range of zero to 0.25%, in addition to purchasing corporate bonds and loans. On the market side of the spectrum, private debt funds raised $88.5 billion in the first half of 2021 after raising $110 billion during the entirety of 2020.[28] Of the $1.4 trillion in capital currently managed by debt funds globally, $1.165 trillion has been invested, while $234.5 billion of capital remains unallocated.[29]

The Corporate Debt Lifeline Continues to Abate Restructuring

Private banks, private equity, and hedge funds were willing to forgo court-supervised restructuring in favor of granting covenant relief, extending maturities, and providing new or additional liquidity to borrowers through debt or equity. In the United States, the nonfinancial corporate debt-to-GDP ratio increased to 50.6% in the first quarter of 2021.[30] Additionally, investment-grade and high-yield spreads declined significantly from their historic levels in June 2020, dropping to 0.86% and 3.03%, respectively.[31] Borrowers were able to seize on available capital at attractive interest rates and delay maturities further into the future, as financing options were available for 70% of high-yield bond issuances.[32]

The corporate debt lifeline enabled some companies to amass liquidity by tapping into existing lines of credit, undertaking major capital structure reconfigurations, and leveraging previously unencumbered assets in order to finance existing debt and sustain operations. One example of this phenomenon began to manifest in December 2020, when AMC Entertainment signaled that it might be on the brink of filing for bankruptcy. Circumstances changed, however, at the beginning of 2021 when AMC was able to raise more than $917 million in new equity and debt. Despite missing earnings expectations in the first quarter of the year, AMC tapped into an additional $587 million in equity issuance in June 2021. Another prominent example is Carnival Corp., which despite facing a notable decline in revenue, amassed approximately $33 billion of total debt by the beginning of 2021, nearly three times more than it had at the end of 2019.[33]

[28] *See* John Bakie, *Debt Funds Raise $88.5bn in First Half of 2021*, Private Debt Investor (July 22, 2021), https://www.privatedebtinvestor.com/debt-funds-raise-88-5bn-in-first-half-of-2021/; John Bakie, *Private Debt Funds Raise $110bn During Pandemic*, Private Debt Investor (Oct. 14, 2020), https://www.privatedebtinvestor.com/private-debt-funds-raise-110bn-during-pandemic/.

[29] *See* Private Equity Fundraising Environment, Bloomberg.

[30] *See* Cornerstone Research, *supra* note 4, at 9.

[31] *Id.*

[32] *See* 2021 Transactions Year in Review, *supra* note 1.

[33] Sam Goldfarb, *Pandemic Hangover: $11 Trillion in Corporate Debt*, Wall Street Journal (June 14, 2021), https://www.wsj.com/articles/pandemic-supercharged-corporate-debt-boom-record-11623681511?mod=article_inline.

Continued from p.9

Future Debtors? Industries Weathering Sustained Distress

Retail & Commercial Real Estate. Notwithstanding the initial wave of pandemic-accelerated bankruptcies in 2020, the retail industry continues to face a variety of structural barriers that may inhibit recovery and lead to another round of in- and out-of-court restructurings in the years to come. The expansion of digital brands into related or core-adjacent product lines has made the market more crowded and competitive. Further, recent calls by investors for retail to separate or spin out e-commerce from brick-and-mortar operations would, if heeded by retailers, isolate profitable e-commerce assets from more structurally challenged brick-and-mortar operations. This, in turn, could precipitate additional (or repeat) in- and out-of-court brick-and-mortar retail restructurings. Unlike the early stages of the pandemic, when retailers benefited from government support and landlord rent concessions or abatements, it is less likely that retailers will be able to negotiate further concessions as landlords face their own financial hurdles, which may limit retailers' abilities to manage liquidity troughs. In fact, based on the challenges facing these landlords, including the potential long-term shift away from brick-and-mortar retail stores, commercial real estate may be among the hardest hit industries during the next round of restructuring activity.

Health Care & Senior Living. In 2021, the average length of hospital stays rose by 12.6% from 2020, while some hospitals with 500 beds or more saw an 18% increase in the median length of stay compared to 2019.[34] Meanwhile, hospitals' cost of care continued to rise, given increased costs associated with inpatient cases, drug prices, labor, and personal protective equipment. These factors resulted in a 15% increase over the pre-pandemic total cost of care per patient.[35] With respect to senior living, occupancy rates recovered to 70% in 2021, but still fell short of the 85-90% pre-COVID levels.[36] Additionally, 84% of nursing homes reported losses in revenue as a result of fewer post-acute patients coming from hospitals.[37] Overall, nursing homes are expected to lose $94 billion over the course of the pandemic.[38] As COVID-19 variants continue to drive this volatility, and near-term debt maturities continue to loom, significant barriers to health care providers' long-term ability to meet the needs of their respective communities will likely remain.

Hospitality & Travel. The airline industry has been forced to adapt continually in response to increasing reports of Omicron variant outbreaks and the attendant increases in flight cancelations. Accordingly, experts have lowered their outlook for global air traffic in 2022.[39] Cruise line operators have likewise reported excess ship capacity, and the dip in cruise bookings following the Delta variant outbreak does not bode well in the wake of Omicron. Furthermore, in an ominous development for other sectors of the hospitality industry, including hotels, business travel is not expected to return to 2019 levels for several years at the earliest. Pronounced volatility is likely to continue plaguing these industries in 2022 and beyond as the population at large navigates the evolving pandemic threat and changes to the way we live and work.

Automotive. The automotive industry is facing an extraordinary level of productivity disruption due to ongoing supply chain issues. Where OEMs have been able to sustain revenues through fewer discounts and higher prices, tier-1 and below suppliers have struggled to acquire necessary parts and raw materials as a result of supplier shutdowns, excess demands on shipping, and labor shortages. The supplier industry has little bandwidth to endure these ongoing disruptions, which may trigger restructuring events in the first half of 2022. The price tag may be substantial; it is projected that the auto industry will sustain an estimated net loss of $270 billion over the course of the pandemic.[40] With little relief in sight, suppliers may find themselves searching for other ways to correct course or bridge liquidity.

Restructuring Outlook for 2022 and Beyond

Price Increases and Rising Interest Rates

In forecasting corporate restructuring in 2022 and the years to follow, a primary indicator of future activity will likely stem from current and prior high-yield borrowers. As of November 2021, high-yield bond issuances exceeded $440 billion, already topping the $431 billion mark set in 2020.[41] Many companies have offered previously unencumbered assets (*e.g.*, cruise ships, frequent flier miles, foreign subsidies, intellectual

34 Hospitals Face Continued Financial Challenges One Year Into the COVID-19 Pandemic, American Hospital Association (March 2021), https://www.aha.org/system/files/media/file/2021/03/hospitals-face-continued-financial-challenges-one-year-into-covid-19-pandemic-fact-sheet.pdf; Financial Effects of COVID-19: Hospital Outlook for Remainder of 2021, American Hospital Association, at 7 (September 2021), https://www.aha.org/system/files/media/file/2021/09/AHA-KH-Ebook-Financial-Effects-of-COVID-Outlook-9-21-21.pdf.

35 *Id.* at 8.

36 Chris Sinnott, Jones Day Pandemic Report.

37 Survey: Only One Quarter of Nursing Homes Confident They Will Make it Through to Next Year, American Health Care Association & National Center for Assisted Living (June 29, 2021), https://www.ahcancal.org/News-and-Communications/Press-Releases/Pages/Survey-Only-One-Quarter-Of-Nursing-Homes-Confident-They-Will-Make-It-Through-to-Next-Year.aspx.

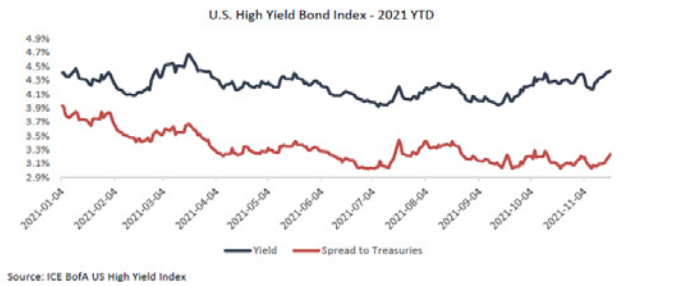
38 *Id.*

39 Leslie Josephs, *Omicron Clouds Outlook for International Travel That Was Just Turning a Corner*, CNBC (Dec. 2, 2021), https://www.cnbc.com/2021/12/02/omicron-clouds-outlook-for-international-travel-that-was-just-turning-a-corner.html.

40 Chris Isidore, *Automaker's Problems Are Much Worse Than We Thought*, CNN (Sept. 28, 2021), *https://www.cnn.com/2021/09/28/business/auto-industry-supply-chain-problems/index.html*.

41 Gowri Gurumurthy, *U.S. High Yield Open: Junk-Bond Yields Rise to Highest in Eight Months*, Bloomberg, https://blinks.bloomberg.com/news/stories/R2NVJ0DWLU6L.

Exhibit 7: U.S. High Yield Bond Index – 2021 YTD Inflation[42]



property) as security for new financing just to keep their heads above water. Prime examples include companies like Boeing and Delta Air Lines, whose total debt doubled between the end of 2019 and beginning of 2021, to $64 billion and $35 billion, respectively.[43]

Nevertheless, high-yield issuances have already shown signs of regression. The $30 billion and $29 billion of high-yield issuances in October and November, respectively, mark the second and third slowest months for primary pricings in 2021. Despite the high level of issuances in 2020 and the beginning of 2021, rising consumer and producer prices could depress demand by reducing the purchasing power of fixed bond payments. An uptick in inflation has prompted the Federal Reserve (and other central banks) to accelerate plans to raise interest rates and taper corporate bond and loan purchases. The resulting potential increases in borrowing costs could then lead to greater expenses for borrowers and impact companies' ability to refinance, particularly if they are still in the midst of recovery. But, such plans could change yet again if central banks need to respond to the impact of additional virus variants on the world economy and if inflation becomes less of a relative concern (Exhibit 7).

The high-yield market as a whole has exhibited some indications of strain as inflation concerns also remain a factor. Borrowers have prioritized acquiring cash at current rates before yields rise further. The junk-bond index posted a loss for its third straight month in November 2021, while yields rose to their highest levels in eight months at 4.29%.[44] BBs, single Bs, and CCCs all posted negative returns during this period.[45] New issue pricing has also shown signs of instability, while U.S. equity markets have fluctuated on market uncertainty given possible policy changes at the Federal Reserve and open questions regarding Omicron's impact on the return to pre-pandemic norms. Further, central banks may face a quandary between the need to respond to inflation while maintaining the flexibility to respond to additional COVID-19 variants and impacts from lockdowns or economic volatility associated with COVID-19 disruptions.

Market Volatility

Unsurprisingly, the uncertainty regarding ongoing public health concerns remains a significant driver of volatile market activity, and this will likely continue for the foreseeable future. Periodic increases in COVID-19 cases and the advent of new variants have the potential to depress demand within industries whose recovery is contingent on public confidence in a return to normalcy. This, in turn, may impact financing resources for companies like Carnival Corp., which continue bolstering their liquidity through ongoing debt sales. While analysts and investors anticipate a low rate of junk bond defaults in 2022,[46] a continued slowdown of sales may impact some borrowers' ability to service their existing debt while maintaining sufficient operational liquidity. As of November 2021, $283.6 billion of high-yield issuances had been used to refinance existing debt, a 13% increase from the record-setting pace of refinancing in 2020.[47]

Broader Leveraged Market

In August 2021, the U.S. leveraged finance market surpassed $3 trillion for the first time in history. Leveraged loans increased by nearly 130% since the 2008-2009 financial crisis, and below-investment-grade loans have steadily increased over the last two years.[48] In North America, leveraged buyouts and acquisitions have accelerated since the height of the pandemic, with companies announcing $2.2 billion of mergers and acquisitions as of August 2021, a 152% increase during this period.[49] This activity has led to increased sales of short-term loans by lending institutions, indicating that more leveraged buyout lending may be on the horizon in the short term. However, rate increases may lead to a decline in refinancing over the next year given that companies have already maximized favorable market conditions to delay debt maturities.

[42] Ice Data Indices, LLC, ICE BofA US High Yield Index Effective Yield, Federal Reserve Bank of St. Louis, https://fred.stlouisfed.org/series/BAMLH0A0HYM2EY (data retrieved Jan. 7, 2022).

[43] *See* Goldfarb, *supra* note 33.

[44] *See* Gurumurthy, *supra* note 41.

[45] *Id.*

[46] *See* Sebastian Pellejero, *High-Yield Bond Sales Soar to Record as Investors Have Few Other Places to Go*, Wall Street Journal (Nov. 26, 2021), https://www.wsj.com/articles/high-yield-bond-sales-soar-to-record-as-investors-have-few-other-places-to-go-11637931601.

[47] Rachelle Kakouris, *High-Yield Bond and Leveraged Loan Sales Top $1 Trillion in 2021*, S&P Global, (Nov. 16, 2021), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/high-yield-bond-and-leveraged-loan-sales-top-1-trillion-in-2021-67670013.

[48] Mayra Rodriguez Valladares, *The U.S. Leveraged Finance Market Is At a Record $3 Trillion*, Forbes (Aug. 10, 2021), https://www.forbes.com/sites/mayrarodriguezvalladares/2021/08/10/the-us-leveraged-finance-market-is-at-a-record-3-trillion/?sh=11957d497880.

[49] Paula Seligson, *Banks Are Already Bracing for a September Leveraged Buyout Boom*, Bloomberg (Aug. 16, 2021), https://www.bloomberg.com/news/articles/2021-08-16/banks-are-already-bracing-for-a-september-leveraged-buyout-boom.

Continued from p.11

Looking forward, according to data from Bloomberg L.P., approximately $2.8 trillion of high-yield bonds are set to mature between 2022 and 2030, and these bonds have current yields that are primarily lower than the coupons at which they were issued.[50] The gap between yield and coupons compresses toward the latter end of this timeframe, suggesting that issuers' ability to continue refinancing at lower rates may already be reaching its limit.[51] During this same eight-year time period, according to data from Bloomberg L.P., $130 billion of leveraged loans issued to fund dividend payments will also come due.[52] The attendant deterioration of traditional leveraged buyout and dividend recaptures will undoubtedly yield a blossoming direct lending movement and, possibly, defaults.

OUTLOOK

The retail, commercial real estate, health care, hospitality, travel, and automotive industries will likely face continuing headwinds as payments on high-yield issuances become due. Businesses serving the consumer discretionary retail market will need to address approximately $37 billion worth of high-yield debt maturities through 2030, with nearly $10 billion maturing within the next four years.[53] High-yield issuances within the health care industry appear equally daunting, with more than $32 billion of maturities coming due by 2030.[54] The travel, lodging, and airline industries are facing more than $45 billion of high-yield debt maturities through the end of the decade, $7 billion of which will mature by 2025.[55] With respect to the automotive sector, approximately $32 billion worth of maturities will come due over the course of the next 10 years.[56]

While the uptick in refinancing activity may have temporarily abated concerns from investors, these strategies may have only delayed the inevitable. Another economic downturn or increased interest rates could force a debt reckoning on companies that have not yet rebounded from the initial market shock following the outbreak of the pandemic.[57] Likewise, uncertainty regarding the pandemic's impact on market demand, inflation, and government intervention will all factor into whether high-yield issuances remain steady or continue to slow in the coming year. This will likely impact some borrowers' ability to service their existing debt and could prompt alternative approaches to addressing debt obligations in 2022. As maturities on high-yield debt and leveraged loans become due, private credit will likely continue to expand, possibly as lenders of last resort. In what may amount to a precursor of things to come, private lenders will continue utilizing loan-to-own strategies that anticipate a thawing out of the post-pandemic restructuring freeze.

[50] Chris Sinnott, Jones Day 2021 Report.
[51] *Id.*
[52] *Id.*
[53] Chris Sinnott, High Yield Issuance by Industry and Maturity Year Report.
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] These risk factors are not unique to the United States. Companies across Europe, the Middle East, Africa, and Asia will face continuing pressure in 2022 as increases in the price of energy, raw materials, and logistics could push businesses to the edge. The cost and scarcity of labor will only exacerbate this threat to profitability. These inflationary pressures, combined with the uncertainty surrounding future responses to the COVID-19 pandemic, will loom over distressed industries across the globe as they try to recover from the initial outbreak of 2020.

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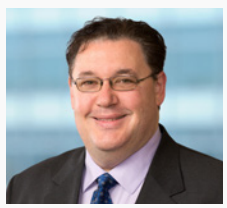

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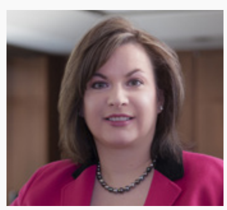

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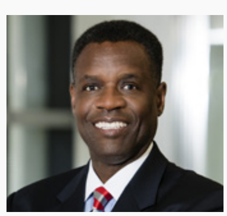

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CASH IS KING—EVEN IN CRYPTO

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For most people and companies, "Cash is king." Having liquidity helps aid some basic necessities, at home and for companies small and large. As Fintech continues to evolve, innovators have found additional ways to blend crypto technology with lending to facilitate alternative means of liquidity.

In the simplest form, the process is as follows: if you own a cryptocurrency and need liquidity in the short term, you can borrow against your cryptocurrency used as collateral without having to sell your current position. Pioneers in the crypto lending space have uncovered many opportunities for investors and borrowers, but regulation has not kept up. What comes next in this market likely will be a blend of more innovators, investors, and regulations. Lending will be a natural extension and a key component of broad acceptance.

Growth to $2.3 Trillion in the Past Five Years

Over the last five years, cryptocurrencies have sprung up across all corners of financial services (Exhibit 1). As of January 2022, there were nearly 10,000 active crypto coins and tokens with a combined market capitalization of over $2.3 trillion.[1] Cryptocurrencies serve many different purposes, providing users with the ability to be involved directly in the development of new finance technologies, facilitate decentralized finance transactions on blockchain, and invest and speculate on future crypto price appreciation and industry growth. With a large market capitalization, markets and services have developed for people to lend and borrow against these assets much as they would with traditional fiat currency.

At its simplest level, cryptocurrency is a digital or virtual currency created and secured by cryptography. This reliance on cryptography provides a level of transparency and security, making it nearly impossible to counterfeit or double-spend. This is a very important feature for a facilitator of digital transactions.

Cryptocurrency transactions are recorded on a blockchain. A blockchain is an open, permanent record of transactions that have occurred. The public nature of a blockchain means that all transactions are independently verified, allowing for consensus that the digital transaction that took place actually occurred.

Crypto.com estimates that there were over 295 million global crypto owners by the end of 2021, up from 106 million at the end of 2020.[3] While cryptocurrency eventually may evolve into "money" in the truest sense of the word and act as a medium of exchange, store of value, and unit of account, today it is still not widely accepted or used commonly in everyday life. Most people treat cryptocurrency primarily as an alternative

[1] Statista, "Number of cryptocurrencies worldwide from 2013 to February 2022," as of February 2022, https://www.statista.com/statistics/863917/number-crypto-coins-tokens/.

[2] Statista, "Crypto total market cap 2010 to 2022," as of March 2022, https://www.statista.com/statistics/730876/cryptocurrency-maket-value/.

[3] crypto.com, "Crypto Market Sizing: Global Crypto Owners Reaching 300M," January 20, 2022, https://assets.ctfassets.net/hfgyig42jimx/5i8TeN1QYJDjn82pSuZB5S/85c7c9393f3ee67e456ec780f9bf11e3/Cryptodotcom_Crypto_Market_Sizing_Jan2022.pdf.

Exhibit 1: Cryptocurrency Growth in Participants and Capitalization Since 2017[2]

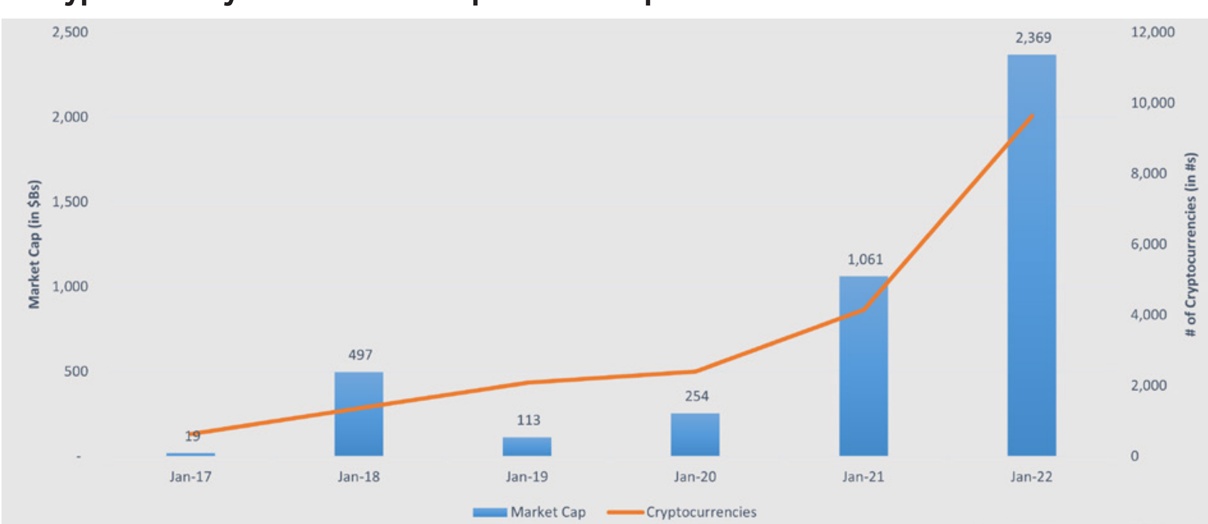
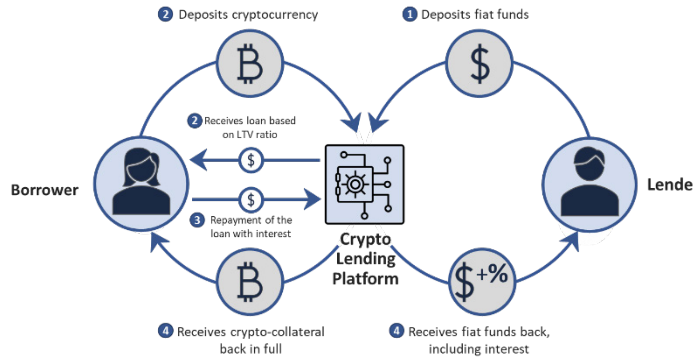


Exhibit 2: How Crypto Loans Work[4]



investment class, largely uncorrelated with stocks, bonds, or other world currencies. Individuals desire its financial systems and tools to be similar to the existing fiat currency infrastructure. They want the ability to borrow and leverage cryptocurrency holdings, use options to manage risk and speculate on cryptocurrencies, and lend against existing assets.

Crypto Lending and the Basics

Cryptocurrency lending first emerged in 2017. Since then, many companies have emerged focused on facilitating loan transactions backed by cryptocurrency. The largest of these companies include BlockFi, Celsius, Abra, Nexo, and Binance. A cryptocurrency loan can be made in either fiat currency or in cryptocurrency and is typically collateralized by existing crypto holdings.

How does borrowing a crypto loan work in its basic form? Exhibit 2 illustrates the process:

1. The lender deposits fiat currency into the Decentralized Finance (DeFi) lending platform.
2. The borrower deposits crypto assets into the DeFi lending platform as collateral and obtains a loan. The loan terms and conditions are highly dependent on loan to value (LTV) of the crypto asset: the lower loan to value, the lower the interest rate payments.
3. The borrower repays the loan with interest. Interest payments are made to the lender.
4. Upon repayment of principal, posted collateral is returned to the borrower. The lender's original loan amount is repaid in full along with interest.

With the volatility of cryptocurrency, low LTV ratios are typical; most lenders typically do not exceed 50 percent LTV. Margin calls are another feature of crypto lending. Lenders can take possession of the underlying cryptocurrency if margin demands are not satisfied by posting additional collateral or paying down the existing loan; forced liquidations may occur.

Exhibit 3 highlights key facts about the major crypto lenders.

The market is larger than most would have expected. Assets under management for BlockFi, Celsius, Abra, and Nexo combined exceed $43 billion. Lending yields can exceed 8 percent to 10 percent for USD Coin or stablecoins. [5] Borrowing rates for LTVs of 50 percent range from ~9 percent to ~10 percent and in some cases higher.

Current Regulatory Framework

Unlike traditional lending, cryptocurrency lending is not regulated by governments. The existing fiat currency lending regulatory infrastructure was developed over decades, usually as a reaction to past events. The Great Depression and failed banks led to financial disclosures and FDIC insurance. The Great Recession led to the Dodd-Frank Act, which resulted in fair value accounting and changes to capital requirements. Cryptocurrency lending is new and has an evolving regulatory overlay. Governments around the world are starting to exert control over crypto lending and cryptocurrencies.[6]

Governments have yet to decide if cryptocurrencies are securities, money, collectibles, or other assets. This definition will be important in developing the legal framework that will govern future market innovation and acceptance. Without clear government guidance on what cryptocurrency is and which regulations should exist, litigation is reduced to traditional contract law.

Exhibit 3: Platform Participants, Lending Yields, and Borrowing Costs[5]

Crypto Lending Platform - Overview	BlockFi	Celsius	Abra	Nexo
Processed Loans	N/A	N/A	$7B	$50B+
Members / Active Users	1M+	2M	~2M	3.5M
Assets	$10B	$19.7B	~$1.5B	$12B

Crypto Lending Yields	BlockFi	Celsius	Abra	Nexo
Bitcoin	4.5%	6.3%	3.2%	4.0%
Ether	.25%	3.3%	3.7%	4.0%
Tether (Stablecoin)	9.5%	10.0%	9.0%	10.0%
USD Coin (Stablecoin)	8.0%	10.0%	8.0%	8.0%

Crypto Borrowing Costs	BlockFi	Celsius	Abra	Nexo
Loan Amount	10,000	1,000	Various	Up to $2M
Collateral (examples)	BTC, ETH, LTC	BTC	BTC, ETH	BTC, ETH, LTC
Loan Term	1 Year	1 Year	1 Year	1 Year
Rate				Varies based
LTV: 20 to 25%	4.50%	1.00%	3.85%	on # of NEXO
LTV: 33%	7.90%	6.95%	6.75%	Tokens held:
LTV: 50%	9.75%	8.95%	9.95%	6.9% - 13.9%

[4] Blockchain Simplified, "DeFi based Crypto Loans, Explained!" February 19, 2021, https://medium.com/@blockchain_simplified/defi-based-crypto-loans-explained-85e40cd485c9#:~:text=1)%20As%20simple%20as%20it,his%20crypto%20assets%20as%20collateral.&text=Similar%20to%20a%-20traditional%20loan,pays%20EMIs%20to%20the%20lender.

[5] Sourced from companies' websites: BlockFi (https://blockfi.com/), Celsius (https://celsius.network/), Abra (https://www.abra.com/), Nexo (https://nexo.io/); Daren Fonda, "Lending Your Crypto Could Generate Attractive Yields: But How Safe Is It?" Barron's, updated December 12, 2021, barrons.com.

[6] Our BRG colleague Dustin Palmer recently wrote an article addressing the increased regulatory focus that cryptocurrencies and exchanges face around the world. See Dustin Palmer, "Cryptocurrencies and Exchanges Will Face Increased Regulatory Focus," ABA Banking Journal, September 30, 2021, https://bankingjournal.aba.com/2021/09/cryptocurrencies-and-exchanges-will-face-increased-regulatory-focus/.

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From a legal and disclosure standpoint, crypto investors and those lending and borrowing crypto are being treated more like accredited investors; however, many individuals involved in crypto are retail investors with less investing experience. In fact, many crypto projects are being designed explicitly to avoid securities laws. Future regulations that will try to address these ambiguities could include disclosure requirements, leverage limits, liquidity requirements, tax and reporting requirements, and possibly restrictions on certain types of crypto transactions altogether.

Without additional regulation and protections, borrowers and lenders face many risks in crypto lending. For example:

- Crypto deposits are not insured by the FDIC.
- Platforms are subject to outages and disruptions that can prevent the execution of transactions.
- Funds held can be hacked and stolen, and they cannot be recovered once they are gone.
- Cryptocurrencies have experienced significant volatility, which can trigger margin calls.
- Potential for future restrictive regulations.

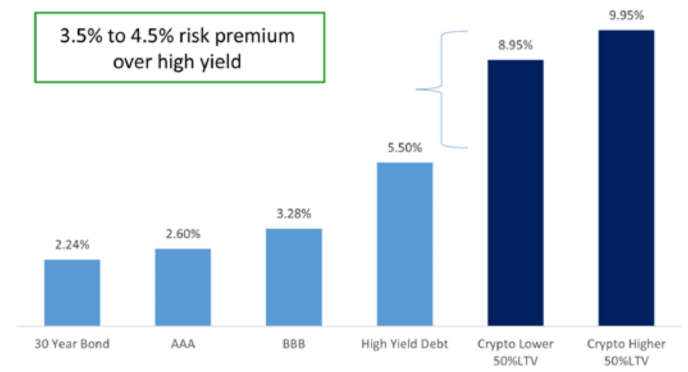
Why Are Yields in Crypto Lending Much Higher Than in Other Industries?

The blockchain ecosystem requires computing power, hardware, electricity, occupancy, and security costs, which is most often are provided by cryptocurrency "miners." Miners are rewarded with cryptocurrency in exchange for providing the computing power necessary for to maintaining the blockchain network. The influx of rewarded tokens to the existing circulating supply can dilute the value of existing crypto should there be insufficient demand to absorb the added supply.

Other companies may charge high transaction fees for exchanging one form of crypto into another, similar to a broker processing a fiat foreign currency exchange. These transaction fees pass down the cost of "gas fees" to the consumer only if the underlying cryptocurrency requires such a fee to operate within the network. For example, a "gas fee" is required to perform any function within the Ethereum blockchain and can be significant, reaching over 0.05 ETH per transaction (*i.e.*, $150) at times based on the demand. Converting to proof of stake mining would result in lower energy consumption by up to 99.95 percent according to the Ethereum Foundation[7] and by extension, lower fees. Additionally, alternative coins such as Avax claim to be green by utilizing carbon offsets and charging low gas fees.

[7] Carl Beekhuizen, "Ethereum's energy usage will soon decrease by ~99.95%," Ethereum Foundation Blog, May18, 2021, https://blog.ethereum.org/2021/05/18/country-power-no-more/?utm_source=morning_brew.

Exhibit 4: Crypto Risk Premium vs. High-Yield Bonds[8]



Crypto lending offers a way to offset crypto costs and earn a rate of return from otherwise non-income-producing assets. This rate of return can be lucrative depending on the specific type of token, exceeding even high-yield debt. The crypto risk premium versus high-yield debt can be more than 350 to 450 basis points (Exhibit 4).

The Horizon: Innovation, Regulation, Expansion

Innovation is important provided the risks and opportunities are made transparent. Banks and other lenders have opportunities to enter the crypto lending space but must do so knowing that the market will evolve significantly in the next five years. The crypto lending industry is still a nascent industry; ample first-mover advantages are available for institutions that are open to entering the space. Throughout the history of financial services, first movers have been able to develop a foothold in their markets and gain technological and marketing advantages over competition, dominating conversation, building scale, and obtaining key talent. Whether it was PayPal in 1998 in the online payment processing space, WeChat in 2011 in social network payment processing, or even Salomon Brothers in the 1980s developing securitizations and bond market innovation, first movers typically are rewarded for the risks they take creating systems, infrastructure, and new innovation.

These opportunities exist for companies now to gain a meaningful advantage in the world of cryptocurrency and crypto lending. But entering this market will require addressing a few questions:

- How will the lender develop risk management guidelines for cryptocurrency?
- What voluntary disclosures are necessary in the absence of federal and state regulations?
- How will regulatory changes, including the possible determination that cryptocurrencies are securities, impact the lending environment?

[8] Federal Reserve Bank of St. Louis, Moody's Seasoned Aaa Corporate Bond Yield (AAA), FRED, https://fred.stlouisfed.org/series/AAA (first four columns).

- How will a bank perfect a lien or take custody of cryptocurrency collateral?
- What lending products will be offered?
- What does the competition look like for crypto lending? Are crypto-focused customers interested in using a traditional bank?
- How will the government endorse crypto lending from regulated institutions?

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IFRS VS U.S. GAAP – ARE YOU READY FOR IMPAIRMENT TESTING?

A Framework for U.S. Financial Statement Preparers, Auditors, and Advisors

DAVID M. KAYE and JASMEET SINGH MARWAH

Stout

Most major capital markets outside of the U.S. have either adopted or indicated that they intend to adopt International Financial Reporting Standards (IFRS). In modern capital markets, where U.S. companies have the option to list or register internationally / are owned by international conglomerates, it is important for companies and investors to understand the differences that exist to apply and interpret financial information. While the broader fair value standards and business combinations standards are largely aligned across the two reporting frameworks, significant divergence in impairment testing exists.

At a broad level, IFRS applies a single framework across almost all non-financial assets whereby an asset should not be carried at more than what could be recovered through use (value in use [VIU]) or sale of the asset (fair value less costs of disposal [FVLCD]). U.S. Generally Accepted Accounting Principles (GAAP), on the other hand, applies a fair value framework to indefinite-lived intangible assets and a recoverability test for finite-lived assets. Furthermore, across the two frameworks, the recognition of impairment losses as well as the treatment of any subsequent recovery in the value of an asset may differ.

In 2020 and 2021, the International Accounting Standards Board (IASB) gathered and reviewed comments from market participants to a discussion paper that proposed certain changes to the impairment testing framework under IFRS. This is a similar project to what was undertaken by the Financial Accounting Standard's Board (FASB) in the U.S. Although no concrete changes have been implemented by IASB or FASB, the result of both efforts may see convergence in some areas but will most likely result in even more differences between the two most commonly used accounting frameworks in the world.

As a valuation advisory firm, Stout provides numerous impairment tests annually, including those under U.S. GAAP and IFRS. The purpose of this article is to provide an overview of the impairment testing requirements under IFRS for financial statement preparers, auditors, and advisors that primarily perform, or have experience performing, impairment tests under U.S. GAAP.

Why Is This Relevant to U.S. Accountants and Advisors?

Of the 166 jurisdictions (representing around 98% of the world's GDP) analyzed by the IFRS Foundation, 144 require IFRS standards[1] for all or most domestic publicly accountable entities in the respective capital markets. Of the countries that have not adopted IFRS, the most significant (from a GDP perspective) are China, India, and the U.S., each of which apply their own national reporting standards. Instances where U.S.-based preparers of financial statements may need to consider IFRS include:

- M&A opportunities in international markets
- Raising capital in international markets
- Statutory reporting requirements of non-U.S. subsidiaries or foreign parent entities

Impairment Testing for Other Long-Lived Assets (ASC 360 / IAS 36)

Two key differences that we often encounter in relation to impairment testing of long-lived assets (other than indefinite-lived assets[2]) relate to the testing framework and future treatment of prior impairment losses.

[1] It is important to understand the extent to which IFRS is used in local reporting and where there may be differences with full IFRS standards, including different treatment of domestic and foreign filers.

[2] Depending on the identification and alignment of the CGU and reporting unit, the impairment testing requirements for the indefinite-lived assets are relatively similar under IFRS and U.S. GAAP (if the asset can be tested on a standalone basis, for IFRS).

Impairment Testing Framework

U.S. GAAP – Upon a triggering event,[3] the preparer should first determine the asset group to which the subject asset(s) belong. For long-lived asset groups (other than indefinite-lived assets), the preparer should perform a two-step impairment test whereby they first determine whether the sum of the undiscounted cash flows (measured over the remaining useful life of the primary asset of the asset group) and the residual value of the asset group exceed the carrying value of the asset group. If the asset group fails this test, the fair value of all assets in the asset group should be determined (if different from the carrying value) and compared to the carrying value in order to quantify and allocate the impairment charge.

IFRS – The preparer should first determine if the asset can be assessed on a standalone basis or at the cash generating unit[4] (CGU) level. Either way, the recoverable amount (higher of VIU and FVLCD) is compared to the carrying amount of either the asset or CGU, and any impairment charge is equal to the difference (allocation of impairment charge is discussed later). To determine if the asset should be assessed at the asset or CGU level, the preparer should consider:

1. Does the asset generate cash inflows that are largely independent of those from other assets or groups of assets?
2. Is FVLCD higher than its carrying amount?

We note that there may be situations where an asset would be deemed impaired under IFRS but not under U.S. GAAP as a result of the different frameworks discussed above.

Future Treatment of Impairment Losses

U.S. preparers should be aware that, under IFRS, with the specific exception of goodwill, there is a need to perform an annual review for indicators of a reversal for prior impairment charges on long-lived assets. Gains are recognized in other comprehensive income. Under U.S. GAAP, the reversal of prior impairment losses is not allowed.

Impairment Testing of Goodwill (ASC 350 / IAS 36)

U.S. GAAP – The carrying value of a reporting unit is tested against its fair value to identify an indication of impairment and then ultimately to quantify an impairment charge.

IFRS – The carrying value of the CGU is compared to its recoverable amount, which is defined as the greater of its (i) VIU and (ii) FVLCD. In our experience, for a going-concern entity that the preparer intends to continue to operate, the entity's VIU typically exceeds its FVLCD. The following highlights certain differences between the fair value measurement approach under U.S. GAAP and the VIU approach under IFRS.

Market Participant (Fair Value) vs. Entity Specific Cash Flows (VIU)

U.S. GAAP – Cash flows used in fair value measurement are defined as that which a *market participant* could reasonably expect to realize from the asset, which may differ from that available to the current owner.

IFRS – Cash flows used in VIU measurement represent what the *reporting entity* expects to realize from its investment in the asset (*i.e.*, entity-specific expectations). Cash flows in a VIU framework should generally be for a period of up to five years and exclude cash flows from future restructurings or enhancements of the asset's performance. Cash flows in a FVLCD framework will be largely consistent with the fair value framework under U.S. GAAP.

Valuation Methodologies

In order to calculate the fair value of an asset or CGU, generally accepted valuation approaches and methods must be considered, and the value determination must be derived by applying the most applicable method(s). VIU is far more prescriptive and requires the preparer to apply a cash flow model that considers a maximum five-year discrete period, unless a longer period can be supported (usually the case with finite-lived or early-stage assets), on a pre-tax basis (discussed further below).

Carrying Value-Deferred Tax Considerations

Impairment testing under IFRS is required to be performed on a pre-tax basis, and as such deferred tax assets and liabilities are excluded from the carrying value calculations. Consistently, the cash flow projections are not affected by specific tax attributes, such as net operating loss carryforwards. Under U.S. GAAP, deferred tax assets and liabilities are included in the carrying value calculations, and as such, the cash flow implications of entity- or transaction-specific tax attributes are reflected in the calculation of future tax payments.

[3] For further details regarding the triggering events, refer to https://www.stout.com/en/insights/commentary/is-covid-19-triggering-event-impairment-testing.

[4] A CGU is defined in IAS 36.6 as "the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets."

Continued from p.19

Practical Pre-Tax Valuation Issues

Fair value is typically measured on a post-tax basis. Under IAS 36, reporting entities are required to perform and present certain metrics associated with an impairment test on a pre-tax basis. Theoretically, this is to be consistent with the tax agnostic framework discussed above. Practically, and acknowledged in the IASB's Basis for Conclusions to IAS 36, valuation metrics (such as discount rates) are quantified using post-tax/real-world data. As such, it is generally accepted that the VIU test is performed on a post-tax basis (excluding entity-specific tax attributes) and that certain metrics that need to be disclosed (such as the pre-tax discount rate) are imputed by removing tax cash flows and solving for the pre-tax discount rate that arrives at an equivalent value to the post-tax analysis.

Measuring and Recognizing an Impairment Loss

Recent changes to U.S. GAAP have bridged certain significant differences with IFRS, such as the shift to a direct calculation of goodwill impairment under ASC 350 resulting from Accounting Standards Update (ASU) 2017-04 that more closely aligns with IFRS.

U.S. GAAP – under the changes introduced by ASU 2017-04, if the Fair Value of a reporting unit exceeds its carrying value, goodwill is not impaired. If the Fair Value of a reporting unit is less than the carrying value, an impairment charge is recognized for the amount by which the carrying value exceeds the Fair Value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit.

IFRS - the impairment charge is measured in a similar fashion with respect to a CGU (carrying amount less recoverable amount) however, the loss is allocated, first to goodwill, then proportionately to all other assets in the CGU, where the asset's respective carrying amount shall not reduce below the highest of (i) the assets' FVLCD (if measurable); (ii) its VIU, or (iii) zero.

Other Valuation Considerations

Lease Accounting – While the income statement impact of financing and operating leases is largely unchanged under U.S. GAAP, under IFRS all leases are accounted for in a manner consistent with financing leases under U.S. GAAP. Valuation analysts and preparers should be cognizant of this when deriving certain valuation inputs from comparable public companies, such as discount rates, multiples, etc.

Probability-Weighted Scenario Projections – When a business faces a significant uncertainty about future events and potentially very significant adverse effects on entities (similar to our current economic reality in the COVID-19 Pandemic), the CGU cash flows should likely be based on a number of probability-weighted scenarios when impairment testing under IFRS. These scenarios should also include significant adverse downside case. Given the foregoing, as preparers apply this probability-weighted scenario projections in the impairment testing analysis, the company-specific risk premium (reflecting the unsystematic risk premium) in the discount rate estimation should be evaluated accordingly, given the downside risk is also captured in the probability adjustments and downside case application.

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TAMING INFLATION? CONSIDER THE TRADEOFFS

Central bankers face some difficult choices when deciding how to wrangle rising costs.

KEN DITZEL and SCOTT NYSTROM
FTI Consulting

For the past four decades, Americans have enjoyed consistent inflation that has hovered near the Federal Reserve's target of 2%.[1] Now a combination of factors is upsetting the status quo. In February, the key U.S. inflation measure, the Consumer Price Index ("CPI"), showed that prices for goods and services rose 7.9% compared to a year ago,[2] the highest level since January 1982.[3] On a monthly basis, prices for food, clothing, shelter, fuel, and other essentials that make up the CPI "basket" increased by 0.8%, higher than the expectations[4] of many economists.

Faced with inflation at a 40-year high and roiling energy and financial markets because of the war in Ukraine, U.S. policymakers are debating how best to respond and balance the need to tame inflation without suppressing post-pandemic recovery. It is a delicate dance; the usual levers for controlling inflation, such as the Federal Reserve adjusting the benchmark lending rate (more about that below), come with tradeoffs that risk cooling the recovery.

The tradeoffs have stirred much debate among policymakers, academicians, business leaders, and even the public about the best way to respond.

What Is Driving Inflation, Anyway?

Inflation is driven by many factors. The genesis of our current inflation is the start of the pandemic in March 2020, with three major factors playing a role.

First, factories shutting down due to the pandemic disrupted supply chains, hence businesses could no longer acquire the components and materials they needed, such as microchips, to produce the merchandise consumers wanted. Second, those retaining jobs altered their behavior and withheld spending. Third, federal stimulus measures pumped more money into savings.

And boom! When consumers threw open their wallets in 2021, demand soared, causing too many dollars to chase after too few goods and services, provoking inflation. Additional factors were at play, including labor shortages and other temporary supply chain disruptions — all of which add to the complex inflation puzzle policymakers now face.

The "Catch-22" of Counter-Inflation Measures

Policymakers are typically concerned with three issues when it comes to inflation. Rising prices is one, of course. The others are employment and interest rates.

Taken together, the three issues are in the scope of the Federal Reserve (the "Fed") and monetary policy. All three require scrutiny and interact with the federal debt. Here's why:

Interest Rates: While the Fed cannot directly lower prices, it can, as noted earlier, raise the benchmark borrowing rate. In fact, it did just that on March 16 of this year when it announced an increase of a quarter percentage point[5] — the first such increase since 2018. A higher benchmark rate incentivizes savings at the expense of spending and leads to higher interest rates on everything from consumer loans — like mortgages, auto loans, and credit cards — to business loans intended for starting new businesses or expanding existing ones.

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1 Kimberly Amadeo, "US Inflation Rate by Year From 1929 to 2023: How Bad Is Inflation? Past, Present, Future," thebalance.com, updated March 28, 2022, https://www.thebalance.com/u-s-inflation-rate-history-by-year-and-forecast-3306093.

2 United States Consumer Price Index, U.S. Bureau of Labor Statistics, as of March 2022, https://tradingeconomics.com/united-states/consumer-price-index-cpi.

3 Jeff Cox, "Inflation rose 7.9% in February, as food and energy costs push prices to highest in more than 40 years," CNBC, https://www.cnbc.com/2022/03/10/cpi-inflation-february-2022-.html.

4 *Ibid.*

5 Tim Smart, "Fed Raises Interest Rates for the First Time Since 2018 in Bid to Curb Inflation Sees Six More Hikes in 2022," *U.S. News & World Report*, March 16, 2022, https://www.msn.com/en-us/money/markets/fed-raises-interest-rates-for-the-first-time-since-2018-in-bid-to-curb-inflation-sees-six-more-hikes-in-2022/ar-AAV9kcR.

Continued from p.21

As credit becomes more expensive, the economy "cools" with a dampening of demand. Fewer dollars chase available goods and services, thereby alleviating inflation.

Employment Levels: When it comes to higher interest rates and a dampening of demand, policymakers weigh serious real-world consequences for individuals and businesses. Purchases and investments that made sense at low interest rates might no longer make sense at higher interest rates. Tighter credit weakens consumer demand and investment, slowing economic growth.

Federal Debt: Like all borrowed money, the federal government's debt is sensitive to interest rates. According to the Congressional Budget Office (CBO), federal debt held by the public in the form of bonds reached $21 trillion in 2021.[6] Net interest payments were $331 billion, nearly the gross domestic product ("GDP") of the state of Missouri ($366 billion).

The average remaining maturity of the federal debt is 5.5 years. This means that approximately 18% of the federal debt is refinanced every year. Higher interest rates might tame inflation, but they would risk the economic recovery and degrade the fiscal position of the federal government by increasing interest costs.[7]

Following the March 16 announcement, the Fed is scheduled to meet six more times this year to discuss further increases in the benchmark borrowing rate.

How Policymakers Can Tame Inflation Outside of Interest Rates

Increasing interest rates is the classic response to tame inflation, but it comes with its costs. Here are three options for addressing inflation that might have other benefits:

Energy Sector: Addressing rising energy prices, a significant cause of supply-side inflation, has become a more pressing concern for policymakers, particularly given the major potential disruption to energy exports from Russia. Multiple issues are at work here. First, energy prices affect suppliers directly in the commodities they purchase, such as diesel fuel and electricity, and indirectly through energy-intensive sectors, such as steel, which must pay more for their inputs. Second, electricity prices strongly correlate with natural gas prices, which are seeing their highest persistent levels since the Great Recession.

The United States could expand domestic production of natural gas and petroleum to put downward pressure on energy prices. It could also encourage more renewables, such as wind and solar, which can help to reduce electricity prices. Additional supporting infrastructure (*e.g.*, pipelines or transmission lines to move wind and solar power to urban centers) could also help against inflation.

Technology: Advances such as predictive analytics could improve supply chain resiliency and visibility. Whether it is forecasting worker shortages or improving networks and sourcing agreements, businesses have reason to innovate to minimize future disruptions. Policymakers could help incentivize these developments through tax credits or strategic workforce investments.

Immigration: Low unemployment during a recovery (signifying a labor shortage) could slow the economy. Policymakers could allow for more immigration to fill gaps between labor supply and labor demand, especially in fields developing new technology or building infrastructure.

Conclusion

While there are no easy "fixes" to inflation, policymakers have a variety of methods from which to choose. Whatever direction they decide to go, whichever levers they pull, there will be tradeoffs — and understanding these is crucial for individuals and businesses.

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6 Congressional Budget Office, https://www.cbo.gov/system/files/2021-07/51118-2021-07-budgetprojections.xlsx.

7 An example of such risk would be requiring higher taxes or spending cuts to combat compounding interest on the debt.

A RUSSIAN SOVEREIGN DEBT DEFAULT? NO LONGER IMPROBABLE

DENNIS HRANITZKY, RICHARD EAST, ALEX GERBI, EPAMINONTAS TRIANTAFILOU, LIESL FICHARDT, YASSEEN GAILANI, and RUPERT GOODWAY
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On 16 March 2022, the Russian Federation (Russia) was due to make its first coupon payments on its sovereign debt (totalling $117m on two dollar-denominated bonds) after its invasion of Ukraine. It appears that some creditors have received the coupon payment, but whether all creditors will receive payment remains uncertain.[1]

Following the sweeping economic sanctions by the US, Canada, EU, UK and Japan against Russia's key financial institutions, including the Central Bank of the Russian Federation (the CBR), a default by Russia on its sovereign debt is no longer 'improbable' according to the head of the IMF.[2]

Should Russia fail to make payment in dollars and attempt, as it has suggested, to make payment in roubles, that may also constitute a default depending on the terms of the relevant bonds. If payment is not made on the relevant coupon payment date, or indeed if repayments of principal are not made timely, Russia will typically have a 30-day grace period in which to make the payment at which point creditors may have few options but to resort to legal action to seek to recover their investments.

Immobilizing the Assets of the Central Bank of Russia

The US, Canada, EU, UK and Japan have introduced sweeping economic sanctions that target Russia's key financial institutions including the CBR:

1. On 28 February 2022, the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) prohibited United States persons from engaging in transactions with the CBR, the National Wealth Fund of the Russian Federation, and the Ministry of Finance of the Russian Federation. This action effectively immobilized any assets of the CBR held in the United States or by US persons, wherever located.[3]
2. On the same day, similar restrictions were introduced by the EU and Canada.[4]
3. On 1 March 2022, the UK amended the Russian (Sanctions) (EU Exit) Regulations to restrict UK persons from undertaking financial transactions involving the CBR, the Russian National Wealth Fund, and the Ministry of Finance of the Russian Federation.[5]
4. On 1 March, Japan also introduced similar restrictions on assets of the CBR.[6]

The combined result of these sanctions is a severe curtailment of Russia's ability to access and utilize its foreign currency and gold reserves. According to the Russian finance minister, Anton Siluanov, the sanctions mean that Russia is now unable to access at least US$ 300 bn of its gold and foreign currency reserves, which amount to approximately US$ 640 bn in total.[7]

Potential Russian Sovereign Debt Default

Russia has circa US$ 40 billion worth of USD or Euro denominated bonds (Eurobonds) outstanding, of which approximately half is held by foreign persons.[8] On 16 March 2022, Russia was due to make two coupon payments in relation to Eurobonds maturing in 2023

1 Karin Strohecker, Sujata Rao, and Mark Jones, "Some Russia Creditors Have Received Dollar Bond Payment Sources," *Reuters*, March 17, 2022, https://www.reuters.com/world/europe/russia-says-its-order-pay-117-mln-eurobond-interest-fulfilled-2022-03-17/.

2 "IMF Managing Director Kristalina Georgieva on 'Face the Nation,' " (transcript), CBS News, March 13, 2022, https://www.cbsnews.com/news/kristalina-georgieva-imf-face-the-nation-transcript-03-13-2022/.

3 U.S. Department of the Treasury, "Treasury Prohibits Transactions with Central Bank of Russia and Imposes Sanctions on Key Sources of Russia's Wealth," Press Release, February 28, 2022, https://home.treasury.gov/news/press-releases/jy0612.

4 European Commission, "Financial Sector Sanctions," *EU Sanctions Against Russia Following the Invasion of Ukraine*, as of April 2022, https://ec.europa.eu/info/strategy/priorities-2019-2024/stronger-europe-world/eu-solidarity-ukraine/eu-sanctions-against-russia-following-invasion-ukraine_en#financial-sector-sanctions; Dept. of Finance Canada, "Canada and G7 partners prohibit Russian Central Bank Transactions," News Release, February 22, 2022, https://www.canada.ca/en/department-finance/news/2022/02/canada-and-g7-partners-prohibit-russian-central-bank-transactions.html; European Commission, "Joint Statement on Further Restrictive Economic Measures," Press Release, February 26, 2022, https://ec/europa.eu/commission/presscorner/detail/en/statement_22_1423.

5 "UK Statement on Further Economic Sanctions Targeted at the Central Bank of the Russian Federation," GOV.UK, News Story, February 28, 2022, https://www.gov.uk/government/news/uk-statement-on-further-economic-sanctions-targeted-at-the-central-bank-of-the-russian-federation.

6 "Japan Freezes Assets of Russia's Central Bank as Part of New Sanctions," CNA, updated 01 March 2022, 09:25 AM, https://www.channelnewsasia.com/asia/japan-freezes-russia-central-bank-assets-new-sanctions-2527646.

7 "Russia Lost Access to Half Its Reserves, Finance Minister Says," *Bloomberg* News, March 13, 2022, 6:13 AM PDT, https://www.bloomberg.com/news/articles/2022-03-13/russia-lost-access-to-half-its-reserves-finance-minister-says.

8 Guy Faulconbridge and Karin Strohecker, "Russia Warns Sovereign Bond Holders That Payments Depend on Sanctions," *Reuters,* March 6, 2022 10:34 AM PST, https://www.reuters.com/markets/rates-bonds/russia-says-sovereign-bond-payments-will-depend-sanctions-2022-03-06/; Tommy Stubbington, et al., "Russian Bonds Tumble as New Sanctions Trigger Default Fears," *Financial Times*, February 28, 2022, https://www.ft.com/content/7a72d966-15ee-424a-bc62-1f46980827d4.

and 2043 of US$ 73.1 million and US$ 44.1 million respectively, which were the first coupon payments to fall due following Russia's invasion of Ukraine. It appears that the coupon payments have been processed by the depositories but it is not yet clear whether all creditors have received payment.[9]

Due to the sanctions imposed following Russia's invasion of Ukraine, and in particular those that have targeted the CBR, the ability of Russia to make those (or future) coupon payments on time or within the 30 day grace period remains uncertain. If Russia is unable to make payment in dollars, according to the Russian finance minister, Anton Siluanov, it may do so in roubles.[10] However, depending on the exact terms of the Eurobonds, Russia may well have no express contractual right to make coupon payments in roubles.

The payments due on 16 March 2022 are just the start of potential issues with Russia's sovereign debt. In the next few months, a further US$ 485 million in coupon payments on Russian Eurobonds will fall due. Russia is also due to repay US$ 2 bn worth of principal in relation to Eurobonds which mature on 4 April 2022.[11]

If Russia does default on its sovereign debt, bondholders may have little choice but to resort to legal action to seek to recover their investments. The scope of existing sanctions, including prohibitions on dealing with securities issued by Russia on or after 1 March 2022, and the ongoing war in Ukraine, are likely to rule out the possibility of either of Russia raising fresh financing internationally in order to service existing debt or of a negotiated restructuring.

[9] Tommy Stubbington and Philip Stafford, "Russian Bond Interest Payments Flow Through Western Financial System," *Financial Times,* March 18, 2022, https://www.ft.com/content/c381f620-1897-489a-81d1-956f01fb0bf0.

[10] Max Seddon and Adam Samson, "Russia Threatens to Make External Debt Payments in Roubles," *Financial Times*, March 13, 2022, https://www.ft.com/content/299c95ec-8c01-472e-99ec-feeb1a4b2c66.

[11] Irene García Pérez and Bloomberg, "Putin's Ruble Work-Around Still Leaves Bond Payments in Doubt," *Fortune*, updated March 7, 2022, 8:11 AM PST, https://fortune.com/2022/03/06/putin-aims-to-avert-defaults-with-ruble-payment-to-creditors/.

Governing Law and Jurisdiction of Russian Eurobonds

In general (although each issuance must be viewed on its own terms), Russian Eurobonds:

1. Are governed by English law; and
2. Do not contain a jurisdiction clause.

There is usually an express reservation in relation to jurisdiction which states that Russia has not: i) submitted to the jurisdiction of any court; ii) agreed that disputes may be resolved in any forum; or iii) appointed any agent for service of process in any jurisdiction in connection with any action or proceeding.

In the absence of an express jurisdiction clause, it will be for the court of the jurisdiction presented with a claim to determine whether it will accept jurisdiction to hear the case.

The US Position

In the US, the Foreign Sovereign Immunities Act of 1976 (FSIA)[12] governs all litigation in both state and federal courts against foreign sovereigns. The FSIA provides the exclusive basis for obtaining jurisdiction over sovereigns and contains special rules for service of process.[13] The basic position is that a foreign state is immune from suit and immune from execution of judgments and pre-judgment attachments in any US federal or state court unless, as discussed below, a statutory exception to immunity applies.[14] To obtain both subject matter and personal jurisdiction, a US court must answer three threshold questions: (1) whether the defendant is a "foreign state or government," (2) whether valid service has been made pursuant to the FSIA (*i.e.* in accordance with the specific provisions in FSIA, 28 U.S.C. § 1608), and, (3) whether a statutory exception to immunity applies (as to which see further below).

The UK Position

In England, where jurisdiction is initially established by the process of service of the claim form, it would be necessary to obtain permission to serve Russia outside

[12] The Foreign Sovereign Immunities Act, 28 U.S.C §§ 1602 *et seq*.

[13] FSIA, 28 U.S.C. § 1608.

[14] *Ibid*. §1604.

Continued from p.25

the jurisdiction[15] and then serve the claim form through diplomatic channels, in accordance with the State Immunity Act 1978 (the SIA).[16] A gateway issue to obtain permission to serve out would be whether Russia could rely on the default rule in Section 1 of the SIA that states are immune from suit. However, the issue of Eurobonds is likely to constitute a commercial transaction which is one of the exemptions to immunity under the SIA (on which see further below). Following service of the claim form, Russia may seek to challenge the jurisdiction of the English courts on *forum non conveniens* grounds.

When considering the question of *forum conveniens*, English courts consider a range of factors including the location of the parties, witnesses and documents, the law applicable to the dispute and any pending related proceedings. For Russian Eurobonds governed by English law, England would likely be considered *an* appropriate forum to determine the dispute particularly where there are few, if any, relevant witnesses or documents located abroad.

To successfully challenge the jurisdiction of the English courts, Russia would need to show that there is some other available forum, having competent jurisdiction, which is a clearly more appropriate forum for the trial of the action, i.e. in which the case may be tried more suitably for the interests of all the parties and the ends of justice. Russia may face difficulties persuading a court that there is a clearly more appropriate forum, particularly if the proposed alternative forum is Russia itself. Even if Russia is shown to be the natural forum, the English courts may retain jurisdiction to hear the claim where there is a real risk that justice will not be obtained in the foreign court by reason of incompetence, lack of independence or corruption.[17]

[15] Civil Procedure Rule 6.36 and PD36 paragraph (6)(b) provide a jurisdictional gateway where the dispute is made in respect of a contract which is governed by English law.

[16] Section 12 of the SIA provides that any document for instituting proceedings against a State shall be served by being transmitted through the Foreign, Commonwealth and Development Office to the Ministry of Foreign Affairs of the State. Service shall be deemed to have been effected when the writ or document is received at the Ministry. The process for service out is described in further detail at CPR 6.44.

[17] *AK Investment CJSC v Kyrgyz Mobil Tel Ltd* [2011] UKPC 7.

A BIT Claim?

In some circumstances, sovereign debt has been recognized as an investment capable of being the subject of a bilateral investment treaty claim. A potential alternative to a claim before national courts, therefore, would be a claim under one of Russia's bilateral investment treaties.

Sovereign Immunity

Russian Eurobonds usually also contain a statement to the effect that Russia: i) has not waived any rights to sovereign immunity in any jurisdiction; ii) may be entitled to immunity from suit in any action or proceeding arising out of the Eurobonds; and iii) Russia and its assets, properties and revenues may be entitled to immunity in any enforcement action.

Since Russia has not waived any of its rights to sovereign immunity, in order to succeed any claim against Russia will need to engage with and overcome issues of sovereign immunity. Rules governing sovereign immunity differ from country to country, but there are, in general, two limbs to sovereign immunity:

1. Immunity from suit (*i.e.*, from a claim even being brought against a foreign state); and
2. Immunity from enforcement or attachment of state-owned assets.

This means that, even if a judgment can be obtained from a court of competent jurisdiction against a foreign state such as Russia, the ability to enforce that judgment may nevertheless be curtailed by sovereign immunity.

The US Position

In the US, the FSIA states that a foreign state is immune from suit in any US federal or state court unless one of the enumerated statutory exceptions to immunity applies.[18] The second enumerated exception, the so called "commercial activity" exception, allows for suits to proceed where the action is "*based upon* an act outside the territory of the United States in connection with *a commercial activity* of the foreign state elsewhere and that act *causes a direct effect* in the Unites States."[19] The issue of Eurobonds by Russia and their purchase by US citizens may trigger the commercial activity exception. To satisfy this exception, plaintiffs must show that an action is "based upon" commercial conduct that forms the "basis" or "foundation" of a claim such that the elements, if proven, would entitle the plaintiff to relief.[20]

[18] FSIA, 28 U.S.C. § 1605.

[19] *Ibid.* §1605 (emphasis added).

[20] *MMA Consultants 1, Inc. v. Republic of Peru*, 719 F. *App'x* 47, 52 (2d Cir. 2017) (internal citations omitted).

It is well established that a foreign sovereign's activities related to debt instruments constitutes "commercial activity" and that a suit brought for breach of bond instruments is based upon that commercial activity.[21] Individual potential claims would have to be further analysed to determine if they satisfy the "direct effect" requirement of the commercial activity exception. It is not enough to show that a state's commercial activity outside of the United States caused financial injury to a US citizen.[22] To find a "direct effect" in the United States caused by non-payment of a commercial obligation, US courts have generally required a showing that either the defaulting party was contractually obligated to make payment in the US,[23] or that a provision of the underlying documents permits the holder to designate a place of payment.[24] Courts also look to the language of the bonds to determine if they suggest "a reasonable understanding that the Unites States could be the place of performance."[25]

In the US, even if a plaintiff successfully brings a claim under the FSIA, execution of the judgment is not guaranteed. Under the FSIA, the property of a foreign state is immune from attachment and execution unless an exception applies,[26] for example, where the property is or was used for the commercial activity upon which the claim is based.[27] Since property of foreign central banks such as the CBR is immune from attachment and execution, and there are unlikely to be assets outside the CBR used for the repayment of the Eurobonds, a judgment based on Eurobonds is unlikely to be enforceable in the US.[28]

The UK Position

In England, the general rule under the SIA is that a state is immune from suit before the English courts.[29] Like the US, there are exceptions to that general immunity including where the state has entered into a "commercial transaction." "Commercial transactions" are defined as including loans or other transactions for the provision of finance.[30] Russian Eurobonds would likely fall under this exception.

In relation to enforcement, there is a general rule that the property of a state is immune to any process for the enforcement of a judgment or in an action for its

21 *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 614, 615-16 (1992).
22 *Guirlando v. T.C. Ziraat Bankasi A.S.*, 602 F.3d 69, 74 (2d Cir. 2010).
23 *Rogers v. Petroleo Brasileiro, S.A.*, 673 F.3d 131, 139 (2d Cir. 2012).
24 *Ibid.* at 140.
25 *Ibid., see also Kensington Int'l Ltd. v. Itoua*, 505 F.3d 147, 157 (2d Cir. 2007) (holding that prepayment agreements had "no connection" to the United States where they "were negotiated in France, written in French, apply to foreign entities, and specify France as the exclusive jurisdiction to resolve disputes").
26 FSIA, 28 U.S.C. §1609.
27 *Ibid.* §1610.
28 *Ibid.* §1611.
29 SIA Section 1.
30 *Ibid.* Section 3(1) and 3(3)(b).

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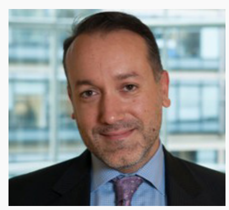

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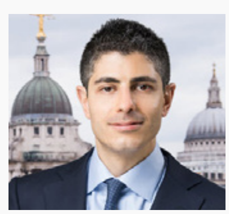

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arrest, detention or sale.[31] There are certain exceptions to that rule including where property of the state is for the time being in use or intended for use for commercial purposes.[32] However, the property of central banks is afforded greater protection, and is expressly excluded from being in use or intended for use for commercial purposes.[33] That said, English law does not impose the same requirement as US law that enforcement may only take place against assets of a state used for commercial purposes if the assets in question are or were used for the commercial activity underpinning the claim, so in principle the scope for enforcement against commercial assets of Russia located within the UK (if any) would appear greater.

Enforcement Elsewhere?

A judgment creditor of Russia may seek to enforce its judgment against assets of Russia located around the world. The scope in any jurisdiction for both the recognition and enforcement of a foreign judgment will depend on the local rules applicable in the enforcing jurisdiction.

Discovery in Support of Enforcement Proceedings

Regardless of where a judgment against Russia is obtained, if that judgment were to be recognised in the US or UK, which would itself engage questions of sovereign immunity, the respective courts would have wide powers to make orders in support of enforcement proceedings.

In the US, the full array of discovery permissible under the Federal Rules of Civil Procedure is available to a judgment creditor of a sovereign state. Discovery into the assets of a judgment debtor is very broad but subject to a principle of proportionality. Available discovery includes the ability to request the production of documents and written responses to interrogatories, as well as sworn deposition testimony. This discovery can in principle be requested from not only from the judgment debtor, but also any other persons or entities believed to have information relevant to the enforcement efforts.

It should also be noted that the United States Supreme Court (in a case on which one of the authors represented the successful party) has ruled that the FSIA does not grant immunity to foreign governments from discovery proceedings in litigation over the enforcement of judgments.[34]

In the UK, the courts have wide powers to makes orders, including asset disclosure orders, third party disclosure orders (Norwich Pharmacal) and orders for cross-examination in support of enforcement proceedings. However, the granting of such orders may also engage questions of sovereign immunity especially where they concern central banks and/or their agents.[35]

What Should Bondholders Do Next?

In the event that Russia fails to make payment of any of its Eurobond obligations, there is likely to be a 30 day grace period for Russia to comply with its obligations. Investors who hold Russian sovereign debt will likely want to organize themselves and seek advice on their options ahead of time, including preparing to issue a claim against Russia to seek to recover their investments.

If you have any questions about the issues addressed in this article, please do not hesitate to reach out to lead author, Dennis Hranitzky, Email: dennishranitzky@quinnemanuel.com, Phone: +1 801 515 7333.

31 *Ibid*. Section 13(2).
32 *Ibid*. Section 13(4).
33 *Ibid*. Section 14(4).

34 *Republic of Argentina v. NML Capital, Ltd.*, 573 U.S. 134 (2014).
35 *KOO Golden East Mongolia v Bank of Nova Scotia* [2007] EWCA Civ 1443.

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RUSSIA IN UKRAINE: HOW THE CRISIS IS PLAYING OUT IN MARKETS[1]

ASWATH DAMODARAN
NYU Stern

As the world's attention is focused on the war in the Ukraine, it is the human toll, in death and injury, that should get our immediate attention, and you may find a focus on economics and markets to be callous. However, I am not a political expert, with solutions to offer that will bring the violence to an end, and I don't think that you have come here to read about my views on humanity. Consequently, I will concentrate this post on how this crisis is playing out in markets, and the effects it has had, so far, on businesses and investments, and whether these effects are likely to be transient or permanent.

The Lead In

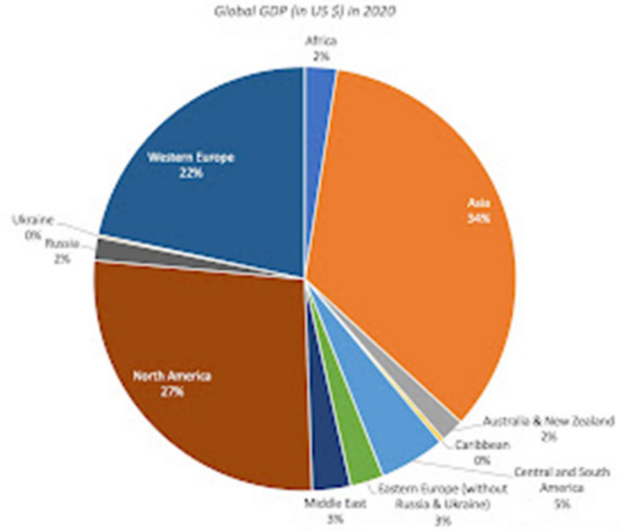
To understand the market effects of the Russia-Ukraine conflict, we need to start with an assessment of the two countries, and their places in the global political, economic and market landscape, leading in. Russia was undoubtedly a military superpower, with its vast arsenal of nuclear weapons and army, but economically, it has never punched that weight. Ukraine, a part of the Soviet Union, has had its shares of ups and downs, and its economic footprint is even smaller. Exhibit 1 provides a measure of the gross domestic product of Russia and Ukraine, relative to the rest of the world.

While Russia's share of the global economy is small, it does have a significant standing in the natural resource space, as a leading producer and exporter of oil/gas, coal, and nickel, among other commodities (Exhibit 2). Ukraine is also primarily a natural resource producer, especially of iron ore, albeit on a smaller scale. Russia was also a leading exporter of these commodities, with a disproportionately large share of its oil and gas production going to Europe; in 2021, Russian gas accounted to 45% of EU gas imports.

The Market Reaction

As the rhetoric of war has heated up in the last few months, markets were wary about the possibility of war; but as Russian troops have advanced into the Ukraine, that wariness has turned to sell off across markets. In this section, I will begin by looking at the bond market effects and then move on to equities and other asset classes, starting with the localized reaction (for Ukrainian and Russian securities) and then the global ripple effects.

Exhibit 1: Russia and Ukraine GDP v. Rest of World, 2020



Region/ Country	Sum of GDP (in $ billions) in 2020		% of Global GDP
Africa	$	2,051	2.45%
Asia	$	28,761	34.33%
Australia & New Zealand	$	1,544	1.84%
Caribbean	$	256	0.31%
Central and South America	$	4,212	5.03%
Eastern Europe (without Russia & Ukraine)	$	2,136	2.55%
Middle East	$	2,461	2.94%
North America	$	22,580	26.95%
Russia	$	1,484	1.77%
Ukraine	$	156	0.19%
Western Europe	$	18,133	21.65%
Global Total	**$**	**83,773**	**100.00%**

[1] This article is from a post by the author, "Russia in Ukraine: Let Loose the Dogs of War!" Musings on Markets blog, March 2022, https://aswathdamodaran.blogspot.com/2022/03/russia-and-ukraine-let-loose-dogs-of-war.html.

Exhibit 2: Natural Resource Production by Country, 2020

Oil Production in 2020		*Coal Production in 2020*		*Nickel Production in 2020*		*Iron Ore Production in 2020*	
Country	*Production (in '000s of barrels)*	*Country*	*Production (in million tons)*	*Country*	*Production (in thousands of metric tons)*	*Country*	*Production (in thousands of tons)*
United States	19510	China	3,902	Indonesia	760.00	Australia	900.00
Russia	11810	India	757	Philippines	320.00	Brazil	400.00
Saudi Arabia	11490	Indonesia	563	Russia	280.00	China	340.00
Canada	5500	United States	485	New Caledonia	200.00	India	230.00
China	4890	Australia	477	Australia	170.00	Russia	95.00
Iraq	4740	Russia	400	Canada	167.00	South Africa	75.00
United Arab Emirates	4010	South Africa	248	China	120.00	Ukraine	60.00
Brazil	3670	Kazhakhstan	113	Brazil	73.00	Canada	50.00
Iran	3190	Germany	107	Cuba	49.00	United States	45.00
Kuwait	2940	Poland	101	Colombia	40.00	Kazakhstan	43.00

Exhibit 3: Sovereign CDS Spreads, Russia (left) and Ukraine (right), Sep. 21 - Mar 16, 2022

Bond Markets and Default Risk

In times of trouble, the first to panic are often lenders to the entities involved, and in today's markets, the extent of the reaction to country-level troubles can be captured in real time in the sovereign Credit Default Swap (CDS) markets. The graphs in Exhibit 3 show the sovereign spreads for Russia and Ukraine in the weeks leading up to and including the conflict.

The sovereign CDS spread for Russia, which started the year at 1.70%, soared above 25% just after hostilities commenced, and were trading at 10.56% on March 16, after rumors that peace talks were underway brought them down. The sovereign CDS spread for the Ukraine started the year at 6.17% and climbed in the first few days of the crisis to more than 100% (effectively uninsurable) before settling in on March 16 at 28.62%. Even the ratings agencies, normally slow to act, have been moving promptly, with Moody's lowering Russia's rating from Ba2 to B3 on March 3, from B3 to Ca on March 6, and from Ca to C on March 8, and Ukraine's rating from B3 to Caa2 on March 4. Other ratings agencies have taken similar actions.

The worries about default have not stayed isolated to Russia and Ukraine, as ripple effects have shown up first in the countries that are geographically closest to the conflict (Eastern Europe) and more generally on sovereign CDS spreads in the rest of the world. Exhibit 4 presents average spreads by region before and after the hostilities started.

There are no surprises in this table, with the effects on spreads being greatest for East European countries. Note, though, that while sovereign CDS spreads increased almost 51% between January 1, 2022 and March 16, 2022 in these countries, the overall riskiness of the region remains low, the average spread at 1.30%. The Middle East is the only region that saw a decrease in sovereign CDS spreads as oil, the primary mechanism for monetization in this region, saw its price surge during the last few weeks. The Canadian sovereign CDS spread widened, but US and EU country spreads remained relatively stable.

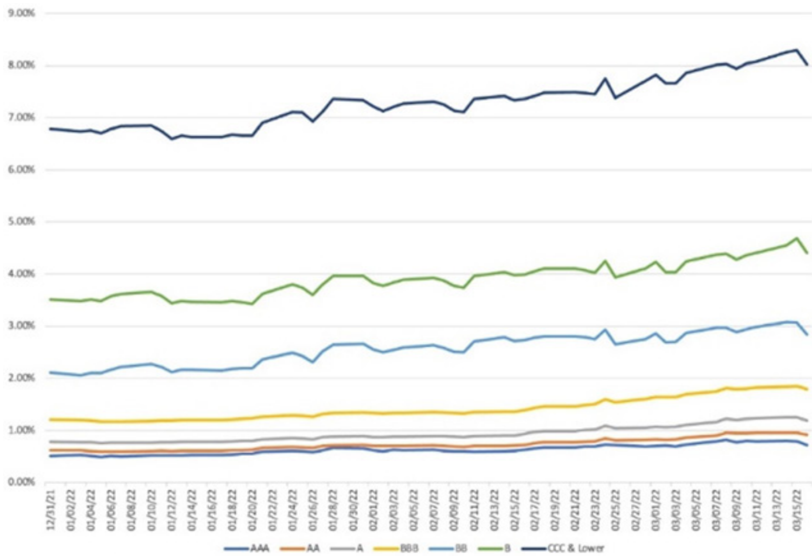
The increase in default spreads was not restricted to foreign markets, as fear also pushed up spreads in the corporate bond market. Exhibit 5 presents analysis of default spreads across US companies on Jan. 1 and March 16, 2022.

Continued from p.31

Exhibit 4: Average Global CDS Spreads Before and After Hostilities

Region	# Countries	CDS (1/1/22)	CDS (3/16/22)	Change	Percentage Change
Africa	12	5.47%	5.80%	0.33%	6.02%
Asia	12	2.65%	3.19%	0.54%	20.50%
Australia & New Zealand	2	0.22%	0.24%	0.02%	9.09%
Central and South America	12	5.84%	6.94%	1.11%	18.96%
Eastern Europe (without Russia & Ukraine)	13	0.86%	1.30%	0.44%	50.89%
Middle East	8	2.02%	1.88%	-0.15%	-7.16%
North America	2	0.24%	0.29%	0.06%	23.40%
Russia	1	1.70%	10.56%	8.86%	521.18%
Ukraine	1	6.17%	28.63%	22.46%	364.02%
EU, Switzerland & UK	19	0.72%	0.77%	0.05%	7.18%
Global	**82**	**2.65%**	**3.39%**	**0.74%**	**27.95%**

Exhibit 5: US Corporate Bond Spreads, 12/31/21 – 3/16/22



	AAA	AA	A	BBB	BB	B	CCC & Lower
12/31/21	0.51%	0.62%	0.78%	1.21%	2.11%	3.51%	6.78%
01/31/22	0.65%	0.72%	0.89%	1.34%	2.66%	3.96%	7.34%
02/24/22	0.73%	0.84%	1.09%	1.59%	2.93%	4.25%	7.75%
02/28/22	0.69%	0.82%	1.05%	1.60%	2.75%	4.11%	7.71%
03/16/22	0.72%	0.92%	1.19%	1.79%	2.84%	4.41%	8.02%

Exhibit 6: Russia and Ukraine Country Indices, January 2021 – March 2022

RTX Russian Traded $ Index (left), Ukraine PFTS Index (right).

It is worth noting that corporate bond spreads, which were are at historic lows to start the year, were already starting to widen before Russia's military moved into the Ukraine on February 24, 2022, but the invasion has pushed the spreads further up at the lower ends of the default spectrum. The overriding message in all of this data is that the Russia/Ukraine war has unleashed fears in the bond market, and once unleashed, that fear has pushed up worries about default and default risk premia across the board.

Equity Markets and Equity Risk Premiums

Lenders may be the first to worry when there is a crisis that puts their payments at risk, but equity investors are often with them, pushing down stock prices and pushing up equity risk premiums. Again, I will start with Russian and Ukrainian equities, using country indices to capture the aggregate effect on these markets from the invasion (Exhibit 6).

Neither index is particularly representative, and currency effects contaminate both, but they tell the story of devastation in the two markets. In fact, since trading has been suspended on both indices, the extent of the damage is probably understated. To get a better sense of how Russian equities in particular have fared in the aftermath of the invasion, I looked at four higher profile Russian companies (Exhibit 7).

The four Russian companies that I picked are representative of the Russian economy: *Lukoil* is a stand-in for Russia's oil businesses; *Sberbank* is Russia's most dynamic bank, a part of almost every aspect of Russian financial services; *Severstal* is a global steel company with roots and a significant market share in Russia; *Yandex* is Russia's largest technology company. In addition to being traded on the MICEX – the Russian exchange – these companies all have listings in foreign markets (Yandex has a US listing and the other three are listed on the London Exchange). The collapse in stock prices has been calamitous, with each of the four stocks losing almost all of their value, and with trading suspended since the end of February, it is still unclear whether the trading will open up, and if so at what price (Exhibit 8 on the next page).

A knee-jerk contrarian strategy may indicate that you should be buying all these stocks as soon as they open for trading, but a note of caution is needed. The price drop in these companies, especially severe at Sberbank, is not necessarily an indication that these companies will cease to exist, but that the Russian government may effectively nationalize them, leaving equity worthless.

As Russian equities have imploded, the ripple effects again are being felt across the globe. Exhibit 9 (on the next page) summarizes the market cap change, by region of the world.

Exhibit 7: Stock Prices of Lukoil, Sberbank, Severstal, Yandex, Sep. 2021 - Feb. 2022

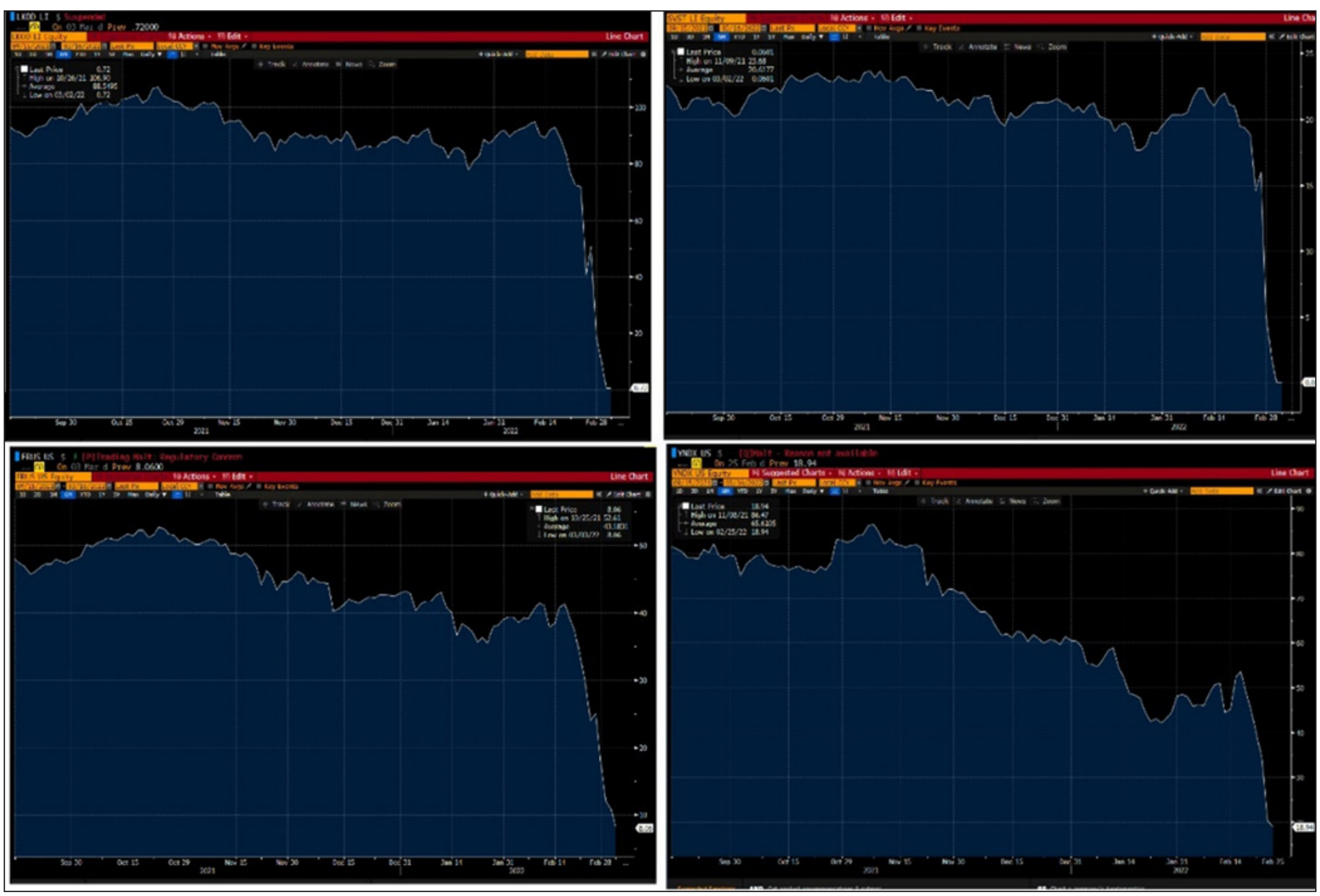


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Exhibit 8: Four Russian Companies Stock Prices, Jan. 1 – Feb. 28, 2022

Company	Price (1/1/22)	Price (2/1/22)	Price (2/23/22)	Price (2/28/22)	% Change
Lukoil	$ 89.44	$ 88.72	$ 71.72	$ 18.81	-78.97%
Sberbank	$ 16.06	$ 13.85	$ 8.97	$ 1.06	-93.40%
Severstal	$ 21.24	$ 19.47	$ 18.79	$ 5.15	-75.75%
Yandex	$ 60.40	$ 48.06	$ 34.04	$ 18.94	-68.64%

Exhibit 9: Global Market Cap Changes by Region, Jan. 1 – March 16, 2022

Sub-Region	# Firms	Mkt Cap on 1/1/22	Mkt Cap on 3/16/22	% Change in Market Cap
Africa and Middle East	2,236	$ 4,602,839	$ 5,049,827	9.71%
Australia & NZ	1,839	$ 1,959,924	$ 1,876,950	-4.23%
Canada	2,753	$ 3,048,061	$ 2,965,784	-2.70%
China	4,934	$ 16,311,119	$ 14,040,029	-13.92%
EU & Environs	5,800	$ 17,638,999	$ 15,328,237	-13.10%
Eastern Europe & Russia	322	$ 289,874	$ 142,996	-50.67%
India	3,812	$ 3,565,693	$ 3,349,269	-6.07%
Japan	3,925	$ 6,520,904	$ 5,845,470	-10.36%
Latin America & Caribbean	3,613	$ 6,333,808	$ 5,264,613	-16.88%
Small Asia	9,179	$ 7,091,566	$ 6,612,669	-6.75%
UK	1,206	$ 3,482,027	$ 3,196,765	-8.19%
United States	6,709	$ 52,180,134	$ 45,888,376	-12.06%
Global	46,376	$ 123,095,378	$ 109,617,766	-10.95%

Exhibit 10: World's Percentage of Change by Sector, 1/1/22 to 3/16/22

Primary Sector	# Firms	Mkt Cap on 1/1/22	Mkt Cap on 3/16/22	% Change in Market Cap
Communication Services	2,156	$ 9,382,907	$ 7,957,323	-15.19%
Consumer Discretionary	6,129	$ 15,406,900	$ 12,428,082	-19.33%
Consumer Staples	2,951	$ 8,944,979	$ 8,105,104	-9.39%
Energy	1,484	$ 6,039,444	$ 6,804,460	12.67%
Financials	5,295	$ 17,252,000	$ 16,512,443	-4.29%
Health Care	4,536	$ 12,589,859	$ 11,082,804	-11.97%
Industrials	8,058	$ 14,322,573	$ 12,835,636	-10.38%
Information Technology	6,103	$ 23,264,992	$ 19,046,163	-18.13%
Materials	6,104	$ 7,754,213	$ 7,305,766	-5.78%
Real Estate	2,663	$ 4,434,176	$ 4,027,117	-9.18%
Utilities	887	$ 3,699,699	$ 3,509,253	-5.15%
Global	46,376	$ 123,095,378	$ 109,617,766	-10.95%

It is no surprise that Eastern Europe and Russia, which are in the eye of the hurricane, have seen the most damage to equities, but other than the Middle East, every other equity market in the world is down, with the US, EU, and China shedding significant market capitalization. Exhibit 10 presents the data sliced by sector. Again, there are no surprises, with energy being the only sector to post positive returns and with consumer discretionary and technology generating the most negative returns. Finally, I looked at firms based upon price-to-book ratios as of January 1, 2022, as a rough proxy for growth/maturity, and at net debt-to-EBITDA multiples as a measure of indebtedness (Exhibit 11).

In this crisis, the conventional wisdom has held, at least so far, with mature companies holding their values better than growth companies. Since these mature companies tend to carry more debt, you see more-indebted companies doing much better than less-indebted companies. While the value crowd, bereft of victories for a long time, may be inclined to do a victory dance, it is worth noting that the same phenomenon occurred between February and March of 2020, at the start of the COVID crisis, but that growth companies quickly recouped their losses and finished ahead of mature companies by the end of 2020.

In keeping with my belief that it is the price of risk that is changing during a crisis, causing contortions in prices, I estimated the implied equity risk premium for the S&P 500, by day, starting on January 1, 2022, going through March 16, 2022 (Exhibit 12).

Note that equities were already under pressure in the weeks before the invasion, as inflation fears surfaced again, and then hostilities have put further pressure on them. The implied equity risk premium, which started the year at 4.24%, was at 4.73% by March 16, and the expected return on equity, which was close to an all-time low at 5.75% at the start of the year, was now up to 6.92%, still lower than historical norms, but closer to the numbers that we have seen in the last decade.

Flight to Safety and Collectibles

As in any crisis, there was a rush to safety, accentuated by wealthy Russians trying to move their wealth to safe havens, with safety defined not just in terms of currency, but also in terms of being beyond the reach of US and European regulators and legislators. I start with two traditional havens for US investors, the US dollar and treasury bonds (Exhibit 13 on next page).

The dollar has strengthened since February 23, with the trade weighted dollar rising about 3% in value, but the ten-year treasury bond, after an initial rise in prices (and drop in yields) has reversed course, perhaps as inflation concerns overwhelm safe haven benefits.

I also looked at crisis investments, starting with gold, an asset that has held this status for centuries and contrasting it with bitcoin, millennial gold (Exhibit 14). Gold, which started the year at just above $1,800 an ounce, rose from $1,850 on February 23 to peak at $2,050/oz a few days ago, before dropping back below

Exhibit 11: Change in Market Capitalization Based on Maturity/Growth and Indebtedness

Mature (Low PBV) versus Growth (High PBV)					Indebtedness (Low to High)				
PBV Decile as of 1/1/22	*# Firms*	*Mkt Cap on 1/1/22*	*Mkt Cap on 3/16/22*	*% Change in Market Cap*	*Net Debt/EBITDA as of 1/1/22*	*# Firms*	*Mkt Cap on 1/1/22*	*Mkt Cap on 3/16/22*	*% Change in Market Cap*
Bottom decile	4,104	$ 3,415,016	$ 3,314,731	-2.94%	Lowest	2,833	$ 3,447,044	$ 2,715,534	-21.22%
2nd decile	4,105	$ 4,958,644	$ 4,791,247	-3.38%	2nd decile	2,834	$ 4,784,744	$ 3,858,507	-19.36%
3rd decile	4,105	$ 6,171,991	$ 5,956,267	-3.50%	3rd decile	2,834	$ 8,495,717	$ 7,342,616	-13.57%
4th decile	4,104	$ 7,487,722	$ 7,305,666	-2.43%	4th decile	2,834	$ 16,583,953	$ 13,968,473	-15.77%
5th decile	4,105	$ 9,844,813	$ 9,546,170	-3.03%	5th decile	2,834	$ 17,318,591	$ 15,916,605	-8.10%
6th decile	4,105	$ 8,240,230	$ 7,826,302	-5.02%	6th decile	2,834	$ 16,173,697	$ 14,987,310	-7.34%
7th decile	4,104	$ 9,803,611	$ 8,993,002	-8.27%	7th decile	2,834	$ 13,621,838	$ 12,293,529	-9.75%
8th decile	4,105	$ 12,254,051	$ 10,621,933	-13.32%	8th decile	2,834	$ 12,089,335	$ 11,184,129	-7.49%
9th decile	4,105	$ 19,492,336	$ 17,007,593	-12.75%	9th decile	2,834	$ 8,453,163	$ 7,815,569	-7.54%
Top decile	4,105	$ 37,583,632	$ 30,880,524	-17.84%	Highest	2,834	$ 3,716,898	$ 3,429,689	-7.73%
Negative Book value	5,329	$ 3,843,331	$ 3,374,331	-12.20%	Negative EBITDA	18,037	$ 18,410,398	$ 16,105,805	-12.52%
Global	46,376	$ 123,095,378	$ 109,617,766	-10.95%	Global	46,376	$ 123,095,378	$ 109,617,766	-10.95%

Exhibit 12: Implied ERP and Expected Return on S&P 500, January 1 – Mar 16, 2022

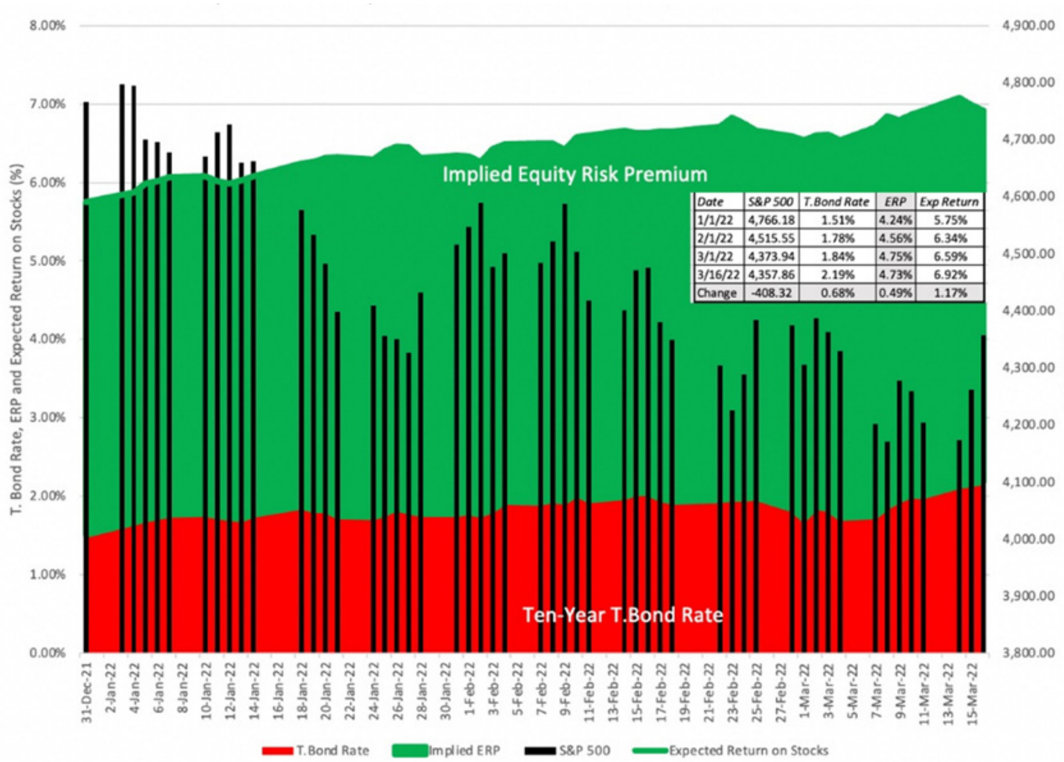

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Exhibit 13: Comparison of Trade-weighted Dollar and US 10-year T.Bond Rate, September 2021 – March 2022

Exhibit 14: Comparison of Gold and Bitcoin, September 2021 – March 2022

$2,000/oz on March 16. Bitcoin, which started the year at about $46,000, had a strong first half of November, also rose at the start of this crisis, but seems to have given back almost all of its gains. To the extent that crypto holdings may be more difficulties for authorities to trace and lay claim on, it will be interesting to see if you see a rise in the prices of crypto currencies as Russian wealth looks for sanctuary.

Economic Consequences

It is difficult to argue that people were taken by surprise by the events unfolding in the Ukraine, since the lead in has been long and well documented. It can be traced back to 2014, when Russia annexed Crimea, setting in motion a period of uncertainty and sanctions, and the global economy and Russia seemed to have weathered those challenges well. As this crisis plays out in financial markets, roiling the price of risk in both bond and equity markets, the other question that has to be asked is about the long term economic consequences of the crisis for the global economy.

Commodity Prices and Inflation Expectations

Given Russia's standing as a lead player in commodity markets, and its role in supplying oil and gas to Europe specifically, it should come as no surprise that the markets for the commodities that Russia produces in abundance has been the most impacted, at least in the short term (Exhibit 15).

All four commodities saw their prices soar in the aftermath of February 23, with oil rising to $130 a barrel, before falling back below $100, and trading in the nickel market suspended on March 7, after prices rose about $100,000 a ton. Even as prices rose in the spot market, the futures market indicated that many participants believed that the price rise would be temporary, with futures prices closer to $80 a barrel, for one year ahead and two years ahead futures contracts.

In a market already concerned about expected inflation, the rise in commodity prices operated as fuel on fire,

Exhibit 15: Commodity Prices for Crude Oil, Nickel, Wheat and Natural Gas, Sept 2021 – March 2022

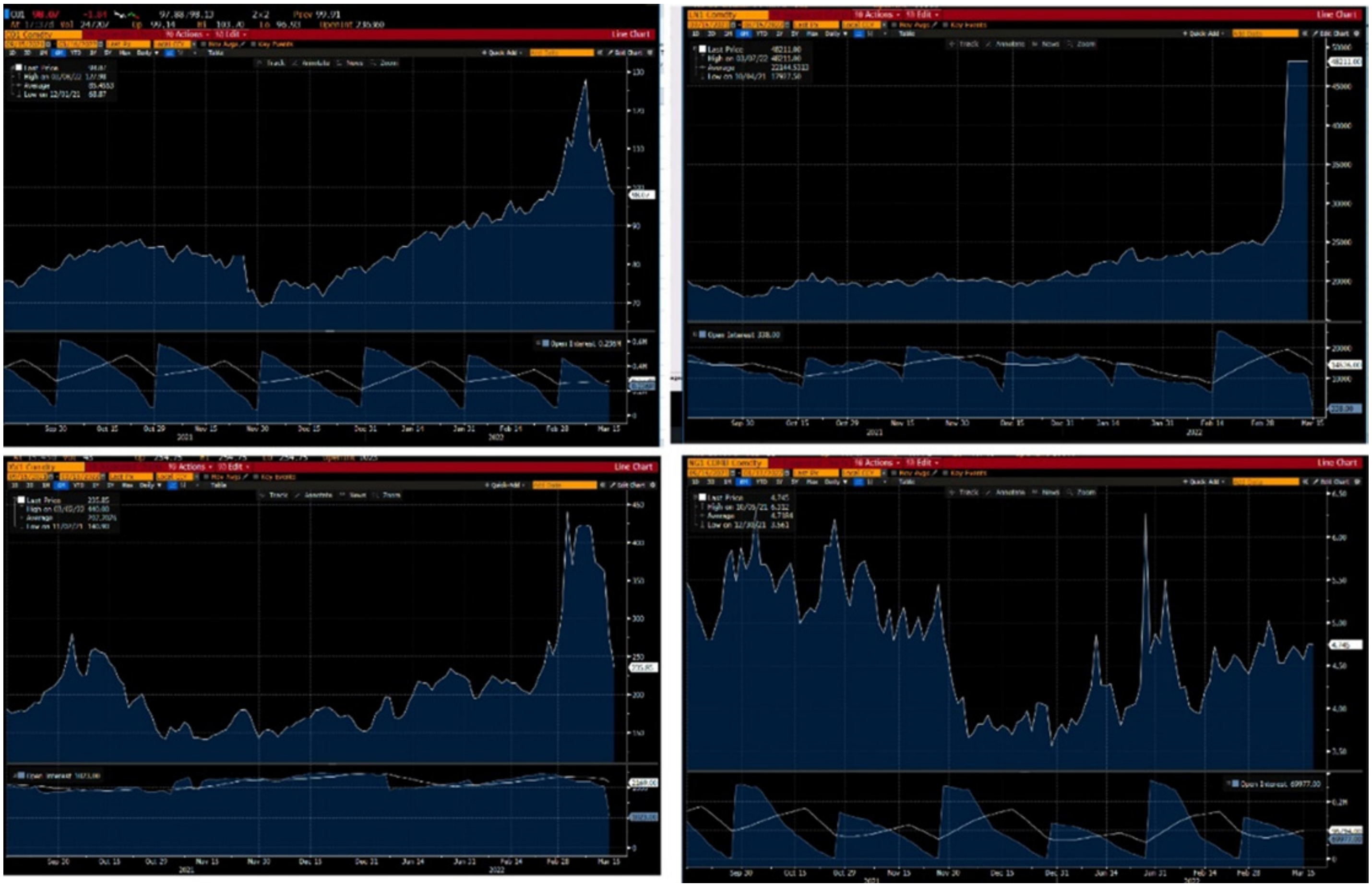

Exhibit 16: Inflation Expectation ETF and US Fed Reserve 5-year Forward Inflation, Sept 2021 – March 2022

and pushed expectations higher. In the graph below, I list out two measures of expected inflation, one from a inflation expectations ETF (ProShares Inflation Expectation ETF) and the other from the Federal Reserve 5-year forward inflation measure, computed as the difference between treasury and TIPs rates (Exhibit 16). Both measures indicate heightened concerns about future inflation, and these are undoubtedly also behind the increase in the US ten-year treasury bond rate this year.

Consumer Confidence and Economic Growth

The question that hangs over not just markets but economic policy makers is how this crisis will affect global economic growth and prospects. It is too early to pass final judgment, but the early indications are that it has dented consumer confidence, as the latest readings from the University of Michigan Consumer Sentiment survey indicates (Exhibit 17).

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Exhibit 17: University of Michigan Consumer Sentiment, June 2016 – March 2022

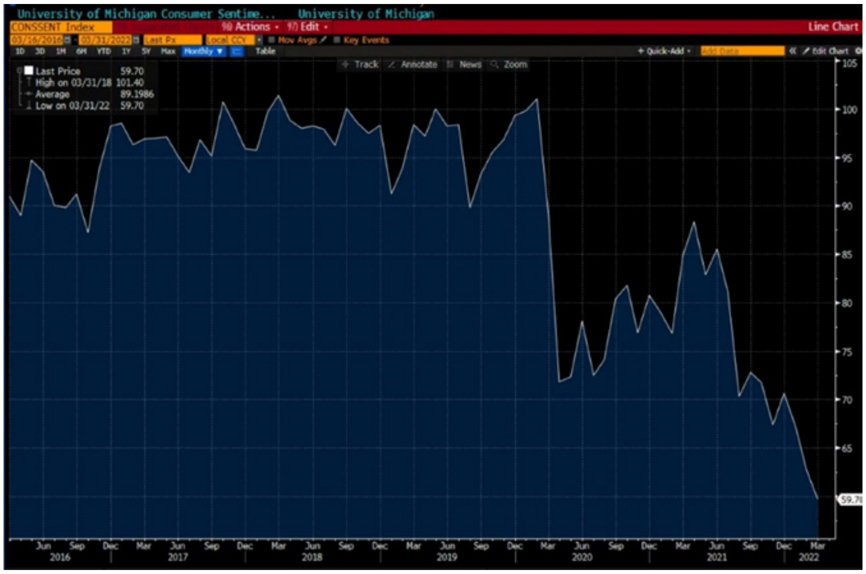

Exhibit 18: Median Forecast Probability of Recession, US (left) and Eurozone (right), September 2021 – March 2022

Exhibit 19: Valuing the S&P 500 on March 16, 2022

Risk free Rate
Assume that the treasury bond rate will rise to 3%, gradually over the next five years.

Expected Earnings in 2022 & 2023
Used analyst forecasts for earnings in 2022 and 2023

Growth rates in 2024-26
Growth rate decreases from 2023 level to stable growth in linear increments.

Growth rate beyond 2026
Expected growth rate is 3% in perpetuity (= Risk free rate in 2026)

	2021E	2022	2023	2024	2025	2026	*Terminal Year*
Expected Earnings	$208.49	226.38	248.77	267.66	281.84	290.29	299.00
Expected Earnings Growth Rate		8.58%	9.89%	7.59%	5.30%	3.00%	3.00%
Expected cash payout as % of earnings	77.36%	77.36%	78.36%	79.36%	80.36%	81.37%	81.37%
Expected Dividends + Buybacks =	$161.29	$175.13	$194.94	$212.42	$226.50	$236.20	243.29
Expected Terminal Value =						$4,865.75	
Riskfree Rate	2.19%	2.35%	2.51%	2.68%	2.84%	3.00%	3.00%
Required Return on Stocks	7.19%	7.35%	7.51%	7.68%	7.84%	8.00%	8.00%
Present Value =		$163.13	$168.90	$170.93	$169.01	$3,524.90	
Intrinsic Value of Index =	**4196.86**						
Actual Index level =	**4431.12**						
% Under or Over Valuation =	5.58%						

Intrinsic Value of Index
PV of expected cash flows for next 5 years + PV of terminal value

Terminal Value
= 243.29/ (.08 - .03) = 4865.75

Consumer sentiment is now more negative than it was at any time during the COVID crisis in 2020, and if consumers pull back on purchases, especially of discretionary and durable goods, it will have a negative effect on the economy. While the contemporaneous numbers on the US economy on unemployment and production still look robust, worries about recession are rising, at least relative to where they were before the hostilities. Exhibit 18 displays the median forecasts of recession probabilities for the US and Eurozone, from September 2021 to March 2022 (from Bloomberg).

As a result of events of recent weeks, forecasters have increased the probabilities of recessions from 15% to 20% for the US and from 17.5% to 25% for the Eurozone.

Investment Implications: Asset Classes, Geographies and Companies

The Russian invasion of Ukraine has undoubtedly increased uncertainty, affected prices for financial assets and commodities, and exacerbated issues that were already roiling markets prior to the invasion. For investors trying to recapture their footing in the aftermath, there are multiple questions that need answers. The first is whether a radical shift in asset allocation is needed, given these perturbations, across asset classes, geographies and sectors. The second is how the disparate market sell off, small in some segments and large in others, over the last few months has altered the investment potential in individual companies in these segments. On January 1, 2022, I valued the S&P 500, building in the expectation that the economy would stay strong for the year and that interest rates would rise over the course of time from the then-prevailing value (1.51%) to 2.50% over five years, and arrived at a value of 4,320 for the index, about 10.3% lower than the traded value of 4766. By mid-March, the index had shed 7.03% of its value, the T.Bond rate had risen to 2.19%, and Russia's invasion of the Ukraine was increasing commodity prices and the likelihood of a recession. I revisited my valuation of the index with the updated values on March 16, 2022; results are shown in Exhibit 19.

There are two things to note in this valuation. The first is that I have raised the target rate for the US T.Bond to 3%, reflecting both the increase that has already occurred this year, and concerns about how current events may be adding to expected inflation. The second is that I continue to use analyst estimates of earnings, and at least as of this writing (with estimates from March 14, 2022), analysts do not seem to be lowering earnings to reflect recession concerns. That may either reflect their belief that this storm will pass without affecting the US economy significantly or a delay in incorporating real world concerns. If you open the spreadsheet in my blog,[2] I offer you the option of adjusting expected earnings, if you believe analysts are being unrealistic in their forecasts. The net effect of the changes is that my estimated value of the index is 4197, making the index over valued by 5.6% as of March 16, 2022.

More generally, the question that investors face as they decide whether to reallocate their portfolios is whether the market has over or under reacted to events on the ground.

- If you are a knee-jerk contrarian, your default belief is that markets overreact and you would be buying into the most damaged asset classes, which would include US, European and Chinese stocks (worst performing geographies), and especially those in technology and consumer discretionary spaces (worst performing sectors), and selling those investments (energy companies and commodities like oil) that have benefited the most from the turmoil.
- If, on the other hand, you believe that investors are not fully incorporating the effects of the long term damage from this war, you would reverse the contrarian strategy, and buy the geographies and sectors that have benefited already and sell those that have been hurt.

As an avowed non-market-timer, I think that both these strategies represent bludgeons in a market that needs scalpels. Rather than make broad sector or geographic bets, I would suggest making more focused bets on individual companies. In picking these companies, market corrections, painful though they have been, have opened up possibilities for investors, though their stock picks will reflect their investment philosophies and their views on economic growth:

1. ***Discounted Tech*** – During the course of 2022, markets have reassessed their pricing of tech stocks, and marked down their market capitalizations, for both older, and profitable tech and young, money-losing but high growth tech. A few weeks ago, I posted my valuation of the FANGAM stocks and noted that only one of them was undervalued, at the prices prevailing then. In the last few days, every company on the list has dipped in price by enough to be at least fairly valued or even cheap. While there may be value in some young tech companies, any investments in these firms will be joint bets on the companies and a strong economy, and with the uncertainties about inflation and economic growth overhanging the market, I would be cautious.

2 Editors note: To access the chart used in Exhibit 19, click any chart in the author's blog and scroll to 19, at https://aswathdamodaran.blogspot.com/2022/03/russia-and-ukraine-let-loose-dogs-of-war.html.

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2. ***Safety First*** – If you have been spooked by market volatility and the Russian crisis, and believe that there is more volatility coming to the market in the rest of the year, your stock picks will reflect your fears. You are looking for companies with pricing power (to pass through inflation) and stable revenues, and in my view, while you should start by looking in the conventional places (branded consumer products and food processing, pharmaceuticals), you should also take a look at some of the big names in technology.
3. **The Russia Play** – For the true bargain hunters, the wipeout of market capitalization of Russian stocks (like Sberbank, Severstal, Lukoil, and Yandex) will create temptation, but I would offer two notes of caution. The first is that you have to decide whether you can buy them in good conscience, and that is your judgment to make, not mine. The second is that corporate governance at Russian companies, even in their best days, is non-existent, and I do not know how this crisis will play out in the long term at these companies. After all, your ownership stake in these companies is only as good as the legal structure backing it up, and in Russia, that means your stake may be worthless, even if these companies recover. A less risky route would be to tag companies with significant exposure to Russia, such as Pepsi, McDonald's, and Philip Morris, and evaluate whether the market is overreacting to that exposure. I have seen no evidence, so far, that this is the case, but that may change.

There is one final sobering note to add to this discussion, and that relates to low probability, potentially catastrophic events, and how markets deal with them. There is a worst case scenario in the Russia-Ukraine war that few of us are willing to openly consider, where the conflagration spreads beyond the Ukraine, and nuclear and chemical weapons come into play. While the probability of this scenario may be very low, it is not zero, and to be honest, there is no investing strategy that will protect you from that scenario, but market pricing will reflect that fear. If we escape that doomsday scenario, and come back to something resembling normalcy, markets will bounce back, and in hindsight, it will look like they overreacted in the first place, even if the risk assessments were right, at the time. Put simply, assuming that crises will always end well and that markets will inevitably bounce back, just because that is what you have observed in your lifetime, can be dangerous.

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Aswath Damodaran is the Kerschner Family Chair Professor of Finance at the Stern School of Business at New York University, where he teaches corporate finance and valuation courses in the MBA program. His research interests lie in valuation, portfolio management and applied corporate finance. Among many publications, Aswath has written four books on valuation (Damodaran on Valuation, Investment Valuation, The Dark Side of Valuation, The Little Book of Valuation), and two on corporate finance (Corporate Finance: Theory and Practice, Applied Corporate Finance: A User's Manual). In addition to his blog, Aswath has an active presence online, on Twitter (@AswathDamodaran) and with his website (http://www.damodaran.com). His corporate finance and valuation classes are carried online and on iTunes U (with more than 100,000 students on iTunes U) and his online classes were chosen as one of the top ten MOOCs in the world in 2012. He is a keynote speaker at VALCON 2021, presenting the topic "A Jedi Guide to Valuation: Disrupting the Status Quo."

ALLOCATING TOTAL EQUITY VALUE ACROSS MULTIPLE CLASSES OF EQUITY

GEORGE MINKOVSKY
Province

In the simplest of capital structures – interest-bearing debt and common stock – total equity value is allocated pro rata to each share of common stock. The proliferation of innovative and hybrid forms of financing, such as debt convertible to equity, options, warrants, preferred stock, and investments imposing special caps on additional funding or triggering special dividends based on prespecified events, requires additional steps to assess the value of each class of equity. The three methods prescribed by the American Institute of Certified Public Accountants (AICPA) for allocating total equity value to different classes of equity include the option pricing method ("OPM"), the current value method ("CVM") and the probability weighted expected return method ("PWERM").

Hybrid Forms of Financing and Complex Capital Structures

Venture capital and private equity investors in startup companies face risks associated with the departures of key management or innovation employees, delayed achievement of profitability targets, dilution of ownership and control in subsequent rounds of funding, and delayed exit via an initial public offering (IPO) or a merger or acquisition. In an attempt to mitigate some of these risks, companies backed by venture capital and private equity investors have introduced innovative forms of financing beyond traditional debt and common equity. Investment instruments, such as debt convertible to equity, options, warrants, preferred stock, investments imposing special caps on additional funding or triggering special dividends based on prespecified events convey different rights or conditional rights to different investors.

This rich menu of investment instruments allows investors with different risk tolerance or investment horizons to invest in a company using the instrument that suits their preferences best. At the same time, complex financial instruments with optionality features and or hybrid features (combining debt and equity funding) pose additional challenges to board directors evaluating and approving employee stock option grants and to financial managers responsible for compliance with financial and tax reporting requirements[1] related to employee compensation packages and equity grants. In addition, complex financial instruments and hybrid forms of financing, when present in an entity's capital structure, require additional steps to assess the value of each class of equity in a liquidation event, a merger-price dispute or a compensation legal dispute.

Methods for Allocating Total Equity Value to Classes of Equity

In 2004, the AICPA released the Practice Aid, "Valuation of Privately-Held-Company Equity Securities Issued as Compensation,"[2] which summarizes valuation standards and procedures that have been adopted by the profession. In addition, the AICPA guidelines present three methods of allocating value amongst classes of equity as follows:

- **Option Pricing Method ("OPM")** uses the liquidation preferences, participation rights, dividend policy, and conversion rights of each class of equity to determine how proceeds from a liquidity event shall be distributed among the various ownership classes. As stated in the AICPA guidelines:

  > The option pricing method treats common stock and preferred stock as call options on the

[1] "In 2004, the US Congress passed the American Jobs Creation Act creating Section 409A of the Internal Revenue Code (Section 409A) in response to a perceived abuse of deferred compensation arrangements that were in the media spotlight in the wake of several significant corporate scandals at the time. Section 409A affects a broad array of compensation arrangements." (DLA Piper, "Section 409A Valuations," available at: https://www.dlapiperaccelerate.com/knowledge/2020/section-409a-valuations.html). "A stock option grant that is "inadvertently granted with an exercise price that is less than the grant date fair market value (FMV) likely will fail to comply with Section 409A." (DLA Piper, "Section 409A Valuations," available at: https://www.dlapiperaccelerate.com/knowledge/2020/section-409a-valuations.html). The text of 26 U.S. Code § 409A - *Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans*, is available at https://www.law.cornell.edu/uscode/text/26/409A.

[2] American Institute of Certified Public Accountants (AICPA), "Valuation of privately-held-company equity securities issued as compensation," AICPA audit and accounting practice aid series, 2004 (Guides, Handbooks and Manuals), 64, (AICPA 2004 Practice Aid), available at https://egrove.olemiss.edu/aicpa_guides/64. *See also* Andrew C. Smith and Jason C. Laurent, "Allocating Value Among Different Classes of Equity," *Journal of Accountancy*, February 29, 2008, available at: https://www.journalofaccountancy.com/issues/2008/mar/allocatingvalueamongdifferentclassesofequity.html).

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> enterprise's value, with exercise prices based on the liquidation preference of the preferred stock. Under this method, the common stock has value only if the funds available for distribution to shareholders exceed the value of the liquidation preference at the time of a liquidity event (for example, merger or sale), assuming the enterprise has funds available to make a liquidation preference meaningful and collectible by the shareholders...Thus, common stock is considered to be a call option with a claim on the enterprise at an exercise price equal to the remaining value immediately after the preferred stock is liquidated...the common implicitly considers the effect of the liquidation preference as of the future liquidation date, not as of the valuation date.[3]

- **Probability Weighted Expected Return Method ("PWERM")** is based on probability-weighted equity values resulting from alternative future scenarios. PWERM involves (i) identifying potential future outcomes for the company (*i.e.*, an IPO, a merger, a sale (of the company or a key asset or division), a dissolution, or continued operation as a private company); (ii) determining the total value of equity and each class of equity in each of the potential future outcomes; and (iii) estimating the probabilities associated with each respective potential outcome. As stated in the AICPA guidelines:

> Under a probability-weighted expected return method, the value of the common stock is estimated based on an analysis of future values for the enterprise assuming various future outcomes. Share value is based upon the probability-weighted present value of expected future investment returns, considering each of the possible future outcomes available to the enterprise, as well as the rights of each share class.[4]

- **Current Value Method ("CVM")** focuses on an imminent event or a known current price or price offer and allocates the corresponding total equity value amongst the classes of equity. The AICPA guidelines acknowledge that this approach is focused on the present and ignores going concern and forward-looking estimates of value and limits the application of the CVM to two possible scenarios:

> Because the current-value method focuses on the present and is not forward-looking, the taskforce believes its usefulness is limited primarily to two types of circumstances. The first occurs when a liquidity event in the form of an acquisition or dissolution of the enterprise is imminent, and expectations about the future of the enterprise as a going concern are virtually irrelevant. The second occurs when an enterprise is at such an early stage of its development that (a) no material progress has been made on the enterprise's business plan,(b) no significant common equity value has been created in the business above the liquidation preference on the preferred shares, and (c) there is no reasonable basis for estimating the amount and timing of any such common equity value above the liquidation preference that might be created in the future. [5]

At any given valuation date there is typically a wide range of possible future exit events for the enterprise. Forecasting specific probabilities and potential exit-values associated with any such future events becomes highly subjective and imprecise. This renders the PWERM method less frequently used than the OPM in practice.

Allocating Total Equity Value to Classes of Equity Using the Option Pricing Method

Step 1: Determine total value of equity

The logical step before allocating total equity value is to determine the value of total equity.[6] For this

[3] AICPA 2004 Practice Aid, 61-62.

[4] *Ibid.*, 59-60.

[5] *Ibid.*, 63.

[6] Total Equity Value equals total enterprise value plus any excess, non-operating assets (i.e., excess cash) minus any interest-bearing debt. Determination of total enterprise value is a matter of judgment, which takes into consideration economic and market conditions, as well as investment opportunities that would be considered as alternatives to the interest being valued. The methods commonly used to value a closely held business include the following:

-- *Income Approach*. This approach focuses on the income-producing capability of a business. The income approach estimates value based on the expectation of future cash flows that a company will generate - such as cash earnings, cost savings, tax deductions, and the proceeds from disposition. These cash flows are discounted to the present using a rate of return that incorporates the risk-free rate for the use of funds, the expected rate of inflation, and risks associated with the particular investment. The selected discount rate is generally based on rates of return available from alternative investments of similar type, quality, and risk.

-- *Market Approach*. This approach measures the value of an asset or business through an analysis of recent sales or offerings of comparable investments or assets. The market approach can be applied by utilizing one or both of the following methods:

- *Market Multiple Method.* Focuses on comparing the subject entity to guideline publicly traded entities on relevant value drivers (i.e., EBIT or EBITDA multiples, revenue multiples, etc.). Valuation multiples are: (i) derived from historical or forecasted operating data of selected guideline entities; (ii) evaluated and/or adjusted based on the strengths and weaknesses of the subject entity relative to the selected guideline entities; and (iii) applied to the appropriate operating data of the subject entity to arrive at a value indication.
- *Precedent Transactions Method*. Under this methodology the valuation multiples are based on actual transactions that have occurred in the subject entity's industry or related industries to arrive at an indication of value.

-- *Cost Approach*. This approach measures the value of an asset by the cost to reconstruct or replace it with another of comparable utility. When applied to the valuation of equity interests in businesses, value is based on the net aggregate fair market value of the entity's underlying individual assets. To implement this method the appraiser effectively restates the balance sheet of the enterprise, substituting the fair market value of individual assets and liabilities for their book values.

article's brevity we assume total equity value has been determined and continue to the next step.

Step 2: Analyze the capital structure of the firm

Identify all financing instruments with equity claims and conditional equity claims.[7] Analyze the rights, liquidation privileges, and liquidation preferences of each class of equity of the firm. Sort these financing instruments in order of their liquidation preference.

Note that in a merger or acquisition scenario or in a negotiated restructuring deal, the equity classes of the target valuation company might become subject to transaction-specific conversion rates. A valuation expert tasked with determining the per-share fair value of a class or classes of equity as of a given date should utilize the liquidation preferences and rights as of that date and not any transaction-specific conversion rates which might be known or knowable as of the valuation measurement date.

Step 3: Determine the breakpoints for each class

As the value of the target company increases, each equity holder class benefits from certain value components. Determine the ranges of equity values at which the various equity stakeholders receive value. The maximum values of these ranges, or "break points," are based on the full liquidation preference amounts, the points at which options holders choose to exercise, and the points at which the preferred shareholders would be indifferent between converting their shares into common and retaining their preferred shares.

Step 4: Calculate the call option value at each break point

The Option Pricing Method values each class of equity as a call option on the respective share of equity each class is entitled to. In practice, the call-option value at each break point can and usually is determined using the call-option formula in the Black-Scholes-Merton model or a similar formula enhanced for dividend distributions or other specificities of the instruments with which the target company is financed.

The inputs and assumptions in a Black-Scholes-Merton model and its call-option formula include:

Stock price – In the OPM method this is the total equity value of the target company.

Strike price or exercise price – The strike price represents the equity value at each break point determined in Step 3. The practitioner will have to recalculate the option value at each relevant break point level (i.e., strike price).

Time to liquidity (Time to maturity of the option) – Based on discussions with control-owners and or management, develop a point estimate for the time to liquidity event or expected time to exit scenarios.

Volatility – For a publicly traded target company, volatility is measured based on the standard deviation of quoted market prices for the target company's shares. For a privately held business, volatility can be measured from observed volatilities of guideline public companies, benchmarks, and other sources. For early stage companies, volatility will often approach the upper end of observed volatilities for guideline public companies. The range of guideline public company stock returns should equal the same period as the estimated time to liquidity.[8]

Risk-free rate – Typically, the risk-free rate is derived from the yield on U.S. Treasury instruments with a corresponding term as the time to liquidity identified above in this step.

Step 5: Allocate total equity value

Start with the highest liquidation priority equity class. Allocate total equity value up to the liquidation value[9] of the class – this is the allocation amount for that class. Each share receives its proportionate amount of the allocation amount for that class, calculated as allocation amount divided by the outstanding number of shares of that class. If the allocation amount is less than or equal to the liquidation value, stop here. Otherwise, calculate residual equity value (=total equity value minus liquidation value of this class of equity), and repeat this step for the next, lower-liquidation-preference class of equity. Repeat this step until total equity value has been allocated.

The Option Pricing Method – Illustrated

Assume that the total equity value of the ABC Company has been determined equal to $450,000.

Assume further that the ABC Company has the capital structure and liquidation preferences and rankings in Exhibit 1 on the next page.

All classes receive zero dividend. Series A and Series B Preferred Stocks have no equity participation rights after their respective preferred liquidation preference has been met. Consequently, participation threshold levels and participation thresholds caps are not applicable for ABC Company's Series A and B Preferred Stocks.

Further, assume the set of inputs and assumptions for the Black-Scholes-Merton option pricing model in Exhibit 2:

7 In addition to common equity, options, warrants, restricted stock, preferred stocks, participation rights, instruments with special dividend rights (triggered by a liquidity or a business event), and debt convertible to equity have claims over equity in the firm.

8 Frank Kiepura, "Valuing Securities Using the Option Pricing Method," *CPA Journal Online*, September 9, 2020, https://www.cpajournal.com/2020/09/09/valuing-securities-using-the-option-pricing-method/.

9 Liquidation value = Shares outstanding in that class * Liquidation Price per share for that class of shares.

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Exhibit 1: ABC Company Capital Structure, Liquidation Preferences and Rankings

		(A)	(B)	(C) = (A) * (B)	(D)	(E)	(F) = (C) * (E)	(G)
	Shareholdings:	Shares Outstanding	Conversion Ratio 1 to	Common Share Equivalents	Liquidation Rank	Liquidation Preference Price / sh.	Aggregate Liquidation Preference	% Ownership (Common Sh. Equiv. relative to Total Common Sh. Equiv.)
(1)	Series A Preferred Stock	80,000	1	80,000	1	$2.25	$180,000	6.40%
(2)	Series B Preferred Stock	140,000	2	280,000	2	$2.25	$630,000	22.40%
(3)	Common Stock	530,000	1	530,000	4	$0.00	$0	42.40%
(4)	Warrants (strike price = $0.15)	110,000	1	110,000	3	$0.00	$0	8.80%
(5)	Options (strike price = $0.22)	250,000	1	250,000	3	$0.00	$0	20.00%
(6)	**Total**	**1,110,000**		**1,250,000**			**$810,000**	**100.00%**

Exhibit 2: ABC Co. Option Strike Prices and Call Prices

Assumptions for the Option Pricing Model		
Spot Price (Total Equity Value)	**$450,000**	
Time to Maturity	2	years
Volatility	30%	
Risk Free Rate	2.2%	
Dividend	0%	

Then the break points (strike prices), the respective call-option values at the break points,[10] and the marketable value per share can be calculated as in Exhibit 3.

Note that the inputs and assumptions of the option pricing model (two years' time to maturity, volatility = 30%, risk free rate = 2.2%) yield implied marketable value per share greater than zero for each of the warrants and the options classes, even though the $450,000 spot price is lower than the warrants' and options' indifference thresholds (*i.e.* $826,500 and 857,300 respectively).

[10] Calculated using Black-Scholes-Merton option pricing model and the assumptions above. Black-Scholes-Merton calculators are available online (see for example, https://goodcalculators.com/black-scholes-calculator/).

The optionality and the emphasis on the going concern make the OPM method relevant for estimating value of classes of equity in relation to contemplated new rounds of funding and 409(A) tax reporting related to employee compensation and new grants of equity instruments to salaried employees and directors.

The Option Pricing Method Contrasted with the Current Value Method

Continue with the assumptions from the illustration above. Now assume that the total equity value of the ABC Company has been determined equal to $450,000 in relation to a pending business combination to be consummated within a week. Then ABC Company's total equity value of $450,000 can be allocated to classes of equity using the current value method, as shown in Exhibit 4.

In this pending business combination scenario, an exit option has already been exercised by approving the business combination. Since the call option on the firm has no value (it has been exercised), the option pricing method cannot be applied.

Exhibit 3: ABC Company Allocation of Equity Value – Option Pricing Method

Option Strike Prices and Call Prices					
		(A)	(B)	(C)	(D) = (B) / (C)
Call Option	Description	Strike Price	Call Price	Common Share Equivalents	Marketable Value per share
# 1	Value above payment of Series A liquidation preference	$180,000	$278,220	80,000	$2.2500
# 2	Value above payment of Series B liquidation preference	$810,000	$11,680	280,000	$0.0417
# 3	Warrants' indiference threshold (110,000 warrants at $0.15 strike price)	$826,500	$10,660	110,000	$0.0969
# 4	Options' indiference threshold (250,000 options at $0.22 strike price) includes proceeds from exercise of warrants ($16,500=110,000*$0.15)	$857,300	$8,990	250,000	$0.0360

Exhibit 4: ABC Company Allocation of Equity Value – Current Value Method

		(A)	(B)	(C) = (A) / (B)
(1)	Implied Proceeds to:	Total Amount	Common Share Equivalents	Per Share
(2)	Series A Preferred Stock	$180,000	80,000	$2.25
(3)	Series B Preferred Stock	$270,000	280,000	$0.96
(4)	Common Stock	-	530,000	-
(5)	Warrants (strike price = $0.15)	-	110,000	-
(6)	Options (strike price = $0.22)	-	250,000	-
(7)	**Total Proceeds**	**$450,000**	**1,250,000**	

Key Take Aways

Complex financial instruments and hybrid forms of financing, when present in an entity's capital structure, require additional steps to assess the value of each class of equity. In a new round of funding or when issuing common stock or equity instruments, practitioners use the Option Pricing Method (OPM) to allocate total equity value to classes of equity. In a pending business combination or in a liquidation event, when the option on the equity of the firm has been exercised, the Current Value Method (CVM) of attributing total equity value to classes of equity is typically used. The same is true in a litigation setting, such as in a merger-price dispute or a dispute over compensation.

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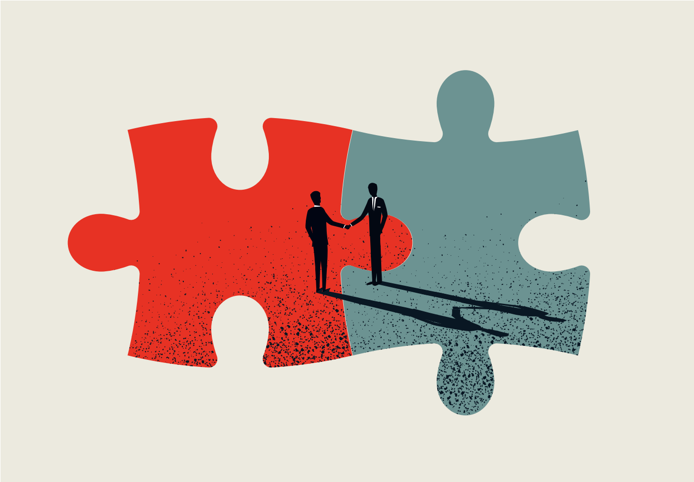
George Minkovsky is Director – Litigation and Forensics at Province, Inc. George has over 25 years of experience in economic and litigation consulting and corporate finance. He has served as an accountant, financial advisor, and consulting expert in antitrust, auditor malpractice, appraisal, bankruptcy & restructuring, contract, intellectual property, international trade and arbitration and M&A disputes. He has worked across a spectrum of industries including financial services, pharmaceutical, biotechnology, information technology, healthcare, consumer goods, chemical, automotive, manufacturing, real estate, retail, and transportation.



ACCOUNTING FOR BUSINESS COMBINATIONS: A THREE-PART OVERVIEW

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An increase in merger and acquisition activity in recent years has highlighted the need for private companies to understand how to account for the business combinations they pursue. There are an assortment of reasons why a company may seek a business combination, like strategic needs to achieve synergy, to increase revenue or market share, to expand into other locations or lines of services, or to achieve economies of scale, to name a few.

Business Combinations (Topic 805), which provides guidance in accounting for business combinations, can be challenging to navigate. In this article, we will highlight key elements of the guidance to be aware of, covering:

- Part 1 – Business combinations – An overview for private companies
- Part 2 – Identifying a business combination or asset acquisition using the screen test
- Part 3 – Private company alternatives to goodwill and business combinations

Part 1 – Business Combinations – An Overview for Private Companies

Topic 805: An overview

Topic 805 discusses accounting for a business combination using the acquisition method. Read on for a summary and brief description of the key elements of the acquisition method.

- **Identifying the acquirer** – The Glossary of Topic 805 defines the acquirer as "the entity that obtains control of the acquiree" in a business combination. To determine the acquirer, the primary guidance to follow is Topic 810, Consolidation, which provides guidance related to identifying the entity that obtains financial control. Generally, the entity that directly or indirectly holds greater than 50% of the voting shares has control. If the acquiree is a variable interest entity (VIE) and meets the definition of a business, then the entity considered to be the primary beneficiary of the VIE is the acquirer. Topic 805 provides additional guidance for identifying an acquirer that should be considered if, after Topic 810 is considered, it is not clear which entity is the acquirer.
- **Determining the acquisition date** – The acquisition date is when control is obtained by the acquirer, which is usually when consideration is transferred, the assets are acquired, and liabilities assumed – also referred to as the closing date. The acquisition date is the measurement date of when the acquired assets and liabilities are recorded. According to Topic 805, the acquisition date can also be earlier or later than the closing date; "For example, the acquisition date precedes the closing date if a written agreement provides that the acquirer obtains control of the acquiree on a date before the closing date." Consideration of all relevant facts and circumstances is needed to properly identify the acquisition date.
- **Recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree** – When applying Topic 805, an acquirer will recognize the identifiable assets acquired (both tangible and intangible), liabilities assumed, and any noncontrolling interest in the acquiree separately from goodwill, and measure them at their acquisition-date fair values. Depending on the complexity of the entity, its assets acquired and liabilities assumed, acquirers should consider whether a valuation specialist is needed to assist with the determination of and concluding on acquisition-related fair value measurements.
- **Recognizing and measuring goodwill or a gain from a bargain purchase** – Simply, goodwill is the difference between the purchase price and the fair value of the assets acquired and the liabilities assumed – goodwill is the residual asset. A bargain purchase occurs in rare circumstances when the purchase price is less than the fair value of the assets acquired and the liabilities assumed – essentially, the acquirer purchased the acquiree for a price less than the fair market value of its net assets. ASC 805-

Exhibit 1: Business Combination v Asset Acquisition – Topic 805 Accounting Differences

Accounting concept	Summary of accounting differences for allocations under Topic 805	
	The acquisition method (Acquisition of a business)	**Relative fair value (Acquisition of an asset)**
Acquisition costs	Expensed as incurred	Capitalized as part of acquired asset
Initial measurement	Consideration transferred to acquire the business is allocated to identifiable assets and liabilities at their acquisition date fair value.	Consideration transferred is allocated to identifiable assets and liabilities based on their relative fair value.
Goodwill	Any excess of consideration transferred over the fair value of the net assets acquired is recognized as goodwill. If the consideration transferred is less than the fair value, the acquirer would recognize a bargain purchase gain.	There would be no goodwill. A gain or loss would only be recognized in transactions involving noncash consideration when the carrying amount of the noncash consideration on the acquiring entity's books differs from fair value.
In-process research and development (IPR&D)	Capitalized at fair value on the acquisition date	A portion of the purchase price is allocated to IPR&D and expensed if it has no alternative future use. That portion with an alternative future use is capitalized.
Contingent consideration	Recognized at fair value on the acquisition date	Generally recognized when the contingency is resolved

30-25-4 indicates that before recognizing a gain on a bargain purchase, the acquirer should reassess whether it has correctly identified all of the acquired assets or assumed liabilities to confirm that the conclusion of a bargain purchase gain is accurate. We will discuss private company alternatives related to a private entity's accounting for goodwill in Part 3 of this series.

Conclusion

The acquisition method has many aspects to consider when accounting for a business combination. Management should understand the complete facts and circumstances of the business they acquired to appropriately apply the accounting guidance. In addition, valuation specialists will most likely be needed to assist management in determining the fair value of the net assets acquired. Understanding Topic 805 and the acquisition method will provide management the tools needed to appropriately account for and provide effective financial statement disclosures related to a business combination.

Part 2 – Identifying a Business Combination or Asset Acquisition Using the Screen Test

Business Combinations (Topic 805) – Clarifying the Definition of a Business (as updated by Accounting Standards Update 2017-01) provides guidance to assist entities with evaluating when an integrated set of transferred assets and activities (referred to as a "set") meets the definition of a business. Transactions where the set does not meet the definition of a business are accounted for as asset acquisitions. Determining whether a set constitutes a business under Topic 805 is critical because the accounting for a business combination differs significantly from that for an asset acquisition. Exhibit 1 presents a listing of those accounting differences.

The Financial Accounting Standards Board (FASB) notes in ASU 2017-01 that the new definition of a business was developed in response to stakeholders providing feedback that the definition of a business in Topic 805 was "applied too broadly, resulting in many transactions being recorded as business acquisitions that to them are more akin to asset acquisitions."

Definition of a business

Under Topic 805 as updated by ASU 2017-01, a business is an integrated set of activities and assets that must consist of, at a minimum, a) an input and b) a substantive process that when applied to the input significantly contributes to the ability of the set to create outputs.

This definition contrasts with the previous definition, as there were no specified minimum inputs or processes in order for a set to meet the definition of a business if a market participant was capable of continuing to produce outputs (*i.e.*, by integrating the acquired business into its own inputs and processes). The ASU also narrowed Topic 805's definition of outputs from "…a return in the form of dividends, lower costs, or other economic benefits…" to "…goods or services

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to customers, investment income (such as dividends or interest), or other revenues."

Application of the screen ("Single or Similar Asset Threshold")

Before determining whether the acquisition of a set meets the definition of a business, reporting entities are first required to apply a screen. If the transaction meets the criteria in the screen, the set will be accounted for as an asset acquisition. The screen simply states that a set would not be considered to be a business when there is a concentration of substantially all of the fair value of the gross assets in either of the following:

1. An individual asset or a group of assets that could be recognized and measured as a **single identifiable asset**, described in ASC 805-10 as:
   a. "A tangible asset that is attached to and cannot be physically removed and used separately from another tangible asset (or an intangible asset representing the right to use a tangible asset) without incurring significant cost or significant diminution in utility or fair value to either asset (for example, land and building).
   b. "In-place lease intangibles, including favorable and unfavorable intangible assets or liabilities, and the related leased assets."
2. A group of **similar identifiable assets**. Topic 805 provides asset groups that specifically should not be considered similar (such as tangible and intangible assets).

If a transaction does not meet the screen, the reporting entity would need to determine whether the set has, at a minimum, an input and a substantive process that when applied to the input significantly contributes to the ability of the set to create outputs.

The following are summaries of two examples from Topic 805 to illustrate the screen test; see Topic 805 for more.

The Acquisition of Real Estate

Background facts

ABC's operations consist of acquiring, renovating, leasing, selling, and managing real estate properties. ABC acquires a portfolio of 10 single-family homes. Each home has 1) an in-place lease and consists of 2) land, 3) building, and 4) improvements.

Scenario 1 – Screen met

ABC did not acquire any employees or other assets in the transaction. The objective of applying the screen is to determine whether the fair value of the gross assets acquired is concentrated in a single identified asset or group of similar assets. For purposes of applying the screen, ABC must identify the assets acquired. Therefore, ABC determines that the homes represent 10 single identified assets because:

a. Each home consists of land with a building and improvements attached thereto. The building and improvements cannot be removed from the land without incurring significant cost and should therefore be considered a single asset; and
b. The in-place lease for each home is an intangible asset that, for purposes of applying the screen under Topic 805, should be combined with the related real estate considered a single asset.

Scenario 2 – Screen not met

In addition to the 10 single-family homes, ABC also acquires six 10-story office buildings that are fully occupied and have significant fair value. The six office buildings have contracts with vendors for cleaning services, maintenance, and security. ABC does not acquire any employees involved in strategic management, tenant management, or leasing, and will use its internal resource to fulfill those roles. ABC does, however, acquire certain building employees, but intends to replace them and property management with its own internal resources.

a. ABC concludes the office buildings and single-family homes are not similar assets because the nature and risk characteristics of operating them are significantly different. The risks associated with the scale of operating an office building, as well as obtaining and managing those tenants, are significantly different from those associated with single-family homes.
b. ABC therefore concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and the transaction has not met the screen. Accordingly, ABC must evaluate whether the set has, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs under the framework in Topic 805. In determining how to apply the framework, ABC must first determine whether the set has outputs. Through in-place leases for the office buildings and single-family homes, the set has continuing revenues, and therefore it has outputs.

c. ABC must then assess whether it has acquired the following:

- Employees that form an organized workforce that possesses the necessary skills, knowledge, or experience to perform an acquired process (or group thereof) that is/are critical to the ability of the integrated set to continue producing outputs – *Criteria not met*
- An acquired contract providing access to an organized workforce that performs a substantive process – *Criteria not met*
- Acquired process that when applied to acquired inputs, significantly contributes to the set's ability to continuing producing outputs and (a) cannot be replaced without significant cost, effort, or delay in the set's ability to continue producing outputs and (b) is considered unique or scarce – *Criteria not met*

As none of the criteria were met, "ABC concludes that the set does not include both an input and substantive processes that together significantly contribute to the ability to create outputs and, therefore, is not considered a business," Topic 805 states.

Conclusion

As noted above, if the transaction meets the criteria in the screen, the set will be accounted for as an asset acquisition. However, if the criteria in the screen is not met, that does not automatically mean the transaction will be accounted for as a business combination. Careful consideration of the facts and circumstances of the transaction will need to be considered to determine if it meets the definition of a business under Topic 805.

Part 3 – Private Company Alternatives for Goodwill and Business Combinations

In recent years, the FASB has issued updates to U.S. generally accepted accounting principles (GAAP) that provide alternatives for private companies. The updates are consensuses of the Private Company Council (PCC) that were endorsed by the FASB.[1]

The purpose of these alternatives is to simplify the application of complex accounting areas like goodwill and provide some relief to private entities on such topics, in response to the voluminous number of changes to GAAP over the years and the relevancy of those changes to users of private companies' financial statements compared to users of public companies' statements.

Private companies will need to be aware of alternatives adopted because in an event like the entity being acquired by a public company (*i.e.*, significant acquisition under SEC Regulation S-X, Rule 3-05) or planning an initial public offering, revisions to the privately held financial statements may need to be made to comply with public entity guidance if the private company alternatives were adopted previously.

The private company alternatives for subsequent measure of goodwill and business combinations, which have been codified in Topics 350 and 805, are the following:

- Accounting Standards Update No. 2014-02 (ASU 2014-02), *Intangibles – Goodwill and Other* (Topic 350): *Accounting for Goodwill*
- ASU 2014-18, *Business Combinations* (Topic 805): *Accounting for Identifiable Intangible Assets in a Business Combination*

Read on for a summary of each ASU.

Topic 350, as updated by ASU 2014-02: Accounting for goodwill

With ASU 2014-02, a private company can elect to "amortize goodwill on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that another useful life is more appropriate." This alternative also permits a private company to apply a simplified impairment model to goodwill. For impairment purposes, goodwill should be tested for impairment when a triggering event occurs that indicates that the fair value of the company (either on an entity-wide basis or reporting unit basis) may be below carrying value. A company electing this alternative is also required to make an accounting policy election to test goodwill for impairment at either the company or reporting unit level.

ASU 2014-02 provides relief for private companies because amortizing goodwill could reduce the likelihood of impairment and could allow private reporting entities to test goodwill for impairment less frequently.

Topic 805, as updated by ASU 2014-18: Accounting for identifiable intangible assets

ASU 2014-18 allows private companies to elect the accounting alternative to no longer recognize separately from goodwill in a business combination the following: "… (1) customer-related intangible assets unless they are capable of being sold or licensed independently from other assets of the business and (2)

[1] Financial Accounting Standards Board, fasb.com, https://www.fasb.org/Page/PageContent?PageId=/pcc/aboutpcc.html&bcpath=f.

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noncompetition agreements." It is intended to reduce "the cost and complexity" associated with measuring these identifiable intangible assets.

It is important to note that a private reporting entity that elects the accounting alternative that ASU 2014-18 added to Topic 805 must also adopt the alternative to amortize goodwill as described in ASU 2014-02; but, an entity that elects to adopt ASU 2014-02 does not have to adopt ASU 2014-18.

As a result, the adoption of ASU 2014-18 will generally result in private reporting entities recognizing fewer intangible assets in a business combination compared to if they did not adopt the alternative, the ASU says.

Conclusion

The PCC accounting alternatives for goodwill are intended to provide relief to private reporting entities in the application of GAAP while considering the needs of the users of the financial statements. But, a private reporting entity will need to consider the future of the entity when adopting the alternative guidance. A private reporting entity considering an IPO or being acquired by a public entity should know that there may be additional costs and time incurred associated to the entity in reversing the adoption of the alternative accounting guidance for compliance with public company standards.

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THE HARSH REALITY OF THE PUERTO RICO GOVERNMENT PLAN OF ADJUSTMENT

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A Dictatorship of Proconsuls

The United States Congress enacted PROMESA in 2016, based upon Article 4 of the United States Constitution. Article 4 is the provision that controls the territories. Before PROMESA, Puerto Rico was the Commonwealth of Puerto Rico, a frail self-govern entity supposedly based in a compact between the United States and Puerto Rico. After PROMESA, Congress admitted that Puerto Rico does not have a special status based on an autonomous or sovereign power, but a mere unincorporated territory of the United States. An unincorporated territory belongs to the United States but is not part of the United States and, therefore, only some provisions of the Federal Constitution apply.

Under this discriminatory and anti-democratic scheme, Congress enacted PROMESA to establish a non-voted Oversight Board ("Board"), composed of 7 members selected by the President from lists determined by Congress. Puerto Ricans do not have any say or influence in that process, and this Board chooses the direction and substance of all the public policies of the government of Puerto Rico. These public policies outlined in fiscal plans establish determinations that cannot be reviewed by the courts or by the government of Puerto Rico. These public policies provide the basis for the Board to resort to court to annul laws and regulations of Puerto Rico that, at its sole discretion, are determined as incompatible with the fiscal plan. In a reiteration of the Board's plenary powers, PROMESA contains more than 30 references about the Board's sole discretion. Not even the President of the United States oversees the Board. The imposition of the Board exacerbated Puerto Rico's colonial disenfranchisement. As the late Judge Torruella of the Court of Appeals for the First Circuit in Boston said, the Board members are Roman-style proconsuls.

A Board with a Neoliberal Philosophy of Austerity

Congress vested the Board's powers over Puerto Rico under a neoliberal capitalist philosophy of reducing government intervention and investment in the economy and social well-being. This philosophy is framed in Title VII of the Law that establishes the sense of Congress that all fiscal measures imposed by the Board must be permanent and guarantee the free flow of capital between Puerto Rico and the United States. The problem is that, as Dr. Jose Alameda will explain to you, Puerto Rico's economy is one of a colonial enclave, without powers to control its growth opportunities. Without economic growth, Puerto Rico is at risk of defaulting its debt again. Recently, Nobel Laureate in Economics Joseph Stiglitz said that 50% of countries that adjust their debt return to default within five years. Under this philosophy, the Board has cut the budget and public spending to unprecedented levels. The Board dramatically reduced the government employee workforce, and it is planning to deregulate transportation, permits and labor, while maintaining tax expenditures at unprecedented levels. For example, as of 2018, Puerto Rico's tax expenditures amounted to 20 billion dollars annually. Puerto Rico is a tax haven in which the government refrains from the collection of billions of dollars while almost half of the population lives below the poverty line. Under this austerity scheme, squeezing the rocks, the Board saved much-needed money to disburse $10.8 billion to creditors and the first annual debt service payment of 1,150 million.

A Two-Headed Monster

PROMESA, in addition to the Board and its colonial powers, established in its Title III a debt adjustment proceeding. This process is a hybrid between Chapters 11 and 9 of the federal Bankruptcy Code. However, this approach has several innovations. First of all, contrary to Chapter 9 of the Bankruptcy Code, PROMESA applies to the central government. It is as if a State could file a Chapter 9 case. Second, the debtor is not the one who files and prosecutes the case. It is the Board. Nor are the decisions on this process subject to the control or supervision of the debtor. Third, the entity that negotiates and establishes the plan of adjustment is not the debtor either. It is the Board. In addition, the plan of adjustment must be consistent with the fiscal plan that contains the unilateral determinations and forecasts of the Board on the financial condition of Puerto Rico. If the policies and estimates of the fiscal plan fail, so does the plan of adjustment. However, for the Board to obtain confirmation of a plan, it needs the participation of the Puerto Rico Legislature through enabling legislation. That is, the legislation to put into effect the plan's provisions. Thus, the Legislature can influence and even obstruct the process of a debt adjustment plan through mere inaction or by enacting legislation requiring changes to the plan. This dichotomy causes constant clashes and problems implementing policies outlined by the Board that do not have the central government's

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endorsement. This means that half of the Board's goals established in the fiscal plan regarding structural changes required in the government to improve the economic forecast are still pending after five years under the rule of PROMESA. For example, the certified financial statements under modified accrual accounting are not yet available, and permits, transportation, and labor law reforms are on the drawing desk. Thus, I call Title III of PROMESA the two-headed monster.

An Unsustainable Plan of Adjustment that Did Not Comply with PROMESA

Under this scenario, the Board has just confirmed a plan of adjustment for the central government. The plan has many deficiencies and problems that could result in Puerto Rico ending up in a second bankruptcy, since the growth estimates prepared by the Board sink in negative territory as of the year 2024. However, the Board paints a rosy picture of the results of the confirmation of the plan. For example, it claims that the plan reduced the total debt of the central government by 80%. The reality is that only unsecured creditors suffered a cut of 82%. The reduction of the total debt of the bondholders was only 57%, since on March 15, 2022, the Board made an advance payment of 7 billion (The plan reduced bondholder debt from 33 billion to 14 billion). Therefore, the plan did not reduce the bond debt to 7 billion; the reduction was to 14 billion. In addition, they allege that the plan decreased the annual debt service from a maximum payment of $3,900 million per year to $1,150 million per year. This is also false, since this figure does not include the cost of pensions that amount to $2,200 million annually for a total of debt service of $3,350 million annually. Pensioners are also creditors included in the plan. So, the actual annual savings in debt service is only $550 million. The Board spends $1.2 billion on cost and professional fees to achieve these modest savings. A meager return on investment. But the most critical question is not how much the plan reduced the debt. The crucial question is whether Puerto Rico can collect $3,350 million annually for the debt service that the Board imposed.

Moreover, the confirmed plan rests on a fiscal plan that violated PROMESA. Title II of PROMESA requires the definition of essential services and adequate financing for public pension systems. The Board refused to define essential services. Therefore, it never knew the minimum amount of money required for government operations. Any personal or business restructuring professional knows that you have to determine the debtor's needs to assist him in achieving a fresh start. Once that is determined, it is clear how much money would be available for the payment of the creditors according to priorities and guarantees. In Puerto Rico, the process was the opposite way. Nor was PROMESA complied with regarding the pension systems. On the contrary, the Board liquidated the pension systems. Providing adequate financing to a pension system is not the same as abolishing the pension system. That forced monthly pensions payments to come out of the general budget. Currently, the annual expenditure for pensioners payments amounts to $2,200 million. That is why to make ends meet; it is necessary to subtract $3,350 million for debt service annually from the general budget of the government of Puerto Rico for the payment of bondholders and pensioners. If we were to consider the average budget of Puerto Rico, which is $10,000 million, the remains to operate the entire government would be $6,650 million. An insufficient amount to run the government of Puerto Rico. In an economy without economic growth, the government will have to struggle every year to obtain revenues for the payment of the bondholders and retirees claims and use the rest to operate the government. This constraint will cause dramatic reductions in social spending indispensable in a developing country's bankrupt economy.

The Plan Harms Puerto Rico and its Economic Development

The plan limits and conditions any future measure to improve the salaries and working conditions of public employees. It changed retirement systems to defined-contribution systems that will be insufficient to support retirees at the end of the road. For at least ten years, it prohibits improving the situation of pensioners or reinstating defined benefit pension systems. Pension cuts have been devastating for the country's teachers, reducing large numbers to destitution upon retirement. For example, it reduced many teacher's pensions from $1,500.00 to $400.00 per month. In addition, the fiscal plan aims to reduce the government workforce further. In the year 2006, there were 160,000 employees in the government of Puerto Rico. As of this year, there are only 77,000 employees left. When you call a public agency, they are unable to answer the phone. There is not enough workforce to perform the most basic governmental functions. In addition to this, the Board intends to eliminate an additional 3,000 jobs. Under these conditions, public service loses attractiveness to motivate the best university graduates that could be interested in civil service. This would encourage immigration and the loss of the investment in the education of college graduates. The result is fewer employees with adequate skills, short-term civil service employment commitments, and less ability to deliver effective government services. Neither the fiscal plan nor the confirmed plan considers the harsh realities we are subject to: Hurricanes, earthquakes, pandemics, local or regional conflicts, the elimination of Act 154, which enable more than one billion in government revenues annually, the instability of Medicaid funding, the proposed global agreement on minimum taxes for foreign companies, etc. Any of these will shake the confirmed plan and bring the specter of a second bankruptcy closer. In addition, the debt restructuring of the Puerto Rico Electric Power Authority, which is the most critical public company in the country, could cause dramatic increases in the cost of energy that could shock the economy, accelerating the failure of the central government's plan of adjustment.

Lastly, Puerto Rico's economy needs to grow so that we can meet the requirement of the plan. The fiscal and confirmed plans are not economic growth and development agendas. The second bankruptcy would be the worst for Puerto Rico since its government could not modify the plan's provisions in the future because it secured the credits of the bondholders, and it is a court order, which creditors would enforce through the court contempt mechanism. The fragility of the confirmed plan in terms of its feasibility and compliance means that the Board must remain in Puerto Rico as long as the Title III case is open. Therefore, PROMESA sunset clause regarding the exit of the Board, which provides that it could leave when it achieves four consecutive balanced budgets and access to markets at a reasonable cost, is faulty. The Board is the only one that can prosecute the bankruptcy case, and as such, it will continue operating in Puerto Rico until the case is closed. As a frame of reference for Puerto Rico, Detroit Chapter 9 case is still open, even though the city achieved confirmation in 2014. Puerto Rico's case is much more complex than Detroit's Chapter 9 case, and it will take many years to close it.

Conclusion

The prolongation of the operations of the Board in Puerto Rico is unfeasible. There is a severe problem of an autocratic and anti-democratic regime. Furthermore, the economic situation will continue to worsen, emigration will increase, and Puerto Rico will not be able to recover from its financial crisis.

The colonial regime exhausted all its possibilities. Therefore, the only alternative is to return Puerto Rico to its sovereign powers through a fair process of decolonization. Only then will Puerto Rico have the necessary tools to manage its economic development.

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"STEALTH" CORPORATE TAX CHANGES IN 2022

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Corporate tax changes in 2022 may disproportionately affect distressed C Corporations.

The Tax Cuts and Jobs Act (TCJA) was signed into law on September 22, 2017.[1] The TCJA generally expires in 2025 and many of the "paybacks" in the TCJA take place in the latter effective years of the Act.

In particular, three provisions of the TCJA will result in large "stealth" tax increases for many C corporations in the 2022 tax year. These provisions may disproportionately affect distressed C corporations.

Capitalization of Research and Development Expenditures

The Internal Revenue Code of 1954 added section 174 which provided taxpayers the option to immediately deduct Research & Development (R&D) expenditures under section 174(a) or elect under section 174(b) to capitalize them over a period of at least 60 months.[2]

For taxable years ending on or after December 31, 2000, software development costs could be (i) deducted currently under rules similar to section 174(a); (ii) capitalized and amortized over 60 months from the date of completion of the project; or (iii) capitalized and amortized over 36 months from the date the software is placed in service.[3]

The TCJA amended section 174(a) to eliminate the ability to currently deduct R&D expenditures in tax years beginning after December 31, 2021.[4] As such, domestic R&D expenditures will have to be amortized over 5 years and 15 years for expenditures incurred outside of the United States, both with a midyear convention.

When considering the timing implication of this provision, taxpayers with R&D expenditures would be disproportionately affected in the 2022 tax year, as only 10% of the R&D expenditures could be deducted (12/60 months times 50% midyear convention). As depicted in the table at right, by 2025, significantly more R&D expenditures incurred during tax years 2022 through 2025 could be deducted than during the initial 2022 tax year.

	Current R&D Outlays	Amortization			
		2022	2023	2024	2025
2022	$100	10	20	20	20
2023	110		11	22	22
2024	120			12	24
2025	130				13
		10	31	54	79

The Build Back Better Act[5] as passed by the House of Representatives, contains language to extend the immediate deductibility of R&D expenditures through the end of 2025. In addition, several stand-alone bills have been introduced to extend the deductibility of R&D expenditures. These bills have broad bipartisan support but have not yet moved past the stage of proposed legislation.

For example, in a letter to Congress, RSM US LLP wrote:

> It is our belief that this new requirement . . . (to capitalize) creates a disincentive to engage in research and, as such, would significantly reduce U.S. competitiveness.
>
> At a time when Congress is close to agreement on bipartisan legislation that will boost U.S. competitiveness in manufacturing, technology, and other areas crucial to our economic success, it is distressing that U.S. companies engaging in these efforts through research and experimentation would be made less competitive globally through the U.S. tax code. Rather than focusing time on conducting innovation and research, U.S. companies are instead trying to determine the impact of the new law on current operations, as well as associated compliance related obligations. This is clearly not consistent with the intent of the provision when it was enacted in 1954 and runs counter to the overall notion of further incentivizing the U.S. research and development environment.[6]

Section 163(j) Restrictions

The TCJA attempted to address the issue of excessive corporate debt by modifying section 163(j). These changes brought section 163(j) more in line with OECD guidance and expanded the application of the limitation to all interest expense, not simply related party interest. Under the TCJA, interest expense deductions are generally limited to the sum of business interest plus 30% of adjusted taxable income (ATI).[7] Any interest

1 Public Law No: 115-97.
2 Beginning with the month in which the taxpayer first realizes benefits from such expenditures.
3 Notice 2000-50.
4 Including software development costs.

5 H.R.5376 - Build Back Better Act, 117th Congress (2021-2022).
6 Comments on research and experimental expenditures, RSM US LLP, March 2, 2022. https://img.en25.com/Web/McGladrey/%7b28dd3304-48d2-4db8-9961-6988fb677b25%7d_RSM_Section_174_Research_and_Development_Comment_Letter_3-2-22.pdf.
7 Floor financing interest is also included in the formula for auto dealerships. IRC § 163(j)(1).

disallowed under this section is allowed to be carried forward indefinitely until it can be deducted.[8]

Section 163(j)(c) exempts small businesses from the section 163(j) limitation. For the 2022 tax year, a small business for this purpose is defined as a company with gross receipts not exceeding $27 million.

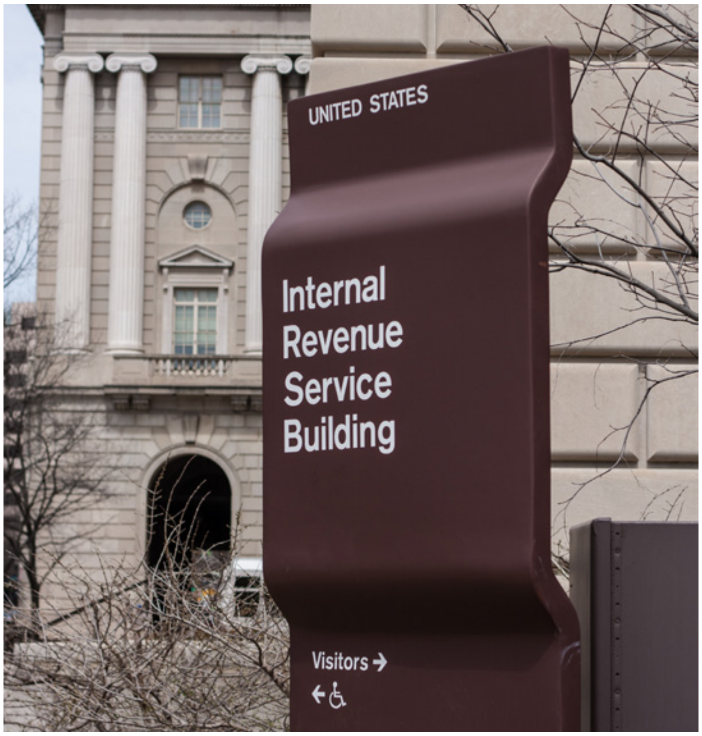
Section 2306 of the CARES Act[9] added section 163(j)(10) to increase the ATI limitation from 30% to 50% for taxable years beginning in 2019 and 2020, unless a taxpayer elects out of the change.

For the 2021 tax year, the ATI limitation thus decreased back to the 30% statutory amount. For tax years before 2022, ATI was computed before interest deductions, NOLs and non-business income (essentially EBIDTA). For the 2022 tax year, ATI is computed before interest deductions, NOLs, non-business income, depreciation, amortization and depletion (essentially EBIT).[10]

For example, assume taxable income is $100, interest incurred is $60 and depreciation is $50 both in 2021 and 2022. ATI for 2021 would thus be $100 plus $60 of interest incurred and $50 of depreciation = $210. 30% of $210 would be $63. As such, all interest incurred would be deductible. In 2022, ATI would thus be $100 + $60 = $160. 30% of $120 would be $48. As such, $12 of interest would not be deductible in 2022, and would be carried forward to subsequent years.[11]

	2021	2022
Taxable Income	100	100
Interest	60	60
Depreciation	50	
ATI	210	160
30% of ATI	63	48
Deductible Interest	60	48

As more fully articulated in a prior *AIRA Journal* article, "New Tax Law May Limit Interest Deductions for Distressed Businesses,"[12] distressed businesses experience disproportionately higher taxes with correspondingly lower cash flows as a result of the section 163(j) adjusted taxable income limitation. The reversion to the 30% limitation, the decrease from EBITDA to EBIT and increasing interest rates will result in an especially difficult burden for distressed C corporations.



80% Limitation for Post-2017 NOLs

The TCJA removed the ability to carryback net operating losses (NOLs) to prior tax years. However, the TCJA did extend the prior carryforward period from 20 years to an indefinite carryforward period.[13] The TCJA also generally imposes an 80% limitation on the use of NOL carryforwards for NOLs generated in tax years beginning after December 31, 2020.[14]

For example, assume a company is formed in 2021 and generates an NOL of ($100) in that year. In 2022, taxable income is $100; only ($80) of NOL carryforwards could be used in that year. The remaining ($20) NOL carryforward could then be carried forward indefinitely, but the taxpayer would be subject to tax on the remaining $20 of income.

Alternatively, assume a corporation was formed in 2017. In 2022, the company has $200 of income, and has an NOL carryforward of ($20) from 2017 and ($180) from 2021. Section 172(a)(2) provides that the NOL deduction equals the 2017 NOL[15] plus the lesser of the 2021 NOL[16] ($180) or 80% of $200 ($160). In that case, net taxable income would equal $200 less the 2017 ($20) NOL and less the ($160) allowed NOL from 2021 = $20.[17]

8 IRC § 163(j)(2).

9 Coronavirus Aid, Relief, and Economic Security Act, Public Law 116-136, 134 Stat. 281.

10 IRC § 163(j)(8)(A).

11 IRC § 382(d)(3) provides that section 163(j) carryforwards are treated as pre-change losses for purposes of section 382.

12 Loretta Cross and Jaime Peebles, "New Tax Law May Limit Interest Deductions for Distressed Businesses," *AIRA Journal*, Vol. 31 No. 4, 2018.

13 IRC § 172(b)(1)(A)(ii)(I) — in the case of a net operating loss arising in a taxable year beginning before January 1, 2018, to each of the 20 taxable years following the taxable year of the loss; IRC § 172(b)(1)(A)(ii)(II) — in the case of a net operating loss arising in a taxable year beginning after December 31, 2017, to each taxable year following the taxable year of the loss.

14 IRC § 172(b)(2). This restriction was waived by the CARES Act for tax years beginning before January 1, 2021 and after December 31, 2017.

15 *i.e.*, pre-2018 NOL.

16 *i.e.*, post-2017 NOL.

17 These example assume no section 382 or other limitations on the use of NOL carryforwards.

Continued from p.55

Summary

For many corporations, the amortization of 2022 R&D expenditures over 5 years, combined with the 30% of EBIT deduction for business interest, will result in large increases to taxable income.[18] Moreover, for companies attempting to use post-2017 NOLs, such NOL utilization will be subject to the 80% taxable income limitation.

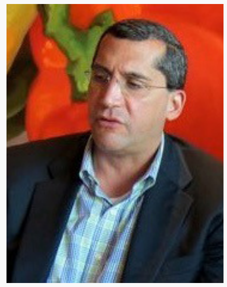
Absent Congressional action, the amortization of R&D expenditures will have an outsized effect on 2022 taxable income. For distressed corporations with large R&D and business interest expenses, these tax law changes will be felt most keenly.[19]

Distressed companies may find themselves struggling to service debt payments as federal income tax liabilities increase negative cash flows.

[18] In some cases, converting a current year loss into positive taxable income after these two large adjustments.

[19] A situation exacerbated if there are limited pre-2018 NOLs available to offset 2022 taxable income.

ABOUT THE AUTHOR



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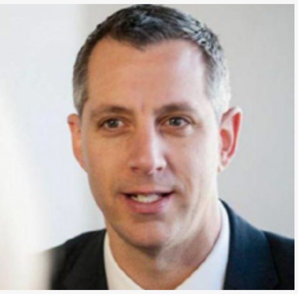
RSM US LLP

Michael is a Senior Director in the RSM Mergers and Acquisitions Tax group in New York. Michael has over 20 years of experience with distressed companies, corporate bankruptcies, loss preservation, stock basis, attribute reduction, loss disallowance, earnings and profits, and general M&A issues. He received a BA from Emory University, MBA and JD degrees from Tulane University, as well as an LLM in Taxation from NYU. Michael is a licensed attorney and holds CPA licenses in New York, California and Louisiana. Email michael.barton@rsmus.com.

AIRA members and others are invited to submit articles or propose topics to AIRA Journal's Editorial Board: Michael Lastowski, mlastowski@duanemorris.com; David Bart,david.bart@bakertilly.com; and Boris Steffen, bsteffen@provincefirm.com. Articles are currently being accepted for upcoming issues; see www.aira.org/journal.

3 DISTINGUISHED KEYNOTES

WEDNESDAY



Jeremy Borys
Managing Director, AlixPartners, LLP

THURSDAY

James H.R. Sprayregen P.C.
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FRIDAY

Judges Roundtable

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*(*Includes Pre/Post-Conference and Annual Conference. CLE based on a 60–minute hour)*

PRECONFERENCE - 1 ALL DAY SESSION

WED, JUNE 8, 2022

Financial Advisors' Toolbox
The Financial Advisors' Toolbox program will educate an intermediate practitioner about bankruptcy law and practice, including an introduction to core fundamentals and key emerging issues. Panel sessions include: Introduction to Cross Border Restructuring; Third Party Releases; Financial Reporting in Chapter 11; Cash Forecasting in the Age of Covid; Claim Reconciliations; and Bankruptcy and the Future Outlook.

CONFERENCE - 17 SESSIONS

THU, JUNE 9, 2022

State of Disruption: A Discussion with Experts in Industries Dealing with Significant Change

Mass Tort Bankruptcies and Third-Party Releases - Navigating These Complex Issues

Cutting Edge Issues in Recent Complex Confirmation Disputes

CONFERENCE, CON'T

FRI, JUNE 10, 2022

Supply Chain Disruption and the Impact on Restructuring

Back to the Future - Digital Assets and Insolvency: Same Issues, New Solutions?

The Great Repositioning: The Impact of the Pandemic on Commercial Real Estate

The Intersection of SPACs and Restructuring

The Texas Two-Step: A Divisive Topic Any Way You Merge It

Treatment of D&O Policies in Bankruptcy Cases

Distressed M&A: Recent Trends & Issues

Using Litigation Finance to Maximize Value in Distressed Situations

The Labor Shortage: Where is Everyone?

Trending Tax Issues Impacting Turnaround Professionals

Inflation: Why Should It Matter?

The State of the Banking & Loan Market Industry: Where Are We Now?

SAT, JUNE 11, 2022

The Khan Game: In re Khan, and Lessons Learned from the Largest and Longest Check Kiting Scheme in U.S. History

The Role of Independent Directors Serving on the Board of Distressed Companies

VIRTUAL POST CONFERENCE

WED, JUNE 14, 2022

Bankruptcy Taxation Part 1
Panel sessions during Part 1 include: Corporate Tax Considerations in Bankruptcy; Representing the Challenged Debtor - Tax Planning and Stress Control; and, Bankruptcy Case Law Update.

THU, JUNE 15, 2022

Bankruptcy Taxation Part 2
Panel sessions during Part 2 include: Chapter 7 & 11 Tax Basics; Abandonment - Property Sales vs. Abandonment and Trustee Liability; and, Liquidating Trusts.

EXCURSIONS NEXT PAGE

CONFERENCE HOTEL -HILTON CLEVELAND DOWNTOWN

The Hilton Cleveland Downtown is located within a mile of Playhouse Square and East 4th Street shopping. Guests can unwind in the hotel's indoor pool, fitness center, and top floor bar with views of Lake Erie.

AIRA's group room rate is $209 single/double. To qualify for this discounted rate, your reservation must be made by May 27, 2022.

Hilton Cleveland Downtown
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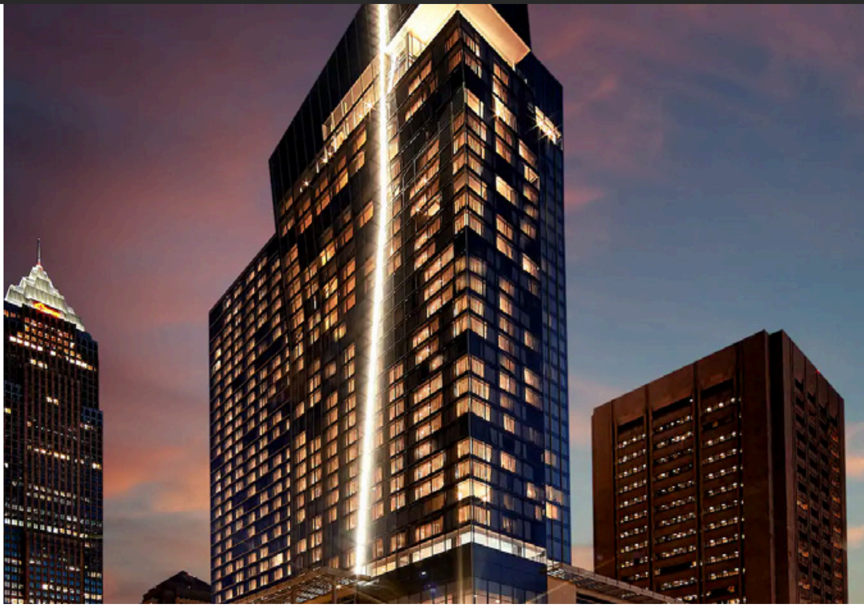
Cleveland, OH 44114
Phone: +1-(216) 413-5000

For Online Registration visit www.aira.org



4 FUN-FILLED EXCURSIONS

THURSDAY AFTERNOON

Self-Guided Tour of the Botanical Gardens

In 2014, the Holden Arboretum integrated with Cleveland Botanical Gardens, to create Holden Forests & Gardens, which is the 12th largest public garden in the country. Located in the heart of Cleveland's iconic University Circle, the gardens offer an enchanting escape from the bustling city and a captivating way to enjoy the great outdoors and get in touch with nature. They take pride in connecting people with the wonder, beauty, and immense value of trees and plants.

Join this excursion for a self-guided visit to the Cleveland Botanical Gardens and their mesmerizing, manicured gardens and specially curated glasshouses. The Cleveland Botanical Garden is awakening in the new season and you will not want to miss it!

The cost of this excursion includes round-trip transportation. Enjoy lunch on your own before departing the hotel at 1:00 or enjoy lunch at the Botanical Gardens Cafe.

Sailing

Relax and enjoy an afternoon sail with the Foundry Community Rowing and Sailing Center. Our sailing staff welcomes you onboard as we sail the Cleveland Harbor with one-of-a-kind views of downtown Cleveland, the Rock & Roll Hall of Fame, First Energy Stadium and the Historic Coast Guard Station. Experience the city in a whole new way with extraordinary views of the North Coast of Lake Erie. We depart from the E 55th Street Marina for an hour and a half of exciting adventure.

Enjoy lunch on your own before going to the Marina.

Self-Guided Tour of the Rock and Roll Hall of Fame

The Mission is clear: to engage, teach and inspire through the power of rock and roll. Alive with the passion and energy of the musical legends they celebrate, the inductees are represented throughout seven floors of exciting exhibits, films and of course the music, bumping from wall to wall. Get a front-row concert feeling as you witness performance highlights from over 30 years of induction ceremonies.

Enjoy lunch on your own before going to the Rock Hall for a self-guided tour (they recommend allowing 2-3 hours to see everything).

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FRIDAY NIGHT

Baseball Game - Cleveland Guardians

On the final night of the conference, guests can enjoy a baseball game at Progressive Stadium between the Cleveland Guardians and Oakland Athletics. AIRA has a block of Club-level seats for a limited number of guests. Food and beverage are available for purchase at the stadium.

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WELCOMING THE 2022 CLASS OF
DISTINGUISHED FELLOWS

AIRA will induct the latest class of Distinguished Fellows during AC22. Join us in recognizing their contributions to AIRA and fellow professionals Thursday Night during the Awards Ceremony.

To learn more about the program and nominations, visit the AIRA Distinguished Fellows Program page at www.aira.org/aira/fellows

Awards Ceremony Presented By: AlixPartners

Sponsored by: A&M

Young Professionals Reception

Returning this year, AIRA is hosting a reception exclusively for professionals 35 and under prior to the Annual Conference Opening Reception, featuring hors d'oeuvres and refreshments. This cocktail reception is the perfect opportunity to meet other young professionals in the corporate restructuring industry and you'll also get face time with several of the judges who are attending the conference.

CO-CHAIRS & PLANNING COMMITTEE

Thank you to the Co–Chairs and Planning Committee for their hard work and time in making this year's conference a big success!

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MACKINAC PARTNERS TO CONSOLIDATE UNDER ACCORDION BRAND

Accordion, a private equity-focused financial and technology consulting firm, has announced that it will formally consolidate its acquisition of Mackinac Partners, a financial advisory, restructuring, and operational turnaround firm, under the Accordion brand umbrella. As of April 1, 2022, Mackinac has transitioned into Accordion's Turnaround & Restructuring practice, led by Jim Weissenborn, the founder of Mackinac, who has more than 35 years of restructuring and operating experience.

Accordion's Turnaround & Restructuring practice is trusted by companies and their stakeholders to help address key challenges, improve business performance, and enhance value. The team is dedicated to helping companies move quickly in challenged situations. Comprised of seasoned experts with C-level and interim experience, the Accordion team has deep experience in financial and operational distress, liquidity, and working capital management. The team focuses on a results-oriented, hands-on approach to restructurings, turnarounds, and performance improvement initiatives.

According to Nick Leopard, Accordion's CEO & Founder, "Accordion has grown tremendously over the last few years. Our brand now has enormous equity as the unrivaled consulting leader in the PE space, and formally integrating our recent acquisitions into Accordion underscores that brand equity and represents another step forward in our accelerated growth trajectory. The introduction of new practice areas and leaders highlights our ability to partner with sponsors and portfolio company management at every possible stage of the investment lifecycle."

SUBMIT MEMBER NEWS OR A PRESS RELEASE

One of AIRA's objectives is to provide accurate and timely information to apprise members of professional developments, important events and resources. The AIRA encourages AIRA members and industry professionals to submit Member News and Press Releases for publication in the AIRA Journal.

For more infromation on how to submit a press release or news item visit www.aira.org/journal

AIRA
Distinguished Fellows Program

The 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.

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CLUB 10

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

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FTI Consulting	**59**
Alvarez & Marsal	**53**
Ernst & Young LLP	**28**
Riveron	**23**
Huron	**19**
Ankura Consulting Group, LLC	**18**
Berkeley Research Group, LLC	**15**
Deloitte	**15**
PwC	**15**
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