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## WHAT'S INSIDE

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# From the Executive Director's Desk

**JAMES M. LUKENDA, CIRA**
*AIRA*

On June 9th, AIRA was pleased to commence its 38th Annual Bankruptcy & Restructuring Conference (AC22), *live and in person* in Cleveland, Ohio. It felt so good to get together again, and to do so in a great city for an incredible conference! I cannot say enough to express my satisfaction with the quality of the educational program and the chance to experience it with so many colleagues and acquaintances, who have only been digital images on computer screens for the past two years.

From the planning committee to AIRA's sponsors, to the panel moderators and participants, as well as all of you who attended the sessions, everyone's involvement in these programs continues to provide superb education on timely topics and issues important to our profession.

I especially appreciate the Judges who made time in their schedules to participate as moderators and panelists. I found Friday's Luncheon Program, the Judge's Roundtable, to be particularly interesting. Attendees had the opportunity to take away not only the learning points conveyed about what Judges expect from professionals practicing before them, but also a more thorough understanding of what it means to sit on the bench from both a personal and professional point of view. I am very grateful to **Hon. Jerrold Poslusny**, the conference Judicial Co-Chair, for all his efforts in arranging his colleagues' participation in AC22 as well as AIRA's other programs.

Finally, I would be remiss if I failed to acknowledge the six individuals who bore the greatest burden for the conference success: Conference Co-chairs, **John Creighton (AlixPartners)**, **Dan DeMarco (Hahn Loeser & Park)**, and **the Hon. (Ret.) Judith Fitzgerald (Tucker Arensberg)**; and, of course, **AIRA's Cheryl Campbell, Michael Stull,** and **Michele Michael**.

As you read through the technical articles in this issue, be sure to look at the conference highlights section, including the announcement of AIRA's second class of **Distinguished Fellows**, the **AlixPartners CIRA Awards**, and the 2022 recipient of the **AIRA Grant Newton Educational Endowment Fund Scholarship:** Pepperdine University's Isabella Tsai.

For those of you who attended AC22, you may recall **Tom Morrow's** challenge to all of us to contribute to the Grant Newton Educational Endowment Fund. AIRA has subsequently received donations of over $14,000 to the Fund. Our thanks to all who contributed! AIRA continues to welcome gifts to the Fund – please consider a donation as you evaluate your end of year giving.

Next year, AIRA returns to the west coast for AC23 at **Newport Beach Marriott Hotel & Spa**. Please mark your calendar for June 7-10, 2023. Planning is underway, and if you would like to actively participate on the planning committee, please contact **Cheryl Campbell** right away.

As this edition of the *AIRA Journal* is completed and summer and school vacations are almost behind us, the balance of 2022 is coming into focus. I hope you find the content of this issue will expand your knowledge and increase your skill set, as we all address the rigors of today's business environment.

Read, enjoy, and learn. Keep well. Jim Lukenda



## UPCOMING AIRA EVENTS

**Sep. 15, 2022:** 10th Annual Energy Summit, Arts District Mansion, Dallas, TX

**Oct. 21, 2022:** NCBJ – AIRA Breakfast Program, "Procrustes Challenge – Designing Mass Tort Settlement Trusts and TDPs: One Size Does Not Fit All" (7:30-8:45 AM), Orlando Marriott World Center.

**Nov. 14, 2022:** AIRA 21st Annual Advanced Restructuring & POR Conference, The Union League Club of New York, NY

**June 7-10, 2023:** 39th Annual Bankruptcy & Restructuring Conference ("AC23"), Newport Beach, CA

*For more details, see p. 54 and www.aira.org.*

# A Letter from AIRA's President

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

There is an old saying, "May You Live in Interesting Times." In our profession, change and uncertainty make for Interesting Times. The changes brought about by COVID have materially affected the labor workforce, the supply chain, demand, and delivery of both goods and services. Combine those effects with unprecedented government spending, newly generated price inflation, rising interest rates and geo-political issues, and the results finally begin to mature into higher levels of business distress. There are elements in the current economic climate and forward economic cycle that have not been present since the late seventies and early eighties. There are new elements not present in our more recent economic cycles. The resultant changes and uncertainty should generate greater demand for restructuring services. (Please note: This market outlook represents my individual personal opinion and not opinions of any firm or organization.)

As the incoming president for fiscal year 2022-2023, I want to learn more about our members' needs; i.e., how can AIRA better serve your firm in areas of training, education, and sharing of data/best practices/methods. I want to communicate your needs more directly and timely to AIRA's Board and Executive Director. I look forward to reaching out to many of you to gather more information regarding your practices and outlook for the services you provide.

Finally, the AIRA conference schedule for the remainder of calendar year 2022 has been confirmed. The Energy Summit is set for the afternoon of September 15th at the Arts District Mansion (formerly Belo Mansion) in Dallas. The 21st Annual Plan of Reorganization Conference is scheduled for November 15th at the Union League Club and will be jointly sponsored with NYIC this year. These in-person educational events will also be offered virtually to assist with your continuing education requirements. Of course, in-person participation provides additional opportunities for practice development and networking with restructuring professionals and judges – the return of which we welcome in these Interesting Times.

**CDBV**

**2022 CDBV courses have finished, but the 2023 CDBV course schedule is coming soon!**

**More information on the CDBV program at www.aira.org/cdbv**


**With our new online membership application it's easier than ever to get involved!**

**AIRA's purpose is to unite and support professionals providing business turnaround, restructuring and bankruptcy services. AIRA brings together individuals from a broad range of practices and disciplines:**

- Financial Advisors
- Accountants & CPAs
- Attorneys
- Investment Executives
- CEOs & CFOs
- Legal Professionals
- Valuation Professionals & Appraisers
- Investment Consultants
- Real Estate Appraisers
- U.S. Trustees
- Bankruptcy Judges
- Restructuring Advisors
- Turnaround Specialists
- Business Consultants
- Investment Professionals
- Authors & Professors
- Distressed Asset Investors
- And many others.

**AIRA was formed in 1979, at the dawn of modern restructuring work, and we are committed to keeping our members up to date on the latest developments in the profession. AIRA believes in the future of the industry and your membership will help us with the important work of encouraging the next generation of professionals.**

**Help spread the word about why you belong, and direct potential members to the website to learn more about the benefits of membership!**

**To join visit: https://www.aira.org/membership.**

# DISRUPTION IS HERE: WHAT'S NEXT FOR UTILITIES?

**PATRYK SZAFRANSKI, CIRA, and JEN QUINLAN, CIRA**
*AlixPartners, LLP*

Distribution utilities (electric utilities that own and operate a distribution system connecting the transmission grid to the retail electricity consumer) are facing unprecedented changes driven by technology breakthroughs and the evolution of the regulatory framework, including Environmental, Social, and Governance (ESG). Utility operators must become more agile, adapt their business models to respond quickly to shifting imperatives, build dynamic capital plans with well-mapped optionality, pivot more quickly than competitors, and develop financial acumen that provides shock resistance to shifting markets and adverse weather conditions.

In the most recent AlixPartners Disruption Index Survey, interviews with 295 energy executives were conducted and incorporated into the detailed report, *AlixPartners Disruption Index: Taking Control in a Disrupted World, 2022.*[1] The responses collected in the survey are presented visually in grid format in Exhibit 1. Notably, energy was ranked among the industries most affected by disruption in terms of both magnitude and frequency of change. Other areas of greatest concern according to the executives were supply chain, workforce, and digitalization. Key observations from the analysis and report are:

- 94% of energy executives expect the utility business model to change within the next 3 years.
- 74% report that supply chain actions they are taking are not making enough impact.
- 66% indicate they are concerned their company's employees will not have the skills required to succeed in the future.
- 77% state they believe adoption of digital tools is critical to the survival of their company.
- 46% say their top digital challenges are poor execution and the workforce not knowing how to use the tools in which the company has invested.

[1] *AlixPartners Disruption Index: Taking Control in a Disrupted World, 2022,* available at https://disruption.alixpartners.com/alixpartners-disruption-index-2022/industry-energy-power/index.html.

**Exhibit 1: Disruption Index Survey – Energy & Power**

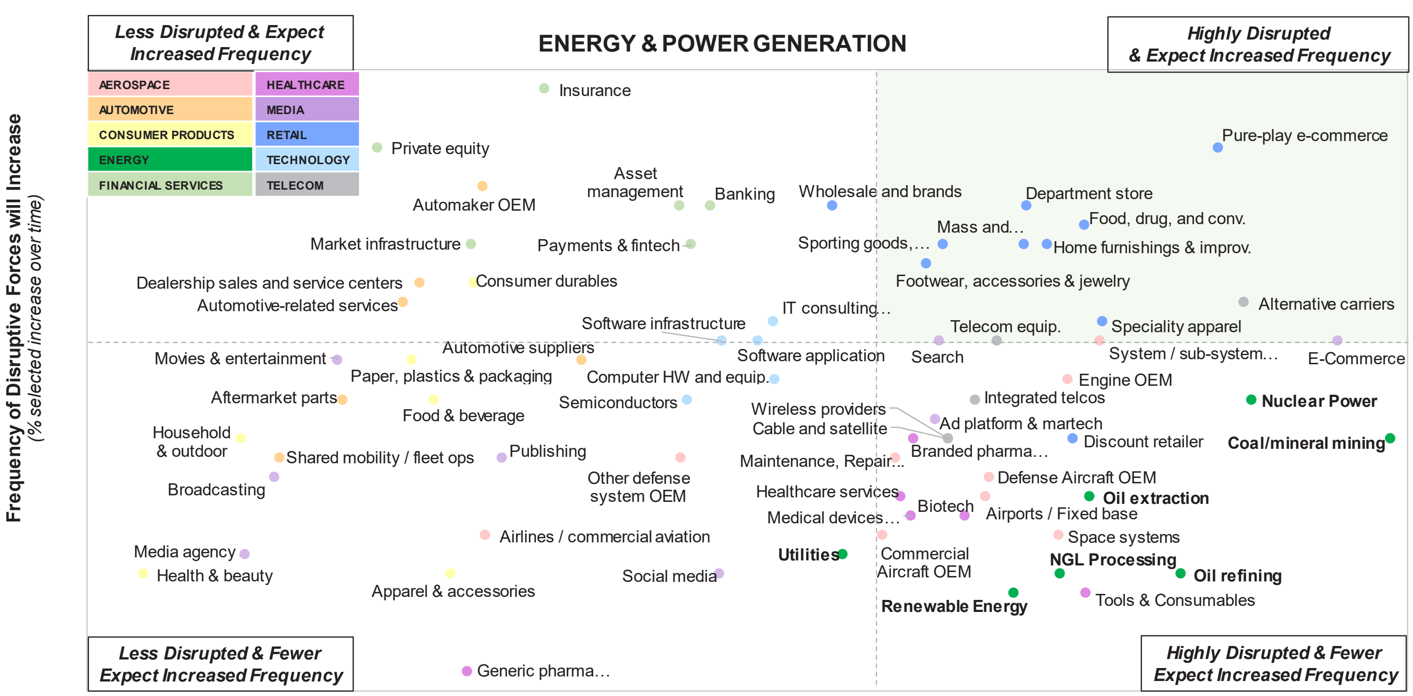
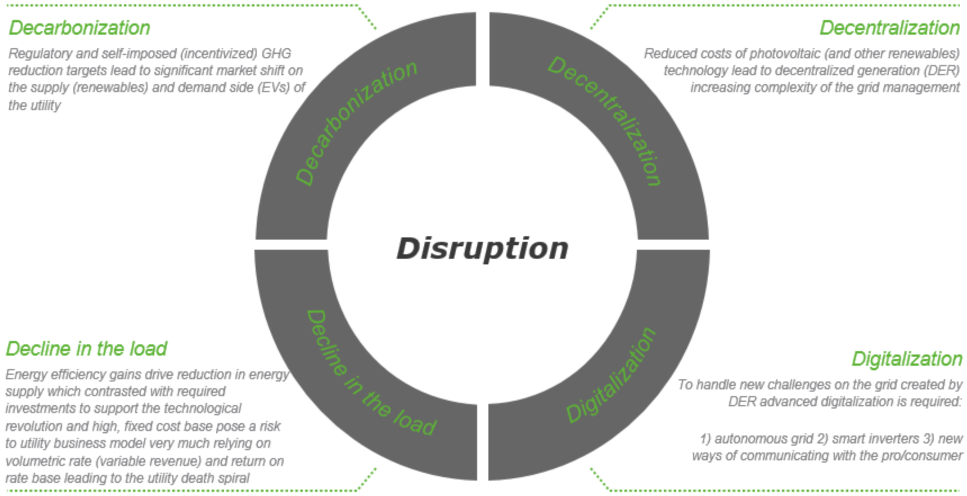


**Exhibit 2: Disruptive Impacts of Four External Forces**




The traditional, stable for decades, monopoly-based business model of a distribution utility is being challenged through four external forces: decarbonization, decentralization, digitalization and decline in the load. These forces and their impacts are presented in Exhibit 2.

Changes in response to these external forces may be particularly difficult for utilities. While utilities have historically been rewarded for delivering affordable and reliable electricity, the monopoly-type marketplace has promoted the following practices:

- High sunk costs are invested in legacy assets often at the expense of high leverage;
- Technical expertise is developed for operating legacy and traditional assets efficiently;
- Strongly regulated environment with strict safety and reliability rules drives high fixed operational costs; and
- Cost of service rate-making leads to extensive capital investments in traditional assets and not reimbursing development of new offerings ("resource deepening").

In the past, the high asset base was perceived by utilities as a barrier to entry for a competitor; but in the environment of rapidly evolving technologies and declining unit costs, the high asset base becomes an anchor weighing down growth.

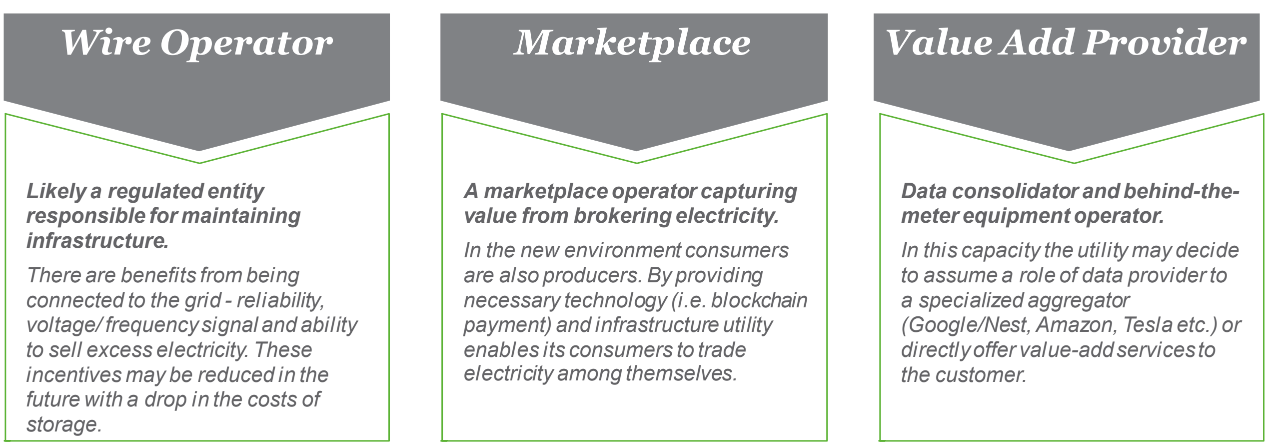
To enable transition, utility leaders must ask three strategic, business model defining questions:

- What value does and will the company bring to the market?
- Who is and will be the consumer?
- How is and will value be captured for shareholders?

As a result, the linear-pipe business model focused on throughput and electricity consumed will likely cease to exist in today's form. The distribution utility is inherently moving away from a single-sided business model toward a marketplace platform, such as employed by Amazon or eBay. The value proposition is a two-fold question about 1) what value will the utility deliver through the platform, and 2) to what extent does leadership feel comfortable with expanding beyond the regulated market? The key issues are highlighted in Exhibit 3.

Traditionally, the consumer of the distribution utility was the "rate payer." It was to a large extent a non-personalized relationship with limited brand recognition. Given paradigm shifts, the consumer now evolves to prosumer, who consumes and produces electricity depending on the time of a day/year. In the immediate future, the relationship with prosumer may expand even further and include such services as vehicle-to-grid (V2G), storage, and active supply/demand management (*e.g.*, smart inverter, smart

**Exhibit 3: Factors in Selection or Transition of Business Models**



Continued from p.7

meter/ time of use tariffs, active management of appliances for a fee). In an enhanced interaction environment, a utility may want to decide if 1) a direct relationship with the consumer is optimal, or if 2) acting through an aggregator is preferable. In either case, today's utility must develop new capabilities to communicate and interact with its clients.

The sustainability of the traditional "cost of service" rate-making method comes into question as market changes require utilities to make extensive capex investments, such as smart grids, transmission interconnectors, renewable energy generation, storage, and digital tools. The volumetric-based variable revenue generation approach is based on set rate of return on invested capital, and that does not correspond with the new reality of decreasing load, high fixed cost base, and decentralized capex. Cost of services offered to distributed energy resources (DER) (*e.g.,* reliability, access to the market, and voltage/ frequency signal) remains, to a large extent, spread among a shrinking base of traditional utility consumers, affecting affordability while not creating incremental value to the utility shareholders. Performance-based ratemaking along with alternative tariff solutions, such as minimum bill or network access fees, should be explored to address the challenges utilities face to create a sustainable business model.

For the first time since the nineteenth century, electric utility leaders face three simultaneous hurdles:

1) technological revolution,
2) expanding regulation, and
3) challenges to the traditional economics in the underlying the business model.

Financial performance of the utilities will largely depend on strategic business model selection decisions. Decisions related to company positioning on the value chain must be consistent with a company's capex plan and assume building new capabilities to deliver on commitments made to the shareholders.

ABOUT THE AUTHORS

**Patryk Szafranski, CIRA**
**AlixPartners, LLP**

Patryk is a director and leader in the AlixPartners Global Power and Utilities practice and strategic advisor to the largest energy companies in North America. Patryk has over 15 years of experience focused on implementation of revenue growth and cost reduction strategies, oversight of cash management, and project management of complex transactions. Patryk has a PhD in insolvency law from Polska Akademia Nauk, the Polish Academy of Sciences, and an MBA from London Business School. He is a Board Member of the TMA New York City Chapter, a Certified Financial Analyst Charterholder, and a Certified Insolvency & Restructuring Advisor.

**Jen Quinlan, CIRA**
**AlixPartners, LLP**

Jen is a Vice President with AlixPartners with experience in private and government sectors as well as a number of industries, including aerospace and defense, food and beverage, and broad government services. Jen's experience includes operational improvements, strategic planning, M&A synergy analysis, buy- and sell-side diligence management, cash management, contingency planning, and bankruptcy execution. Prior to AlixPartners, Jen led private equity and debt fund due diligence teams while managing US non-discretionary client relationships at Wilshire Associates. Jen also served as career staff in the White House Office of Management and Budget (OMB), overseeing and strategically planning $3B annually for the FAA.

# AIRA GRANT NEWTON EDUCATIONAL ENDOWMENT FUND

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

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

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

# PERSPECTIVES ON SUPPLY CHAIN ISSUES FOR TURNAROUND AND BANKRUPTCY[1]

**DAVID BART, CIRA, CDBV**
*BakerTilly US, LLP*

This article comments on the emerging trends and challenges faced by turnaround consulting and distressed investment professionals due to disruptions in the supply chain and its concomitant vulnerabilities. No industry is immune, but many have been more significantly impacted than others, including:

- Computer chips and downstream products; *e.g.*, automotive and electrical/home goods.
- Logistics; *e.g.*, domestic and international freight.
- Home goods; including construction, home improvement supplies, and consumer goods.
- Energy related supply and products related to energy; *e.g.*, oil and gas, and byproducts.

Time-honored approaches to the challenges of financial and/or operational distress may not be as effective as in the past when confronting the unique challenges of the current environment and inflationary pressures.

## Origin of the Crisis

Numerous authors have shared their insights into the origins of the supply chain problem and attempted to trace the indications of sources and contributing factors. For example, *The New York Times* published an analysis of the origins of the supply chain problem concluding it involves a complex, dynamic, and multifaceted set of issues (Exhibit 1).[2] Practitioners initially observed supply chain issues at the beginning of the COVID pandemic, manifesting with domestic shortages and China's impact on the supply of personal protective equipment (PPE) when in great demand and the reorganization of U.S. food supply chains to provide food to people isolated at home in response to containment efforts and lockdowns.

The outlook in spring/summer 2022 remains pessimistic about whether core issues may be resolved. More likely, a slow evolution of solutions may emerge, stretching a recovery into late 2022 or 2023. The primary catalyst, the pandemic and its attendant responses, has diminished; however, it continues to manifest itself in disruption of nearly every aspect of global supply and demand and logistics mechanisms. This has resulted in an explosion of "post-pandemic" demand without the ability to produce and ship supply. Major producing nations continue to struggle with workforces, raw material sources, production, and COVID responses while facing an ever-evolving and diverse set of COVID management approaches. Production interruptions and supply issues persist in China, South Korea, Taiwan, and Southeast Asia; European industrial giants including Germany, U.K., and France; and in the U.S. Key problems cluster around the sourcing of labor and components, and management of factories and shipping.

Supply chain issues have been central causes for bankruptcies such as Armstrong Flooring, Service King, and Party City, all of which struggled to manage cash and throughput of inventory amid changing consumer demand. Many observers expect more companies may face bankruptcy as their cash is depleted and working capital is threatened by interruptions in both resources and costs as well as sales. The level of corporate debt trading at distressed levels is near the pre-pandemic levels of December 2020, and the yields on risky bonds have steadily risen. The issues are compounded by their complexity and the fact that there seems to be no consensus on the outlook for the economy or the ripple effects on supply chains.

## Logistics Problems

In general, logistics has been and continues to be what many view as an ongoing nightmare, with empty containers, partial loads, stranded full containers, and worker shortages at all levels. Transportation links have become dysfunctional or broken in all modes: air/water, rail/trucking, and pickup and delivery. E-commerce has changed traditional models of delivery and has added its own species of stress to the nest of problems. Traditionally, goods were shipped to and from factories and warehouses around the world to centralized distribution points that supplied retail outlets, and consumers went to select and buy products at stores, which functioned as distribution points. Currently, a huge proportion of individual orders are produced, sorted, and delivered directly to homes and businesses. The retail distribution model is being/has been radically and rapidly changed, and there is a significant need for new models and

[1] This article is based on a portion of the panel presentation by the author with panelists Tom Goldblatt, Jim Bienas and Curtis Tuggle, "Supply Chain Disruption and the Impact on Restructuring," AIRA Annual Conference, June 2022. Comments and opinions in this article are those of the author and are intended for discussion purposes only.

[2] Lazaro Gamio and Peter S. Goodman, "How the Supply Chain Crisis Unfolded," *New York Times*, Dec. 5, 2021, https://www.nytimes.com/interactive/2021/12/05/business/economy/supply-chain.html.

**Exhibit 1: Origins of the Supply Chain Crisis**

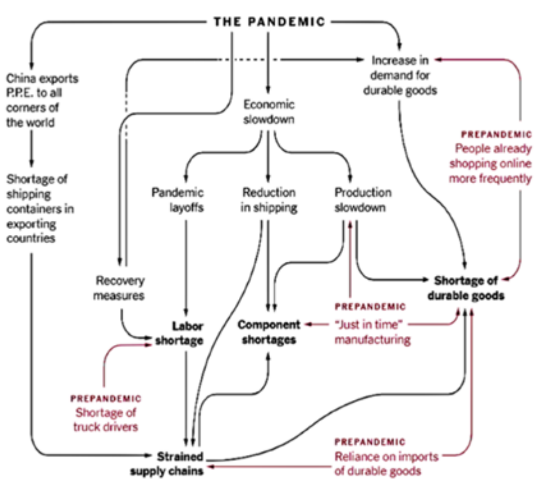
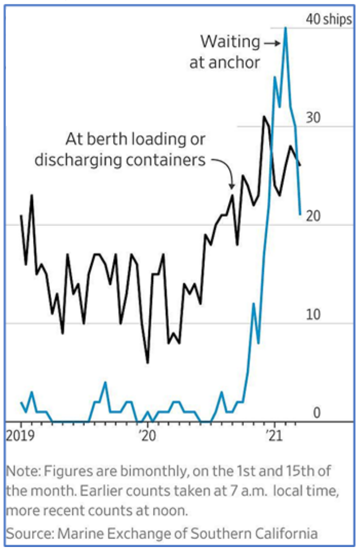


**Exhibit 2: Container Ships by Status at Los Angeles and Long Beach, January 2019 – March 2022**




mechanisms to accommodate storage, warehousing, and logistics mechanisms. Essentially, this is a production and sorting problem compounded by mass delivery issues.

Solutions are slowly coming online; however, inland supply chain bottlenecks are still leaving ports clogged; for example, consider the number of container ships backed up at the ports of Los Angeles and Long Beach, California (Exhibit 2).[3] As noted in the *Wall Street Journal*,[4] there is ongoing improvement and the worst may be behind us, although progress is uneven and unpredictable. However, things do seem to be getting better as shown by the decline, since the peak in early 2021, in the numbers of ships waiting at anchor and at berth in Los Angeles and Long Beach (Exhibit 3).[5]

[3] Kara Dapena and Dylan Moriarty, "America's Imports Are Stuck on Ships Floating Just Off Los Angeles," Logistics Report, *Wall Street Journal*, March 31, 2022, 5:30 AM, https://www.wsj.com/articles/americas-imports-are-stuck-on-ships-floating-just-off-los-angeles-11617183002?mod=business_trending_now_article_pos2.

[4] *Id.*

[5] Bill Mongelluzzo, "Coming LA-LB Cargo Surge to Rebuild Vessel Backlog: Terminals," *Journal of Commerce Online*, Mar. 10, 2022, 4:56 PM EST, https://www.joc.com/port-news/us-ports/coming-la-lb-cargo-surge-rebuild-vessel-backlog-terminals_20220310.html.

Nevertheless, whole industry groups are being impacted as ports work through the shipping backlog while structural problems persist from: aging and overtaxed infrastructure; a shortage of chassis used to haul containers with trucks; general worker shortages; and a dearth of drivers even as trucking companies increase pay and hasten their training. In February 2021, the *Wall Street Journal* reported the one-year growth in seaborne imports to the U.S., highlighting the increasing use of ocean transportation for a wide range of products (Exhibit 4 on next page).[6]

## CEO Responses

An AlixPartners survey of CEOs in late January 2022 found widespread apprehension and lack of success in finding and implementing longer term solutions. Their greatest concerns included the following:[7]

**Supply Chain Upheaval**

- Only 43% are taking longer-term action to address core issues.
- 58% are focused on short-term solutions, *e.g.*, new transportation contracts, paying more for materials, products, and transportation, and raising prices.
- 77% feel their actions are not effective enough.

**Workforce Crisis**

- 80% fear current labor shortages may be permanent – issues include finding employees with the right skills, attracting and retaining a diverse workforce, and finding sufficient budget to invest in AI and automation.
- 65% worry their employees will not have the skills required to succeed in the future, putting productivity in jeopardy, while top strategies to address these issues, specifically training and education, are not seen as sufficient.

[6] Dapena and Moriarty.

[7] AlixPartners, "Three in Four CEOs Fear Losing Their Jobs Says AlixPartners Survey," Press Release, alixpartners.com, Jan. 31, 2022.

**Exhibit 3: Container Ship Backlog at Los Angeles and Long Beach Ports, December 2021 – March 2022**

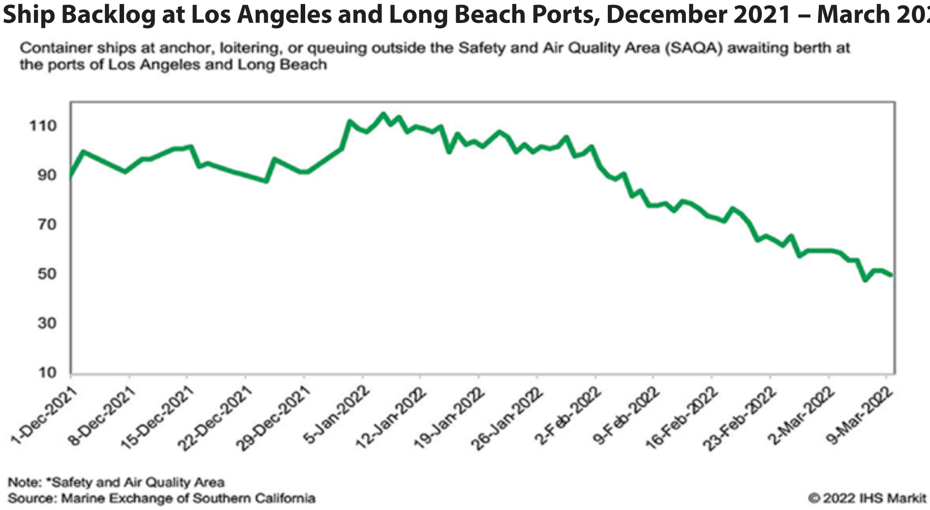


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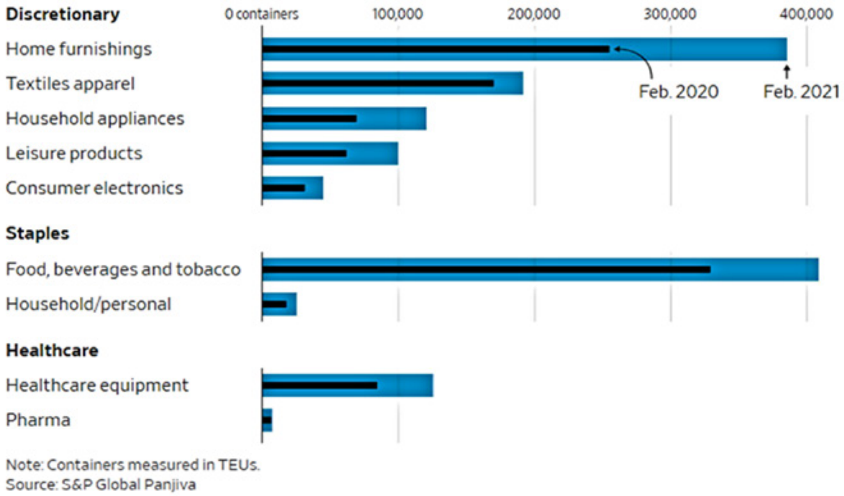
**Exhibit 4: Seaborne Imports to the U.S. for Select Categories, February 2020 and 2021**




**Digital Transformation**

- 78% believe the adoption of digital tools is critical to the survival of their company; however,
- 46% say their top challenge is poor execution of the technology and tools in which they have invested.

Perhaps the biggest challenge centers upon the shortage of skills in dealing with supply issues. Key industries have not yet fully responded or corrected their supply issues, and inflation is/has become a major problem while skills remain in short supply. For example, the shortage of computer chips is having a tremendous impact on all downstream products; *e.g.*, automotive and consumer goods. A McKinsey analysis reported virtually no growth over five years in the number of professionals who had end-to-end mastery of the skills and training necessary to work on supply chain issues.[8]

The skill levels necessary to transform procurement is a long-standing problem. Consider that the very language has changed for the concept of resource management: purchasing became procurement, which became supply chain management, which became integrated supply chain management, notwithstanding the concept of value chain management, and the emergence of digital value chain management. Has "just-in-time" become "just-in-case" management? The impact can be seen in inventory management approaches that try to build a cushion to accommodate unexpected shortfalls or timing issues.

## Global Concentration

Global concentration of resources poses serious risks to supply chains worldwide when disruptions occur; for example, consider tech supplies. A Deloitte study underscored the high concentrations of resources across the world that could impact technical supply chains if instability arises in any one area. Risks could arise from political instability, wars, economic disruption, or other causes, but the result could be significant interruption in essential commodities.[9]

Global and U.S. shortages are expected to continue in five key areas in the coming years:

- **Semiconductors** – affected by shortages in talent, raw materials, manufacturing, and shipping as well as shifts in new product uses (5G); localization of production is beginning to come online with increasing capital investment, but this will take years to fully integrate.
- **Aluminum** – affected by longer term Chinese production decisions, natural gas prices, and delays in new capital investment.

[8] Knut Alicke, Elena Dumitrescu, and Margarita Protopappa-Sieke, "Transforming Supply Chains: Do You Have the Skills to Accelerate Your Capabilities?," McKinsey & Company, Mar. 18, 2022, https://www.mckinsey.com/business-functions/operations/our-insights/transforming-supply-chains-do-you-have-the-skills-to-accelerate-your-capabilities.

[9] Michael Wolf and Ira Kalish, "Supply Chain Resilience in the Face of Geopolitical Risks: Preparing for the Tumult Ahead," *Deloitte Insights*, Dec. 3, 2021, https://www2.deloitte.com/za/en/insights/economy/us-china-trade-war-supply-chain.html.

**Exhibit 5: Skills Across Supply Chain Management**

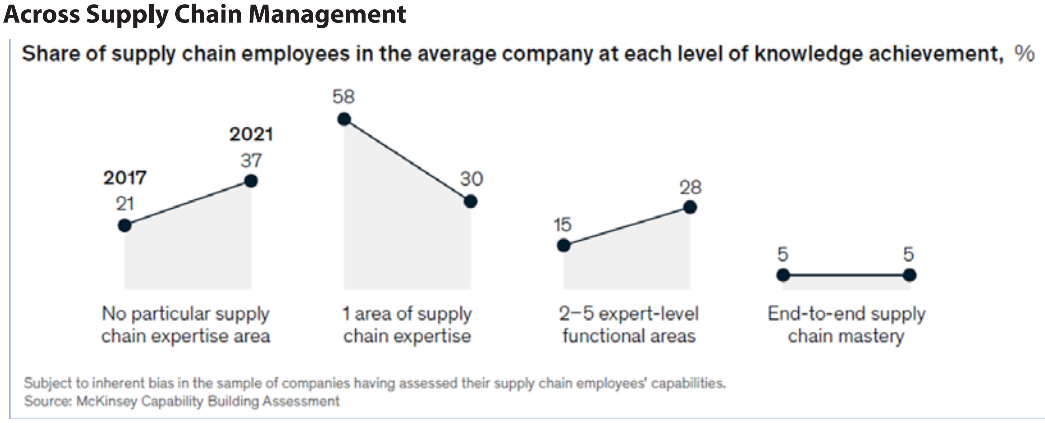
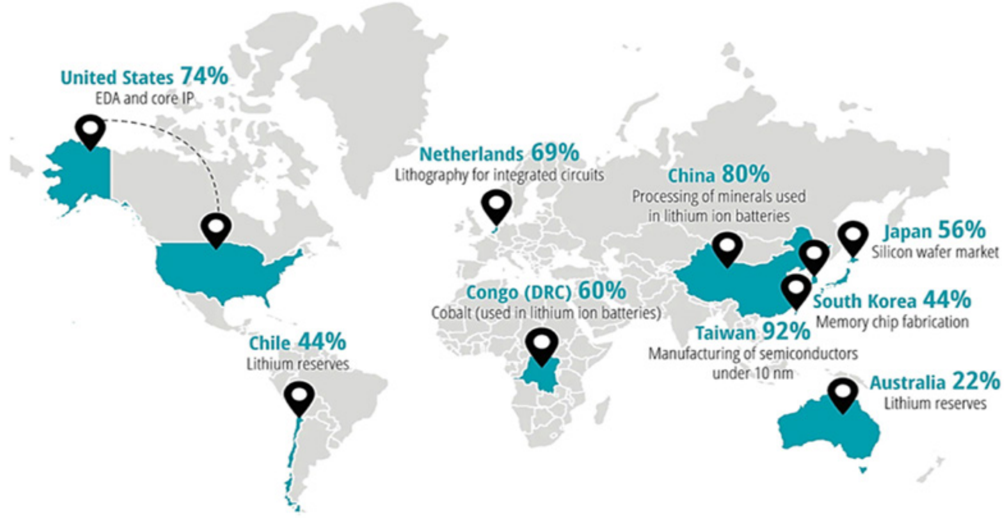


**Exhibit 6: Global Supply Chain Concentrations in Sample Commodities and Resources**




Sources: The White House, *Building resilient supply chains, revitalizing American manufacturing, and fostering broad-based growth*, June 2021; Boston Consulting Group and Semiconductor Industry Association, *2021 state of the us semiconductor industry*, April 2021.

- **Food** – largest cost item is energy, which is further affected by shipping issues and shortages in labor, fertilizer, and pesticides; global inflationary risk for food is affected by the Ukraine war.
- **Plastics** – unexpected scarcities are driven by resin shortages and interruptions from power outages in Texas and Southern U.S.
- **Building Materials** – inflation risk in all areas is driven by price and availability of labor, materials, and long lead times that cannot meet increased demand.

## Russia-Ukraine Conflict

Raw material shortages are likely to continue due to the war in Ukraine that will create additional supply chain issues in several key areas, including:[10]

- **Semiconductor Manufacturers** – Manufacturers were previously impacted in 2014 by the Ukraine / Crimea conflict and began to reduce their dependence on both neon and Ukraine, but manufacturers could still feel effects from Ukrainian-based neon shortages since the country was producing up to 70% of the world's supply.[11]
- **Chip Manufacturers** – While chip manufacturers are confident that neon supply chain disruptions will not have a significant near-term impact, a prolonged conflict could create significant bottlenecks and renew the global chip production crisis.[12]
- **Automotive** – While not directly impacted, automotive companies need to monitor the ability of chip manufacturers to deliver products as well as their inventory levels. For example, as of 2020, Ukraine was a critical producer of electrical wire harnesses used in automotive production by countries in the European Union.
- **Auto Catalysts** – In 2021, auto catalysts / exhaust manufacturers accounted for 84.7% and 39.5% of global palladium and platinum demand, respectively.
- **Elective Vehicles** – Russia is the third largest producer of nickel, accounting for 10% of global production. Nickel is an important raw material for electric vehicle batteries, representing more than 10% of the cost. The price of nickel remains elevated relative to historical averages.
- **Industrial** – Companies in the industrial sector are impacted by palladium and platinum as Russia is among the largest global supplier of both materials. The sector accounted for 15.2% and 32.0% of global demand in 2021 for palladium and platinum, respectively.
- **Jewelry** – Jewelry manufacturers are the 3rd largest global user of platinum, representing 24.3% of global consumption.
- **Oil/Natural Gas** – Russia is the 3rd largest producer of petroleum and 2nd largest producer of natural gas in the world. The conflict will have an impact on the energy sector and those that use oil and natural gas as fuel sources (*e.g.*, automotive). Europe relies on Russia for its natural gas needs.

[10] Volker Roelofsen, "How to Mitigate the Impact of the Russia-Ukraine War on Your Global Supply Chain, Supply Chain," SupplyChain247.com, Apr. 9, 2022, https://www.supplychain247.com/article/how_to_mitigate_the_impact_of_the_russia_ukraine_war_on_your_supply_chain; and Ram Ganeshan & Tonya Boone, "How the War in Ukraine Impacts Global Supply Chains," *IPS Journal*, Apr. 4, 2022, https://www.ips-journal.eu/topics/economy-and-ecology/how-the-war-in-ukraine-impacts-global-suppy-chains-5894/.

[11] *Id*., and Paul Heney, "Why There's a Neon Shortage — and Why It Matters," *R&D World*, Apr. 19, 2022, https://www.rdworldonline.com/why-theres-a-neon-shortage-and-why-it-matters/.

[12] *Id.*

Continued from p.13

## Inflation

Inflation is a global phenomenon, and no one seems to know where it is headed. Consider that nearly 80% of the value-added GDP in the U.S. economy is service based, where labor is the primary expense.[13] Or, that many believe 80% of pharmaceuticals source some component from China and overconcentration is an issue.[14] Or, is the issue more fundamental, such as material scarcity and cost escalation due to changing consumer demand and out-of-date logistics models?

The Federal Reserve Bank of San Francisco released a study that concluded demand factors accounted for approximately one-third of current inflation, supply factors accounted for another third, and that a remaining third of current inflation was caused by some ambiguous mix of supply-and-demand factors.[15] Global risks of war, shortages of food, and shifting consumer demand can all have long-lasting impacts in unexpected ways. Strategies of on-shoring or near-shoring will require time and capital investment to have a meaningful impact on the economy. As a consequence, many experts, including Federal Reserve Chair Powell, anticipate a period of great uncertainty for the near term.[16]

## Issues for Turnaround and Bankruptcy

A number of key issues are posing challenges for turnaround and bankruptcy specialists, driven by uncertainty, leaving room for debate and possible future litigation.

- **Financial and Operating Projections** – The key analytical tools used in turnarounds are uncertain. Development of cash flow projections (13/26 week, 5-year) requires increased scrutiny. Models may not just involve a revenue/expense or cash flow timing problem. Consider including operating models that address units of production and throughput as well as ratios or dollar-based assumptions with careful and robust assessments of efficiencies and margins. In addition, consider assessments of pricing power, captive supply sources, relative power among a firm's supply chain nodes, investment efficiencies, and cost of capital. Major risks and uneven cash flows are making it difficult to anticipate needs and to project meeting obligations. Models may need to incorporate significant operational information and assumptions that can impact working capital, covenant tests, cash, and other items, including a thoughtful assessment of "failure risk".
- **Values –** Stock market and merger and acquisition EBITDA multiples continue to be high, despite recent volatility and declines in the market. Interest rates are also changing. The analysis of business valuations may need more detailed analysis of key assumptions, and greater use of scenario testing to reach a conclusion of value that can be defended and upheld. Do not simply adjust specific company risk with arbitrary and unsupported assumptions. For valuations in a world of exceptional risk and great uncertainty, focusing on the fundamentals of value – cash flows, growth, and risk – become vitally necessary.
- **Lending Terms** – Lending terms may still be considered relatively lax, and too much money is still chasing deals; however, investors are increasingly nervous given the responses by the Federal Reserve to high inflation. Will there be a significant return to asset-based lending alternatives?
- **Post-Closing Issues** – Significant risks for merger and acquisition post-closing adjustments to receivables, inventory, other working capital may exist, especially in a highly inflationary environment. This increases the risk that post-closing disputes may arise with greater frequency and involve larger stakes.
- **Recession Risks** – Ukraine war shocks (short/longer term), inflation, Federal Reserve responses, and other uncertainties may or may not trigger a full-blown recession that can create significant uncertainty and heighten the risks of disputes across many types of financial transactions.
- **Litigation** – Significant uncertainty for key litigation tests that rely on value, solvency, damages or other cash flow projections and the dependability of transaction comparisons leave room for debate and litigation over facts, interpretations, and opinions.

Bankruptcy and turnaround professionals can employ a number of potential methods to address the uncertainties in their analyses. The first step is to recognize the complications involved in dealing with financial projections and business values. Next, consider the following or other options that can be developed to address these issues, for example:

- **Financial Projections** – consider focusing on the pressure points, e.g., inflation, labor, sources/capacity, product delivery (units and $), and timing issues and develop detailed supporting analysis and assumptions until stability can be achieved. For example, should more months/years be added to the projection periods? What significant factors will change, and when?

[13] Services, value added (% of GDP) - United States, The World Bank, Open Data website, accessed Jun. 23, 2022.

[14] This figure is often cited but is disputed. See, "Is the United States Dependent on China for Pharmaceuticals?" The U.S. China Business Council website, accessed Jun. 23, 2022.

[15] Adam H. Shapiro, "How Much Do Supply and Demand Drive Inflation?" *FRBSF Economic Letter*, Federal Reserve Bank of San Francisco, Jun. 21, 2022, https://www.frbsf.org/economic-research/publications/economic-letter/2022/june/how-much-do-supply-and-demand-drive-inflation/.

[16] Nick Timiraos, "Fed Chair Jerome Powell Says Higher Interest Rates Could Cause a Recession," *Wall Street Journal*, updated June 22, 2022, https://www.wsj.com/articles/powell-says-fed-needs-compelling-evidence-of-inflation-slowdown-to-alter-rate-rise-path-11655904616.

- **Develop and Test Scenarios** – Consider developing short/long term scenarios until the projections reach a stability state. Consider focusing on a base case versus alternative scenarios. Consider modelling the impact on working capital, capital expenditures by really focusing on timing issues in greater detail and tying those analyses directly to production models.
- **Weighting** – The courts prefer to avoid using simple averages of projected outcomes in cash flows or in implied values. Consider focusing on a central base case that is subjected to scenario tests and consider Monte Carlo or other stochastic methods to evaluate the distributions of outcomes before reaching a final opinion.
- **Supply Chain Specific Analysis** – Consider working with the management team to evaluate strategy, costs, and investment in managing supply chains and inventory. Consider performing a supply chain mapping analysis. Has management tried to optimize product line SKUs and its sources of components as well as transportation modes and strategies? How are these accounted in the financial models and valuation analysis?
- **Communication** – Consider communicating and partnering or working with stakeholders (employees, vendors, customers, lenders) to educate, to realign and solve key issues, and to realign both vendors and customers toward common solutions. Consider working closely with lenders to keep them aware of issues, analysis, and pro-active responses.

## Crisis Teams and Mapping

A crisis management team approach offers one solution to supply chain problems. Just as a crisis management team may work to analyze and manage the options employed in a turnaround, such a team could be deployed to analyze and manage supply chain issues. A dedicated, cross-functional group that utilizes digital modelling and scenario analysis and which incorporates an understanding of operational timing and inputs, as well as financial constraints and impacts, may be an important contributor to a solution. Frequent and thorough communication with key stakeholders in the supply chain may enable implementation of critical changes to processes and may be able to build in flexibility and accommodation with suppliers and vendors who collectively can better manage outcomes with more resilience.

Consider identifying the risk points, pressure points, or points of failure. Analytical mapping offers an approach to help find the controllable and uncontrollable factors. These factors can be addressed in operational as well as financial models as projected outcomes are analyzed. Capacity limits in both sourcing and sales to customers should be understood, with particular focus on working capital. Supply chain disruption poses both an accounts payable and accounts receivable issues, and these can ripple into both lending and covenant problems. Can a safety stock of inventory be accommodated? What are the costs?

One important goal can focus on identifying and minimizing single points of failure. Developing working partnerships with vendors and customers can help to find clever solutions and even stimulate new innovations and capital investment to solve supply chain issues. Consider one story: an electronics manufacture was stymied by the long delays being experienced between China and Long Beach. They rerouted through another country, air freighted from that country directly to U.S. factories, and ultimately saved time and expense by eliminating a substantial percentage of the long shipping delays. Their inventory backlogs declined from 14 weeks to 2 weeks. The net savings in transportation expenses from bypassing Long Beach while also significantly reducing trucking expenses to the factories offset much of the increased air freight expenditures. Other supplies were sourced from Europe instead of China. The expertise and time invested in the analysis, remapping, and implementation of new supply chains was a success at this company. They identified the points of failure and the boundaries of the problem, harvested their knowledge, and invested considerable time and resources into finding solutions, communicating with their suppliers and customers, and redesigning their supply chain model.

## Conclusion

Supply chain disruption is likely to continue for the near future, some say for the next several years. The impact is widespread. In response, specific issues will need to be addressed by turnaround and restructuring professionals. These may involve operational, analytical consulting efforts, dispute resolution, or other matters. The key is to appreciate the complexity of the problem, and to approach the issues with an open mind and a sense of teamwork with clear communication so that all involved can work toward finding and implementing a solution.

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# THE USE OF DEBT AND EQUITY TRADING PRICES TO MEASURE FAIR VALUE AND SOLVENCY

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## Introduction

In adjudicating enterprise valuation and solvency matters within the context of corporate restructurings, courts endeavor to emulate how the capital and merger and acquisition markets would value the business but for the financial distress of the debtor, the objective being to calculate the fair value of the business as a going concern. The three most commonly accepted methods used for accomplishing this task are variously known as the discounted cash flow, comparable publicly traded company, and comparable merger and acquisition methods.[1] Alternatively or in conjunction with these methods, market evidence based on the observed prices of publicly traded debt and equity securities using the stock and debt method may provide indications that appear dispositive.[2] However, as illustrated by events leading up to the bankruptcy of Caesars Palace, and in the findings of the Court in the case of *Tronox Incorporated et al. v. Kerr-McGee Corporation et al.,* the markets in which securities are traded may be inefficient due to information asymmetry or other impediments, with the result being anything but an indication of fair value.

## The Balance Sheet Test Paradigm

Insolvency in the bankruptcy sense, also referred to as legal insolvency or the balance sheet test, is defined by the United States Bankruptcy Code in 11 U.S.C. § 101(32)(A) as a "....financial condition such that the sum of such entity's debts is greater than all such entity's property, at a fair valuation, exclusive of (i) property transferred, concealed or removed with intent to hinder, delay, or defraud such entity's creditors and (ii) property that may be exempted from property of the estate under Section 522."[3] As such, the balance sheet test requires that a company's assets be valued under an appropriate standard and premise of value, and that the fair value of the firm's assets be compared to the value of its total liabilities, with debt valued at face value[4] and contingent liabilities discounted as appropriate for their probability of occurrence.[5] Debt is defined as a liability or a claim,[6] while a claim is defined as a right to payment, or to an equitable remedy for breach of performance, whether or not such right or remedy is reduced to judgment, liquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.[7]

## The Fair Value Standard

Fair valuation "is generally defined as the going concern or fair market value '[u]nless a business is on its deathbed.'"[8] Further, it is what "an informed willing seller under no compulsion to sell and an informed willing buyer not pressed for an immediate return would attribute to the property."[9] Similarly, Treasury Regulation Section 20.2031-1(b) defines fair market value as "The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." Accordingly, solvency is not implied by either a positive accounting book value[10] or positive equity trading price,[11] while

1 *Contested Valuation in Corporate Bankruptcy: A Collier Monograph*, ¶[3.03] (Robert Stark et al., eds., 2011).

2 *Id.*, ¶ [4.02].

3 Grant W. Newton, *Bankruptcy and Insolvency Accounting: Practice and Procedure, Volume 1*, 7th ed. (Hoboken: John Wiley & Sons, Inc., 2009), 134.

4 *See, e.g., Hanna v. Crenshaw (In re ORBCOMM Global L.P),* Adv. No. 02-1914 (MFW), 2003 Bankr. LEXIS 759, *8 (Bankr. D. Del. June 12, 2003) (holding that "for purposes of determining whether a debtor is insolvent under section 547, the liabilities of the debtor must be valued at face value.").

5 *In re Xonics Photochemical, Inc.,* 841 F.2d 198, 200-01 (7th Cir. 1988); *Covey v. Commercial Nat'l Bank of Peoría*, 960 F2d 657, 660 (7th Cir. 1992).

6 11 U.S.C. § 101(12).

7 11 U.S.C. § 101(5).

8 *Fisher v. Enter. Truck Line, Inc. (In re CXM, Inc.),* 336 B.R. 757, 760 (Bankr. N.D. Ill. 2006) (quoting *In re Utility/Stationery Stores, Inc.,* 12 B.R. 170, 176 (Bankr. N.D. Ill. 1921)).

9 *Covey v. Commercial Nat'l Bank of Peoria,* 960 F.2d 657, 660 (7th Cir. 1992).

10 *See, e.g., DeRosa v. Buildex Inc. (In re F & S Cent. Mfg. Corp.),* 53 B.R. 842, 849 (Bankr. E.D.N.Y. 1985) ("'Asset values carried on a balance sheet, even if derived in accordance with 'generally accepted accounting principles,' do not necessarily reflect fair value: 'Generally accepted accounting principles' are not synonymous with any specific [valuation] policy.'"); *In re Lamar Haddox Contractor, Inc.*), 40 F 3d 121 (5th Cir. 1994) ("Needless to say, a fair valuation may not be equivalent to the values assigned on a balance sheet. Financial statements reflect the book value of assets, ordinarily the cost of the property reduced by accumulated depreciation. The rate of depreciation is usually the maximum allowed by income tax regulations.").

11 *See, e.g., Covey v. Commercial Nan Bank of Peoria*, 960 F.2d at 661 (Easterbrook, J.) ("A stumble-bum would pay 1 cent for the most hopelessly insolvent firm, as the deal puts none of the bum's nonexistent assets at risk and could pay off if the debtor unexpectedly strikes it rich.").

"the stigma of bankruptcy alone is a factor that will seriously depress the market value of a company's securities."[12]

## The Stock and Debt Method

In situations where a firm's debt and equity securities are publicly traded, depending on the structure of the market in which the securities are traded, the value of the firm might be calculated using the stock and debt method under the market approach by adding the market values of its outstanding securities.[13] For example, on April 14, 2020, Twitter had approximately 762.0 million shares outstanding.[14] At the close of trading, the price per share that day was $45.08 per share, implying a market capitalization of $34.352 billion. Twitter also had senior bonds and notes outstanding with a market value of $4.253 billion, and leases outstanding with a market value of $1.294 billion. Adding the market value of Twitter's debt and equity together, the indicated value of Twitter's invested capital was $39.898 billion. As compared to Elon Musk's unsolicited and non-binding offer to purchase Twitter that day for $43 billion, or $54.20 per share,[15] the implied acquisition premium was 20 percent.

## Structure of the Market

Determining whether the structure of the market lends itself to the application of the stock and debt method depends on the relationship between the information available to investors and security prices, as defined by the efficient market hypothesis ("EMH"),[16] and on which the stock and debt method is based.[17] The fundamental construct of the EMH is that security prices accurately and fully reflect available information and respond quickly to such information as soon as it is available.[18] What is meant by "available information" varies between the three forms of the theory. The weak form, or random walk theory (*i.e.*, price changes are independent of one another) holds that security prices reflect all historical information.[19] The semi-strong form is that security prices reflect all historical and publicly available information, while the strong form posits that security prices reflect all historical, public, and private information. The upshot of the EMH is that security prices can be trusted to fully reflect all available information regarding the value of a security, and that most investors will not be able to consistently realize superior rates of return in an efficient market.[20] Notwithstanding, the market for distressed securities is not as efficient as other markets, which provides opportunities for knowledgeable investors to achieve superior risk-adjusted returns.[21]

12 *In re New York, New Haven & Hartford R.R.,* 4 B.R. 758, 791 (D. Conn. 1980); *In re Missouri Pacific R.R.,* 39 F Supp. 436, 445-46.

13 Bradford Cornell, *Corporate Valuation: Tools for Effective Appraisal and Decision Making* (Burr Ridge: Richard D. Irwin, 1993), 34.

14 S&P Capital IQ.

15 Giles Turner and Maxwell Adler, "Elon Musk Makes $43 Billion Unsolicited Bid to Take Twitter Private," *Bloomberg News*, updated April 14, 2022, retrieved April 22, 2022.

16 Bradford Cornell, *Corporate Valuation,* 35.

17 *Id.*, 55.

18 Richard A. Brealey, Stewart C. Meyers, and Franklin Allen, *Principles of Corporate Finance, 13th* ed. (New York: McGraw-Hill Irwin, 2019), 910. *See also, Basic Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 99L. Ed. 2d 243-47 (1988).

19 *Id.*, 340.

20 *Id.*, 354.

21 Stephen Moyer, *Distressed Debt Analysis: Strategies for Speculative Investors* (Fort Lauderdale: J. Ross Publishing, 2005), 32.

## The Market for Distressed Securities

Three key assumptions on which the EMH is based are (1) equal access to information, (2) rational behavior and (3) low transaction costs, none of which hold consistently across the market for distressed securities.[22]

### Equal Access to Information

Under the equal access to information assumption, all investors are assumed to have equal access to all available information. This might be a reasonable assumption for the equity securities of firms whose events are widely covered by security analysts and the press, where each stock trade is immediately reported publicly on an information service, such information is accessible with minimal cost, time and effort, and consequently fully reflected in market prices.[23] It is not true of the market for distressed debt, however.

There are numerous issuers of high-yield bonds that are not covered in any depth by analysts. Further, the majority of distressed debt trades in privately negotiated over-the-counter transactions for which prices are not made public. Also, many issuers do not have public equity, or have a small number of security holders which exempts them from the reporting requirements of the Exchange Act. Consequently, whatever information the issuer discloses, if any, might only be given to those holders.

Moreover, when operating under bankruptcy protection, even large capitalization firms often discontinue or delay filing information required by the SEC. Though information regarding matters in bankruptcy court is ordinarily public, the effort to identify and locate it requires significant effort, time, and know how. For example, from July 16, 2002, the day WorldCom/MCI filed for bankruptcy, through June 30, 2003, there were roughly 350 stories unique to WorldCom posted on Bloomberg, while on the bankruptcy docket, there were 9,686 filings totaling over 100,000 pages.

In many distressed debt situations, access to information also differs between parties. On the one hand, there is whatever information that makes it to the public domain. On the other, parties involved in negotiations with the issuer will have access to material non-public information pursuant to their signing non-disclosure agreements. However, investors and creditors with restricted information are typically allowed to trade in the subject securities provided they disclose that they possess such information to the counterparty in what is known as a "big-boy" letter.

### Rational Behavior

This EMH has been challenged by the behavioral finance school, in part based on evidence of economically irrational behaviors engaged in by investors. For instance, trading on noise rather than information, failing to diversify, actively trading stocks, churning their portfolios, selling winning while holding loosing

22 *Id.*, 33-41.

23 A firm with a positive equity value may nevertheless be insolvent due to factors including fraud on the market or imperfect information, option value, stockholder settlement expectations, irrational exuberance, and information not known and knowable by the market. (*Contested Valuation in Corporate Bankruptcy: A Collier Monograph*, ¶ [4.03] (Robert J. Stark et al., eds., 2011).

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stocks, and following stock price patterns.[24] The main reason for questioning whether transactions in the distressed market are rational, however, is forced, or coerced selling.[25]

Coerced sales arise from factors having little to do with a rational view of the subject instrument's fair value. Loan sales by banks are often intended to manage portfolio characteristics important to regulators or investors' perceptions of the bank's health. The sales typically occur at a discount to the loan's face value. If reserved for, the effect is limited to a reduction in nonperforming assets with no impact on the income statement, while the purchaser may be receiving a windfall. In addition, where a bank holds a nonperforming loan it has written down to zero, such as an unsecured or under secured loan of a distressed or bankrupt firm, it may sell the loan for less than fair value to generate earnings.

Collateralized debt obligation ("CDO") trusts also face pressure related to portfolio management rather than profit maximization. For a CDO to be economically viable, the spread between cost of the debt and high-yield collateral held in the trust must provide a sufficient risk-adjusted return on the equity invested. Achieving this depends on the backing of the rating agencies, which requires the CDO manager to comply with a highly negotiated set of CDO operating rules ("CDO-ORs"). Among other restrictions, the CDO-ORS may limit the type of credit, industry or credit quality of the portfolio, and require the manager to undertake irrational transactions regardless of fair value. In the case where an investment has been downgraded to a B- or CCC, for example, the manager may be forced to sell the investment simply to comply with the CDO-ORS.

Involuntary sales by high yield mutual funds to meet their liquidity requirements in the face of investor redemptions are another source of irrational selling. When investors decide to withdraw funds, the manager must have cash to pay the redemptions, which can require selling securities. To illustrate, in 1994 and 2000 high-yield mutual funds experienced net outflows. The outflow was not uniform, however, with funds that had experienced poor performance having had to liquidate their holdings at the weakest point in the market.

**Low Transaction Costs**

The EMH assumes that transactions costs are low or non-existent. This is true of the settlement, or transaction fee for trading a distressed bond, which is nominal and intended to cover the costs of processing the transaction. The unwind fee, which represents the bid-ask spread in the market, can be significant, however. For an investment to be profitable based on price appreciation, then, the minimum move in the market must be greater than the sum of the buy and sell transaction fees and unwind fee.

Specifically, for a large, liquid, actively traded bond, the unwind cost might be as narrow as for an on-the-run high-yield bond. For a less liquid bond having few known or active holders, the spread might be several points, however, which for a lower priced security can be large on a percentage basis. The contemporaneous, in-and-out trading required under the EMH for prices to fully reflect all available information may therefore not take place given potentially significant transaction costs.

## The Caesars Saga

The actions of investors in the Caesars B-7 financing make clear that contrary to the EMH, in the distressed market, investors might not have equal access to all available information, and coerced sales may arise from factors having little to do with a rational view of a security's fair value, while transaction costs may be so high as to preclude contemporaneous trading necessary for prices to fully reflect all available information.

**The B-7 Financing[26]**

Since its 2008 LBO by Apollo Global Management and TPG Capital, Caesars had taken on six different tranches of bank loans. Its seventh would become known as B-7 in 2014. At the time, Apollo needed more money and wanted to amend Caesars' credit agreement to remove the parent guarantee and weaken the senior secured loan covenant by increasing the ratio of OpCo senior debt to cash flow. For their part, GSO and BlackRock were to commit to buying a large part of the loan while OpCo was to contribute $135 million in cash, the result being that the $1.8 billion in loans and bonds of OpCo would be paid back.

The cost to Caesars of the B-7 financing was significant. GSO and BlackRock bought $820 million of the issue in return for being paid approximately $130 million in extra fees, which brought the total of fees to $219 million, or 12.5 percent of the $1.75 billion raised. With an interest rate of 9.75 percent, the loan was used to pay off debt that was mostly less expensive. Consequently, interest expense went up by $43 million. New cash was used to buy back debt for more than 100 cents on the dollar that was

24 Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* (Oxford: Oxford University Press, 2000), 10.

25 Stephen G. Moyer, *Distressed Debt Analysis,* 35.

26 Max Frumes and Sunjeet Indap, *The Caesars Palace Coup: How a Billionaire Brawl Over the Famous Casino Exposed the Power and Greed of Wall Street,* (New York: Diversion Books, 2021), 93-99.

trading at far less, while $450 million of bonds held by Caesars Growth were purchased by OpCo for 100 cents, seemingly favoring another entity controlled by Apollo and TPG.

With the B-7 financing, Caesars had modified the parent guarantee on $5 billion of bank debt. Still, Apollo wanted to sever the parent guarantee on the $12 billion remainder, which ultimately became a condition of GSO and BlackRock funding the B-7 financing so no other creditor had a guarantee. The solution was for Caesars parent to find minority investors for OpCo. Investment bankers from Blackstone advising in the process gave a presentation to the Caesars parent board regarding the benefits of selling stock in OpCo, noting it would facilitate a restructuring, that "it contractually releases [Caesars parent] from liability for approximately $14.9 billion of OpCo debt and thus protects $2.5 billion of [parent] equity value for shareholders," and that "there might be hostile responses from [OpCo] creditors."

In opining on the value of OpCo equity, Blackstone determined that under any traditional valuation method, OpCo equity was worthless, and that the only way OpCo stock was marketable was as an option, which nevertheless could not be reliably quantified. Blackstone also explained that the only buyers for the security would be funds already invested elsewhere in Caesars capital structure who stood to benefit from the termination of the bond guarantee, as buying OpCo's intrinsically worthless stock would save their investments. Apollo identified three such funds in April 2014: Paulson & Co., Scoggin Capital Management, and Chatham Asset Management.

Paulson & Co. had participated in a 2012 bond exchange and greatly overestimated the value of Caesars parent stock at that time. Accordingly, Paulson bought 1 percent of OpCo for about $1 million, though its concerns over perceptions regarding its purchase of worthless stock led to its negotiation of a provision that would protect it from being liable if Caesars creditors later sued. Scoggin also bought 1 percent, and like Paulson, based its calculations on how its parent equity would benefit, while Chatham's strategy focused on its investments in OpCo's junior bonds.

Subsequent to being informed by Apollo that proceeds from the sale of OpCo stock and B-7 term loan would be used to pay back junior debt like Chatham was holding, Chatham agreed to purchase the largest portion of the OpCo stock offering for $4 million in addition to $50 million of the B-7 term loan bearing interest of 9.75 percent. Caesars also bought out $412 million of Chatham's junior bonds for $435 million, and though the value of Caesars bonds fell precipitously on May 6th when Caesars announced the B-7 term loan and 5 percent OpCo stock sale which brought about the termination of the parent guarantee, Chatham's bonds were those paid off for greater than 100 cents per dollar.


Concurrent with the May 6th announcement, Caesars parent stock held by Apollo, TPG, Paulson and Scoggin increased by 14 percent even as OpCo debt fell. Up until then, Apollo had frequently maintained that its contentious actions had been undertaken for the benefit of creditors. The increase in the market price of OpCo's stock price together with the decrease in the market price of its debt demonstrated otherwise, however.

## The Case of Tronox v. Kerr-McGee

**Kerr-McGee's Restructuring and Spin Off of Tronox**

Kerr-McGee Corporation was at year-end 2005 one of the largest U.S.-based independent oil and natural gas exploration and production companies, with $5.9 billion in revenue and nearly 1 billion barrels of oil equivalent proven reserves. Accordingly, as part of a strategic restructuring initiated in 2000, in October 2005 the Board approved the spin-off of its chemical business, Tronox, through an IPO, to be followed by a distribution of its remaining interest in a stock dividend. The IPO was executed in November 2005, along with an issue of unsecured notes and a term loan. The proceeds of the financings, which came to about $775 million, together with existing cash in excess of $40 million, were distributed to Kerr-McGee. The Board subsequently declared a dividend of Tronox's Class B common stock on March 8, 2006, which in effect transferred ownership of Tronox to its shareholders, along with its environmental liabilities and those of the oil and gas business retained by Kerr-McGee. Kerr-McGee also required Tronox to assume $442 million in pension obligations and $186 million in unfunded other post-employment benefits.

**Consequential Claims[27]**

On November 30, 2010, Tronox confirmed its First Amended Joint Plan of Reorganization which created the Anadarko Litigation Trust to pursue certain claims brought against Anadarko Petroleum Corporation and several of Anadarko's subsidiaries, including Kerr McGee Corporation. The amended complaint, filed on May 12, 2009, alleged that three of the Debtors, Tronox Incorporated, Tronox Worldwide LLC, and Tronox LLC, were left with 70 years and billions of dollars in legacy environmental and tort liabilities when the oil and gas assets of the group were spun off; that the transaction was intended to hinder, delay or defraud creditors, that it left the Debtors insolvent and undercapitalized, and that creditors could recover the value of the assets transferred, which had been acquired by Anadarko for $18 billion a short time after they were spun off.[28]

[27] *Tronox Inc et al. v. Kerr McGee Corp et al.*, U.S. Bankruptcy Court, Southern District of New York, No. 09-1198.

[28] Tronox was spun off with a capital structure that consisted of $550 million in debt, $40 million in cash, and environmental liabilities that had cost Kerr-McGee more than $1 billion in prior years. Its projected cash flow was not adequate to service its debt absent large land sales that were not guaranteed. Further, Tronox's future prospects were uncertain given the downturn in the business cycle for its sole product.

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**Defendants' Public Market Defense**

Referring to cases in which the use of public market evidence had been relied on by the courts in finding for defendants on solvency, Defendants cited the cases of *VFB LLC v. Campbell Soup Co*., *Iridium Operating LLC v. Motorola, Inc.,* and *In re Old CarCo LLC.* Then arguing that such evidence was even stronger than that in the case of Tronox, Defendants continued that:

> This is not simply a case built on the public market evidence of stock and bond prices – although those are key indicators of solvency and plainly demonstrate solvency here…The evidence at trial also established two critical bookends to the public market. On the one hand is Apollo's signed, fully-financed offer to purchase the Chemical Business, based on six months and millions of dollars in diligence…On the other hand are the compelling, contemporaneous statements and actions of *Tronox's* own officers and managers, including statements subject to the securities laws – all of which are consistent with the public market evidence of solvency.

**The Court's Findings and Conclusions**

The Court did not find Defendants' reliance on the public market and the facts that lenders loaned Tronox $450 million in senior secured debt, or that Tronox was able to sell $350 million in bonds, and $224.7 million in stock, persuasive evidence of solvency. To start with, the Court opined that the fact that lenders loaned Tronox $450 million did not deserve any weight in a solvency analysis given that the debt was secured by the assets of all the Tronox companies, and that the lenders who bought the debt were sophisticated parties that knew they would be first in line in a bankruptcy or liquidation. As for Tronox's issuance of bonds and stock in Tronox's November 2005 IPO, while noting that it was Defendants' strongest evidence of solvency, the Court determined, based on the testimony of Grant Newton, Professor Emeritus of accounting at Pepperdine University, and Executive Director of the Association of Insolvency and Restructuring Advisors, that the financial statements that the market relied on were false and misleading for reasons including that the projections on which the IPO were based were inflated, sell-side projections, in which certain key numbers were imposed by Kerr-McGee's CFO, and unrealistic as compared to Tronox's historical financial performance.

The Court also found that Tronox's financial statements omitted significant contingencies and potential liabilities. Ranking among the most important of these that Tronox failed to disclose was its liability for the Federal Superfund at Manville, NJ, which as of the trial date, net of the EPA's recoveries, had increased to roughly $350 million. In addition, Tronox omitted from its IPO Registration Statement contingencies related to a $515 million contract for the sale of land in Henderson, Nevada. Due to its 30 percent interest in the property, $154 million was payable to Tronox and included in its projections of future cash flow. Tronox, however, failed to disclose risks associated with the closing of the contract, including that it had previously been used as an industrial waste site; it had to be remediated; and that "no action letters" had to be obtained from the Nevada Division of Environmental Protection for each of four parcels being sold. Relatedly, Tronox did not disclose that by the time of the IPO, the first three of four closing dates had passed and that in economic substance, the contract was the equivalent of an option with the purchasers having the right to walk away by paying $2 million in liquidated damages, an amount less than 1% of the purchase price. Accordingly, based on the totality of the insufficiencies inherent to the financial statements used in Tronox's IPO, the Court concluded that Plaintiffs had "clearly overcome the assumption of market efficiency," as the case had to do with the legacy liabilities with which Kerr-McGee had burdened Tronox and their effect on Tronox's solvency.

## What's an Investor to Do?

In an efficient market, the fair value of a firm or its equity might be calculated by adding the market values of its outstanding debt and equity securities. What Caesars' B-7 financing and OpCo stock sale illustrate, however, is that in a distressed market, the price of a debt or equity security may be a reflection of investment and trading strategies indicative of perspectives unrelated to the fundamentals underlying the fair value of the subject instrument as if determined in an efficient market. And as illustrated in the case of Tronox, a market in which securities trade based on false, misleading, or incomplete information is not an efficient market from which relevant and reliable indications of fair value may be determined. Concluding otherwise requires analysis of the relevant market to determine whether: (1) all investors have equal access to all available information; (2) prices are informed by rational investment criteria rather than forced sales; (3) high transaction costs preclude the market from trading to an efficient price; and (4) prices are based on relevant and reliable data and information.


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# SOVEREIGN DEBT RESTRUCTURING FOR EMERGING ECONOMIES IN A TURBULENT GLOBAL ECONOMIC ENVIRONMENT[1]

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*Many emerging economies are currently faced with a perfect storm of soaring inflation, acute shortages of fuel and food (and even medicines in some cases), major disruptions in supply chains, escalating global interest rates, large-scale capital flight of 'hot money,' and sharply depreciating currencies.* Alas, it was not supposed to be this way for the emerging economies as they moved through 2022.

In 2021, these economies had shown fairly remarkable resilience in rebounding from the severe adverse impact of the COVID-19 pandemic on their economies, and emerging economies and developing countries taken together were expected to grow at nearly 5% for 2022, as per International Monetary Fund (IMF) projections. In October 2021. However, just as the emerging economies and developing countries were entering a second year of economic recovery from the pandemic-related negative growth in their economies, Russia invaded Ukraine in late February and that huge geopolitical development and the economic repercussions that have flowed from it have changed the economic outlook for emerging economies and developing countries fairly dramatically.

In fact, in just the short period between January and April of this year (*i.e.*, in the wake of the onset of the war in Ukraine), the IMF has lowered its projections of growth for emerging economies and developing countries by not insignificant margins. The IMF is now projecting that emerging economies and developing countries will grow by only 3.8% in 2022 and 4.4% in 2023 compared to growth of 6.8% for these economies in 2021.

Two-plus years ago when the COVID-19 pandemic first struck, world oil prices were at all-time lows (and even went into negative territory for a period of time for certain oil futures). As a result, oil-producing countries around the globe were put in a serious economic and financial bind as government revenues generated from taxes and royalties on oil production shrunk. However, now in the wake of Russia's invasion of Ukraine and the tightening of global oil supplies, world oil prices have reached heights that the market has not seen in recent years with oil prices in early June at a level of approximately US$120 per barrel.

Furthermore, the war in Ukraine has affected both the availability and price of such basic commodities as wheat and other grains, particularly since Russia and Ukraine have effectively served as a breadbasket for the world. The current acute shortages of wheat and other grains, as well as shortages of fertilizer, that exist in countries around the world, accompanied by the higher price for these commodities, is already having a serious inflationary effect on emerging economies and developing countries.

Moreover, such shortages and the rising prices on foodstuffs could potentially lead to widespread 'food insecurity,' including widespread malnutrition and/or hunger, in the affected countries. Some development experts have not ruled out the possibility of famines in certain countries, and in fact the UN Secretary-General has warned that the war in Ukraine could risk plunging "tens of millions" into famine.[2] In addition, pervasive 'food insecurity' can have political consequences: under certain circumstances, it can lead to large-scale demonstrations and rioting against incumbent governments with the attendant possibility of political instability in the affected countries (as has been the case recently in Sri Lanka).

[1] A version of this article was originally published in *International Insolvency & Restructuring Report 2022/23* and is reprinted with the kind permission of its publisher, Capital Markets Intelligence (https://capital-markets-intelligence.com). (This article was first published in mid-June 2022 and, unless otherwise specifically noted, speaks to events only as of that date.)

[2] António Guterres, "Secretary-General's Remarks to the Global Food Security Call to Action Ministerial," United Nations speech, May 18, 2022, https://www.un.org/sg/en/content/sg/speeches/2022-05-18/secretary-generals-remarks-the-global-food-security-call-action-ministerial%C2%A0.

As noted above, with rising commodity prices, the global economy is now faced with significant new inflationary pressures, and these inflationary pressures are being felt particularly hard in a number of emerging economies and developing countries. Inflation was already a concern in many countries pre-Ukraine, but the price hikes on crucial commodities such as oil and grains in the wake of the Ukraine invasion have pushed inflation to even higher levels. Inflation has reached perhaps as high as 8.5% in March 2022 for emerging economies and developing countries, and, according to a report from Brookings,[3] this represents the highest rate of inflation in emerging and developing economies since 2008.

While rising inflation is a major concern for emerging economies and developing countries, another major concern is the rise in interest rates globally. To be sure, even before the start of the war in Ukraine, global interest rates were set to rise in an effort to tame the inflation seen in many countries around the world. Notably, in the course of 2022 and into 2023, the US Federal Reserve is expected to raise interest rates several times by as much as 50 basis points or more at a time, and this in turn could sharply increase borrowing costs for emerging and developing economies.

Separately, one must take account of important domestic developments taking place in China. The recent COVID-related lockdowns in China as part of its so-called zero-COVID policy, particularly in highly populated urban centers such as Shanghai and Beijing, has led to a significant slowing of the Chinese economy. In fact, many observers believe that China will not be able to meet its economic growth target of 5.5% for 2022, and there is even some speculation that the growth will come in at a much lower level such as at 4% or less.

Since the Chinese economy has widely been viewed as one of the main engines, if not the main engine, for economic growth in the global economy in the last decade or longer, a sharp slowdown in the Chinese economy will inevitably have an adverse impact on the overall global growth rate. It will also affect growth rates of many individual economies around the world, including emerging and developing economies.

On the debt front, many emerging economies and developing countries already found themselves in very fragile and vulnerable positions prior to the war in Ukraine. For instance, in a recent report, the World Bank indicated that 60% of low-income countries are now either in a state of debt distress or at high risk of debt distress. In addition, a top economist at JP Morgan Chase[4] recently noted that there are at least sixteen emerging economies whose sovereign bonds are currently trading at distressed debt levels.

Furthermore, during the pandemic, the governments in many emerging economies and developing countries undertook unprecedented levels of borrowing in order to help them address the health and economic crises caused by the pandemic. Yet, that high level of borrowing has now left many of these countries vulnerable to serious debt difficulties, if not outright debt distress and debt defaults.

Indeed, some commentators have suggested that the coming period in the wake of the war in Ukraine may see more debt defaults and debt restructurings than at any time since the debt crisis of the 1980s. It remains to be seen, though, whether such prognostications will come to pass, and if so, whether such future sovereign debt defaults will give rise to a systemic crisis as was the case in the 1980s.

## Specific Types of Emerging Economies at Risk of Debt Default and/or Restructuring

**Economies directly impacted by economic fallout from the Ukraine war**

**Egypt**. There is perhaps no starker example of a country more severely impacted from the fallout of the war in Ukraine than Egypt. Egypt has felt the brunt of the fallout in the form of significant wheat shortages and a marked run-up in prices for wheat/grain products.

As Egypt is dependent on Ukraine and Russia for 80% of its wheat imports, the virtual cessation of exports from the war zone (apparently due in particular to the Russian blockade of Ukrainian ports on the Black Sea) is having a dramatic impact on the Egyptian economy. For instance, inflation in Egypt has soared from 5% prior to the war in Ukraine to its current level of approximately 14.5%, according to the Financial Times.[5]

Shortages of wheat are also affecting Egyptian society generally given the role of bread as a critical staple in the diet of ordinary Egyptians. And there appears to be a very real prospect of ‘food insecurity’ for the Egyptian people; indeed, many Egyptians are already having trouble finding adequate supplies of food for themselves and their families (or at least food whose price is affordable to the average Egyptian).

Egypt’s tourism industry, a key contributor to the Egyptian economy, is also suffering significantly from the fallout of the war in Ukraine. A large percentage of tourists who travel to Egypt to visit seaside resort areas such as Sharm El Sheikh come from Russia and/or Ukraine, but the war in Ukraine has led to a virtual cessation of this important flow of tourists to Egypt. As a consequence, Egypt has lost a crucial source of foreign exchange, the economic activity generated by the Egyptian tourism industry has plummeted, and many Egyptian workers in the tourism industry are now being laid off from their jobs. Separately, the Egyptian economy has also suffered from the exit of foreign investors, particularly short-term investors who are often referred to as ‘hot money.’

Since 2016, Egypt has entered into two separate programs with the IMF that provided Egypt with US$20bn in financing. But now with the war in Ukraine dealing a body blow to the Egyptian

[3] Jongrim Ha, M. Ayhan Kose, and Franziska Ohnsorge, “Coping with High Inflation and Borrowing Costs in Emerging Market and Developing Economies,” Brookings Institution (May 5, 2022) (available at https://www.brookings.edu/blog/future-development/2022/05/05/coping-with-high-inflation-and-borrowing-costs-in-emerging-market-and-developing-economies/) (last visited on July 29, 2022).

[4] Comments by Joyce Chang (Managing Director and Chair of Global Research, JPMorgan Chase), Panel Discussion entitled “Sovereign Debt and Financial Stability in Europe and Latin America: Choppy Waters or a Cliff?,” Center for Global Development (June 2, 2022) (available at https://www.youtube.com/watch?v=u-4P6wUfj7I&t=1110s; relevant comments at 15 mins:15 secs) (last visited on July 29, 2022).

[5] *Financial Times*, “ ‘Millions’ at Risk of Death as Ukraine War Hits Food Supplies, Egypt Warns,” May 22, 2022.

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economy, the Egyptian government has once again approached the IMF for a new financing package and a new IMF program. It may take some time for Egypt and the IMF to finalize a new program in which Egypt is reportedly seeking financing of several billion dollars, but in the meantime, Egypt has reportedly received billions of dollars in financial assistance from some of the Arab Gulf states.

**Economies weighted down by Chinese lending associated with China's BRI program**

**Overview**. With its globe-spanning Belt and Road Initiative (BRI), China has loaned money to countries throughout the emerging markets and developing world for the development of various types of infrastructure, including roads, ports, airports, railways, and power projects. But many of these countries have borrowed huge amounts of money from China for these infrastructure projects, and a number of these countries find themselves with basically unsustainable debt burdens due to their borrowings from China as well as from other financing sources.

Whether China consciously designed a "debt trap" for the countries participating in BRI is a topic of heated debate, but resolving that controversy is beyond the scope of this article. However, for our purposes, the important point is that in a number of countries the Chinese debt, which often sits alongside debt from other financing sources, has left these countries with huge debt burdens or with what some would consider to be in certain cases essentially unsustainable overall debt burdens.

**Sri Lanka**. Sri Lanka has been a poster child of BRI projects that have gone awry, including most notably the Hambantota port project located in southern Sri Lanka. In that project, Sri Lanka was unable to make the required debt service payments due to China since the port had generated only limited traffic and was therefore not producing anywhere near the expected revenues for the project. To address this situation, China essentially entered into a debt-for-lease swap with Sri Lanka whereby China exchanged the debt that it was owed by Sri Lanka for a 99-year lease on the Hambantota port, thereby effectively shifting control of the port from Sri Lanka to China.

Apart from the Hambantota project, Chinese lenders have financed a number of other BRI-connected infrastructure projects in Sri Lanka, including a port in Colombo, an airport, highways, and even a business hub. In the process, Sri Lanka has incurred huge amounts of debt owed to China, but the debt is not necessarily on very favorable terms since, for example, apparently the interest rates are considerably higher than lending from other sources and the maturities are shorter than other non-Chinese loans.

But now Sri Lanka is going through a very severe economic crisis as its economy has basically been devastated from the fallout of the war in Ukraine, and there has also been political turmoil in Sri Lanka in the last few months with large-scale protests against the government. As reported by Reuters in late April, "Prolonged power cuts and shortages of fuel, food and medicines have sparked nationwide protests."

In May, Sri Lanka defaulted on two foreign bonds, and this represented the first sovereign default in Asia in over twenty years. Sri Lanka appears to have virtually depleted all of its foreign exchange reserves—it reportedly only had US$50m in available foreign exchange reserves at the end of April—so it has been unable to afford essential imports such as food, fuel, and medicines.

Sri Lanka has received financial assistance from certain countries to help tide it over, but it has also recently gone to the IMF seeking a new financing package and new IMF program. Apparently, discussions between the Sri Lankan government and the IMF are still ongoing.

Yet, the level of dysfunction, disarray, and human misery currently existing in Sri Lanka is such that some observers are even calling Sri Lanka a 'failed state.'

**Other countries**. Apart from BRI projects in Sri Lanka, there have been a number of very high profile and costly BRI projects in other countries that have proven to be problematic for various reasons and where the relevant sovereign has incurred significant amounts of Chinese debt to fund the projects in question.

To cite just a few examples, such projects include the Chinese-Pakistan Economic Corridor (CPEC) in Pakistan (which is actually a collection of many different infrastructure projects), the single-gauge railway (SGR) in Kenya connecting Nairobi to Mombasa, and the highway in Montenegro linking its Adriatic coast with neighboring Serbia (but traversing very mountainous terrain).

Projects such as these can become uneconomic if there is insufficient demand and/or if there are construction delays, cost overruns, quality issues, and so forth. In the meantime, the sovereign may have taken on considerable debt to finance such projects, and, notwithstanding the potentially adverse project economics discussed above, the sovereign may still be required to service its BRI-related debt to its Chinese lenders (together with any other sovereign debt it may have outstanding), assuming it can. However, it may not be able to do so, thereby resulting in a possible sovereign debt default and/or sovereign debt restructuring.

**Economies where sovereign debt travails have been an ongoing challenge**

**Argentina**. Argentina recently sealed a deal for a new arrangement with the International Monetary Fund (IMF), its 22nd such arrangement with the IMF since 1958. As part of a new Extended Fund Facility (EFF), Argentina will receive a new loan from the IMF of approximately US$44bn. Without this new loan, Argentina would not have been in a position to make the two large debt service payments to the IMF that were falling due in late March since Argentina had basically depleted its available foreign exchange reserves.

In return for the loan, Argentina will now be subject to an IMF program that focuses, among other things, on reducing inflation, zeroing out Argentina's primary fiscal deficit by 2025, gradually reducing Central Bank financing of Argentina's fiscal deficit, boosting Argentina's foreign exchange reserves, and raising interest rates.

Nonetheless, it was hardly a foregone conclusion that Argentina and the IMF would be able to reach a deal on a new loan and a new program before a de facto deadline of late March at the time those two debt service payments fell due to the IMF. Actually, it literally came down to the wire with the IMF Executive Board only approving the new loan and program on March 25.

With its new arrangement, Argentina seems to be temporarily off the hook, but few observers expect the new deal between Argentina and the IMF to proceed exactly as planned. For instance, there will be a range of complications caused by the war in Ukraine, such as the impact that the rising prices for Argentina's oil imports will have on inflation levels in Argentina. Moreover, Argentina's president, Alberto Fernández, is up for re-election in October 2023. Thus, his willingness to strictly implement the IMF program may be shaped to one degree or another by domestic political considerations, especially with respect to politically sensitive matters such as the reduction of fuel subsidies called for under the new IMF program.

Finally, the IMF itself has recognized what it has called the "exceptionally high" risks to the successful implementation of the new program for Argentina due to external factors, including fallout from the war in Ukraine, as well as social and political considerations in Argentina, such as the long-standing hostility of many Argentineans towards the IMF.

**Venezuela**. The Venezuelan government (the Republic of Venezuela) and its state-owned oil company, PDVSA, have a combined estimated US$150bn-US$200bn of total outstanding debt and other liabilities, but Venezuela has been in default on this debt for some time. For various reasons, including the fact that the Venezuelan regime led by Nicolás Maduro is considered a pariah regime by numerous Western countries, there have not been any serious debt restructuring discussions or negotiations between the Maduro regime and its creditors in the last few years since Venezuela's original bond defaults in late 2017.

Nonetheless, in early March 2022, there was a brief flurry of excitement around Venezuela when the Biden administration dispatched a few high-level envoys to meet with President Nicolás Maduro for the principal purpose of exploring the possibility of easing existing US sanctions against Venezuela's oil sector that were put in place by the Trump administration. Evidently, the idea was to replace as much as possible the expected shortfall in oil imports to the US resulting from US sanctions against the importation of Russian oil with oil imported from Venezuela.

Despite the fact that Venezuela remains in default on approximately US$60bn of bond debt, the price of some of the outstanding bonds of the Republic of Venezuela and PDVSA rose briefly by a few cents on the dollar on news of the meetings between the Biden administration officials and the Maduro regime. Apparently, the expectation at least among traders in Venezuelan bonds was that the talks might lead to a lifting of some of the US sanctions on the Venezuelan oil industry.

Yet, after strong blowback from the US Congress about making a deal with the authoritarian Maduro regime, the Biden administration initiative appears to have fizzled out. Thus, notwithstanding the early burst of excitement among certain traders in Venezuelan bonds with respect to the recent Biden administration initiative, there does not appear to be any near-term prospect of a restructuring of Venezuela's debt, particularly since the Maduro regime remains in power and has not committed in any way to meaningful political change in Venezuela or even to conduct truly meaningful discussions with the opposition.

## Other Recent Sovereign Debt Developments

**Failure thus far of the G-20 'Common Framework' initiative**

In November 2020, the G-20 group of nations announced a "Common Framework" initiative for debt restructuring. The idea was to bring non-Paris Club bilateral creditors that are members of the G-20 such as China and India into a Paris Club-type process for restructuring sovereign debt. (China is now the largest bilateral creditor to developing countries.) The Common Framework was designed to provide for a coordinated process involving all major official creditors of a particular sovereign so that members of the Paris Club and non-members of the Paris Club could work together in a joint process on sovereign debt restructurings.

The Common Framework also called on private creditors, when restructuring sovereign debt, to provide debt treatment that is "comparable" to the treatment provided by official creditors in their Paris Club-type debt restructuring process. However, the Common Framework did not address how the notion of "comparability of treatment" would be enforced.

In practice, though, the Common Framework has not gained much traction at all. Only three sovereign debtors—namely, Chad, Ethiopia, and Zambia—have applied for 'treatment' under the Common Framework. Yet, as of now, none of those three countries has completed a sovereign debt restructuring under the Common Framework.

Thus, even as the need for something like the Common Framework may increase significantly in the current unsettled or even turbulent global economic environment, the future for the Common Framework as a useful tool for sovereign debt restructuring remains highly uncertain.

**Debt-for-nature swaps**

Perhaps one of the few bright spots in the area of sovereign debt restructuring in recent times concerns the use of a debt-for-nature swap involving Belize, the small Central American country whose economy is heavily dependent on ecotourism. In 2021, Belize needed to restructure a US$553m so-called 'superbond' it had issued because it did not have the resources to pay the debt service on the bond.

But with the help of The Nature Conservancy (TNC), a non-governmental organization, Belize was able to enter into a restructuring transaction whereby it achieved a huge reduction in its outstanding debt burden in exchange for Belize making a series of commitments to protect and conserve the enormous but delicate barrier reef that lies off the Caribbean coast of Belize. The commitments Belize made included, among other things, agreeing to spend US$4m annually until 2041 on marine conservation efforts and doubling its so-called 'marine protection parks' from 15.9% of its oceans to 30% by 2026.

Thus, this was a classic win-win situation. Belize achieved huge debt reduction (equivalent to 10% of its annual GDP) and the global community achieved commitments for additional conservation and protection of an ecologically vital barrier reef. Going forward, it will be interesting to see the extent to which a Belize-type debt-for-nature restructuring will be replicated

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by other sovereign debtors with important but potentially endangered ecological assets and whose debt is trading at a deep discount.

## Conclusion

The rising level of debt distress in many emerging economies and developing countries in the wake of the war in Ukraine (and lingering economic effects of the pandemic) could well give rise to a very high number of sovereign debt defaults and sovereign debt restructurings. Unfortunately, however, the machinery for sovereign debt restructuring has not changed much in recent years apart from some modifications in sovereign bond contracts, including refinements in collective action clauses (CACs) so that they provide for aggregated voting as opposed to series-by-series voting.

In particular, there is still no bankruptcy-type legal regime for sovereigns (unlike for corporate debtors) nor is there any centralized forum where sovereign debt disputes and restructurings can be negotiated, mediated, arbitrated, and/or otherwise resolved. Thus, the existing global financial architecture has a glaring gap, and that could prove to be detrimental to the resolution of the many sovereign debt defaults and restructurings that are expected in emerging economies and developing countries in the coming period.

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# CRYPTOCURRENCY IN 2022: CRITICAL CONCEPTS, RISK, REGULATION, AND THE ROAD AHEAD

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## Introduction

Blockchain technology is now being referred to as "critical for our nation's future" by former SEC chairman Jay Clayton.[1] Harnessing the capabilities offered by this technology is critical to advancing the state of the financial system, banking the unbanked, and generally improving a centuries-old industry rife with convoluted, inefficient processes.

Since the introduction of the cryptocurrency Bitcoin around 2009, the concepts of blockchain and cryptocurrency have increased in popularity – and controversy. To many, it's a Ponzi-like "get rich quick" scheme with no value. To others, it's the beginning of a new technology paradigm that will impact how we represent, store, and exchange value across the globe. However you see it, there are tangible technology advancements occurring at a rapid pace that are outshined by the very real scams and speculation occurring on top of these systems. But make no mistake about it – blockchain is here to stay in one form or another.

Here, we analyze the dominant themes of the crypto-sphere as we move into 2022, but this is by no means comprehensive. New ideas, projects, applications, and entire blockchains appear every day, which is why it is such an incredibly fast-paced environment.

## Crypto – The Critical Concepts

### What Is Cryptocurrency and the Supporting Blockchain Technology?

As a (very) quick primer, the term "blockchain" refers to a type of distributed ledger system that publicly records transactions between participants within the system in such a way that transactions are **verifiable** and **immutable**. Transactions are verifiable, such that anyone can download a copy of the blockchain ledger and confirm the accuracy and validity of each and every transaction that has been recorded. Transactions are immutable in the sense that once they are written to the blockchain, they are cryptographically ensured to be unalterable; this property also makes transactions irreversible.

A cryptocurrency represents the value being transferred on the blockchain, typically referred to as a "coin" or "token." For example, if Alice "sends" one bitcoin to Bob, all she is doing is telling the network to make an entry in the globally shared ledger. At a very high level, because everyone on the network has the transaction history, they will verify Alice has at least one bitcoin to spend, debit her account, and credit the recipient (Bob). In this way, the blockchain acts as a settlement layer that allows this transfer to occur in a "trustless" manner. There are two primary types of tokens: **fungible** and **non-fungible**. Think of fungible as digital currency (like your Starbucks points) and non-fungible tokens as unique items (like character skins in a video game).

While the concept may seem simple, this type of entirely digitally-native value transfer (*i.e.*, currency) introduces a powerful enabling force: **programmability.**

An **address** on the blockchain can be thought of as loosely analogous to a bank account, in the sense that an individual or entity is able to send and receive funds through the address. When funds are transferred in a **transaction**, effected through an update to the blockchain ledger, the receiving address is credited while the sending address is debited the amount being transferred. Funds are "locked" to an address and subsequently controlled through the use of cryptographic keys. While access to the **private key** is required to move or otherwise control (*i.e.*, send) funds to a different address on the network, anybody can view the transaction history of a particular address given the verifiable, open, and immutable nature of the blockchain.[2]

The evolution of different blockchains over the past few years have led to an impressive amount of technological progress, building on this property of programmability. For example, the

1 Jay Clayton, "America's Future Depends on the Blockchain," *Wall Street Journal,* Dec. 16, 2021, 12:16 PM ET, available at https://www.wsj.com/articles/america-future-depends-on-blockchain-crypto-bitcoin-payments-transfers-federal-reserve-11639668586.

2 This applies to most blockchains today, but others such as Dash and Monero are designed to be private.

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well-known Ethereum blockchain was built from the ground up with the idea that entire programs can be deployed to the system and run independently of human intervention.

Think of Ethereum as a special kind of computer "in the cloud"[3] – it serves as the infrastructure layer that runs code that you can send money to.

This opens an entirely new way of thinking about, interacting with, and utilizing money. We're now applying the blisteringly fast pace of software development and innovation to money itself.

To give you a sense of the potential opportunity, return to Jay Clayton's article, which notes the "credit and securities markets that exceed hundreds of trillions of dollars in asset value" are "ripe for functional change." He goes on to say that "end-to-end tokenization of sovereign currencies, securities, loans, real estate, mortgages, pledges, and related payments and credit" can also be executed using blockchain technology.

## Other Important Crypto Concepts

*LAYER 1S*

Layer 1 refers to the "base layer" of the system – the blockchain itself – and the native "token" that can be transferred on that blockchain. Bitcoin, Ethereum, and Solana are all examples of a Layer 1.

**Bitcoin**

The innovation that kicked off an entire industry, Bitcoin is the largest cryptocurrency by market cap and has been around the longest. Its effectiveness as a cryptocurrency comes down to its simplicity: it is just one big ledger of transactions. Through a globally distributed network of computers, this ledger is constantly updated and agreed upon by its participants in a verifiable way. The breakthrough achieved by the pseudonymous creator Satoshi Nakamoto was this ability to achieve consensus between a network of strangers on the internet in a novel way. Hard-coded into the software is a cap of 21 million Bitcoin; no more will ever be created in the current system.

Some compare Bitcoin to a digital gold. As an asset, Bitcoin has no cash flows, which is why many successful investors don't understand it, won't invest in it,[4] or dislike it so much they call it "rat poison squared."[5] Most valuation methodologies rely on discounting cash flows over a period of time, so of course, the absence of this signals to traditional investors and analysts that there is no inherent value. A bitcoin is not a share of a company, a claim on future cash flows, and is generally not considered a productive asset.

However, if you expand your view of "value" to be that of what is important to the holder, you can derive some, at times admittedly nebulous, value from Bitcoin and cryptocurrencies in general. Advantages espoused by proponents include:

*Store of Value (or HODL)*[6] – While the original Bitcoin whitepaper[7] notes the original design was to create "peer-to-peer version of electronic cash," it has evolved into primarily a store of value. While the ability to conduct peer-to-peer transactions of course remains, its use as a cash substitute has not materialized in any significant way. There are innovations such as the Lightning Network attempting to make cheap payments a reality but have yet to catch on in the mainstream.

*A non-sovereign money* – There is no entity in direct control of Bitcoin, and it is not associated with a particular nation state. Governments can ban it, regulate it, make it illegal to transact with, but cannot influence the supply or global operation of the network.

*Hard money* – Only 21 million bitcoin will ever be in existence and one bitcoin = one bitcoin. While there are derivatives and similar instruments that represent "claim" on bitcoin in other markets, on the Bitcoin network you can only transact with bitcoin.

*Bearer instrument* – For better or for worse, users protect their own assets through the use of private keys. Crypto assets are bearer instruments in the sense that if you have the private key, you effectively "control" the assets locked to that address. Funds are not locked away in a bank vault or on the books of a third-party financial institution.

*Global, resilient network* – The infrastructure is global; you don't need to wait until your bank opens on Monday to transfer value to someone anywhere in the world. Only an internet connection is needed to transact with the network. There is a direct transfer of value between participants with no middle-men facilitating the transaction (which often incurs additional fees).

Whether these properties of Bitcoin are worth a nearly $800 billion market cap today is a subject of constant debate; only time will tell. But don't forget those in relatively unstable countries, those who may use Bitcoin as a way to escape runaway inflation, capital controls, or repressive regimes who confiscate the wealth of their citizens. All you need to cross a border with Bitcoin is a few memorized words.[8]

**Ethereum**

The other major Layer 1, Ethereum, arrived in 2015 seeking to build on the ideas of Bitcoin in a big way. Fundamentally, Ethereum follows the same principle: a ledger of all transactions between participants in the network. But Ethereum is also programmable.

The "money" in this case is the native currency used to power Ethereum transactions: ETH. You can think of Ethereum as one giant distributed computer that uses money to operate. Ethereum has unlocked a wave of innovation, and it enables anyone in the world to create novel programs that leverage the

[3] Jay Clayton, "America's Future."

[4] Paul LaMonica, "Jamie Dimon bashes bitcoin again, calling it 'worthless,'" cnn.com, updated Oct. 12, 2022, available at https://www.cnn.com/2021/10/12/investing/jamie-dimon-bitcoin/index.html.

[5] Tae Kim, "Warren Buffett says bitcoin is 'probably rat poison squared,'" CNBC.com, updated May 6, 2018, 10:48 AM ET, available at https://www.cnbc.com/2018/05/05/warren-buffett-says-bitcoin-is-probably-rat-poison-squared.html.

[6] For the uninitiated, "HODL" – a play on the word "hold" – is used throughout the community to refer to being (and staying) long a particular token. Hold On for Dear Life for those with "diamond hands," as they say.

[7] Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System," Bitcoin.org, available at https://bitcoin.org/bitcoin.pdf.

[8] A mnemonic phrase – typically 12 to 24 words – can be used to derive a private key instead of remembering a string of random numbers and letters.

unique properties of a distributed, immutable compute layer. The Ethereum network serves as the "infrastructure layer," allowing developers to build applications that interact with each other on the network.

Ethereum is the technology platform that has enabled the explosion of new cryptocurrencies and projects that live "on top of" the infrastructure that it provides. It's behind the infamous NFT craze, which are special tokens that are one-of-a-kind, or 'non-fungible,' that you can mint and own on Ethereum. Because of its programmability, innovation thrives, and developers continue to flock to the system and those like it. An entirely new industry is beginning to emerge, on its way to engulf aspects of gaming, finance, computing, media, and more.

**Others**

There are many other emerging Layer 1s, including Solana, Avalanche, and Polkadot, that seek to offer benefits over the "original" systems like Bitcoin and Ethereum. Transaction throughput, interoperability, and lower fees are just a few examples of the advantages of these alternative blockchains.

The crypto ecosystem is quickly coalescing around the idea of a multi-chain world that allows various siloed Layer 1s or other systems to talk to each other. Only time will tell how this will play out.

*LAYER 2S*

Layer 2s are just beginning to emerge, so will not be covered in detail here, but know that there are multiple competing efforts to increase the scale and throughput of these Layer 1 systems, with the primary focus on scaling Ethereum.

Layer 1s are often slower and have less throughput due to design choices that keep them secure. Layer 2s attempt to solve this problem by creating "side chains" that record transactions that eventually settle to Layer 1. They play by slightly different rules, which allows them to reaaacord transactions at a much faster pace. Some examples of Ethereum Layer 2s include Polygon, Optimism, and Arbitrum, but there are many more.

The industry is moving towards a "multichain" future focused on exchanging data *between* blockchains such that developers can leverage the advantages of different solutions. This space is just starting to evolve and will be an interesting one to watch.

## Today's Crypto Landscape

### Scams, Waste, and Status Symbols

The elephant in the room is worth addressing up front: much of crypto today is absolutely rife with scams, speculation, hacking, hand-waving, contradictions, and naivete.

Due to the open nature of the blockchain, a copycat project can be created, deployed, and promoted with little effort. Scammers regularly take advantage of novices in the space, tricking innocent people into divulging their wallet's password to steal their funds. Hackers identify and exploit bugs in smart contracts, draining them of the assets under their control. And proponents of the space produce excellent and informative podcasts, essays, and videos full of impressive, albeit optimistically futuristic, ideas – but they sometimes fail to grasp basic economics or acknowledge inherent limitations in the logic of their arguments.

There is significant waste in the system, as the space has attracted some bad[9] actors, leading to many instances of lost funds.[10] There are even crypto "yield farming" pools claiming to offer 1,000% APY. This is evidence of a nascent, growing, but still very immature industry, which seems like a natural byproduct of the central innovation being financial in nature. If this was simply developers playing with a novel database technology, it wouldn't get nearly the same level of attention and no one would care, and scammers may not be as attracted to the space. But because we have moved from "magic internet money" to "this could threaten the U.S. financial system,"[11] the entire space has increased in popularity, for better or worse.

Many people have become incredibly rich from of the rise in cryptocurrencies over the past few years, which leads to an almost religious zeal about the tokens that yielded this wealth. NFTs have become not only a status symbol, but an asset worth hundreds of thousands to millions of dollars. For example, an NFT from the "Bored Ape Yacht Club" recently sold[12] for 93 ETH, worth approximately $350,000 USD. In 2021, the $SHIB token rose 3,413,999,900%; Dogecoin rose 3,602%. Projects with little substance are often "pumped to the moon" with little to no concept of any inherent value. However, beyond the extremes, there are things worth paying attention to.

Many of the market dynamics we see in the crypto ecosystem provide examples of why we have many financial regulations in the first place. Wash trades, market manipulation, and lack of liquidity are common. Many find themselves rediscovering the downsides of an unregulated marketplace in a very volatile market.

### Emergence as an Asset Class

That being said, at the time of writing the global market capitalization of cryptocurrencies is $2 Trillion USD.[13] That's more than the market caps of: JP Morgan, Bank of America, Wells Fargo, Morgan Stanley, Charles Schwab, RBC, Goldman Sachs, and HSBC– combined. That number is likely inflated due to the lack of liquidity in many of these markets, but even halving that number shows crypto's staggering presence. Ethereum and Bitcoin, two of the most liquid, combine for approximately $1.2 trillion. Volatility aside, returns over time (for the established assets) have been surprisingly impressive.

Bitcoin, for example, has performed exceptionally well, handily beating all asset classes, albeit over a short timeframe of approximately 10 years. Naturally, an asset starting at $0 and rising to approximately $60k will outperform just about anything, yet

9 Taylor Locke, "Over $7.7 billion stolen in crypto scams in 2021 and 4 other updates you should know," Dec. 20 2021, 3:46 PM EST, CNBC.com, available at https://www.cnbc.com/2021/12/20/crypto-news-7-billion-dollars-stolen-in-crypto-scams-in-2021-radioshack-defi.html.

10 Bayan Wang, "Denver man loses $1.6 million in new 'Pig Butchering' cryptocurrency scam," thedenverchannel.com, last updated 1:06 AM, Dec. 22, 2021, available at https://www.thedenverchannel.com/news/contact-denver7/denver-man-loses-1-6-million-in-new-pig-butchering-cryptocurrency-scam.

11 Thomas Franck, "Elizabeth Warren presses Janet Yellen, regulators to address 'growing threats' in crypto market," CNBC.com, updated Thu., Aug. 12, 2021, 7:07 AM EDT, available at https://www.cnbc.com/2021/07/27/elizabeth-warren-presses-yellen-financial-regulator-to-manage-crypto.html.

12 The Bored Ape Yacht Club, NFT Token ID #6434, OpenSea.io, https://opensea.io/assets/0xbc4ca0eda7647a8ab7c2061c2e118a18a936f13d/6434.

13 Coingecko.com, https://www.coingecko.com/en.

Continued from p.29

**Exhibit 1: Asset Class Total Returns Over Last 10 Years (as of 3/13/21)**

| ETF | ASSET CLASS | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 YTD | 2011-21 CU-MULATIVE | 2011-21 ANNUAL-IZED |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| N/A | Bitcoin ($BTC) | 1473% | 186% | 5507% | -58% | 35.0% | 125.0% | 1331.0% | -73.0% | 95.0% | 301.0% | 109.0% | 20037142% | 230.6% |
| QQQ | US Nasdaq 100 | 3.4% | 18.1% | 36.6% | 19.2% | 9.5% | 7.1% | 32.7% | -0.1% | 39.0% | 48.6% | 0.5% | 541.3% | 20.0% |
| SPY | US Large Caps | 1.9% | 16.0% | 32.2% | 13.5% | 1.2% | 12.0% | 21.7% | -4.5% | 31.2% | 18.0% | 5.4% | 282.4% | 14.0% |
| IWM | US Small Caps | -4.4% | 16.7% | 38.7% | 5.0% | -4.5% | 21.6% | 14.6% | -11.1% | 25.4% | 20.0% | 19.1% | 244.7% | 12.9% |
| VNQ | US REITs | 8.6% | 17.6% | 2.3% | 30.4% | 2.4% | 8.6% | 4.9% | -6.0% | 28.9% | -4.7% | 7.9% | 147.7% | 9.3% |
| TLT | Long Duration Treasuries | 34.0% | 2.6% | -13.4% | 27.3% | -1.8% | 1.2% | 9.2% | -1.6% | 14.1% | 18.2% | -13.5% | 88.7% | 6.4% |
| PD | Preferred Stocks | -2.0% | 17.8% | -1.0% | 14.1% | 4.3% | 1.3% | 8.1% | -4.7% | 15.9% | 7.9% | -0.6% | 76.3% | 5.7% |
| EFA | EAFE Stocks | -12.2% | 18.8% | 21.4% | -6.2% | -1.0% | 1.4% | 25.1% | -13.8% | 22.0% | 7.6% | 4.6% | 76.3% | 5.7% |
| HYG | High Yield Bonds | 6.8% | 11.7% | 5.8% | 1.9% | -5.0% | 13.4% | 6.1% | -2.0% | 14.1% | 4.5% | -0.2% | 71.0% | 5.4% |
| LQD | Investment Grade Bonds | 9.7% | 10.6% | -2.0% | 8.2% | -1.3% | 6.2% | 7.1% | -3.8% | 17.4% | 11.0% | -6.4% | 69.4% | 5.3% |
| EMB | EM Bonds (USD) | 7.7% | 16.9% | -7.8% | 6.1% | 1.0% | 9.3% | 10.3% | -5.5% | 15.5% | 5.4% | -5.8% | 62.4% | 4.9% |
| TIP | TIPS | 13.3% | 6.4% | -8.5% | 3.6% | -1.8% | 4.7% | 2.9% | -1.4% | 8.3% | 10.8% | -2.1% | 40.3% | 3.4% |
| EEM | EM Stocks | -18.8% | 19.1% | -3.7% | -3.9% | -16.2% | 10.9% | 37.3% | -15.3% | 18.2% | 17.0% | 4.5% | 39.8% | 3.3% |
| BND | US Total Bond Market | 7.7% | 3.9% | -2.1% | 5.8% | 0.6% | 2.5% | 3.6% | -0.1% | 8.8% | 7.7% | -3.7% | 39.5% | 3.3% |
| GLD | Gold | 9.6% | 6.6% | -28.3% | -2.2% | -10.7% | 8.0% | 12.8% | -1.9% | 17.9% | 24.8% | -9.5% | 16.4% | 1.5% |
| BIL | US Cash | 0.0% | 0.0% | -0.1% | -0.1% | -0.1% | 0.1% | 0.7% | 1.7% | 2.2% | 0.4% | 0.0% | 4.8% | 0.5% |
| DBC | Com-modities | -2.6% | 3.5% | -7.6% | -28.1% | -27.6% | 18.6% | 4.9% | -11.6% | 11.8% | -7.8% | 18.5% | -34.9% | -4.1% |
| **Highest return** | | BTC | BTC | BTC | VNQ | BTC | BTC | BTC | BIL | BTC | BTC | BTC | BTC | BTC |
| **Lowest return** | | EEM | BIL | GLD | BTC | DBC | BIL | BIL | BTC | BIL | DBC | TLT | DBC | DBC |
| **% of asset classes positive** | | 65% | 94% | 41% | 65% | 41% | 100% | 100% | 6% | 100% | 88% | 47% | 94% | 94% |

*Source: @CharlieBilello; YCharts.*

the annualized returns are just as impressive, returning 230.6% on an annual basis. The table from Twitter user CharlieBilello in Exhibit 1[14] captures the dominance well.

This has caught the attention of retail, institutions, and companies alike. Crypto assets under management have grown from $190 million in 2016, to $59.6 billion, as of October 2021[15] and is not likely to stop any time soon. Crypto companies are putting their marketing budgets to work as well – see FTX Area (where the Miami Heat play) and the renaming of the legendary Staples Center to the Crypto.com Arena. Even U.S. sports superstars like Tom Brady, Kevin Durant, and Steph Curry are getting involved, either appearing in commercials or participating in the crypto community itself.

We've also seen "experimentation" with holding digital assets on corporate balance sheets. In perhaps an extreme example, MicroStrategy holds approximately 122,478 BTC on its balance sheet; Tesla has also famously held Bitcoin on its books. Public miners such as Marathon Digital and BitFarms have entire business models dedicated to generating revenue from cryptocurrencies.

Volatility in the space will remain as crypto becomes more mainstream, new entrants emerge, and projects are built. Lots will fail, but many will succeed. The inherent volatility and "wild west" nature of the space should not prevent us from having an open mind and learning more about realizing the potential of a new technology.

## Web3: A New Paradigm

While the markets may be volatile, it is an indication of a thriving and engaged community that is excited about the future. The good and the bad are amplified because we're talking about a new technology; one that has the potential to fundamentally alter how we interact with the financial system, so controversy inevitably follows.

Regardless of what you think of the space, the pace of innovation is impressive. By its nature, the blockchain is open, transparent, and able to be built upon by anyone. This allows rapid innovation in the open and naturally allows other interested parties to observe, iterate, adapt, and evolve that much more quickly than other industries. There are questions surrounding the real-world use cases for the technology that still need to be worked out.

However, the innovation of blockchain has led to a new term becoming synonymous – perhaps overtaking – the concept of cryptocurrency: Web3 (or Web 3.0).

To many, the internet is evolving once more: starting with simple websites (1.0), to major FAAMG corporate-owned platforms (2.0), to an emerging user-owned distributed paradigm (3.0). The following description of the evolution has been mentioned elsewhere,[16] yet it bears repeating because it boils down the fundamental shifts we're seeing into a few key concepts: Web

[14] CharlieBilello, "Asset Class Returns over the Last 10 Years… ," posted March 13, 2021, https://twitter.com/charliebilello/status/1370722188739891202.

[15] Cryptocurrency Investment Fund Industry Graphs and Charts, https://cryptofundresearch.com/cryptocurrency-funds-overview-infographic/.

[16] Cdixon, posted Nov. 11, 2021, https://twitter.com/cdixon/status/1459036992050716697.

1.0 – Read, Web 2.0 – Read/write, and Web 3.0 – Read/write/own – or Execute.[17]

Web3 embodies the concept that users own their identity and their assets in a way that is portable. A crypto wallet can send and receive funds, sometimes across multiple blockchains. As a user, your crypto wallet acts as your identity. Web3 services allow you to connect your wallet and then look up additional information about that wallet on the blockchain. In effect, this inverts the traditional web 2.0 model by moving ownership from the service to the user. A commentator notes that "one of the main attractions of web3 vs. web2 is that the user is no longer the product being sold, but a network participant being rewarded for their active contributions."[18]

As a concrete example, the assets in your wallet can be used to customize the user experience – if you recently bought an NFT from Adidas,[19] the avatar could be used in a future video game or other website to reflect this purchase. If a consumer wants to read an article, they can pay the creator immediately using an integrated wallet at the click of a button. They can also register an "ENS" name, a kind of domain name for web3 that is then used by these services to further customize the experience.

## Major Concepts Related to Crypto and Web3

Major concepts arising out of crypto and web3 include the following which are each discussed separately: tokens, decentralized finance (DeFi), stablecoins, nonfungible tokens (NFT), decentralized autonomous organization (DAO), gaming, and currency.

### Tokens

There are thousands of tokens listed on sites like coingecko.com, which track the price and market capitalization across exchanges. There are the "layer 1" tokens, like Bitcoin and Ethereum, but also a slew of others that have been built *on top of* blockchains themselves. Take, for instance, USDC or Wrapped BTC (WBTC), both of which live on the Ethereum blockchain. These tokens follow the "ERC-20" standard, which allows participants in the system to interact with them in the exact same way – the benefits we'll see in a moment with DeFi.

Anyone can create a token simply by deploying a contract to the Ethereum blockchain. One can define how many tokens should exist (the total supply), who can own or receive them, and generally add any type of functionality they wish. The ease by which one is able to create tokens has certainly led to scams (known as "rug pulls"), manipulated marketplaces, and pump-and-dumps. But it has also led to the emergence of some promising, special-purpose, tokens that can be used throughout the crypto-ecosystem.

### Decentralized Finance (DeFi)

Arguably the main engine of growth over the past two years has been the impressive growth of decentralized finance (DeFi). DeFi is an ecosystem of smart contracts that provide financial tools such as borrowing, lending, trading, and other yield-producing mechanisms. DeFi is powered by, among other things, decentralized exchanges (DEX). These DEXs are smart contracts deployed to the blockchain that cannot be otherwise changed or interfered with. As a simple example, these contracts allow you to trade any digital asset for another, e.g., swapping ETH for USDC and vice versa. The chart in Exhibit 2 (on p. 32) from the Bank of International Settlements captures the growth from essentially $0 to over $240 billion "locked" in DeFi applications.

Because at its core a blockchain is a settlement layer, DeFi has the potential to change how individuals and entities interact with each other. In a sense, one could argue it's a pure example of a capitalistic free market. Everything is transparent: trades across DEXs, leverage in the system, sometimes individual positions. But this new way of thinking has the potential to unlock new ways of transferring, building, or settling value.

Platforms like Aave and Yearn allow for supplying or borrowing liquidity in different tokens. The non-custodial[20] DEX called dYdX allows for leveraged trades using synthetic derivative financial instruments. Synthetix is a "derivatives liquidity protocol providing the backbone for derivatives trading in DeFi." Yield farming services aggregate many different DeFi building blocks together to maximize yield across the ecosystem.

Automated market makers (AMMs) such as Uniswap create markets for token pairs, e.g., USDC and ETH. Individuals can become "liquidity providers," supplying assets to a swap pool in return for a cut of the fees when a swap occurs, generating yield.

And all of this functionality is enabled through the use of smart contract programs. Once deployed, there are no humans involved to facilitate these interactions.

There are criticisms that much of the space is circular in nature, *i.e*., that yield comes from swapping tokens amongst each other or that yields are synthetically derived from unstable pools of liquidity. There's also "Miner Extractable Value" (MEV), which is the ability for cryptocurrency miners to order transactions in such a way to create arbitrage opportunities. "Searchers" will pay miners a fee for accepting a set order of profitable transactions – often at the expense of an innocent user who will quite often lose money or not get the same amount of funds they were expecting. Entirely new market dynamics are emerging that take advantage of the unique opportunities offered by this new technology that is not well understood, and even less regulated.

### Stablecoins

Stablecoins are special tokens intended to provide price stability, typically pegged to the U.S. Dollar. The U.S. Treasury puts it succinctly: "stablecoins are generally created, or 'minted,' in exchange for fiat currency that an issuer receives from a user or third-party. To maintain a stable value relative to fiat

[17] One could argue Execute because you can deploy and run your own logic on a global computer for anyone to use that also interacts with anyone else's code. "Ownership" is merely a byproduct of the underlying capabilities enabled by the system.

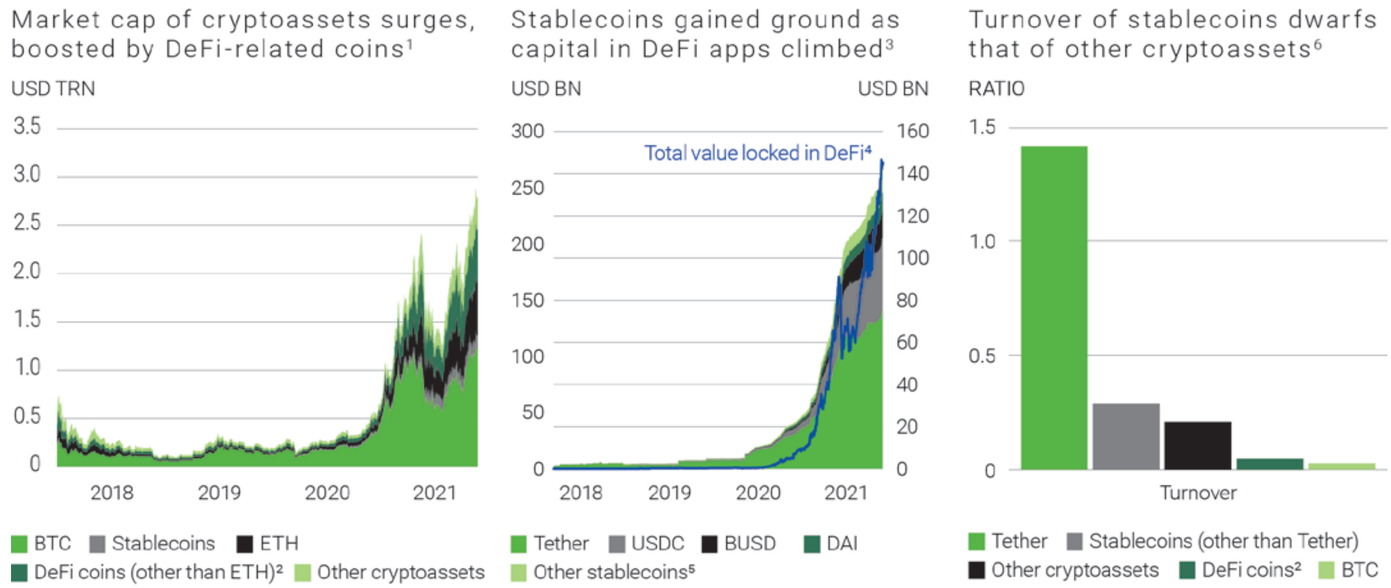
[18] Ansem, 2022 General Market Outlook, posted Dec. 31, 2021, https://blknoiz06.substack.com/p/quarter-i-2022.

[19] *See* https://www.adidas.com/into_the_metaverse/mint.

[20] Non-custodial means you retain control of your assets, unlike a centralized exchange such as Coinbase.

Continued from p.31

**Exhibit 2: DEFI Underpins the Rapid Growth in Crypto Activities**




1. Market capitalisation of top 100 cryptoassets as of 15 November 2021 (seven stablecoins, 36 DeFi coins and 55 other cryptoassets).
2. Cryptoassets issued by DeFi platforms.
3. Stacked areas plot stablecoins' value in circulation. The selected stablecoins are those ranked as the top four by market capitalisation as of 15 November 2021.
4. Total value locked refers to the size of capital pools underpinning DeFi protocols. The sample includes 679 protocols.
5. Includes 57 other stablecoins.
6. Based on the top 20 cryptoassets by market capitalisation as of 15 November 2021 (three stablecoins, 10 DeFi coins and seven other cryptoassets). Turnover is the monthly average of the daily volume-to-market capitalisation ratio from 15 October to 15 November 2021.

Sources: Bank for International Settlements (full publications are available on the BIS website free of charge at www.bis.org); CoinGecko; Defi Llama; authors' calculations

currency, many stablecoins offer a promise or expectation that the coin can be redeemed at par upon request."[21]

This allows you to remain within the crypto ecosystem while preserving capital or generally dampening the effects of volatility in other native assets like ETH. Stablecoins such as Tether and USDC are issued by real-world entities that, in theory, should back each issued coin with a USD cash equivalent in their reserve. However, there have been allegations[22] against certain issuers that claim this isn't always the case.

Interestingly there are also *algorithmic* stablecoins, such as RAI or FEI, which utilize pools of liquidity or actual mathematical equations coded into smart contracts that attempt to hold the peg to the U.S. dollar. The robustness of these mechanisms under considerable pressure has yet to be proven.

Their use continues to grow: at the time of writing the total value of circulating stablecoins is approximately $150 billion.[23] Stablecoins are likely high on the list of regulators to address first, since they are effectively "printing" money, as we'll explore later.

[21] President's Working Group on Financial Markets, the FDIC, and the Office of the Comptroller of the Currency, *Report on Stablecoins*, Nov. 1, 2021, 4, https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf. *See also* https://home.treasury.gov/news/press-releases/jy0454.

[22] Tim Hakki, "Tether Accused of 'Unlawful and Deceptive' Practice in New Class-Action Lawsuit," Decrypt.com, Dec. 14, 2021, available at https://decrypt.co/88250/tether-accused-unlawful-deceptive-practice-class-action-lawsuit.

[23] The Block, Total Stablecoin Supply (chart), theblock.co, https://www.theblockcrypto.com/data/decentralized-finance/stablecoins/total-stablecoin-supply-daily.

## NFTs

A non-fungible token, known as NFT, is a scarce or unique digital asset that you can own (and transfer) with your crypto wallet. They can be used to prove ownership, establish governance, provide access and membership perks to a community, or serve as a collectable. Much like a limited edition playing card or sportscar, a creator can "mint" a limited number of NFTs on the blockchain. From then on, everyone on the blockchain can see how these assets are transferred and which wallets own them. The popularity and value come from the "legitimacy" that you own a "real" one because *your* address *demonstrably* owns that asset; ownership is recorded in the blockchain.

Profile picture (PFP) NFTs like "CyptoPunks" or the "Bored Ape Yacht Club" are the posterchild of speculation at the moment, with pixelated pictures being sold for hundreds of thousands of dollars. Some see these as a cultural status symbol, with big names like Steph Curry and Shaq getting involved. Others point to these sales as a prime example of the ridiculousness of the market. For the more popular ones, we simply don't know whether it'll turn out to be as valuable as a collectable Lebron James card or a repeat of the Beanie Baby fad. For many of the copycat projects, it would appear closer to the latter.

The idea is catching on in the sports world. Tom Brady recently launched autograph.io, a platform dedicated to creating NFTs as collectable sports memorabilia. There's also NBA TopShot, which at its peak was trading some $32 million per day.[24]

[24] Tim Copeland, "NBA Top Shot Sees $32 Million of Trading Volume in a Day," Decrypt.co, Feb. 22, 2021, available at https://decrypt.co/58473/nba-top-shots-sees-32-million-of-trading-volume-in-a-day.

But behind the speculation really is a potentially useful technology that can be applied in all sorts of novel ways that haven't been explored yet. It can be used to unlock new potential in membership, ownership, representation, badging, etc.

One potential use case (ignoring significant regulatory, industry, and technical challenges) would be ownership of a stock. Much like you may have stock certificate #1234 of Acme Co, you could digitize that into an NFT with dividend payments being dispersed automatically to all holders of the NFT. We're already seeing companies explore paying dividends with Bitcoin.[25]

Gary "Vee" Vaynerchuk[26] is using NFTs as a kind of collectable crossed with a ticket gaining exclusive access to future events. NFTs in this sense can be used to signal community, status, or be used for more utilitarian purposes such as tickets.

Finally, the Ethereum Name Service (ENS) uses NFTs to establish ownership of a new kind of domain name. Instead of registering google.com with ICANN and multiple other intermediaries, you can register your own. ens name and use that as your identity. With web3 services, your ENS name becomes a human-readable form of your actual crypto address.

## DAOs

DAO stands for a Decentralized Autonomous Organization, which can be thought of as a type of online collective where participants from around the world coalesce to advance a common goal. DAOs often have large treasuries of "donations" or funds from users, which grant them access to participate in the DAO. Because they're built on the rails of crypto, DAOs have a built-in financing mechanism that allow anyone to contribute funds to the DAO's treasury, and then vote as a collective on how to utilize the funds.

While the original concept of a DAO was devoid of humans altogether, today they've evolved into more of a collective construct. Typically, a small team of creators will launch a DAO, write code of applicable smart contracts, and manage the community. Members of a DAO may also receive tokens specific to that DAO, called "governance tokens," or leverage NFTs to signal (and enforce) membership.

Governance tokens are somewhat analogous to shares in a company, in the sense that community members are able to vote on proposals to the DAO. If a proposal receives enough votes, the DAO adopts the changes in the proposal in accordance with the community vote. In some circumstances, this process is automated, such that code is deployed upon approval of the vote. As an example, governance proposals for DeFi protocols may choose to divert some fee revenue to token holders, increasing the value of the token in turn.

Two recent examples show the breadth of ideas out in the market: First, the ConstitutionDAO was a collection of individuals with one goal: buy one of the remaining thirteen copies of the U.S. Constitution that was recently put on sale at Sotheby's. It raised over $40 million[27] but was just outbid by Ken Griffin.

Similarly, recently launched LinksDAO has sold NFTs to fund the purchase and operation of a golf course, in an effort to create a "modern golf and leisure club."

Some say DAOs may represent the future of capital formation and individual organization; to others, these efforts look suspiciously similar to the 2017 ICO boom or the proliferation of unregistered securities.

Only time will tell to see how effective these DAOs are compared to more traditional organizations.

## Gaming

Play-to-earn games have emerged as a type of hybrid on-and-off chain experience, where players interact with characters that they own on the blockchain. Instead of winning points in the traditional sense, they receive an in-game currency that is then tradable on the Ethereum blockchain using the DeFi protocols mentioned before. NFTs are used to represent in-game items like avatars, clothing, or other collectables.

The popular example of this is Axie Infinity, which at its peak exceeded one million users and was generating $364,000 in just one month.[28] Through September 2021, the AXS token native to the game had increased 14,155% giving it a total market cap of $5.12 billion USD, although it has since come down considerably.

## Currency

Ray Dalio defines a money[29] as a portable medium of exchange and storehold of wealth, most useful when recognized in multiple countries. One could argue Bitcoin and Ethereum satisfy these properties and are already a form of new alternate money.

The day-to-day use of crypto assets as a money to buy something like groceries has not taken hold in the mainstream, but there are advancements such as Bitcoin's Lightning Network that are being built to make this a reality.

Dalio also makes the case that, because of the depreciated value of existing fiat currencies caused by the incredible amount of money that has been printed by Central Banks, we will begin to see a competition for alternate moneys emerge. Whether that happens at scale remains to be seen, but the tools are there for cryptocurrencies to become an "alternate money" on the global stage.

El Salvador, perhaps controversially, has declared Bitcoin a legal tender that requires all businesses in the country to accept it. The Lightning Network and new emerging technologies are being deployed to onboard the millions of users in the country.

25 Michael Bellusci, "Blockchain Firm BTCS to Offer Dividend in Bitcoin; Shares Surge," Coindesk.com, updated Jan 5, 2022, 7:52 AM PST, available at https://www.coindesk.com/business/2022/01/05/blockchain-firm-btcs-to-offer-dividend-in-bitcoin-shares-surge/.

26 Welcome to VeeFriends, https://veefriends.com/.

27 Nilay Patel, "From a Meme to $47 Million: ConstitutionDAO, Crypto, and the Future of Crowdfunding," Dec. 7, 2021, available at https://www.theverge.com/22820563/constitution-meme-47-million-crypto-crowdfunding-blockchain-ethereum-constitution.

28 Ajibola Akamo, "Axie Infinity Generates $364 Million in August, Highest Since Inception," Nairametrics, Sept. 6, 2021, available at https://nairametrics.com/2021/09/06/axie-infinity-generates-364-million-in-august-highest-revenue-since-inception/.

29 "Ray Dalio: Money, Power, and the Collapse of Empires," Lex Fridman Podcast #251, Dec. 25, 2021, https://www.youtube.com/watch?v=TISMidxdZoc?t=4587.

Continued from p.33

Even Sotheby's, the esteemed auction house, recently quoted[30] prices of items in ETH.

One could see a natural extension of this technology be applied to securities as well. While nearly all securities transactions today are digital in nature, there's a complex web of brokerages, market makers, clearing houses, and other regulated entities that facilitate the transfer and distribution of securities and dividends.

We've even seen a well-regarded financial institution, Societe Generale, submit a proposal[31] to a DAO to refinance a bond represented as a digital asset on Ethereum. The industry is just beginning to experiment with these new ways of representing and transferring value.

## The Environmental Impact of Crypto

Satoshi Nakamoto's invention of Bitcoin relied on a novel way of achieving consensus on this network of strangers, which is famous for its perceived "waste" of resources: proof of work. At a high level, proof of work is the process by which transactions are added to the blockchain. The novel mechanism devised by Nakamoto secures the network by having "miners" continuously expend compute power in search of a solution to a mathematical puzzle. Because all miners are doing this simultaneously, no one knows who the next miner will be to successfully solve the puzzle. While this is great from a security perspective, the process was intentionally designed to continuously utilize compute resources that incentivizes securing the network instead of attacking it but isn't exactly energy efficient. Ethereum uses a different algorithm, **and until "The Merge" – a major upgrade to switch to a more "green" consensus mechanism – occurs, Ethereum** still relies on the same Proof of Work concept as Bitcoin.

Recent studies have pegged Bitcoin's energy usage at around 110 terawatt-hours per year, which is roughly equivalent to the energy usage of Sweden.[32]

There have been many articles written on the potential environmental implications of cryptocurrencies that use proof of work. However, not all of them tell the full story. According to Bitcoin proponent Nic Carter, many of these articles misunderstand[33] Bitcoin or make unfair comparisons. Because Bitcoin itself is a self-enclosed monetary settlement system, he argues, energy comparisons to single companies like Visa are unfair since they in turn rely on other financial intermediaries to eventually settle the transactions. This is an ongoing debate in the community but is one that requires a nuanced understanding.

30 Adam Cochran, posted Nov. 18, 2021, 3:13 PM, https://twitter.com/adamscochran/status/1461472758353870860.

31 Société Generale -Forge, [Security Tokens Refinancing] MIP6 Application for OFH Tokens, Sept. 2021, https://forum.makerdao.com/t/security-tokens-refinancing-mip6-application-for-ofh-tokens/10605.

32 Nic Carter, "How Much Energy Does Bitcoin Actually Consume?" *Harvard Business* Review, May 5, 2021, available at https://hbr.org/2021/05/how-much-energy-does-bitcoin-actually-consume.

33 Nic Carter, "What Bloomberg Gets Wrong About Bitcoin's Climate Footprint," CoinDesk, updated Sep. 14, 5:08 AM PDT, available at https://www.coindesk.com/markets/2021/02/08/what-bloomberg-gets-wrong-about-bitcoins-climate-footprint/.

Bitcoin has also spurred innovation in the energy sector. Take, for example, natural gas producers, who have recently teamed up with Bitcoin miners[34] to harness excess gas that is normally "flared" (or burned off). Bitcoin miners are capturing what would otherwise be completely wasted energy.

Miners who move to low-cost energy providers may act as a "buffer" for extra energy that isn't of immediate use to the grid, such as in West Texas, where an explosion of solar projects actually produce more energy than is needed. This has led to Bitcoin miners "acting as a kind of shock absorber [where] they buy up excess energy when it's not needed, then shut down their mining rigs when demand surges."[35]

Another interesting, albeit optimistic, example is El Salvador, where they are planning to harness energy from a local volcano to mine Bitcoin.[36] Whether this comes to fruition remains to be seen, but it is a taste of the type of ideas being explored in the space.

To address similar concerns, the Ethereum development community is actively developing an alternative to proof of work, known as "Proof of Stake." In this model, miners "stake," or escrow, their digital assets as they participate in the transaction validation process. If they act maliciously, such as approving an invalid transaction, the funds they have in escrow are taken by the network. This incentivizes good behavior without the need for extensive computing power. By some estimates, the move to Proof of Stake will reduce energy consumption by 99.95% compared to today's network.[37]

Other ideas are being explored as well. Solana uses a "Proof of History" that develops consensus using provenance of time and order of events instead of expenditure of computing power. Others are being developed and will continue to do so as the market matures, and the environmental impacts are better understood.

By some estimates, the move [from Proof of Work] to Proof of Stake will reduce energy consumption by 99.95% compared to today's network.

## The Regulatory Environment

Cryptocurrency has certainly caught the attention of governments and regulators around the world. China is among some eight countries that have banned it outright.[38] Others are putting restrictions on the use, transfer, or mining of crypto.

34 Laila Kearney, "Oil Drillers and Bitcoin Miners Bond over Natural Gas," May 21, 2021, 4:07 AM PDT, available at https://www.reuters.com/business/sustainable-business/oil-drillers-bitcoin-miners-bond-over-natural-gas-2021-05-21/.

35 Christopher Helman, "Green Bitcoin Mining: The Big Profits in Clean Crypto," *Forbes,* Aug. 2, 2021, available at https://www.forbes.com/sites/christopherhelman/2021/08/02/green-bitcoin-mining-the-big-profits-in-clean-crypto/?sh=2fa52dab34ce.

36 "El Salvador Bitcoin City Planned at Base of Conchagua Volcano," BBC.com, Nov. 21, 2021, https://www.bbc.com/news/world-latin-america-59368483.

37 Carl Beekhuizen, "Ethereum's energy usage will soon decrease by ~99.95%," Ethereum Foundation Blog, posted on May 18, 2021, https://blog.ethereum.org/2021/05/18/country-power-no-more/.

38 Marco Quiroz-Gutierrez, "Crypto is fully banned in China and 8 other countries," *Fortune,* Jan. 4, 2022, 1:11 PM PST, available at https://fortune.com/2022/01/04/crypto-banned-china-other-countries/.

Still others are more amenable to the technology, such as Portugal, where cryptocurrency has been exempt from capital gains and VAT.[39]

In the U.S., there's an interesting jurisdictional battle unfolding between the SEC and CFTC. Early on, CFTC effectively claimed jurisdiction of major cryptos (e.g., Bitcoin and Ethereum) by designating them a commodity.[40] Other players, such as Treasury, the Fed, and OCC will become increasingly involved as they work through issues and better understand the technology. Ultimately, it's very likely the Financial Services Oversight Council (FSOC) will have an outsized role in up driving much of the policy response and implementation, having members from the Federal Reserve, SEC, OCC, FDIC, CFPB and others.

There are very real risks that must be sorted out, as summarized by industry figure Ryan Selkis:[41]

- Exchange Risks – Lack of insurance, liquidity risks, hacks.
- Stablecoins – Unregulated money printing, draining of liquidity, market stability.
- Banking Integration – Unclear "rules of the road" that serve as the on/off ramps to crypto.
- AML – Pseudonymous nature of crypto makes enforcement and surveillance more difficult.
- Tax Evasion – Coin mixing services, unlimited wallet creation, esoteric decentralized services make tax enforcement and visibility difficult.
- Securities Fraud – The open nature has attracted scammers and grifters taking advantage of the system.
- User Privacy – Due to its inherently open nature, blockchain technology can be at odds with the push for global privacy. There remain open questions on regulations around tying real-world identities to individual addresses.

## Regulatory Developments

Arguably the biggest regulatory development over the past year was the Infrastructure Bill that pushed through requirements widely seen in the community as detrimental and, in some cases, unrealistic. An analysis by Gibson Dunn[42] captures this concern; for many DeFi services "there is no way for a business that receives a digital asset from a liquidity pool to trace the asset to particular individuals or entities." It also shows that the Bill requires reporting of any digital asset transaction over $10,000, which in practice may be impossible for some DeFi services because they run in a completely decentralized manner completely devoid of human intervention. It also expands the definition of "broker" to potentially include software developers, wallet manufacturers, DeFi services, and others.

Industry advocacy groups are beginning to emerge to fix the problem: the Blockchain Association, led by Kristin Smith, is a coalition of major players in crypto and has done a great job of promoting practical and reasonable legislation. Coin Center, Fight for the Future, the Crypto Council for Innovation, and the Chamber of Digital Commerce are still more examples of DC groups emerging to promote smart crypto policy. Investors are getting involved too: a16z, the well-known VC fund, has stepped up lobbying efforts; Paradigm, a crypto-focused fund, has also gotten into the mix.

In the U.S., crypto-friendly jurisdictions are also emerging. Wyoming[43] has created a "special purpose depository institution" provision allowing chartered banks to deal with crypto assets. This allows for a state-regulated entity to deal with crypto assets such as Bitcoin directly, although the provision requires assets to be "fully reserved and generally prohibits lending using customer deposits of fiat currency." The state even passed a law recognizing DAOs[44] as a legal entity for any "limited liability company whose articles of organization contain a statement that the company is a decentralized autonomous organization."

## Stablecoins

Stablecoins are likely the first target for serious regulation because they are, in effect, money printers. Private entities such as Tether and Circle (which manages the USDC coin) mint tokens that are pegged to the U.S. dollar for use in the crypto economy.

The SEC is maneuvering for control over this area. In recent testimony to Congress,[45] SEC Chairman Gensler mentioned "stable value coins" as a focus of the Commission, a potential nod towards their existing authority to regulate stable value *funds*.

Similarly, a joint report[46] from the President's Working Group on Financial Markets, the FDIC, and OCC notes multiple regulatory gaps and risks relating to stablecoins. Similar to traditional markets, stablecoin issuers are vulnerable to a "run" on assets that, if are not managed appropriately, could lead to the collapse of the stablecoin and a loss of billions in (perceived) value.

As stablecoin issuers continue to grow, they may well represent systemic risks: first to the crypto market, and possibly others as well.

As the report notes, "if insured depository institutions lose retail deposits to stablecoins, and the reserve assets that back stablecoins do not support credit creation, the aggregate growth of stablecoins could increase borrowing costs and impair credit availability in the real economy". Currently there's a dislocation in the market, where traditional banks are not the issuers of

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39 https://www.forbes.com/sites/kellyphillipserb/2019/09/19/portugal-tax-authorities-clarify-that-buying-or-selling-cryptocurrency-is-tax-free/?sh=66902f7e77e3.

40 William Foxley, "CFTC Chairman Confirms Ether Cryptocurrency Is a Commodity," CoinDesk, updated Sep. 13, 2021, https://www.coindesk.com/markets/2019/10/10/cftc-chairman-confirms-ether-cryptocurrency-is-a-commodity/.

41 *Crypto Theses for 2022,* https://messari.io/pdf/messari-report-crypto-theses-for-2022.pdf.

42 "Infrastructure Bills New Reporting Requirements May Have Sweeping Implications for Cryptocurrence Ecosystem," GibsonDunn, Nov. 18, 2021, https://www.gibsondunn.com/infrastructure-bills-new-reporting-requirements-may-have-sweeping-implications-for-cryptocurrency-ecosystem/.

43 Gina Chon, "Cryptocurrency's Wild West Is in Wyoming," *Reuters*, July 7, 2021, available at https://www.reuters.com/breakingviews/cryptocurrencys-wild-west-is-wyoming-2021-07-07/.

44 State of Wyoming 66th Legislature, Bill Text: SF0038 - Decentralized Autonomous Organizations, accessed July 2022 at https, ://www.wyoleg.gov/Legislation/2021/SF0038.

45 Testimony of Gary Gensler Before the United States Senate Committee on Banking, Housing, and Urban Affairs, Sept. 14, 2021, available at https://www.banking.senate.gov/imo/media/doc/Gensler%20Testimony%209-14-21.pdf.

46 President's Working Group on Financial Markets, the FDIC, and the Office of the Comptroller of the Currency, *Report on Stablecoins*, Nov. 2021, https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.

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stablecoins, and thus these tokens are created "outside" the traditional financial system. While the report notes a valid concern of liquidity being taken away from banks (which then should lend out for productive uses of capital), we're still a long way off from impacting markets in this way.

Certainly, uninformed participants who view stablecoins as "cash" with the same guarantees as an FDIC-insured bank account may not fully understand the financial, technological, and other risks that they are taking on.

The fact that "95% of stablecoins by value" are pegged to the U.S. dollar could be seen as an opportunity to incorporate digital assets into the U.S. financial system. Crypto assets already represent a universal, global settlement layer, albeit not exactly compatible with the traditional financial system. Complementary technical and regulatory advancements are needed to make this a reality. As Clayton observes, "primacy of the U.S. dollar is by no means certain." Just ask Ray Dalio.[47]

### Looking Ahead

Referring back to Jay Clayton's piece, because it so succinctly captures many important concepts including his perspective on regulation, he says that "[r]egulation is essential to our financial markets, and there is no doubt that tokenized financial assets should be regulated to ensure financial stability, promote capital formation, prevent illicit activity, and protect consumers." While there may not be many crypto-maximalists enamored by the idea of government intervention or regulation, it is a necessary component of any successful mainstream adoption of the technology. It is simply impossible to operate outside the bounds of existing regulatory frameworks and thrive as an industry.

This is why direction and clarity from regulators is so important. The industry has been seeking a better understanding of the rules of the road for some time now, and regulators are beginning to do their research.

## Institutional Adoption

Because of volatility, regulatory uncertainty, and general lack of understanding, many institutions have been unable or hesitant to participate in a meaningful way. This arena is clearly volatile, still has a stigma, and is not well understood. Many legal questions remain unresolved and have yet to be tested in court.

There is also a lack of public financial instruments (in traditional markets) that provide the type of exposure that many may want, or be required, to hold. The first Bitcoin ETF application was 2013,[48] but as of this writing no cryptocurrency spot ETF has been approved. There are financial products that provide exposure through an open-ended private trust, purchased by accredited investors who can then sell them on secondary markets (e.g. GBTC), but these are not a long-term solution. Jurisdictional questions remain between SEC, CFTC, Treasury, OCC, DoJ, among others, which will serve to contribute to regulatory uncertainty until these are resolved.

That being said, an eye-opening study from Fidelity Digital Assets[49] shows that "70% of all investors surveyed had a neutral-to-positive perception of digital assets" and that "nearly 8 in 10 investors surveyed felt digital assets have a place in a portfolio." While "44% of investors surveyed shared that the lack of fundamentals to gauge appropriate value as a barrier to investment," "nearly 9 in 10 investors surveyed said they found digital assets appealing." The digital asset space is certainly an exciting one to watch as institutional investors begin to dive in to learn more.

### Risk Management

Regulatory questions aside, financial institutions need to better understand the risk profile of these assets. Because these systems are global in nature, traditional AML/KYC systems and transaction monitoring systems won't work. If this is going to serve as the financial rails of the future (still a big if), there will inevitably need to be significant work done to integrate blockchain data with legacy monitoring and risk systems. The industry will need transaction monitoring, sanctions enforcement, and generally new ways of thinking about mitigating illicit financial activity.

Thankfully, in 2021 only 0.15% of cryptocurrency transaction volume was illicit, according to Chainalysis.[50]

Many questions remain in this area, as banks and financial institutions will need to decide which blockchains to support, use for settlement, and how far "down the rabbit-hole" to go. Do they host nodes directly, or use third party data providers? How do we track and classify "bridged" assets across blockchains? What about blockchain forks? Hacked funds? "Dust" transactions from sanctioned parties? All of these questions and more will need to be reconciled before used as an "approved" method of financial exchange. But it is coming.

## Conclusion

There is much more to crypto than simply scams, ponzis, and criminals (although those certainly exist as well). There is meaningful progress being made in cryptography, financial technology, and arguably, economics and money as we know it. Crypto is an example of our world becoming increasingly digital at an increasingly rapid pace. No one knows what is just around the corner, but the pace of innovation thus far is promising for what this industry will produce next, with work ongoing in identity, banking, and payments, to name just a few.

Commissioner Clayton may be on to something – America's (and the West's) acceptance of blockchain technology and what it offers could be critical to our collective success.

The regulatory landscape will continue to evolve, and as it does, we should see continued adoption of "real" use cases of the technology. Illegitimate projects will get washed out, the

47 Katherine Burton, Erik Schatzker, and Bloomberg, "Ray Dalio Issues Stark Warning About U.S. Dollar's Future as Global Reserve Currency," *Bloomberg*, Sep. 15, 2020, available at https://fortune.com/2020/09/16/ray-dalio-us-dollar-global-reserve-currency/.

48 Nathaniel Popper and Peter Lattman, "Winklevoss Twins Plan First Fund for Bitcoins," *The New York Times,* July 1, 2013 8:53 PM, available at https://dealbook.nytimes.com/2013/07/01/first-name-in-the-first-fund-for-bitcoins-winklevoss.

49 Accessed July 2022, at https://www.fidelitdigitalassets.com/bin-public/060_www_fidelity_com/documents/FDAS/2021-digital-asset-study.pdf.

50 "Crypto Crime Trends for 2022: Illicit Transaction Activity Reaches All-Time High in Value, All-Time Low in Share of All Cryptocurrency Activity," chainalysis.com, Jan. 6, 2022, available at https://blog.chainalysis.com/reports/2022-crypto-crime-report-introduction/.

scammers caught, and companies becoming defunct. However, continued digitization of the world's financial system will continue to evolve, and chances are blockchain technology will be involved.

Many questions remain, but one thing is certain: the pace of technological innovation is accelerating. So keep an open mind, dive in, and continue to learn.

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# 38TH ANNUAL BANKRUPTCY & RESTRUCTURING AWARDS & HONORS

## 2022 MANNY KATTEN AWARD PRESENTED TO KENNETH J. MALEK

AIRA's 2022 Emanuel M. Katten Award was bestowed on Kenneth J. Malek, CIRA, CDBV, at a ceremony in June, during AIRA's 38th Annual Conference. The following article includes comments made by AIRA President David Payne during his presentation of the award, followed by Ken Malek's acceptance. The AIRA congratulates Ken on this prestigious recognition of his many contributions to the Association and to the profession.

### PRESENTATION REMARKS BY DAVID PAYNE

My name is David Payne, and I will be presenting the Manny Katten award this evening. My remarks about tonight's recipient, Ken Malek, began with a trip to West Point over Memorial Day weekend. A trial in New York finished a day early, which allowed me to travel to West Point to honor the men and women who have served our country. While waiting at the visitor's center for my background check to be completed for entrance onto the campus, I looked up at the entryway signage which stated: "Leaders of Character". Below those words were the following: "Duty", "Honor", and "Country". As I continued to wait for completion of my background check, I began to formulate my thoughts regarding Ken. I concluded that "Commitment To Service" should replace the attribute of "Duty", "Competence" should replace "Honor" and "Professional Organizations" should replace "Country" in organizing my remarks and presenting Ken Malek with this award.

After I was approved for entry onto the West Point campus, I proceeded to the 1910 Cadet Chapel, wherein I read several statements regarding the qualities of Cadets: (1) "Endeavor to Live Above the Common Level of Life"; (2) "Loyalty to All That is Noble and Worthy"; and (3) "Grant Us New Ties of Friendship and New Opportunities of Service". Ken Malek possesses these qualities.

**Commitment To Service** — First, I will describe Ken's "Commitment To Service". I reached out to Ken's partner, Bob Remian, to inquire about Ken's commitment and obtained the following response: "Work, Work, Work". So how does one stay so committed to service in an industry where so many assignments involve adverse parties and interests over a forty (40) plus year career? The answer: you have a passion for interests outside of our profession. Ken Malek has those outside interests. For example, Ken is a blue-ribbon owner of seven Saddlebred horses and he is also a classic car collector. He also sponsors a classic car show called "Car Fun on 21" which raises funds to support local businesses in Ken's hometown of Libertyville, Illinois.

**Competence** — Next, I will recite Ken's "Competence". I first met Ken when we were both employed at Arthur Young & Co. in 1987. Ken was in the Chicago office, and I was in New York. Ken transitioned into the insolvency practice from a tax background. Back in the 1980s the tax practice was an incubator for both insolvency advisors and valuation professionals. Ken's competence is based upon both his "attention to detail" and his knowledge as a "student of the law". He received his B.S. Degree in Accounting and an M.S. Degree in Taxation from DePaul University in 1976 and 1978, respectively. Ken holds the alphabet soup of certifications: CPA, CIRA, CDBV, CTP, CFF, and CGMA. He has been qualified as an expert and testified in Delaware, Illinois, Texas, Indiana, Louisiana, Michigan, and Virginia to name a few states. He has been involved in numerous cases including: Allis Chalmers, Mercury Finance, Wickes Furniture, and Global Crossing. Ken recently testified in a matter involving a $625 million damage award in which the court found Ken's damage model to be "Logical, Well Supported and Well Reasoned".

**Professional Organizations** — Finally, I will recount Ken's involvement in Professional Organizations. Ken is a Founding Board of Directors member of the Association of Insolvency Accountants (AIA), the predecessor in name to the AIRA. He attended the August 1984 Summit Meeting and the October 1984 Steering Committee Meeting, at which time the AIA had eighty-eight (88) regular and associate members. Ken actually served on the Board with Manny Katten as a Founding Director in 1984. Ken was intimately involved in the formative years of developing certification materials for members which led to the roll-out of the CIRA Program in 1992. He served as President of AIRA from 1996 to 1998 and as Chairman from 1999 to 2001. Ken is part of the first class of Fellows nominated by the AIRA. In addition to serving the AIRA, Ken is an ambassador in other professional organizations including: (1) being elected a 1996 Fellow in the American College of Bankruptcy for the 7th Circuit, (2) serving on the Board of Trustees for the TMA, and (3) working on the Valcon Advisory Board.

**Closing** — Before I close my remarks, I must state that one of Ken's best qualities is that he builds interpersonal relationships. For example, on December 23, 2021, when most of us are busy preparing for the holidays, Ken sent me an email stating "Warmest Wishes To You and Ann for a Safe and Delightful Holiday". Without further comment, it is my honor to present Ken Malek with the Katten Award.

## MANNY KATTEN AWARD ACCEPTANCE REMARKS BY KENNETH J. MALEK, CIRA, CDBV

I am humbled and honored to receive the 2022 Manny Katten Award.

The honor of associating with the AIRA board members has been one of the most cherished aspects of my career. I remember working for our first three presidents Alex Knopfler, Pete Gibbons, and Dan Armel. I remember the ever enthusiastic and affable Bob Seideman, Mike Policano, and our long-time Board member and now Executive Director, Jim Lukenda. And of course there was Randy Waits, for whom we named the CIRA Randy Waits Award, who took friendly but fiendish delight in his inquisitions of our treasurers' reports at quarterly AIRA Board meetings, keeping his techniques ever sharp for 2004 exams. Neither you nor I will ever forget Professor Grant Newton – the main architect of our certification program – as well as Valda Newton, as they served in countless other key roles with the AIRA.

And one person who really stands out in my mind is Manny Katten (the Chair of our first annual conference), a big presence in our industry but a generous, humble man defined most by his contributions.

For the benefit of our members who joined in the past two decades, this letter explains Manny Katten's key role in founding the AIRA and helping propel it to the national educational and professional organization it has become.

Our friend Manny Katten was a mentor to many icons and stalwarts of our industry, during his practice leadership positions at the Spicer Oppenheim firm and at Arthur Andersen. After Manny's untimely passing in 1999, your AIRA Board voted at its October 1999 meeting to establish the Emanuel "Manny" Katten Award, to be bestowed annually on an individual selected by the Board for demonstrating exceptional leadership, dedication and service to the bankruptcy, restructuring, and turnaround field.

Manny was the Chairperson of the first AIRA Annual Conference – held in October 1985 – and was a founding Board Member. A former partner and friend of Mr. Katten attested, "Manny was a big, affable guy who liked everyone and in return was loved by all. He left us way too soon." Each year, the Board selects the recipient of the Manny Katten Award based on contributions that best commemorate the spirit and legacy of Manny's giving tirelessly to the restructuring profession.

I had the privilege and pleasure of knowing Manny through his many years of service and financial support to the AIRA, from 1984 until he passed away in early 1999. Manny was a national leader in establishing the role of the accountant and financial advisor in bankruptcy and restructuring proceedings, under the then new regime of the 1978 Act. His reputation in the restructuring community and his leadership in our 1985 annual conference helped put AIRA on the map and attracted the support of many large professional services firms – LEGAL, FINANCIAL, AND TURNAROUND - throughout the country. We continue Manny's legacy at this conference.

In 2022, the AIRA celebrates its 38th year of providing key education in the form of its Annual Bankruptcy and Restructuring Conference. This culminates over 42 years during which the AIRA and its predecessor organizations have been in the forefront of the restructuring field, serving professionals in business turnaround, bankruptcy and restructuring practice. We believe that our educational and certification programs, with broad appeal across a range of professional disciplines, provide the platinum standard of education for financial and business practitioners engaged in the distressed business field.

It is only because of the support of our members, through your firms, through your attendance and participation, through sending new recruits to our AIRA bootcamps of CIRA and CDBV certifications … through sharing your expertise and serving as valued speakers at our programs … it is only through you that Manny Katten's vision lives on. So let us stand and take our glasses for a toast – TO MANNY KATTEN AND TO EACH OF YOU, THE FUTURE OF THE AIRA.

Remembering that our host city Cleveland is home to the Rock and Roll Hall of fame – please stand and let your voices ring out with me:

*ROCK AND ROLL*
*HOOTCHIE COO*
*LET'S GO OUT AND SPREAD THE NEWS*
*MANNY KATTEN'S VISION LIVES ON*
*THROUGH ME AND YOU …*
*BY OUR SUPPORTING THE AIRA*

It is my honor and privilege to accept the 2022 Manny Katten award. Thank you and good evening.

# AIRA INDUCTS 2022 DISTINGUISHED FELLOWS

*The AIRA inducted the class of 2022 Distinguished Fellows during the AIRA's 2022 annual conference in June. This article includes the presentation of Distinguished Fellows and Alan Holtz's acceptance on behalf of the class.*

## PRESENTATION REMARKS BY DAVID BART

It is my distinct pleasure to introduce the new class of AIRA Distinguished Fellows.

Several years ago, AIRA's Board of Directors conceived and launched the Distinguished Fellows Program to recognize the significant contributions that AIRA's senior members have made to the art and science of corporate restructuring and to AIRA. This program is intended as an academic and professional honor for those AIRA members who exemplify the highest level of excellence in professional practice and whose contributions have left a significant positive legacy to our profession and to AIRA.

The new Fellows inducted tonight have contributed in many ways to the profession and to AIRA. They have served as a distinguished judge and educator, provided important leadership in AIRA as well as the Turnaround Management Association (TMA) and American Bankruptcy Institute (ABI), provided years of service on the AIRA board, taught the AIRA's CIRA and CDBV certification courses, presented and organized AIRA and other professional conferences, published articles and books, and most importantly, founded this organization. Congratulations to you all on your generosity and your many professional contributions over the years.

We will now introduce the 2022 fellows, and then Alan Holtz, a former AIRA Chair and President, Manny Katten Award Recipient, and a Silver Medalist on the first CIRA examination, will accept on behalf of the entire class of new fellows. Since we did not meet live in 2021, we will also recognize the 2021 class of fellows tonight, to recognize their accomplishments.

With that, I am pleased to welcome as new AIRA Distinguished Fellows:

| CLASS OF 2022 | CLASS OF 2021 |
|---|---|
| Larry Ahearn | David Berliner |
| Ed Bond | Judge Kevin Carey |
| Jay Crom | Steve Darr |
| Walter Greenhalgh | Ken Malek |
| Alan Holtz | Jose Monge |
| Soneet Kapila | Tom Morrow |
| Ted Phelps | Grant Newton |
| Judge Jerrold Poslusny | Valda Newton |
| Tonny Sasso | Grant Stein |
| Matt Schwartz | Terri Stratton |
| Angela Shortall | |
| Joel Waite | |

## ACCEPTANCE REMARKS BY ALAN HOLTZ

Thanks so much for the introduction, David. I appreciate the opportunity to accept the Distinguished Fellows award on behalf of all 12 recipients this year. Angela Shortall, Matt Schwartz, Joel Waite, and Judge Poslusny should be in the room this evening, and if you could each stand for a moment, that would be great.

I am fortunate enough to have known and worked alongside 15 of the other 21 honorees from this year and last. So, at least with respect to these 15, I know that the honor is very well deserved. And by extrapolation, I can assume that it is also well deserved for the other 7 of us!

I am personally humbled to be counted among this truly distinguished group, and I thank the AIRA Board for recognizing me and my work for the organization and in the restructuring industry in this way. Further, on behalf of those mentioned before who are with us tonight, and the other 2022 honorees: Larry Ahearn, Ed Bond, Jay Crom, Walter Greenhalgh, Soneet Kapila, Ted Phelps, and Tony Sasso, I accept the honor of becoming an AIRA Distinguished Fellow and thank the AIRA.

From personal experience, it is easy for me to say that serving on the AIRA Board and helping to perpetuate and grow the organization was one of the most fulfilling opportunities in my professional career. The cliché "a labor of love" comes immediately to mind when I think back to my time as an active member of the AIRA. With respect to service and contributions to the industry, I can say that nothing better could have happened to me professionally than receiving a call from Art Newman in April of 1988, when he offered me the opportunity to leave the audit practice at a firm then called Ernst & Whinney, and to become a member of his recently formed group that focused on helping troubled businesses. Truthfully, I got into restructuring because almost anything sounded better than being an auditor – and not because I foresaw the fulfilling career that restructuring would provide.

The profession which I — and the other Distinguished Fellows and all of you in this room — have selected can be intense at times and a little quiet at others, but a few things are certain:

- There will always be cycles of economic downturns.
- There will always be some bad management teams and bad decision making.
- There will always be a lack of "institutional memory."
- There will always be the same mistakes made from business cycle to business cycle.

Fortunately, businesses that suffer from these ailments have us "company doctors" to help them, and as much as we all serve our clients and the industry, it is clear that the industry serves us well, making much of what we all do a true "labor of love."

Fortunately, as professionals in the industry, we have the Association of Insolvency and Restructuring Advisors to support us and the profession.

On behalf of all the 2022 Distinguished Fellows, we thank the AIRA for its service and contributions to the industry and once again, for recognizing our own contributions.

*Ken Malek during his acceptance speech.*

*Some of the 2021 and 2022 Distinguished Fellows present at the banquet: Matthew Schwartz, Joel Waite, Alan Holtz, David Berliner, Ken Malek, and Hon. Jerrold Poslusny*

# 2022 Class of Distinguished Fellows

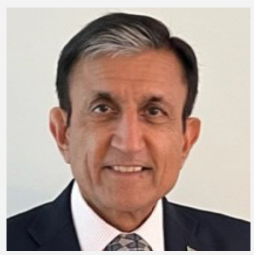
**Lawrence Ahern, III**
*Brown & Ahern*

**Edward Bond, CIRA**
*Bederson LLP*

**Jay Crom, CIRA**
*Bachecki Crom & Company LLP*

**Walter Greenhalgh**
*Duane Morris LLP*

**Alan Holtz, CIRA**
*AlixPartners, LLP*

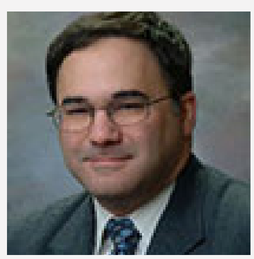


**Soneet Kapila, CIRA**
*KapilaMukamal, LLP*

**Theodore Phelps, CIRA, CDBV**
*FVLS Consultancy*

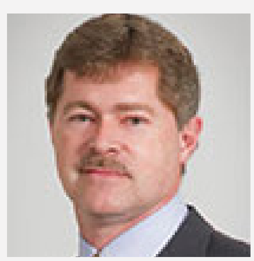
**Hon. Jerrold Poslusny Jr.**
*U.S. Bankruptcy Court*

**Anthony Sasso, CIRA**
*Deloitte Financial Advisory Services LLP*



**Matthew Schwartz, CIRA**
*Bederson LLP*

**Angela Shortall, CIRA**
*3Cubed Advisory Services, LLC*



**Joel Waite**
*Young Conaway Stargatt & Taylor LLP*

*EDITOR'S NOTE: For those interested in additional information about AIRA's Distinguished Fellows program, please see the AIRA website at https://www.aira.org/aira/fellows.*

# 2022 ALIXPARTNERS CIRA AWARDS

**The AlixPartners CIRA Awards were conferred upon candidates who earned the top composite scores for all three parts of the CIRA exam completed by end of the previous year.**

## 1st PLACE: Thomas Prince, CIRA – *AlixPartners, LLP*

Thomas Prince is a Vice President in the Turnaround and Restructuring practice at AlixPartners, based in Houston. He advises debtors and creditors, with an emphasis on representing Official Committees, and has extensive experience in the Oil & Gas industry. Thomas has worked with clients on both in- and out-of-court complex restructurings, including providing support through business plan development, liquidity forecasts, valuations, litigation support, bankruptcy preparation and administration, sales processes, and plans of reorganization. In his downtime, Thomas spends his time performing with the Pearland Community Band and supports other organizations including the Chevron Houston Marathon Run for a Reason Program, Texas Center for the Missing, and local and national parks programs. Thomas earned his Bachelor of Science in Finance from Louisiana State University (LSU). Economics, and a BA from the University of Michigan with a concentration in Economics.

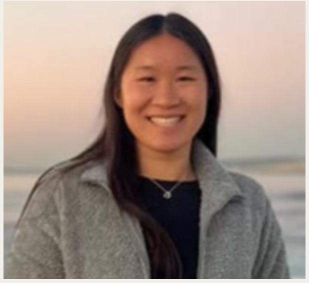
## 2nd PLACE: David Katz, CIRA – *Alvarez & Marsal*

Dave Katz is a Senior Managing Director in FTI Consulting's Corporate Finance & Restructuring segment, based in Houston. Dave specializes in restructuring and turnaround, performance improvement, liability management, and ESG and capital markets execution. Prior to joining FTI, Dave was a Managing Director at JP Morgan, where he headed the firm's North American Risk coverage of oil & gas, metals & mining, utilities, diversified industries, transportation, chemicals, and paper & packaging. Dave earned an MBA from Northwestern University's Kellogg School of Management and a BA in Mathematical Economic Analysis from Rice University. Dave is a Chartered Financial Analyst (CFA).

## 3rd PLACE: Conor Jackson, CIRA – *GLC Advisors & Co, LLC*

Conor Jackson is an Associate at GLC Advisors & Co., based in New York, where he focuses on advising companies and creditors through bankruptcy reorganizations, out-of-court workouts, financing, and M&A transactions. Conor was previously a credit analyst at several commercial banks where he sourced, underwrote and managed portfolios of middle market and broadly syndicated loans. He received his Bachelor of Science in Business Administration from the McDonough School of Business at Georgetown University and is a Chartered Financial Analyst (CFA).

# AIRA GRANT NEWTON EDUCATIONAL ENDOWMENT FUND 2022 SCHOLARSHIP

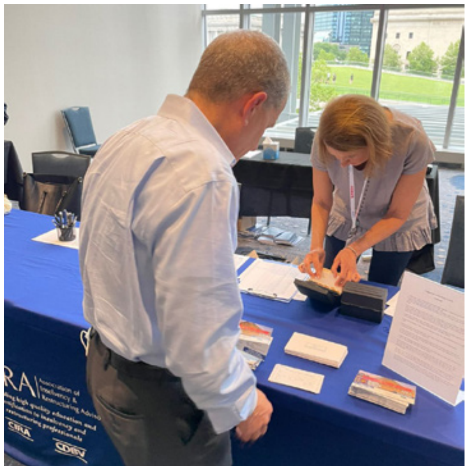


## CONGRATULATIONS TO ISABELLA TSAI

A junior from Southern California, Isabella Tsai is a highly motivated student and a student leader on campus. She is outstanding academically and has been elected by her peers as the incoming Accounting Society President. This past year, Isabella was part of the winning Pepperdine team in the Global Innovation Challenge organized by the Center for Accounting Transformation. She has strong data analytics skills and is a great asset to the Accounting Program, working as a teaching assistant for the Financial Accounting course. Recognizing the importance of children in our society, Isabella comes up with fun activities to facilitate learning for young kids through JumpStart. She is very creative and particularly enjoys Italian and Mexican food. The AIRA is pleased to honor Isabella and wishes her all the best in the future.


## BACK IN-PERSON AND READY TO ROCK!




Guardians
AT THE OLD BALL GAME
PROGRESSIVE


Joyce
Barker


Ulmer


Simkulak
O'Neil
Dubow

# 38TH ANNUAL BANKRUPTCY & RESTRUCTURING CONFERENCE SPONSORS

## THANK YOU TO OUR SPONSORS FOR THEIR GENEROUS SUPPORT OF THE CONFERENCE!

**AlixPartners**

AlixPartners is a results-driven global consulting firm that specializes in helping businesses successfully address their most complex and critical challenges. Our clients include companies, corporate boards, law firms, investment banks, private equity firms, and others. Founded in 1981, AlixPartners is headquartered in New York, and has offices in more than 20 cities around the world. For more information, visit www.alixpartners.com.

**ArentFox Schiff**

ArentFox Schiff LLP is internationally recognized in core industries where business and the law intersect. With more than 600 lawyers and policy professionals the firm serves as a destination for an international roster of corporations, governments, private individuals, and trade associations.

**epiq**

Epiq, a global technology-enabled services leader to the legal services and corporations, takes on large-scale, increasingly complex tasks for corporate counsel, law firms, and business professionals with efficiency, clarity, and confidence. Clients rely on Epiq to streamline the administration of business operations, class action and mass tort, eDiscovery, regulatory, compliance, restructuring, and bankruptcy matters. In the restructuring space, Epiq provides full support for all types of bankruptcy and restructuring cases for companies of all sizes including pre-filing consulting, claims management, solicitation and balloting, creditor notification, strategic communications, escrow services and disbursement, and virtual data rooms.

**FTI™ CONSULTING**

FTI Consulting is an independent global business advisory firm dedicated to helping organizations manage change, mitigate risk and resolve disputes: financial, legal, operational, political and regulatory, reputational and transactional. Individually, each practice is a leader in its specific field, staffed with experts recognized for the depth of their knowledge and a track record of making an impact. Collectively, FTI Consulting offers a comprehensive suite of services designed to assist clients across the business cycle — from proactive risk management to the ability to respond rapidly to unexpected events and dynamic environments.

Pachulski Stang Ziehl & Jones LLP (PSZJ) is the nation's leading corporate restructuring boutique, with offices in Los Angeles, San Francisco, Wilmington (DE), New York, and Houston. PSZJ attorneys are experienced in representing all major constituencies in bankruptcy proceedings and out-of-court workouts, including debtors, committees, trustees, bondholders, asset-purchasers and third-party plan proponents. PSZJ also handles sophisticated business litigation and transactional matters as part of its renowned practice. The firm is perennially named a "Best Law Firm" by U.S. News & World Report, and was named a 2021 and 2020 Bankruptcy and Restructuring "Practice Group of the Year" by Law360.

Thompson Hine's Business Restructuring group is the go-to resource for business clients confronted with borrowers, customers, suppliers, partners, or competitors in financial distress. We provide peer-recognized excellence in representation with innovative pricing and service delivery that improves predictability and transparency and minimizes risk. Clients turn to us to address their most consequential issues knowing that we will provide the highest quality counsel and deliver exceptional service and results in all aspects of insolvency law, from acquiring a distressed target to protecting and enforcing creditor rights and remedies, in both in court and out of court restructurings.

Privately-held since 1983, Alvarez & Marsal is a leading global professional services firm that delivers performance improvement, restructuring & turnaround and business advisory services to organizations seeking to transform operations, catapult growth and accelerate results through decisive action. We advise on every aspect of the process from strategic direction to liquidity management to business plan development, helping management, investors, or creditors seeking to accelerate performance, overcome challenges and maximize value across the corporate and investment lifecycles. We fill executive officer roles, on an interim basis, to help guide companies through crises and other challenging business or economic environments.

Bederson is a full-service accounting and advisory firm with offices in Fairfield and West Orange, New Jersey. The firm's West Orange office comprises six partners, professional and support staff solely dedicated to providing insolvency and litigation services. For close to ten years, the firm has attained top recognition by New Jersey's legal community for service expertise in bankruptcy, business valuations, forensic accounting and business accounting. Bederson is privileged to have helped clients in the legal community, private business and home offices reach optimal outcomes since 1937.

CohnReznick LLP is one of the leading advisory, accounting, and tax firms in the United States, combining the deep resources of a national firm with the hands-on, agile approach that today's dynamic business environment demands. Many of the country's top companies, lenders, law firms, and investment firms call on CohnReznick's Restructuring and Dispute Resolution team to assist in transitional, stressed, and distressed situations. The Firm, with origins dating back to 1919, is headquartered in New York, NY with 2,700 employees in offices nationwide. CohnReznick is a member of Nexia International, a global network of independent accountancy, tax, and business advisors.

CR3 Partners is a national financial advisory consulting firm serving organizations and stakeholders across a broad range of industries during times of transition, opportunity, or distress. Our team consists of seasoned executives and industry veterans who bring a profound bias for action and exceptional results, with a keen focus on turnaround management, restructuring, forensic accounting, litigation support, and operational improvement services. From our offices in Atlanta, Boston, Charlotte, Chicago, Dallas, Houston, Los Angeles, New York, and Richmond, CR3 Partners infuses agility, passion, experience and value creation into everything we do. To learn more, please visit us at www.cr3partners.com.

Deloitte Turnaround and Restructuring is a leader in helping organizations transform periods of financial difficulty or crisis into opportunities for resilience. Having led both large multinational organizations and mid-market companies through unprecedented challenges, we apply our unrivalled experience and superior foresight to achieve successful outcomes for our clients, their creditors and equity holders. Whether the goal is to enhance the performance of a healthy company or guide stakeholders through complex bankruptcy reorganization, our team works closely with the client to quickly understand their business and most urgent issues.

Development Specialists, Inc. (DSI) is one of the leading providers of management consulting and financial advisory services, including turnaround consulting, financial restructuring, litigation support and forensic accounting. Our clients include business owners, private-equity investors, corporate boards, financial institutions, secured lenders, bondholders and unsecured creditors. For almost 40 years, DSI has been guided by a single objective: maximizing value for all stakeholders. With our highly skilled and diverse team of professionals, offices in the U.S. and international affiliates, and an unparalleled range of experience, DSI not only achieves that objective, but has also built a solid reputation as an industry leader.

Duane Morris LLP, a law firm with more than 800 attorneys in offices across the United States and internationally, is asked by a broad array of clients to provide innovative solutions to today's legal and business challenges. Evolving from a partnership of prominent lawyers in Philadelphia a century ago, Duane Morris' modern organization stretches from the U.S. to Europe and the Middle East, and now across Asia. Throughout this global expansion, Duane Morris has remained committed to preserving its collegial, collaborative culture that has attracted many talented attorneys. The firm's leadership, and outside observers like the Harvard Business School, believe this culture is truly unique among large law firms, and helps account for the firm continuing to prosper throughout changing economic and industry conditions.

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Since 1943, Foley Hoag has represented public and private clients in a range of disputes and transactions around the world. We have established a record of success in industries such as life sciences, health care, technology, energy/renewables, investment management and professional services. We also offer our clients market-leading international litigation and arbitration services, and unmatched counsel in the evolving field of corporate social responsibility. From our offices in Boston, Washington, D.C., New York, and Paris, we provide creative, strategic legal advice tailored to clients' unique goals. Our regional, national and international practices share a common emphasis on superior client service.

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FORVIS was created by the merger of equals between BKD and DHG. We now have the scale and scope of a dynamic, top 10 professional services firm—but we'll continue our legacy of Unmatched Client Experiences with remarkable care, expertise, and drive.Our clients benefit from a single organization with the enhanced capabilities of an expanded national platform, deepened industry mastery, greater resources, and innovative advisory services. Our aim is to help you succeed today while preparing you to forge ahead into a clear future.

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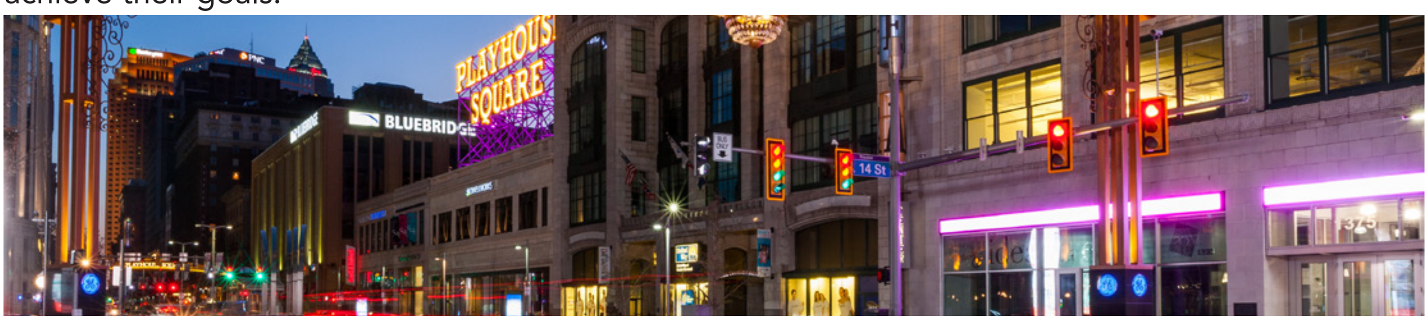
Founded in 1920, Hahn Loeser & Parks LLP celebrates more than a century of client service. Today, Hahn Loeser has six offices and more than 130 attorneys representing Fortune 500 corporations, privately held businesses, non-profit institutions, governmental entities and individuals and families across the country and around the world. Our attorneys have been recognized for their commitment to outstanding client service and their dedication to partnering with our clients to provide creative and strategic solutions that help them achieve their goals.



Huron is a global consultancy that collaborates with clients to drive strategic growth, ignite innovation and navigate constant change. Through a combination of strategy, expertise and creativity, we help clients accelerate operational, digital and cultural transformation, enabling the change they need to own their future. Huron's business advisory experts offer a full suite of services in key areas, including capital advisory, commercial dispute advisory, investment banking, interim management, operational improvement, restructuring and turnaround, transaction advisory, and valuation.

Marcum LLP is a national accounting and advisory services firm dedicated to helping entrepreneurial, middle-market companies and high net worth individuals achieve their goals. Since 1951, clients have chosen Marcum for our insightful guidance in helping them forge pathways to success, whatever challenges they're facing. Marcum offers a complete spectrum of tax, assurance and advisory services. Marcum's industry-focused practices offer deep insight and specialized services to privately held and publicly registered companies, and nonprofit and social sector organizations. Through the Marcum Group, the Firm also provides a full complement of technology, wealth management, and executive search and staffing services. Headquartered in New York City, Marcum has offices in major business markets across the U.S. and select international locations. #AskMarcum

We are a boutique consulting firm representing debtors, creditors, and trustees in all aspects of bankruptcy proceedings. We have built our business to assist parties in the most thought intensive and efficient manner. Through our experience and knowledge of the Court process, we learned parties dealing with distress and bankruptcy need an experienced team of financial professionals to provide proactive Bankruptcy Services; Litigation Support and Expert Testimony; and Forensic and Investigative Accounting.

SSG Capital Advisors is an independent boutique investment bank that assists middle-market companies and their stakeholders in completing special situation transactions. We provide our clients with comprehensive investment banking services in the areas of mergers and acquisitions, private placements, financial restructurings, valuations, litigation and strategic advisory. SSG has a proven track record of closing over 400 transactions in North America and Europe and is a leader in the industry.

Baker Tilly US, LLP (Baker Tilly) is a leading advisory, tax and assurance firm whose specialized professionals guide clients through an ever-changing business world, helping them win now and anticipate tomorrow. Our integrated team of highly experienced and credentialed bankruptcy and restructuring professionals offer clients balanced perspective and comprehensive solutions in distressed situations. Combining decades of bankruptcy, litigation, forensic accounting, valuation, and crisis management advisory experience, a mastery of financial implications, and a deep understanding of the legal landscape, Baker Tilly delivers creative solutions that resonate, educate, and persuade in the boardroom or the courtroom.

The International Women's Insolvency & Restructuring Confederation, (IWIRC) is an international professional association dedicated to enhancing the professional status of women in all disciplines of insolvency and restructuring. We pursue this goal through a simple but effective principle: to create an international networking organization that promotes communication, common interest and community among insolvency practitioners. We have over 1,500 members in 45 networks globally who represent every discipline of restructuring: law, crisis management, financial advisory, banking, private equity, claims management, communications…and more.

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Province is a nationally recognized restructuring and financial advisory firm. The firm specializes in creditor & investor services, trust & liquidation, corporate advisory, litigation services and performance improvement services. The firm creates exceptional value to its clients consisting of individuals, trustees, official committees and companies, across a wide array of sectors, by providing solutions to some of the most complex business challenges imaginable. With firm offices in Los Angeles, Las Vegas, Baltimore, Stamford and Miami, Province is always looking for high-performing talent to expand its professional team.

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RumbergerKirk provides litigation and counseling services in a wide range of civil practice areas including bankruptcy, commercial litigation, construction, real estate, intellectual property litigation, securities litigation, labor and employment law, product liability, insurance coverage, professional liability and administrative law. Offices are located in Orlando, Tampa, Miami, Tallahassee and Birmingham, Alabama.

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Founded in 1930, McDonald Hopkins is a business advisory and advocacy law firm with locations in Chicago, Cleveland, Columbus, Detroit, and West Palm Beach. With more than 50 service and industry teams, the firm has the expertise and knowledge to meet the growing number of legal and business challenges our clients face.

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3CUBED ADVISORY SERVICES LLC

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The Bankruptcy and Corporate Restructuring Section of Young Conaway Stargatt & Taylor, LLP brings a depth of legal knowledge, technological skill, and creativity to complex and fast-paced reorganizations, restructurings, liquidations, and distressed acquisitions and sales. Our 40 bankruptcy attorneys have been able to achieve optimal results in a wide array of industries. Publications such as U.S. News and World Report and Chambers USA continue to rank Young Conaway as one of the nation's preeminent insolvency practices. Young Conaway's bankruptcy and corporate restructuring attorneys represent clients' interests in Delaware, the Southern District of New York, as well as other bankruptcy courts throughout the United States.

**APPLIED BUSINESS STRATEGY**

Applied Business Strategy (ABS) is a professional services firm founded upon leadership, integrity, and excellence. ABS provides interim management and advisory services to insolvent companies, supports commercial litigation as an advisor or expert witness, and provides valuation and forensic accounting services. ABS professionals have deep experience across an array of industries. serving hundreds of clients ranging from large multi-national corporations to small businesses. ABS maintains offices in Cleveland, OH and New York, NY.

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**Bachecki, Crom & Co., LLP**
Certified Public Accountants & Consultants
Forensics · Valuation · Tax

Bachecki, Crom & Co., LLP is a full-service CPA firm located in the San Francisco Bay Area specializing in complex Forensics, Valuation, and Tax matters. We have provided our clients with solutions for over forty-five years. Committed to excellence, we offer a complete array of services delivered with a personal and professional touch. We value our role as trusted advisors who know our business and respect yours. We are committed to integrity and honesty. Our dedication to the three underlying principles of professionalism, responsiveness, and quality ensures outstanding service to our clients.

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**D. R. Payne & Associates, Inc.**

D. R. Payne & Associates (DRPA), Business Valuators & Appraisers (BVA), and Renewal & Recovery Professionals (RRP) can provide a complete array of products and services to assist managers, shareholders, legal advisors and businesses with those key decisions. Our accredited professionals have the specialized training and experience to enhance the journey, chart the course of action, assist those blown off course and provide interventions needed. Located in multiple offices, member firms have successfully provided services to a broad range of industries and markets.

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**KapilaMukamal**

KapilaMukamal (KM) provides creative and innovative solutions to our client's needs. Our collective practical acumen and expertise focuses to analyze complex business and litigation issues. KM has gained prominence and distinction by rendering restructuring, insolvency, fiduciary, forensic and investigative consulting, and litigation support services to a wide spectrum of industries. KM enjoys high credibility and recognition in providing quality and focused service. As a market leader in the areas of creditors' rights and fiduciary matters, distressed business turnaround, insolvency taxation and complex commercial litigation support to law firms, KM believes results matter and has a proven track record demonstrating that goal.

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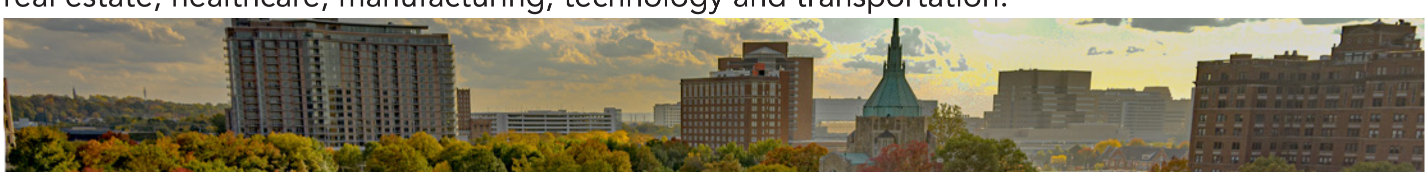
**MALEK REMIAN LLC**

MalekRemian LLC is a team of operations, interim management, corporate transaction, valuation and litigation support professionals providing services throughout the United States. We combine decades of experience with a hands-on client service model, personal commitment and on-call attention, devoted to helping you solve your business challenges and move forward. MalekRemian's senior level expertise drives value-added results across a range of industries, including energy and power, financial services and real estate, healthcare, manufacturing, technology and transportation.



SAK Management Services, LLC
Health Care Turnaround Specialists

SAK Management Services, LLC has specialized in healthcare management and turnaround consulting services for senior living facilities. With nationwide reach and over 250 years of collective experience in all phases of healthcare operations, our associates are seasoned veterans possessing the key knowledge necessary to resuscitate healthcare, long-term care, and senior housing entities in crisis. Our team of experienced and licensed professionals includes hospital CEOs, nursing home administrators, nurses, social workers, and dieticians. For over thirty years, SAK has specialized in turnaround management of single-site hospitals or multiple senior housing facilities across multiple states. Our expertise ensures the highest quality of patient care while maximizing financial returns.

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TUCKER ARENSBERG
Attorneys

Tucker Arensberg, P.C. has over 75 attorneys and is headquartered in Pittsburgh, Pennsylvania. Our Bankruptcy and Creditors' Rights Department advises, counsels and advocates for our clients in all manners of distressed situations across many industries. Clients are secured lenders and creditors, servicers, trade creditors, creditor committees, debtors in bankruptcy, insurers, lessors of real and personal property and purchasers of distressed debt, assets or companies. We have significant experience in bankruptcy matters, mediations, arbitrations and represent our clients nationally in cases across the United States, from the simple to the complex, in Chapter 7, 9,11, 12 and 13 cases.

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For more than 50 years, Bernstein-Burkley, P.C., has cultivated a reputation for excellence among both clients and peers, with more board-certified business bankruptcy and creditors' rights specialists in the state of Pennsylvania than any other law firm. With offices in Pittsburgh, Cleveland, and Wheeling, Bernstein-Burkley concentrates in Bankruptcy & Restructuring, Creditors' Rights, Business & Corporate Transactions, Litigation, Real Estate, and Oil & Gas. We approach each client and case with the same care and diligence in which we handle our own business needs, analyzing the cost and benefits to the client as it relates to every action we might take.

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**Barbara Smith Accounting Inc.**

Barbara Smith Accounting Inc. is an independent accounting firm that specializes in reorganization and bankruptcy tax issues. The company also provides forensic accounting services and expert witness testimony to Chapter 7 and Chapter 11 trustees. The company has been in business for eighteen years and serves clients in the intermountain west region. Barbara M. Smith is a CPA, CIRA and CDBV.

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## SAVE THE DATE:

## 39TH ANNUAL BANKRUPTCY & RESTRUCTURING CONFERENCE ("AC23")

June 7-10, 2023 | Newport Beach Marriott Bayview
Newport Beach, CA

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# 10th Annual Energy Summit

## September 15, 2022, Arts District Mansion, Dallas, TX

AIRA and TMA Dallas/Ft. Worth are excited to present the 10th Annual Energy Summit on September 15th! This innovative program will bring together bankruptcy and restructuring advisors, attorneys and other practitioners for an afternoon of informative programming on the energy industry's current issues, trends and developments. A networking reception will close out the program.

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YOUNG CONAWAY

# 21st Annual Advanced Restructuring & Plan of Reorganization Conference (POR)

## November 15, 2022, at The Union League Club, New York, NY & Online

Mark your calendars and plan now to attend AIRA's Annual POR Conference! POR will be a hybrid event, offering attendees a live, in-person experience and a virtual option for those who choose to attend from home or office, featuring six panel presentations:

- **Pension Issues in Bankruptcy**
- **Valuation**
- **Real Estate**
- **Cryptocurrency and Digital Assets in Distress**
- **Texas Two-Step**
- **2022 - The Year in Review from the Perspectives of Judges and Attorneys**

The in-person conference includes a luncheon and a reception honoring the recipient of AIRA's 2022 Judicial Service Award.

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**For more information on AIRA upcoming events visit www.aira.org/conference.**

# THE MODERN DAY SELL-SIDE PROCESS

**TIM SHEA**

*Solomon Partners*

*Early engagement, accelerated timelines, and incurring significant early deal costs are table stakes for buyers in today's private equity-focused sell-side processes.*

In the world of sought-after companies, the days of the traditional sales process are over.

The old way of doing things looked something like this: Potential buyers would get a call from a banker outlining an attractive investment opportunity on a "no-names" basis. Those buyers would review the teaser, sign a nondisclosure agreement, and receive a confidential information memorandum (CIM) or confidential information presentation (CIP).

From there, potential buyers would submit an indication of interest largely based on reviewing the CIP and conversations with the banker. The banker would then select the 10 or so highest bidders to meet with the management team and learn more about the company.

After the management meeting, potential buyers would submit an updated bid, while the top few parties would continue to review the data room and conduct substantive due diligence. Potential buyers would eventually submit a final bid, where a party is selected to complete due diligence. In some cases, that party would be granted exclusivity for a couple of weeks.

## The Present

In contrast, in today's market where values are elevated and high-quality assets in demand, processes are moving extremely quickly and buyers understand that "if you're not ahead, you're behind." To get ahead of processes and seek a competitive advantage, many private equity buyers are doing significant pre-process work on businesses they expect to come to market over the next 12-24 months.

Examples of that pre-work include conducting market diligence with third-party firms to gain conviction on the overall market opportunity and a competitive position of specific companies in those markets.

That pre-work might also include building a relationship with the current private equity owner and expressing interest in the business so the prospective buyer will be taken seriously (and hopefully prioritized) in the sell-side process. The buyer might meet with the CEO or management team, many times at a private company conference hosted by an investment bank that is aimed at showcasing companies coming to market soon. Finally, that advance work might include thinking about angles to further build a competitive edge, including potential executive additions, strategic combinations and revenue synergies that may exist from current investments, for example.

When the time comes for the process, these well-prepared buyers are ready to strike and move quickly. They have done the work

in advance and built internal consensus around the opportunity with their investment committees. As a result, processes have become significantly compressed.

In today's competitive process, often we are seeing a significant amount of data shared prior to the indication of interest (IOI) submission, including market studies, quality of earnings (QofEs) analysis and data packs. This information allows for highly informed IOIs and a higher likelihood that IOIs will "stick."

We're also seeing many prospective buyers complete their own third-party work prior to the IOI submission, including market studies and their own buy-side QofE analysis. By doing as much work as possible, buyers are hoping to differentiate their bids not only in terms of value, but in terms of providing a more accelerated timeline and a higher degree of certainty.

In many processes, select buyers will have the opportunity to meet management either prior to the process or during the initial stage of the process. And after the IOI submission, instead of going to traditional "dog and pony show" management presentations, buyers are moving immediately into substantive due diligence on all fronts (business, legal, market, etc.) while management meetings are focused on key diligence items and the go-forward strategic plan. Instead of eight weeks or more of meetings, diligence, and multiple process rounds, many deals are now being signed up three to four weeks after data room access is provided.

## Legal and Financing Changes

We are also seeing a drastic change on the legal and financing front causing an acceleration in processes. Historical bottlenecks included arduous negotiation of representations and warranties, and related indemnities, and the need to secure and negotiate financing commitments.

Most deals in today's market resemble the traditional "public company" deal, whereby the seller has no or limited indemnity obligations post-closing. In many cases, buyers are securing reps and warranties insurance as a recourse mechanism against a potential breach. However, that process can sometimes create a bottleneck, and many buyers are now further streamlining the process by either securing reps and warranties insurance between signing and closing or self-insuring.

On the financing front, in the face of highly accommodative credit markets, lenders are moving quickly to provide debt commitments and buyers are increasingly willing to sign an agreement without a financing contingency. That is, if the lenders do not deliver on their commitments, the buyer is still on the hook to close or pay a predetermined break-up fee. This dynamic of providing an "equity backstop" was historically reserved for larger deals and larger funds. Like the evolution in other aspects of the M&A process, willingness to provide an equity backstop has also spread to middle-market firms.


ABOUT THE AUTHOR

**Tim Shea**
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Tim Shea is a managing director and serves as group head of business services for Solomon Partners. He has over 15 years of experience advising clients on M&A transactions, specializing in the facility and residential services sectors. Prior to joining Solomon Partners, Shea was a managing director and head of facility services for Truist Securities and Piper Sandler. His past experience also includes executive roles at two leading facility services companies and as an M&A attorney at a national law firm.

# CONTRIBUTING EQUITY-HOLDER DEBT TO CAPITAL: WHAT, THAT'S TAXABLE?

## Section 108(e)(6)'s taxpayer beneficial rule has important exceptions.

**PATRICK M. PHILLIPS, ERIC D. BRAUER, and JOSEPH A. WIENER**
*RSM US LLP*

## Introduction

On June 15, 2022, the Federal Reserve announced it would increase the federal funds rates by 75 basis points, the largest single rate hike since 1994. The rate hike comes amid a 40-year high Consumer Price Index (CPI) increase of 9.1% as of July 2022. The Federal Reserve set an inflation target of 2% by 2024 and expects the federal funds rate to be around 3.4% by the end of 2022. According to some economists, this inflationary environment is one of several indications that an economic downturn could be on the horizon.

Inflation and any anticipated downturns in the economy may not impact tax *per se*. However, certain issues may arise more frequently in an economic environment such as this one. For example, many companies could increasingly face difficulties in meeting the payment obligations on their indebtedness. In an effort to de-leverage or to manage cash flow issues, a creditor who is also an equity holder in the borrower may choose to cancel the debt of the company. However, this cancellation, generally treated as a contribution to capital, can potentially generate cancellation of debt (COD) income.

A corporate debtor in this situation may sometimes be able to mitigate COD income under section 108(e)(6) (addressing a shareholder who contributes debt to the corporation as a contribution to capital). Taxpayers, however, should be aware of several important caveats pertaining to section 108(e)(6):

- There is a second provision relating to taxpayers in this situation, section 108(e)(8). Although the transactions described in sections 108(e)(6) and 108(e)(8) can be economically identical, they can generate very different results.
- If the corporate debtor is insolvent, section 108(e)(6) may sometimes not permit the mitigation of COD income. This may depend on the degree of insolvency and the quantum of the debt contributed, as is illustrated by a recent IRS ruling.
- While a corporate debtor may mitigate COD income under section 108(e)(6), such treatment is not available to a partnership debtor.


## Background to Sections 108(e)(8) and (6)

In the situation described above, where a company's debt is held by an existing equity holder, satisfaction of the debt typically takes place via one of two forms:

- **Form 1**: The parties convert the debt into equity, *i.e.*, the debtor corporation issues new stock or membership interests to the creditor in satisfaction of the outstanding debt.
- **Form 2**: The equity holder contributes the debt obligation to the debtor as a contribution to capital with no legal issuance of debtor equity.

Though U.S. federal tax law often looks to the substance of a transaction for its characterization, section 108(e) is a rare instance in which form governs. As explained further below, under section 108(e)(8), if a shareholder of a corporation holds debt of the corporation and converts the debt into stock (Form 1), the corporation must treat the excess of the adjusted issue price of the debt instrument over the stock's fair market value (FMV) as COD income. If, instead, the shareholder contributes such debt to capital (Form 2), section 108(e)(6) often permits the debtor corporation to mitigate COD income.

## Section 108(e)(8)

Section 108(e)(8) addresses Form 1 and provides that when a debtor company (corporation or partnership) transfers equity (stock or partnership interests) of the debtor company to a creditor in satisfaction of its debt, the debtor company is treated as having satisfied the debt with an amount of money equal to the FMV of the equity transferred. Thus, if the FMV of stock issued to a creditor is less than the adjusted issue price of the corporation's debt instrument, which is often the case with a distressed corporation or partnership, the excess is COD income for the debtor corporation.

**Example:** T, an unrelated third party, holds a $100 D bond. D issues stock worth $60 in full satisfaction of the bond. D must recognize $40 of COD income (excess of adjusted issue price of the debt, $100, over FMV of stock issued, $60).

## Section 108(e)(6)

Section 118 provides that contributions of capital to a corporation do not constitute gross income to the corporation. Section

108(e)(6), addressing Form 2, explicitly overrides section 118 and provides that a capital contribution by a shareholder of the corporation's own debt is treated as if the debtor corporation satisfied the debt with an amount of money equal to the shareholder's adjusted basis in the debt. Thus, as is typically the case, if the shareholder-creditor's basis in the contributed debt is equal to the adjusted issue price of the debt, upon the contribution of such debt to capital, the debtor corporation will generally mitigate COD income entirely.

Interestingly, the transactions described in sections 108(e)(6) and 108(e)(8)—Forms 1 and 2—could be economically identical. A shareholder of a wholly owned corporation that contributes its debt in the corporation to capital is economically in the same position as if it received stock in exchange for the debt. In several letter rulings, however, the IRS has permitted section 108(e)(6) to trump the section 108(e)(8) realization rule for corporations whenever corporate shareholders cancel the corporation's debt in proportion to their shareholdings and the corporation does not issue new stock as part of the transaction. As described above, form generally controls—if no stock is issued, section 108(e)(6) applies, but if stock is issued, then section 108(e)(8) applies.

**Example:** Corporation D owes $100 to C, the sole shareholder of D. The adjusted issue price of the debt and C's basis in the debt equal $100, but the FMV of the debt has declined to $60. In order to meet certain debt covenants related to outstanding third-party debt owed by D, C contributes the debt to capital and receives no stock from D. C's contribution of the debt to capital does not trigger COD income to D because C's basis in the contributed debt is equal to the adjusted issue price of the debt. By contrast, if D had instead issued stock to C equal to the FMV of the debt, the exchange would have caused $40 of COD income.

## Capital Contributions of Debt to an Insolvent Corporation

While section 108(e)(6) is usually available to a corporate debtor, practitioners should be mindful of situations in which a Form 2 contribution of debt is made to an insolvent corporation. Insolvency may complicate whether a corporation can mitigate COD income under section 108(e)(6).

As discussed above, the corporation must acquire its debt from the shareholder as a contribution to capital in order to receive favorable treatment under section 108(e)(6). In order to be considered a contribution to capital, the debt must at a minimum have some value to the shareholder. In the case of a Form 2 contribution to an insolvent corporation, questions can arise whether the shareholder has in fact contributed any value to the corporation. If there is no capital contribution in a Form 2 debt forgiveness, then the corporation has COD income equal to its entire adjusted issue price (*i.e.*, because the corporation satisfied $0 of debt).

Courts and the IRS have addressed whether a Form 2 contribution of debt to an insolvent corporation is a capital contribution in several situations. The answer to that question can depend on if the corporation becomes solvent or remains insolvent (or even "hopelessly insolvent") after the Form 2 transaction takes place.

The IRS appears favorably disposed to section 108(e)(6) treatment of a Form 2 contribution of debt if the contribution results in the corporation becoming solvent. A recent private letter ruling, PLR 202112003, addressed the forgiveness of a debt the taxpayer owed to a foreign shareholder. The corporation was insolvent prior to the debt forgiveness but expected to be solvent as a result of the debt forgiveness. Citing section 108(e)(6), the IRS ruled that the corporation would not recognize COD income as a result of the debt forgiveness, except to the extent (if at all) that the adjusted issue price of the cancelled debt exceeds the shareholder's adjusted basis in such debt. Notably, the IRS did not limit section 108(e)(6) treatment to the amount by which the corporation was solvent after the debt forgiveness.

**Example:** Corporation D owes $100 to C, the sole shareholder of D. The adjusted issue price of the debt and C's basis in the debt equal $100. D is insolvent (*i.e.*, its liabilities exceed the FMV of its assets) by $80. In order to improve its ability to obtain third party financing, C contributes the $100 debt to capital and receives no stock from D. C's contribution of the $100 debt to D likely constitutes a contribution to capital and is subject to section 108(e)(6) in full because such contribution has value to D. Consequently, C's contribution of the debt to D does not result in COD income because the adjusted issue price and C's adjusted basis in the debt both equal $100.

The outcome of a Form 2 contribution of debt is less clear, however, if a corporation continues to be insolvent or, even more strikingly, 'hopelessly insolvent' after the contribution. As with a Form 2 contribution that results in corporate solvency, however, the relevant question reverts to whether the shareholder contributed any value to the corporation. A Form 2 contribution of debt to an insolvent corporation is likely to have value to the corporation if it improves the financial condition of the corporation (*e.g.*, by making it solvent), improves its ability to obtain additional financing, or otherwise serves a valid business purpose of the company. *See e.g., Lidgerwood v. Comm'r*, 229 F.2d 241 (2d Cir. 1956). By contrast, if the corporation is so hopelessly insolvent that the shareholder's Form 2 contribution has no value because the debt is entirely worthless, then section 108(e)(6) is less likely to apply to the shareholder contribution of debt. *See e.g., Mayo v. Comm'r*, T.C.M 1957-9 (1957).

## Forms 1 and 2 in the Partnership Context

Section 108(e)(8), addressing Form 1, explicitly addresses partnerships and provides that when a debtor partnership transfers a partnership interest to a creditor in satisfaction of debt, the partnership is treated as satisfying the debt with an amount of money equal to the FMV of the interest. Section 108(e)(8) states further that COD income recognized in the exchange is included in the distributive shares of the partners who were partners in the partnership immediately before the discharge of the debt.

Continued from p.59

Unlike section 108(e)(8), the 108(e)(6) beneficial rule addressing Form 2 is confined to corporations. Accordingly, a partnership whose partner contributes its debt in the partnership to capital must calculate its COD income following the rules under Sec. 108(e)(8). *See McKee et al.*, *Federal Taxation of Partnerships and Partners*, ¶4.02[3] (2020).

In a case where the partnership is insolvent, therefore, the FMV of the interest deemed issued in exchange for the debt would likely be zero, and the partnership may recognize COD income equal to the entire adjusted issue price of the debt contributed.

## The 108(a) Insolvency Exception

An additional section 108–related advantage corporations have over partnerships involves the insolvency exception. Under section 108(a)(1), COD income is excluded from an insolvent taxpayer's gross income, but only up to the amount of the taxpayer's insolvency. For purposes of this rule, a taxpayer is insolvent by the amount that the taxpayer's liabilities exceed the FMV of the taxpayer's assets, determined immediately before the discharge. (Although the taxpayer may exclude its COD income, it must instead reduce its tax attributes.)

Section 108(d)(6) sets forth an important distinction between corporations and partnerships: In the corporate context, the determination of insolvency takes place at the corporate level, while in the partnership context, the determination of insolvency takes place at the partner level. Accordingly, partners of an insolvent partnership do not obtain the benefit of section 108 if they are personally solvent.

Thus, the partnership structure has two potential downsides, when contrasted with the corporate structure: (i) section 108(e)(6) is not available to mitigate COD income, and (ii) partners of an insolvent partnership cannot exclude their share of COD income if they are personally solvent.

## Conclusion

We recommend taxpayers consult with a tax advisor prior to entering into a transaction involving cancellation or contributions of debt, especially when the debtor is a partnership or the solvency of the corporate debtor post-transaction is in question.

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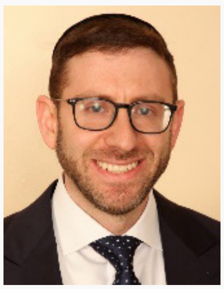

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# AIRA
# Distinguished Fellows Program

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.

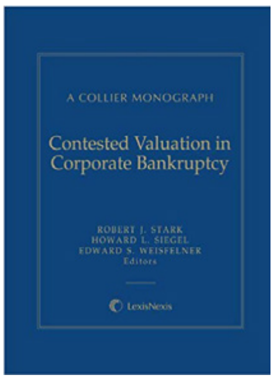
**Additional information about AIRA's Distinguished Fellows Program and nomination forms are available at www.aira.org.**

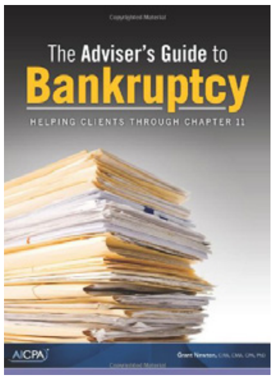
# An Invitation from the AIRA Journal Editorial Board

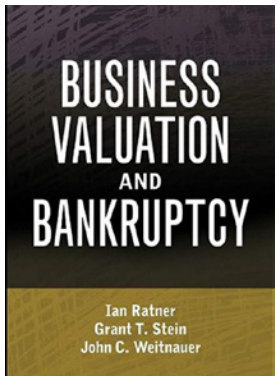
AIRA members and others are invited to submit articles, proposed topics and content-related questions to the *AIRA Journal* Editorial Board: Michael Lastowski, mlastowski@duanemorris.com; David Bart, david.bart@bakertilly.com; and Boris Steffen, bsteffen@provincefirm.com. Articles are currently being accepted for upcoming quarterly issues; see *AIRA Journal* information and Authoring Guidelines at www.aira.org/journal. To inquire about placing an ad or press release in the *AIRA Journal* contact Cheryl Campbell, ccampbell@aira.org

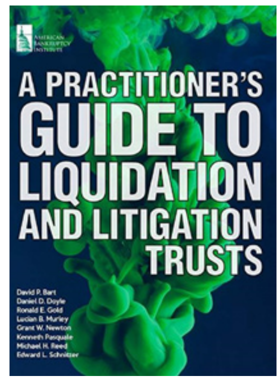
# SALUTE TO AIRA AUTHORS

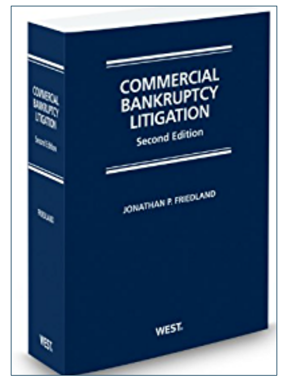
**The AIRA congratulates and appreciates its members and conference participants whose publications have contributed to the body of knowledge in the restructuring field.** *(Note: This recognition does not imply an endorsement or review of these publications.)*

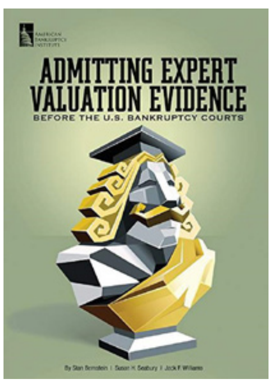


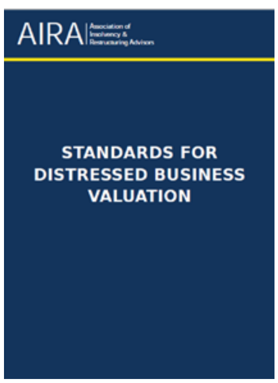



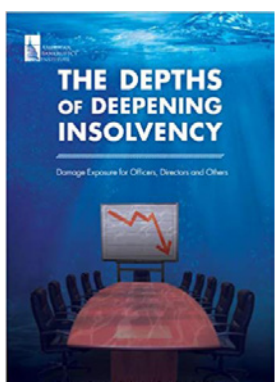



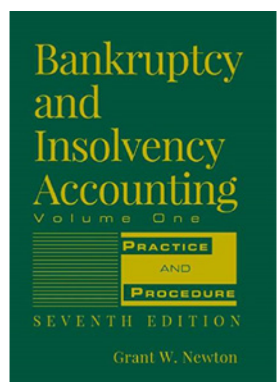



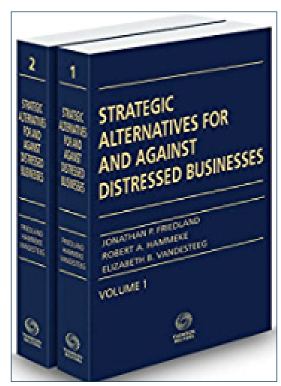



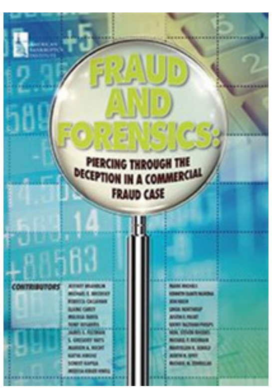



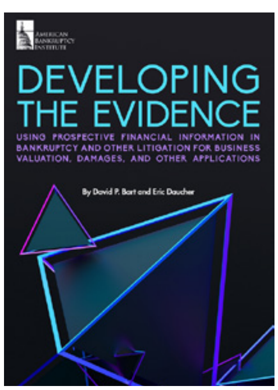





**Have a published book? Do you know of other authors and publications we may acknowledge? Let us know by sending an email to aira@aira.org.**

## MELISSA KIBLER, CIRA, CDBV, NAMED CHAIR OF AMERICAN BANKRUPTCY COLLEGE AND RECEIVES GLOBAL M&A NETWORK AWARD

Melissa Kibler, a Senior Managing Director in Accordion's Turnaround & Restructuring practice and 2003 AIRA Certified Insolvency and Restructuring Advisor Gold Medal Winner, has just been named Chair of the American College of Bankruptcy – becoming only the second woman and first financial advisor to serve in this role. In addition to this appointment, Kibler had the honor of receiving the Global M&A Network's inaugural D&I Leadership Award this year. Along with her dedication to championing women and diversity in the finance industry, Kibler brings over 30 years of experience providing financial advisory, restructuring, turnaround management, and litigation services to Fortune 500 and mid-sized companies and their stakeholders.

Other Accordion News: To meet the growth of Accordion's Turnaround & Restructuring Group and other practice areas, the firm has just opened its new Chicago office at 71 South Wacker Drive and its new Boston office at 111 Huntington Avenue. It will also open its new Dallas office at 1920 McKinney Avenue in August, and its new Santa Monica office at 233 Wilshire Boulevard in September.

## MYCHAL HARRISON HONORED BY CONSULTING MAGAZINE AS A TOP CONSULTANT IN 2022

AIRA member Mychal Harrison was honored by *Consulting Magazine* as a Top Consultant in 2022 for his leadership and continued excellence in driving diversity, equity and inclusion initiatives across his firm, Huron. Mychal serves on the company's Diversity and Inclusion Council and has played an integral role in the ideation and implementation of various diversity and inclusion programs, including organizing townhall discussions and internal workshops. In addition to Mychal's diversity, equity, and inclusion-focused efforts, he is a leader on Huron's investment banking team, where he applies his deep functional expertise in business planning and finance strategy to guide stakeholders through buy-and sell-side transactions.

"Mychal is an exceptional example of a leader who continues to make an impact on our people and our clients," said Jim Roth, chief executive officer of Huron. "This honor is a testament to his leadership in championing our firmwide diversity, equity and inclusion efforts and positioning Huron to be an even better place to work. I am thrilled he is being recognized for his collective achievements and look forward to his continued success."

Read more about Mychal's story at https://www.businesswire.com/news/home/20220614005254/en/.

## STRETTO SELECTED AS TURNAROUND PRODUCT AND SERVICE OF THE YEAR FOR THIRD CONSECUTIVE YEAR IN M&A ADVISOR TURNAROUND AWARDS

IRVINE, Calif., June 8, 2022 – The M&A Advisor has selected Stretto, a market-leading technology and bankruptcy-services firm, as a winner in its 16th Annual Turnaround Awards, naming Stretto Corporate Restructuring Services as the Turnaround Product/ Service of the Year. This recognition marks the third consecutive year that Stretto has received this award. Stretto also was honored in the Chapter 11 Reorganization of the Year category for its role in the crypto company Cred, Inc. case; the Consumer Discretionary Deal of the Year category for its role in the Le Tote, Inc. case; and the Turnaround Award in the Restructuring Award category for its role in the Francesca's case. Jonathan Carson, co-CEO of Stretto, stated they are honored to be recognized among the most highly respected firms and professionals in the turnaround industry, and it is rewarding for the entire team to have these efforts acknowledged and celebrated.

The M&A Advisor will host an awards gala September 20-21, 2022.

## 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 information on how to submit a press release or news item visit www.aira.org/journal**

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