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WHAT'S INSIDE

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AIRA Journal is published four times a year by the Association of Insolvency and Restructuring Advisors, 1314 Center Drive, Suite B-132, Medford, OR 97501.

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

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

This year's POR Conference was a hybrid event allowing attendees to choose a live, in-person experience or opt for virtual participation. Six panel presentations were carefully selected to represent diverse expert perspectives on the most important issues and developments in the field at this time.

The AIRA thanks the chairs, planning committee, moderators, and speakers for contributing their time and expertise to make this a successful conference. We also thank the NYIC for co-hosting the reception to present the Judicial Service Award – see page 50 for details and a letter from this year's recipient:

The Honorable Alan S. Trust
Chief Judge, U.S. Bankruptcy Court, EDNY

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Annual AIRA & NYIC Event

11:00 AM – 1:30 PM ET; January 19, 2023, Online

Gain financial and market insights with the New York Institute of Credit and AIRA on January 19, 2023. NYIC and AIRA will present two panels of finance experts to help you navigate the current economic landscape. Program concludes with a networking session via Zoom. Up to 2.0 CPE available. This event supports the AIRA Grant Newton Educational Endowment Fund.

For more information and registration see "Upcoming Events" at: https://www.instituteofcredit.org.

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

From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

Last week, the 96th annual National Conference of Bankruptcy Judges was held in Orlando, Florida. In addition to holding its Fall board meeting at the conference, AIRA sponsored a Friday breakfast session, "Procrustes Challenge: Designing Mass Tort Settlement Trusts and TDPs: One Size Does Not Fit All." The panelists—**Hon. Robert Drain** (S.D. NY), **Hon. Michael Kaplan** (D. NJ), **Professor Sergio Campos** (University of Miami School of Law), and **Professor Jack Williams, CIRA, CDBV** (Georgia State College of Law)—and moderator **Stephen Darr, CIRA, CDBV** (Huron Consulting) brought greater focus to issues surrounding the use of the bankruptcy process and settlement trusts to address mass tort liabilities and victims' redress. My thanks go out to the panel for a very informative session. I am hopeful AIRA will be able to reprise the panel at one of our future programs. And as to who is/was Procrustes anyway? —I will leave that up to the readers to research.

At their Fall meeting, the AIRA Board of Directors heard from **Jeff Pomeranz** (Pachulski Stang Ziehl & Jones), **Victor Owens** (East West Bank), and **Tammy Hettinger**, Executive Director of **Credit Abuse Resistance Education** (CARE), regarding the CARE program's efforts to address the reprehensible lack of financial education currently available to high school students by providing them access to the information they need to make smart choices with their money as they enter adulthood. To help accomplish this, CARE is reaching out to organizations such as AIRA to enlist help with broadcasting CARE's message and obtaining volunteers to further CARE's program. Please see Tammy's article on page 48 of this publication, and consult CARE's website at care4yourfuture.org. I think CARE provides a great opportunity for our practitioners to share their knowledge and may be the program you are looking for to provide younger members of your firm with a community volunteer outreach opportunity.

For all of us practicing in the insolvency and restructuring area, October 12, 1942, was an important date. It marks the birthdate of Professor **Grant W. Newton**, Ph.D., CIRA, AIRA's founding executive director, author and authority on financial and accounting matters related to bankruptcy and restructuring matters, and, if I may, friend and mentor to so many of us. Grant celebrated his 80th birthday with his family this month and enjoyed receiving congratulations from many friends across the country.

Timing can be everything. I believe that is the case as I am about to relate.

A couple of months ago, I was working in the AIRA office in Medford going through old files when I came across a copy of the *Journal of Accountancy*, May 1976, tucked into a manila folder. Flipping through the pages I quickly found the reason this particular issue was saved in AIRA's files. Beginning on page 59 was an article, "The Practitioner's Role in Debt Settlements: How CPA Firms Can Assist Their Clients in Out-of-Court Agreements," authored by Grant W. Newton, then an assistant professor at the University of Alabama. Since the publication preceded the enactment of the current bankruptcy code, I initially thought Grant's views in the article might be a little outdated. However, as I read the article, I realized the content in terms of out-of-court settlements is as relevant today as it was back in 1976.

Given the timing, I thought what better way to honor Grant on his 80th birthday than to share this article with the AIRA membership and *AIRA Journal* readers. A call to the AICPA and *Journal of Accountancy* quickly secured permission to reprint the article; I send my thanks to them for allowing AIRA to do so. And so, with Happy Birthday wishes to Grant, I invite readers to read and digest this timeless article starting on page 6, as well as the other excellent content of this issue of the *AIRA Journal*.

Read, enjoy, and learn. Keep well.

— Jim Lukenda

A Letter from AIRA's President

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

CELEBRATING GRANT'S 80TH BIRTHDAY – A NOTE TO GRANT NEWTON

When I reflect upon your years leading the AIRA and our members, my thoughts turn to matters beyond insolvency accounting and restructuring advisory services. Those matters surround certain core values which you instilled in AIRA and our membership. I will attempt to organize and articulate those values herein:

#1	Developed a ***Vision***;
#2	Pursued with ***Wisdom***;
#3	Implemented with ***Integrity***;
#4	Aspired to ***Greatness***;
#5	Presented with ***Optimism***;
#6	Delivered to a Degree of ***Excellence***;
#7	Communicated with a Dose of ***Genius***; and
#8	Supported Throughout by ***Perseverance***.

Your ***Vision*** was to take a small group of accounting practitioners on a journey to the pinnacle, the mountain top, of the insolvency and restructuring profession. That mountain top was reserved for legal professionals and law firms at that time. Ultimately, your Vision was all about leading and influencing. You taught financial and accounting trained professionals the nuances of the Bankruptcy Code and helped create essential restructuring principles to reach the summit of the mountain, whereby financial advisors and accountants would play important roles and be viewed as central to the restructuring process.

You pursued your Vision with ***Wisdom*** by understanding how the process by which decisions are made ensures higher and better outcomes. You understood that concepts transcend processing the data. It was by teaching concepts and processes, combined with fundamental values, that you provided a lasting pathway to achieve your Vision for our organization.

You undertook implementing your Vision with a level of ***Integrity*** by which you mentored members to enter the insolvency and restructuring world with a set of fundamental values.

You taught our members that the meaning of ***Greatness*** is not being self-absorbed with where one stands or what one has accomplished; rather, Greatness is measured by the direction one follows to continually progress forward to achieve one's Vision.

Your approach with the organization was grounded in ***Optimism,*** where you saw every obstacle as another stepping stone on the road to success. Passing the CIRA classes and examinations were the means for you to move the membership forward with an attitude of "**I am qualified to provide value added services in legal proceedings addressing insolvency matters**."

Your delivery in or out of the classroom was made at the highest degree of ***Excellence,*** which I have come to learn means: **(i)** "**caring more than some think wise**; **(ii) risking more than some think sensible; and (iii) working more than others are willing to do.**" You epitomized all these traits.

You communicated your knowledge and wisdom to the membership and the Board, with humility and generosity. Your ***Genius*** was your ability to reduce the complex to the simple. You reorganized the complexity of the law as described in the Code into fundamental financial concepts, approaches and methods.

To recap my thoughts and many other members, your Wisdom, Integrity, Greatness, Optimism, Excellence and Genius never wavered as your unyielding ***Perseverance*** propelled you to reach for a Vision for the AIRA. As the saying states: "**In the battle between the stream and the rock, the stream always wins, not through strength, but through perseverance.**" Your stream runs over, under and all around the rocks, we the members of AIRA.

Wishing you all the best on behalf of the AIRA, the Board, and the members, now and always.

— David Payne

THE PRACTITIONER'S ROLE IN DEBT SETTLEMENTS

How CPA Firms Can Assist Their Clients in Out-of-Court Agreements

GRANT W. NEWTON, PH.D., CIRA

Editors' note: This article by AIRA's Director Emeritus, Grant W. Newton, CIRA, originally appeared in The Journal of Accountancy, May 1976. Reprinted with permission.

The number of agreements reached out of court between financially troubled debtors and their creditors has risen considerably. As described in a recent newspaper article,[1] the number of cases in New York was up 36 percent, in Chicago up 30 percent and in Dallas up 20 percent. Not only is the number of such agreements growing but also the number of businesses seeking this type of remedy was reported to be substantially greater than that of a year before. The number of business bankruptcy petitions filed was also up by over 20 percent. No doubt, the heavy case load of the bankruptcy court has made the out-of-court settlement a more attractive remedy.

While the informal out-of-court agreement has been used frequently in selected areas such as in New York City's garment industry, its popularity has now spread to other industries and cities. The object of this article is to describe the nature of out-of-court agreements and to identify ways in which an accountant—particularly a local practitioner—can assist a client who is in financial difficulty and considering the possibility of an out-of-court settlement.

The informal composition settlement is an out-of-court agreement which usually consists of an extension of time, a pro rata cash payment for full settlement of claims, or some combination of both. The debtor, through counsel or credit association, calls an informal meeting of the creditors for the purpose of discussing his financial problems. In many cases, the credit association makes a significant contribution to the out-of-court settlement by arranging a meeting of creditors, providing advice and serving as secretary for the creditors' committee. A credit association is composed of credit managers of various businesses in a given city. Its functions are to provide credit and other business information to member companies concerning their debtors, to help make commercial credit collections, to support legislation favorable to business creditors and to provide courses in credit management for members of the credit community. At a meeting of this type, the debtor will describe the causes of failure, discuss the value of assets (especially those unpledged) and the unsecured liabilities and answer any questions the creditors may ask. The main objective of this meeting is to convince the creditors that they will receive more if the business is allowed to operate than if it is forced to liquidate and that all parties will be better off if a settlement can be worked out.

Advantages and weaknesses of an informal settlement

The following are a few of the reasons why the informal settlement is often used in today's environment:

1. The out-of-court settlement is less disruptive of a business which continues operation.
2. The debtor can receive considerable benefits from the advice of a committee, especially if some of the committee members are businessmen, preferably but not necessarily in the same line of business.
3. The informal settlement avoids invoking the Bankruptcy Act and, as a result, more business-like solutions can be adopted.
4. Frustrations and delays are minimized since problems can be resolved properly and informally without the need for court hearings.
5. An agreement can usually be reached much faster informally than in court proceedings.
6. The costs of administration are usually less in an out-of-court settlement than in a formal arrangement or reorganization.

The weaknesses of informal composition settlements are as follows:

1. A successful plan of settlement requires the approval of substantially all creditors, and it may be difficult to persuade distant creditors to accept a settlement that calls for payment of less than 100 percent.
2. The assets of the debtor are subject to attack while a settlement is pending. (The debtor can, of course, point out to the creditor that if legal action is taken, a petition of bankruptcy will have to be filed.)
3. The informal composition settlement does not provide a method to resolve individual disputes between the debtor and the creditors.
4. Executory contracts, especially leases, may be difficult to avoid.

[1] "More Firms Iron Out Financial Troubles Through Credit Groups to Avoid Courts," *Wall Street Journal*, June 17, 1975.

5. A gain due to debt forgiveness may reduce the operating loss carried forward, whereas the amount of debt canceled in bankruptcy is not taxable.

From the above it is obvious that there are several reasons why it is often best for the debtor to seek assistance out of court. But this avenue can be lost if the debtor is not cautious in his actions.

It is easy to be ethical when everything is going as planned, but, when adversity hits, the temptation to alter a financial statement or commit other dishonest acts is greater.

Conduct of an honest debtor

The creditors want to know at the beginning of any out-of-court negotiations if they are dealing with an "honest" debtor. The actions of the debtor during the time when financial problems are developing and when it becomes necessary to seek assistance from the creditors are scrutinized carefully by the creditors and their accountants and attorneys. It is easy to be ethical when everything is going as planned, but, when adversity hits, the temptation to alter a financial statement or commit other dishonest acts is greater. This is where the role of the independent accountant can be critical. The CPA should take a firm stand regarding certain actions of the debtor. He should insist that the financial books and records not be altered, concealed, or destroyed because this would convince the creditors to force the debtor into the bankruptcy court, where the discharge of any of the debts will be denied. Also, the financial statements filed by the debtor should not in any way be altered as this might open the way to the charge that they are false or misleading.

The accountant should insist that all transfers of property be made for valid consideration.

Another area of concern to creditors is the nature of any preferential payments. A preferential payment is a transfer of property for the benefit of a creditor within four months before the filing of a petition initiating bankruptcy proceedings, when the effect of the transfer is to enable one creditor to receive a greater percentage of his debt than the other creditors of the same class. A preferential payment does not constitute fraud but, rather, a legitimate and proper payment of a valid debt. However, certain types of preferential payments can cause the creditors to view the debtor as dishonest. These preferences, which include repayment of officers' loans, repayment of loans which have been personally guaranteed by officers, repayments of loans from personal friends and relatives, giving of collateral to selected lenders and sale of merchandise on a contra-account basis should, if at all possible, be avoided.

The accountant should insist that all transfers of property be made for valid consideration. A transfer is deemed fraudulent when made within one year prior to filing the bankruptcy petition and without fair consideration by a debtor who is or will be rendered insolvent after the transfer. Authorities do not have to demonstrate that the transfer's main purpose was to defraud creditors for the transfers to be considered fraudulent. In an attempt to minimize their own personal losses, there is a temptation for managers of a bankrupt corporation to conceal some of the debtor's assets. The CPA should inform clients in this position that such assets are usually discovered, leading to further difficulties for the debtor.

Importance of an early meeting date

It is difficult for a debtor to admit that he cannot pay his debts and continue profitable operations. As a result, decisions to call a meeting of creditors or to file a petition under the Bankruptcy Act often are postponed until absolutely necessary. This delay benefits no one, including the debtor. A debtor may place the last penny of his or her life's savings in the business, even when the possibility that this last investment will actually provide the corrective action is remote. In situations where the product is inferior, the demand for the product is declining, the distribution channels are inadequate or other similar problems exist which cannot be corrected, either because of the economic environment or management's lack of ability, it is normally best to liquidate the company immediately.

There are several reasons why it is advisable to call a meeting of creditors as soon as it becomes obvious that some type of relief is necessary. First, the debtor still has a considerable asset base. There also is a tendency for many of the key employees to leave when they see these unhealthy conditions developing. Early corrective action may encourage them to stay. In addition, prompt action may make it possible for the debtor to maintain some of the good will which was developed during successful operating periods.

Preparation for the first creditors' meeting

. . . prompt action may make it possible for the debtor to maintain some of the goodwill which was developed during successful operating periods.

The creditors will have representatives who have handled cases on many occasions and are true specialists in negotiating settlements. Because of this, it is important that the debtor select counsel that is adequately prepared for the meeting with creditors. The independent accountant can, more than anyone else, assist the debtor in this preparation. It is advisable that the debtor's legal counsel be experienced in bankruptcy and insolvency proceedings, and especially familiar with problems associated with an out-of-court settlement. After the counsel has been engaged and before the creditors' meeting is called, it is necessary for both the accountant and counsel to consult with the debtor.

At this conference, the attorney obtains sufficient background information about the debtor's operations so that he can present the facts to the creditors, knowledgeably discuss the situation with them and explain why the debtor is in difficulty and why a settlement out of court would be advantageous to all parties. Also, the attorney will need various types of financial information. First, he should have a summary of the major causes of failure and the possible corrective action that can be taken. To prepare this type of summary, the accountant must analyze the past activities of the debtor, compare the financial statements

Continued from p.7

The out-of-court settlement can, under certain conditions, be the most advantageous remedy for a financially troubled debtor, and independent accountants should be intimately involved in such a settlement.

for the last three or four years and determine what caused the cash shortage. The attorney will need a copy of the most recent balance sheet and income statement, a list of the debtor's creditors and a list of executory contracts. The attorney also should have some idea of the liquidation value of the assets and know the nature of the liabilities (*i.e.*, those secured, unsecured and contingent). He should be familiar with the changes that have occurred in inventory and the reasons for the changes. The debtor's independent accountant should make sure the attorney knows of any sales made below cost, or considerably below normal price, and of any preferential payments or fraudulent transfers.

It is often advisable, provided there is enough time, for the accountant and the attorney to prepare a suggested plan of settlement so it can be presented and discussed at the first meeting with creditors. Typically, only the largest creditors and a few representatives of the smaller creditors are invited to avoid having a group so large that little can be accomplished.

At a typical meeting, the debtor will provide the creditors with copies of the latest financial statements and other pertinent financial information. These statements will be reviewed by the creditors and the liquidating values of the various assets will be discussed. If the debtor has developed a suggested plan of settlement, this also will be discussed by the creditors, who may accept it or, under certain conditions, ask for another plan or recommend that the debtor file a petition in bankruptcy. If a debtor is well prepared by his accountant and has a good opportunity of being rehabilitated at a reasonable cost, he can avoid being forced into involuntary bankruptcy.

Function of the creditors' committee

The creditors' committee serves as the bargaining agent for the creditors, supervises the operation of the debtor during the development of a plan and solicits acceptance of a plan once it had been approved by the committee. Generally, the creditors' committee will meet as soon as it has been appointed for the purpose of selecting a chairman and counsel. The committee also will engage an independent accountant to audit the books and records of the debtor.[2]

At the completion of the audit, the creditors' committee will meet to discuss the results of the audit. If it reveals that the creditors are dealing with a dishonest debtor, the amount of settlement that will be acceptable to the creditors will be increased significantly. It becomes very difficult for a debtor to avoid bankruptcy under these conditions. On the other hand, if the debtor is honest and demonstrates the ability to reverse the unprofitable operations trend and reestablish his business, some type of plan will eventually be approved.

As to the independent auditor who may be engaged by the creditors' committee, he can assist the committee in exercising control over the debtors' business while a plan of settlement is being developed and during the period installment payments are being made under terms of the plan. The objective, of course, is to see that assets of the debtor are conserved and, once agreement has been reached on a plan of settlement, to see that all terms of the plan are being followed. The auditor will establish controls to ascertain that all cash receipts from sales, collections on account and other sources are deposited intact, and that disbursements are for a valid purpose. Also, he will either prepare or review cash flow statements. Procedures must be established to ensure that all liabilities incurred after the first creditors' meeting are paid promptly so the debtor can reestablish himself in the credit community.

Preparation of a plan of settlement

One of the critical functions of the debtor's accountant is to make all parties aware of the long run prospects of the debtor.

There is no set pattern for the form a plan of settlement proposed by the debtor must take. It may call for 100 percent payment over an extended period of time, payments on a pro rata basis in cash for full settlement of creditors' claims or some combination of both. A carefully developed forecast of projected operations, based on realistic assumptions developed by the debtor with the help of his accountant, can help creditors determine if the debtor can perform under the terms of the plan and operate successfully in the future.

Generally, for creditors to accept a plan, the amount they will receive must be at least equal to the dividend they would receive if the estate were liquidated. This dividend expressed as a percent is equal to the sum of a forced-sale value of assets, accounts receivable, cash and prepaid items, minus priority claims, secured claims and expenses of administration divided by the total amount of unsecured claims. Several methods can be used to determine the immediate market price for the assets. The independent accountant may be able to reasonably estimate the values of the assets, especially inventory, because of his previous experience with companies in this industry or another client in the same type of business. To determine the value of plant and equipment, the manufacturer or a used equipment dealer may be contacted. To determine the value of the debtor's property, it may be necessary for the creditors' committee to employ an auctioneer or appraiser. Included in the asset base will be items distributed in preference to creditors or concealed by the debtor, any questionable transactions involving payments to creditors, returns of merchandise to vendors, sales of fixed assets and repayment of loans to owners.

The creditors must be assured by the projected income statement and cash flow statement that the debtor will be in a position to make the payments as they become due. The forecast of the results of operations and financial position should be prepared on the assumption that the proposed plans will be accepted and that the liability and asset accounts reflect the balance which would be shown after all adjustments are made relative

2 For a more detailed explanation of this audit function, see the author's discussion in *Bankruptcy and Insolvency Accounting: Practice and Procedure* (New York: The Ronald Press Co., 1975), 199-202 and 205-255.

to the debt forgiveness. If a division or a given product line is to be eliminated or if the forecast depends on the success of new products or markets, these facts should be clearly set forth.

One of the critical functions of the debtors' accountant is to make all parties aware of the long run prospects of the debtor. The representatives of the creditor are adjustment specialists and represent their employer in all bankruptcy and insolvency proceedings. These specialists did not have anything to do with the original extension of credit. As a result, they are primarily interested in getting the maximum cash possible in a short time period. They are not overly concerned about the long run prospects of the debtor; nor are they concerned about how this debtor may, if rehabilitated, be a very good customer in the future. However, it is the function of the accountant to see that the creditors are fully aware of the long run potential of the company. The debtor should be helped to prepare the type of analysis needed to convince the creditors that the company can survive in the future.

Actually, the accountant, by helping the creditors understand the reason for the financial difficulty and by explaining the corrective action being taken, can lay the groundwork for future credit. Thus, an honest debtor with a sensible plan that avoids previous mistakes and moves in the direction of resuming profitable operations can successfully reach an out-of-court agreement and at the same time acquire new credit.

Conclusion

The out-of-court settlement can, under certain conditions, be the most advantageous remedy for a financially troubled debtor, and independent accountants should be intimately involved in such a settlement. They often discover the need for corrective action, help select the remedy which is best for their client and periodically provide the necessary financial information to creditors and other interested parties to ensure their awareness of the debtor's progress. Their assistance in the development of a plan of settlement is significant—possibly more than any other outside party—for the successful rehabilitation of the debtor.

ABOUT THE AUTHOR

Grant W. Newton, Ph.D., CIRA

At the time this article was published in *The Journal of Accountancy*, the editors indicated Grant W. Newton, Ph.D., CPA, was assistant professor of accounting at the University of Alabama; a member of the American Accounting Association, the Alabama Society of Certified Public Accountants, the AICPA, and the National Association of Accountants; and the author of several articles and a book on bankruptcy and insolvency accounting. He received his Ph.D. in Accounting from New York University.

CREDIT BIDDING: BACK TO BASICS

BRIAN J. LOHAN and MAJA ZERJAL FINK
Arnold & Porter

In this article, the authors offer a compact treatise on a secured lender's right to credit bid obligations owed to it in a sale of a borrower's assets. The topics covered include: the right to credit bid; the reasons to credit bid; limitations to credit bidding; the effect of loan documents; and the importance of diligence and strategy when preparing a credit bid.

As we entered 2022, defaults and bankruptcies were at historic lows. Since then, however, inflation, rising rates and supply chain issues (among other things) have increased the possibility of an uptick in distress activity. Regardless of whether we see continued growth and prosperity or the pendulum swings the other way, understanding—and if applicable, properly negotiating and/or exercising, your rights and remedies as a lender (or potential lender)—is an important tool to prepare for whatever is to come.

This article focuses on a secured lender's right to credit bid obligations owed to it in a sale of a borrower's assets. Specifically, we discuss legal considerations of credit bidding under the Bankruptcy Code, as well as practical considerations under a lender's loan documents.[1] While this article discusses credit bidding in the context of a secured lending relationship, the concept of credit bidding equally applies to secured creditors generally.

What Rights Does a Secured Lender Have to Credit Bid Under the Bankruptcy Code?

With limited exceptions, the Bankruptcy Code permits a debtor to sell its assets free and clear of a secured lender's liens if certain conditions are met.[2] In connection with such a sale, however, a secured lender can generally "credit bid" its claim; *i.e.,* its claim against the purchase price for the assets that are subject to such secured lender's lien.[3]

The right to credit bid is specifically addressed in sections 363(k) and 1129(b)(2)(A)(ii) of the Bankruptcy Code. Section 363 of the Bankruptcy Code generally provides a debtor with the ability to sell its assets (including outside of the ordinary course, which requires court approval), and section 1129 of the Bankruptcy Code addresses confirmation of a chapter 11 plan (including a plan which contemplates the sale of a debtor's assets).

Sales of estate assets can be pursued at any time during a chapter 11 case, including through a chapter 11 plan. Section 1129(b)(2)(A)(ii) requires that a cramdown plan provide "for the sale, *subject to section 363(k)* of this title [*i.e.*, the secured lender's right to credit bid], of any property that is subject to the liens securing such claims, free and clear of such liens … "[4] Until the Supreme Court's *RadLAX* decision (discussed below), certain courts held that a chapter 11 plan could be confirmed even if the secured lender was denied the right to credit bid under subsection (ii), so long as the plan offered the secured creditor the "indubitable equivalent" of its claims, as required by subsection (iii) of section 1129(b)(2)(A). In 2012, the Supreme Court, in *RadLAX Gateway Hotel LLC, et al. v. Amalgamated Bank*, 132 S.Ct. 2065 (2012), held that when a chapter 11 plan contemplates a sale free and clear of a secured creditor's lien, the plan has to satisfy subsection (ii) of section 1129(b)(2)(A), which preserves the secured creditor's right to credit bid.[5]

Accordingly, if a debtor contemplates a sale of its assets during a chapter 11 case (either in a section 363 sale or a sale pursuant to a chapter 11 plan), a secured lender can credit bid under section 363(k) of the Bankruptcy Code. In either scenario, however, the right to credit bid is not unfettered. Specifically, section 363(k) provides that a court could deny, limit or condition a lender's right to credit bid "for cause" (as further discussed below). As 1129(b)(2)(A)(ii) provides that any sale of assets is subject to section 363(k), the same limitation applies in a sale pursuant to a chapter 11 plan. In addition, a secured lender's right pursuant to 1129(b)(2)(A)(ii) only arises if a plan is being "crammed down" on the secured lender class. In other words, if the class of secured claims accepts the plan, section 1129(b)(2)(A)(ii) need not be satisfied with respect to any secured lender in such class for a debtor to confirm its plan.

Why Should a Lender Consider Credit Bidding?

There are a multitude of reasons a secured lender may consider a credit bid, and a credit bid can be part of an offensive or defensive strategy. First, existing secured lenders to a distressed borrower may believe a turnaround story exists for the borrower and want to capture the upside of such turnaround. In addition, investors may acquire secured claims against a borrower (often at a discount) for the purpose of credit bidding such claims in a

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1 While addressing credit bidding generally, the article does not address credit bidding in out of court situations such as Article 9 Sales and foreclosures.

2 11 U.S.C. § 363(f) (estate's property can be sold free and clear of a third party's interest in such assets if, among other things: (a) applicable nonbankruptcy law allows the sale free and clear of such interest, (b) the third party consents to the sale, (c) the interest is a lien and the sale price is greater than the value of all liens, (d) the interest is in *bona fide* dispute, or (e) the entity could be compelled to accept money in satisfaction of its interest).

3 Specifically, section 363(k) of the Bankruptcy Code provides that "[a]t a sale under [section 363(b)] of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."

4 11 U.S.C. § 1129(b)(2)(A)(ii) (emphasis added).

5 The Supreme Court rejected Fifth Circuit and Third Circuit decisions holding that a debtor can confirm a "cramdown" plan without giving a secured creditor the right to credit bid because a secured creditor can supposedly always be offered the "indubitable equivalent" of its claim in lieu of a credit bid under subsection (iii) of section 1129(b)(2)(A). *Pacific Lumber Co., et al. v. Official Unsecured Creditors' Committee*, 584 F.3d 229 (5th Cir. 2009); *In re Philadelphia Newspapers LLC, et al.*, 599 F.3d 298 (3d Cir. 2010).

sale of the borrower's assets.[6] In these scenarios, the secured lender credit bids for, and becomes the subsequent owner of, the borrower's assets.

Conversely, a secured lender can also credit bid in a defensive manner. For example, a secured lender can submit a credit bid to set a floor for the purchase price of its collateral in the hope for higher bids. In this scenario, the credit bid may be for less than the full value of the secured lender's claim, especially if the secured lender does not believe any third party is likely to pay a price that would match or exceed the amount of its secured claim. Such bid may signal to the market that the secured lenders have a "release" price that is less than the full amount of their claim—in essence, a thawing bid.

Conversely, a secured lender may credit bid to prevent a sale of its collateral at a price it believes undervalues the assets. If third parties are not offering enough value at the time of the auction, a secured lender may want to submit a topping credit bid, own the assets, or sell them when market conditions present an opportunity to obtain greater value.[7]

As a general matter, a secured lender can credit bid the face value of its secured claim, regardless of the price at which such lender acquired the secured claim. However, the manner in which the lender acquires its claim (including the price) may be a consideration in whether there is "cause" to deny, limit or condition a secured creditor's right to credit bid.

Whether using a credit bid as an offensive or defensive strategy, lenders can be proactive and seek to act as the "stalking horse bidder," *i.e.*, the bidder that sets the floor for the price and the required sale conditions in exchange for certain benefits, which often include a break-up fee and reimbursement of certain expenses.

Limitations to Credit Bidding

A secured lender can only credit bid for assets that are subject to its lien. To the extent the secured lender seeks to acquire assets of a borrower that are not subject to the lender's lien, the lender will be required to offer consideration, other than its secured claims. Collateral packages securing credit facilities often exclude certain assets (usually where perfection would be costly or impractical), so in a sale of all assets, additional consideration will be likely.[8] Moreover, in the event the assets are subject to more than one lien, secured creditors holding junior liens can be allowed to credit bid, subject to any contractual limitations set forth in any intercreditor agreement, but generally must pay lenders holding senior liens in cash in full.

A secured lender's claim must also be allowed. Because of the Bankruptcy Code's adequate protection requirements for use of collateral,[9] secured creditors (and especially, secured lenders) are typically in a unique position to have a debtor stipulate to the amount and validity of the creditors' claim at the outset of a bankruptcy case (sometimes in the context of a cash collateral order, or, if such lender is providing debtor in possession ("DIP") financing, a DIP order). Such stipulations are typically subject to a "challenge period" for other parties in interest (*e.g.*, a creditors' committee) to challenge a secured creditor's claims or liens. To the extent, however, the priority and validity of a secured creditor's claims are not stipulated by a debtor or not included in a debtor's schedules, a secured creditor should file a proof of claim.[10]

If an objection or challenge creates a *bona fide* dispute as to the validity, extent or priority of a secured creditor's lien or the amount of its allowed claim, the bankruptcy court may condition a secured creditor's ability to credit bid, including on such creditor's agreement to pay the purchase price in cash if the claim is ultimately disallowed (it may also require depositing such amount in escrow, or providing a letter of credit or other security, for example).

Further, as noted above, section 363(k) provides for a secured lender's right to credit bid "unless the court for cause orders otherwise." "Cause" is not defined in the Bankruptcy Code and is left for courts to determine on a case-by-case basis. Generally, bases for limiting credit bidding rights include challenges to the

6 Competitors and certain lenders that the borrower may deem aggressive are often placed on the loan agreement's "disqualified lenders" list, which prevents such entities from acquiring the borrower's loans.

7 In considering strategies, however, lenders must be careful not to engage in collusion. While collaboration among bidders (including credit bidders) is allowed, section 363(n) of the Bankruptcy Code gives the debtor the right to avoid a sale or recover damages "if the sale price was controlled by an agreement among potential bidders at such sale." Generally, disclosing any existing or likely agreements with third parties can shield a credit bidder from section 363(n) issues. *See, e.g., In re Waypoint Leasing Holdings, Ltd.*, 607 B.R. 143 (Bankr. S.D.N.Y. 2019) (section 363(n) challenge was unsuccessful where secured lender's credit bid was the winning bid and the lender was in discussions with a strategic buyer for a subsequent transaction when such discussions with the strategic buyer were disclosed).

8 Such additional consideration is sometimes also required if the estate would be left without cash to wind down or become administratively insolvent if the credit bid is the winning bid and substantially all assets are sold. In addition, this article does not discuss the implications and strategies for "roll-up" DIP financing, as well as credit bidding adequate protection or DIP claims.

9 Practically, a debtor will need to provide adequate protection for, at a minimum, use of the secured lenders' collateral during a case. *See, e.g.*, 11 U.S.C. § 363(e) ("Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.").

10 Section 502(a) of the Bankruptcy Code provides that when a proof of claim is filed, the underlying claim is considered allowed until a party in interest objects.

Continued from p.11

lender's lien or claim and a lender's inequitable conduct.[11] Certain courts have considered the effect a credit bid would have on the auction process, and in at least one instance determined that "freezing" an auction process, in and of itself, could constitute "cause" to deny or limit the right to credit bid. For example, in *Fisker*,[12] the court concluded that freezing the bidding could in and of itself be sufficient "cause" to disallow or limit credit bidding. As a result, the court limited the secured lender's credit bid to what it paid for the claim as opposed to the face value of the claim based on his conclusion that, among other things, (i) if the credit bid were not limited, the auction process would not occur at all and (ii) the claim was disputed. In *In re Aeropostale, Inc.*,[13] however, the court differentiated "freezing" bidding in *Fisker* from "chilling" bidding and found that "chilling" bidding alone does not constitute "cause" under section 363(k). In such case, other factors, such as inequitable conduct, would also have to be present to establish "cause" under 363(k).[14]

Conversely, the debtor and third parties can use these limitations strategically or defensively to try to limit or disallow a secured lender's credit bit.

What Does a Lender Need to Consider Under the Loan Documents When Considering a Credit Bid?

Although the Bankruptcy Code provides a secured lender with the right to credit bid, how that right is exercised is, in part, informed by the loan documents. In the case of a single lender to a borrower, the right is generally controlled and/or exercised by the lender at its discretion (subject to the limitations described above).

Where there is more than one lender to a borrower, however, credit bidding is not as straightforward. For example, while loan documents governing secured lenders' claims generally provide a mechanism to exercise a credit bid, questions that should be considered include:

- Who "controls" the right to credit bid (agent, lenders)?
- What is the threshold for directing the party that has the right to credit bid (simple majority, super majority, other)?
- What indemnities need to be provided, and to whom?
- What triggers a right to credit bid under the loan documents?
- What notice is required?
- What rights, if any, do individual lenders have with respect to a credit bid?
- Can you "drag" dissenting lenders?
- Are there other secured creditors that have rights in the same collateral?
    - What is their priority?
    - Is there an intercreditor agreement?
    - Can they be "dragged"?

In light of all these considerations, a secured lender in a facility with more than one lender should understand, and to the extent possible, protect, its rights with respect to credit bidding—ideally when the applicable documents are drafted.

The Importance of Diligence and Strategy When Preparing a Credit Bid

Diligence plays an important role in determining whether, and to what extent, a lender should credit bid. Two threshold questions, among others, must be considered in the diligence phase: (i) do the governing loan documents impose any requirements or restrictions on a lender's right to credit bid and (ii) which assets being sold are subject to a secured lender's lien?

After doing its diligence, a secured lender should determine whether it (i) wants to or can (there may be regulatory or other restrictions) own and operate the assets, or (ii) is willing to allow a third party to purchase the assets. If a lender concludes the latter, a corollary question arises of what price a secured lender is willing to accept for its collateral (its "release" price). Further, a secured lender must be informed as to the potential market for the borrower's assets. A robust market, itself, may create a competitive environment, and a secured lender must consider whether its credit bid will encourage or "chill" bidding.

Moreover, if a lender intends on credit bidding as a means to own the debtor's assets, other issues need to be considered. For example, some diligence items include:

- **Employee Matters**. What incentive or bonus plans does the borrower maintain for is employees? To the extent there are any equity-based incentive plans, what will need to be done to retain key employees? Would a sale trigger change-of-control severance obligations?
- **Pension Benefit Guaranty Corporation/Control Group Pension Plan Liabilities**. Does the borrower maintain a pension plan? If so, how many active employees participate in the plan, what is its funded status, as well as what is the composition of its assets? The potential bidder will have to decide whether to assume such plans and what liability is associated with them. If a borrower's pension plan is terminated in connection with a credit bid, is the potential bidder acquiring the equity of a non-debtor subsidiary or affiliate that could be liable for pension plan obligations as a member of a "control group"?[15]

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[11] *See, e.g., In re Figueroa Mt. Brewing, LLC*, No. 9:20-bk-11208-MB, 2021 Bankr. LEXIS 1775, *22, 24 (Bankr. C.D. Cal. July 2, 2021) (noting that courts have found cause under section 363(k) when a creditor's lien is questioned or otherwise in dispute and denying the creditor's credit bid where there was "a sufficient dispute regarding [the creditor's] claim).

[12] 510 B.R. 55 (Bankr. D. Del. 2014).

[13] 555 B.R. 369 (Bankr. S.D.N.Y. 2016).

[14] *See also In re Tempnology, LLC*, 542 B.R. 50, 69 (Bankr. D.N.H. 2015) (denying a challenge to a secured creditor's right to credit bid its claim in the absence of any evidence of inequitable conduct or that the secured claim was subject to *bona fide* dispute), *aff›d*, 558 B.R. 500 (B.A.P. 1st Cir. 2016), *aff'd*, 879 F.3d 376 (1st Cir. 2018); *In re Charles Street African Methodist Episcopal Church of Boston*, 510 B.R. 453 (Bankr. D. Mass. 2014) (denying in part a motion to limit a credit bid where the debtor's counterclaims did not relate to the validity of the secured creditor's claims or liens, but requiring the secured creditor to include in its bid cash in an amount equal to a breakup fee payable to the stalking horse bidder).

[15] If there is a defined benefit pension plan, the debtor and its controlled group members could become liable for the pension plan termination liabilities.

- **Environmental Issues**. Does the borrower have ongoing remediation obligations that cannot be released? Are there owner or operator liability concerns?
- **Senior Liens**. Are there liens senior to the secured lenders' liens that may (or may not) be permitted under the loan documents (for example, statutory real property tax liens)? Creditors holding such liens may have to be paid in cash or their liens may have to be preserved
- **Non-Debtor Subsidiaries**. If a lender is acquiring the equity of a subsidiary that is not a debtor in bankruptcy, diligence should be done on the claims at the non-debtor subsidiary (and whether a change of control triggers any additional claims).
- **Intellectual Property Issues**. What intellectual property rights are key to operating the borrower's business? Where do those rights come from? Are those intellectual property rights part of the secured lender's collateral? To the extent a borrower is a licensor of intellectual property, what rights does the licensee have under section 363(n) of the Bankruptcy Code to the continued use of the intellectual property (even if such license is rejected)? What consents may be required to transfer rights under licenses?
- **Regulatory Approvals**. What local, state and/or federal regulatory approvals are required to operate the business (*e.g.*, are there gaming, liquor, or other similar licenses)? What is the process for obtaining such approval or transferring existing certificates?
- **Transition/Shared Services**. Is the secured lender getting everything it needs to operate the business on day one? Is there a need for a period of transition? Are there any pending approvals? Is the cash management system in place? Are customer receivables being purchased? How do customers pay their bills? Do they pay to a lock box of the seller?
- **Executory Contracts/Leases**. Are there contracts or leases that are needed to operate the business that should be assumed? Conversely, are there contracts or leases that are burdensome that should be rejected? For contracts or leases that are to be assumed, what are the cure costs associated with assumption? What is required to demonstrate adequate assurance of performance in the future?

The diligence of these and other aspects of the assets should inform a secured lender's view of the value of its collateral (*e.g.*, it may be more attractive if there is a robust market for such assets or if a secured lender can create additional value by owning such asset through synergies, for example). If a secured lender intends to operate the assets, it should ensure that it can actually use and operate the assets once purchased. For example, if the collateral package excludes important intellectual property rights, a secured lender should understand whether the assets are still valuable without such right, and if not, how, and at what price, those rights can be acquired. Also, while assets are sold free and clear of claims and interests, a lender should understand what assets it is actually purchasing. For example, purchasing equity interests in a non-debtor subsidiary transfers the equity interests free and clear of claims and interests against the equity itself—claims against the non-debtor subsidiary are not impaired.

Additionally, a secured lender will have to consider the acquisition mechanics. Usually, a bidding vehicle is set up to purchase the assets, with secured lenders holding equity or debt interests in such vehicle (if the vehicle were to assume all or part of the seller's debt, for example). Where more than one lender is credit bidding, it is important to define the respective rights and obligations with respect to the bidding vehicle.

Conclusion

Credit bidding is an important right of a secured creditor. Exercising such right, however, requires certain consideration and advanced planning. If you are a secured lender to a distressed borrower, it is never too early to review (i) loan documents for any conditions or restrictions on credit bidding (especially vis-a-vis other secured lenders), and (ii) the assets comprising your collateral, the perfection thereof, and the assets necessary to operate the borrower's business.

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CHALLENGES IN THE VALUATION OF VC-BACKED COMPANIES: WHY RELYING ON POST-MONEY VALUATIONS IS OFTEN INAPPROPRIATE

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Introduction

Valuation of privately held companies can be challenging, especially when those companies are growing rapidly and involve new technologies and markets. In contrast to publicly traded companies, there is no readily available market price, and using commonly accepted methodologies such as discounted cash flow (DCF) or multiples valuation may be difficult due to lack of financial information and/or appropriate comparables. Instead, market participants often rely on the so-called *post-money valuation*, which is calculated by taking the price per share paid in a given external financing round and multiplying it by the total number of shares outstanding (on a fully diluted basis) of the company being valued.

However, this methodology is not appropriate for the vast majority of venture capital (VC) backed firms because these firms typically issue different classes of stock. These classes of stock can have substantially different values depending on the way they are structured and on their rights and preferences. Assuming that all shares are worth the same as the ones issued in the most recent external financing round can result in a substantial overvaluation of the company, as investors typically receive convertible preferred shares, while founders and employees receive common shares or options on common shares. In addition, the most recent investors often receive the most favorable terms compared to investors in earlier funding rounds. Recent research has found that, in a sample of 135 U.S. unicorns, the use of post-money valuation resulted in an average overvaluation of approximately 48 percent, with almost half of those companies losing their unicorn status when an appropriate valuation methodology was used.[1]

Accurate valuation estimates are likely to become central in an increased number of disputes in the next few years for at least two reasons. First, the number of highly valued VC-backed companies has been steadily increasing as more of these companies stay private longer. For example, in 2020 and 2021 alone over 310 companies in the U.S. became unicorns. Second, more recently there have been signs of a significant cool-off in private markets amid increasing volatility, dampening the high valuations reached in years prior.

Growing Importance of VC-Financing and Potential for Disputes Related to Valuation

Venture capital plays a central role in the financing of innovation and high-growth companies in the U.S. Recent research shows that VC-backed companies account for 41 percent of total U.S. market capitalization, and include some of the largest public companies in the world such as Microsoft, Amazon, Alphabet, Meta, and Tesla.[2] VC financing has grown substantially over the last fifteen years and, together with the growth of other private capital sources,[3] has enabled companies to remain private for longer.[4] Further, as the VC market grew, it attracted the attention of a broader set of investors than what was historically the case, including mutual funds and individual investors.

Disputes involving VC investors and other stakeholders—including limited partners (investors in VC and private equity funds), entrepreneurs, other investors, lenders, competitors, and tax authorities, among others—often center around the valuation of a company at the time of a round of financing. Using post-money valuations in such cases is usually inappropriate; instead, a methodology that appropriately accounts for the complexity in the capital structure of VC-backed firms is required.

The Gornall-Strebulaev Methodology

Will Gornall and author Ilya Strebulaev developed a valuation methodology that explicitly models the features of each class of stock issued by a VC-backed firm, thereby allowing for the recovery of an accurate estimate of the company's value from

[1] Will Gornall and Ilya A. Strebulaev, "Squaring Venture Capital Valuations with Reality," *Journal of Financial Economics* 135, 1 (2020): 120-143 ("Gornall and Strebulaev (2020)"), available at https://www.gsb.stanford.edu/faculty-research/publications/squaring-venture-capital-valuations-reality. A unicorn is a VC-backed company that reaches a reported valuation of $1 billion or more while remaining private.

[2] Will Gornall and Ilya A. Strebulaev, "The Economic Impact of Venture Capital: Evidence from Public Companies," Working Paper, June 2021.

[3] *See e.g.*, Sirio Aramonte and Fernando Avalos, "The Rise of Private Markets," *BIS Quarterly Review*, December 6, 2021, https://www.bis.org/publ/qtrpdf/r_qt2112e.htm.

[4] *See e.g.*, Michael Ewens and Joan Farre-Mensa, "The Deregulation of the Private Equity Markets and the Decline in IPOs," *Review of Financial Studies, Forthcoming*, February 7, 2020: 5463-5509. Available at SSRN: https://ssrn.com/abstract=3017610.

the fair price of one class of stock.[5] The Gornall-Strebulaev methodology is the foundation of an academic article published in 2020 in the *Journal of Financial Economics*.[6]

As noted above, the Gornall-Strebulaev methodology requires a fair price for at least one of the series of stock issued by a VC-backed company. This fair price is often taken to be the price in an investment by informed, sophistical, independent parties (such as VC funds), typically as part of an external financing round. The intuition behind the methodology is that the value of a company at the time it raises external financing should be consistent with the price and terms of such financing.

Armed with the fair price of a class of stock, the Gornall-Strebulaev methodology relies on a state-of-the-art option pricing methodology to model the expected payoff of the different classes of stock issued by a VC-backed firm at the time of exit (via liquidation, M&A, or an IPO). Crucially, the methodology allows for substantial flexibility in incorporating the payout structures and rights of each class of stock, arriving at an implied (fair) valuation of the company as a whole and for each class of stock.[7]

Preferred Convertible Stock

VC-backed firms typically issue a new series of preferred convertible stock with each new round of outside financing. Preferred convertible stock issued by private firms is very different from the common or preferred equity issued by companies that are listed on public exchanges. In particular, preferred convertible stock has (1) a liquidation preference, meaning that in case of liquidation of the company, its holders have priority over other investors in receiving a payout (typically the dollar amount they invested); and (2) an option to convert into common stock, allowing the holders to benefit from increases in the equity value of the company. In most cases, conversion into common stock may also be forced by the company if there is an IPO meeting certain criteria.

The Gornall-Strebulaev methodology can account for the liquidation preference and conversion rights of convertible preferred stock issued by VC-backed firms. Importantly, it can also account for other features that are commonly observed in convertible preferred stock series. For example, certain series provide the potential for a more favorable payout in case of an IPO, such as the right for additional shares in a "low priced" IPO (called IPO ratchet) or the right to benefit from both the payout upon conversion and the liquidation preference (called participation). Other contractual features that convertible preferred stock series often include offer additional protection in downside scenarios, such as protection from down-rounds (known as anti-dilution) and protection from automatic conversion at IPO. The latter exempts the preferred stock from automatic conversion at IPO if the IPO does not reach certain thresholds in terms of price or proceeds.

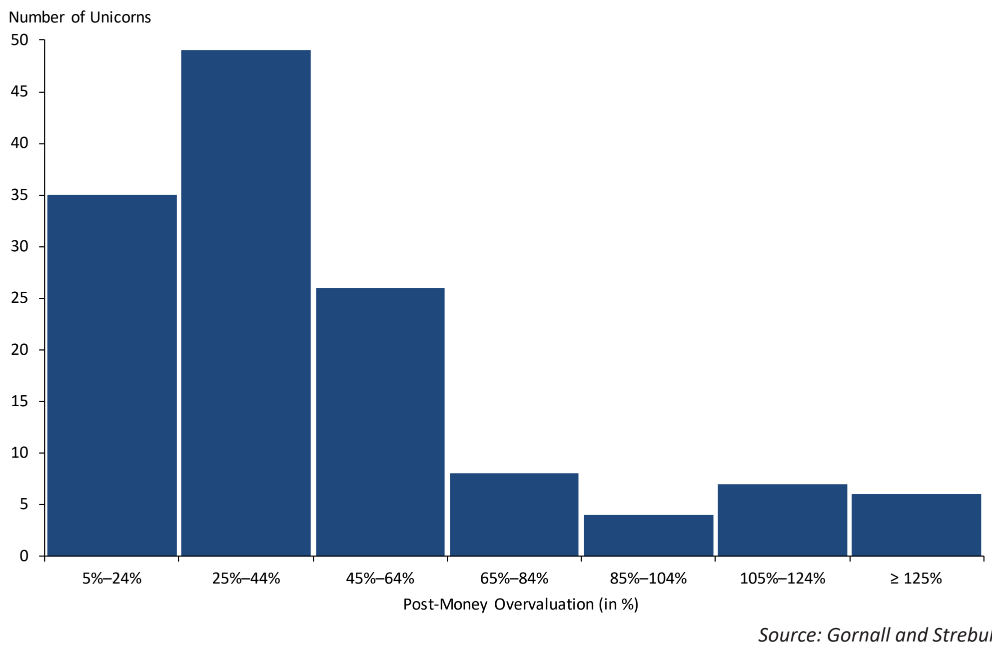
These and other rights can make a series of preferred stock more valuable than, and potentially less representative of, the remaining classes of stock, making a naïve post-money valuation—which ignores differences between classes of stock—inappropriate. The chart in Exhibit 1 shows the difference (in %) between the post-money valuations and the valuations estimated using the Gornall-Strebulaev methodology for the 135 U.S. unicorns described in Gornall and Strebulaev (2020). The average unicorn post-money valuation is 48 percent above its fair value as estimated using the Gornall-Strebulaev methodology. The post-money valuation was at least 100 percent higher than the value given by the Gornall-Strebulaev methodology for more than 10 percent of the unicorns that were analyzed.

[5] An important precursor to the Gornall-Strebulaev methodology is covered in Metrick (2007), who implements an option-pricing method to value securities of VC-backed firms. *See* Andrew Metrick, *Venture Capital & the Finance of Innovation,* 1st ed. (New York: John Wiley & Sons, 2007).

[6] Gornall and Strebulaev (2020).

[7] The methodology also requires certain other inputs, including the expected volatility of a company's value, that may need to be adjusted depending on the firm being considered.

Exhibit 1: Difference (in %) Between Post-Money Valuations and Valuations Estimated with Gornall-Strebulaev Methodology



Source: Gornall and Strebulaev (2020)

Continued from p.15

While the Gornall-Strebulaev methodology was designed to be used in the context of capital raising rounds, when a fair price for a series of stock may be available, it can also be used as a starting point for a valuation on a different date. In those cases, adjustments to the valuation or a combination with other valuation techniques may be required, depending on the characteristics of the firm and its growth.

Conclusion

VC financing has long been an important feature of capital markets for high-growth companies in the U.S., but its importance has grown substantially over the past fifteen years, and more companies delay their IPOs and reach very high valuations while private. Valuation of VC-backed private companies can be challenging because of the lack of financial information and because of the distinctive characteristics of those firms. Thus, market participants often rely on the price of new financing rounds to back out the total value of the company as given by the post-money valuation, which is calculated by multiplying the per-share price of the latest round of financing by the total number of (fully diluted) shares outstanding. However, this metric does not appropriately reflect the complexity and heterogeneity of the preferred convertible stock issued by VC-backed companies. Using an appropriate methodology to value the company at the time of a financing round, such as the Gornall-Strebulaev methodology, can and often does result in valuations that are substantially below those implied by the post-money valuation.[8] These differences can be central to many types of disputes involving VC-backed companies, their investors, employees, founders, and tax authorities, among others.

[8] Conceptually, the Gornall-Strebulaev methodology is similar to the backsolve methodology that is often used in the context of 409A valuations in the sense that it can back out the value of the whole company and of each equity claim from the price of a single equity claim. However, there are some important differences. Among other things, the Gornall-Strebulaev methodology explicitly models the distribution of the value of the company over time, allowing for a more reliable incorporation of more complex features and providing an interval for the valuation of each class of stock, rather than a single point estimate. Further, 409A valuations often (erroneously) include approved but unissued stock options in their calculations, while the Gornall-Strebulaev methodology does not.

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Professor Strebulaev is a coauthor on the paper discussed in this article: Will Gornall and Ilya A. Strebulaev, "Squaring Venture Capital Valuations with Reality," Journal of Financial Economics 135, 1 (2020).

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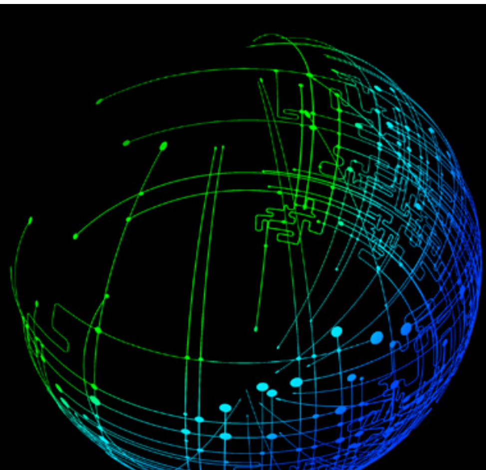

VALUATION CHALLENGES: FASB FINALIZES CHANGE TO FAIR VALUE RULES[1]

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On June 30, 2022, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2022-03, amending a longstanding, albeit somewhat diverse fair value measurement practice with respect to equity securities subject to contractual sale restrictions. The change prohibits taking into account contractual restrictions on the sale of an equity security when estimating its fair value—on the basis that such restrictions are not part of the equity security itself. Recognizing and measuring the contractual sale restriction as a separate unit of account (as a contra-asset or a separate liability) is also prohibited.

The change impacts all equity securities measured at fair value that are subject to contractual sale restrictions but will likely impact investors in alternative asset funds the most.

Prior Rules

Under the prior FASB fair value rules—and current International Financial Reporting Standards (IFRS) rules, which have not been amended—fair value is the amount that would be received in an orderly transaction using market participant assumptions as of the measurement date. When an equity security is contractually restricted from sale, a hypothetical sale (the premise used by FASB ASC Topic 820 to measure fair value) would consider a market participant's assessment of that restriction, including whether a buyer of the equity security would be obligated to abide by the same restriction. As a simple example, if an equity security without a restriction is valued at $100 (based on the traded price on an exchange) but because of the restriction a buyer would only pay $90 (as the buyer/seller cannot trade the security on an exchange due to the restriction), fair value under the prior FASB rules would be $90.

Amended Rules

Under the amended rules, using the example above, the rationale is that the contractual sale restriction is not part of the unit of account of the equity security, and therefore fair value will be $100, leading to a potential divergence with international standards and an overstatement of what would be received in an orderly transaction between market participants. Notably, the amendments apply not only to actively traded securities (Level 1) but to all securities, including those categorized in Level 2 and Level 3.

The amendments do not apply to unregistered securities under Rule 144 or similar SEC rules, whereby the argument is that the restriction would be included in the unit of account of the equity security, and therefore its effect will be reflected in the fair value measurement.

Potential Unintended Consequences and Open Questions

Many private investors have investment agreements (Level 3 investments) with contractual language that could be deemed to prohibit sale. The impact of such embedded clauses could present challenges when a security is purchased at its "economic value," inclusive of the effect of the restriction (*i.e.*, at what would have been fair value under the prior FASB rules). As such, the purchase price may now have to be adjusted to remove the effect of the restriction (*i.e.*, the illiquidity discount) under the new rule, resulting in a 'day-one' gain.

Investors who use the 'practical expedient' in valuing fund interests using net asset value (NAV) will need to consider the divergence in reported fair value-based NAV between funds reporting under the new U.S. Generally Accepted Accounting Principles (U.S. GAAP) fair value rules and the existing IFRS fair value rules. Does the FASB change mean that investors reporting under U.S. GAAP will now need to modify reported NAV for all funds reporting under IFRS to be compliant with the practical expedient?

ASU 2022-03, paragraph 820-10-35-6B clearly states that "[if] an entity cannot sell on the measurement date because of a contractual sale restriction [the equity security] shall be measured at fair value on the basis of the price in the principal (or most advantageous) market. A contractual sale restriction does not change the market in which that equity security would be sold." Yet many could interpret the market in which an equity security with a restriction can be sold to be the private market, not an exchange traded market that cannot be accessed. How will this potential conflict be interpreted and applied?

These questions and others will likely be addressed through expected amendments to the AICPA accounting and valuation guide, *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*.

New Disclosure Requirements

After adoption, the following will be required disclosures for equity securities subject to contractual sale restrictions:

- The fair value of equity securities subject to contractual sale restrictions.
- The nature and remaining duration of the restriction(s).
- Circumstances that could cause a lapse in the restriction(s).

[1] This article originally appeared online at www.kroll.com on July 5, 2022. Available at https://www.kroll.com/en/insights/publications/valuation/valuation-challenges-fasb-finalizes-change-to-fair-value-rules.

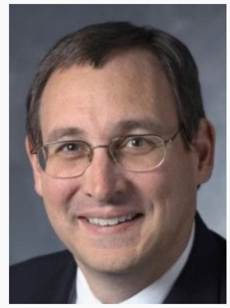
Equity securities restricted from sale because they are pledged as collateral are not included in any of the above disclosures as they are subject to other existing U.S. GAAP disclosure requirements.

Effective Date and Transition

- For public business entities, the amendments are effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. Early adoption is permitted.
- For all other entities, the amendments are effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that have not yet been issued or made available for issuance.
- For all entities except investment companies, the amendments apply prospectively, and the impact of the change is reported in current-period earnings when first applied.
- For investment companies, the amendments apply prospectively to equity securities subject to contractual sale restrictions that have been executed or modified on or after the date of adoption. Contractual sale restrictions executed before the date of adoption will be measured using the existing accounting policy to reflect the impact on fair value of the restriction until the restriction expires or is modified.

Accordingly, investment companies will be required to differentiate between these two groups of equity securities subject to contractual sale restrictions when providing the required disclosures.

ABOUT THE AUTHORS



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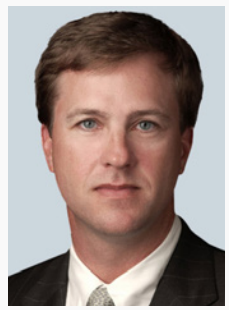

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RETHINKING BANKRUPTCY: THE IMPORTANCE OF FOCUSING ON TECHNOLOGY

SUMEET GUPTA and WILLIAM BRYDGES
FTI Consulting

"Technology is often the critical element that enables a bankrupt company to turn itself around and become a competitive business, although it is often the most overlooked transformation aspect in bankruptcy."

Bankruptcy is a formal process geared toward preserving stakeholder value. Often, the proceedings include negotiations between stakeholders that are arduous, time-consuming, and expensive. As such, the main focus during bankruptcy tends to be on completing the process, rather than positioning the company for healthy and sustainable growth after emergence.

This limited focus is certainly understandable, given all the pressures and constraints that accompany bankruptcy. And it is amplified by the rise of pre-packaged and pre-arranged bankruptcies, which primarily focus on solving capital structure challenges (with minimal attention to operational changes to the business). However, some of the constraints that companies operate under during bankruptcy may be self-imposed or driven by conflicting priorities that restrict management's options and limit the ability to grow and thrive post-bankruptcy.

To gain real-world, quantifiable insights about the bankruptcy process, FTI Consulting recently conducted an in-depth survey of senior executives with direct experience leading large companies through bankruptcy. Our experts then created an emergence playbook to help companies in bankruptcy design and execute more effective strategies for achieving post-bankruptcy success.

The full report, "Emerge to Grow: An FTI Consulting Report,"[1] provides a general overview of the bankruptcy process and landscape, including a broad look at the five key business dimensions of capital, cost, growth, technology and talent. This report takes a closer look at the technology dimension, which is critical to post-bankruptcy success but, according to the survey, is often overlooked during the traditional bankruptcy process.

Key Survey Findings Related to Technology

Our survey revealed critical gaps in the traditional bankruptcy process, with a clear need and opportunity for more effective emergence planning. According to the business leaders we surveyed:

The bankruptcy process does not fully prepare emergent companies for post-bankruptcy success. Across all five dimensions, relatively few survey respondents believe their companies were substantially prepared for post-bankruptcy success. Technology ranked the lowest (14%), followed by cost (22%), talent (26%), growth (28%), and capital (32%). The speed of the bankruptcy process likely hampers the ability to address these topics.

Other important business issues are often not meaningfully addressed. Looking beyond the five key dimensions, like business planning, ESG, and risk management, among others, nearly half of respondents (44%) also did not feel they were able to meaningfully focus on other important business issues during the bankruptcy process — an oversight that is likely to limit their ability to succeed after emergence.

Technology is not a high priority during bankruptcy. Of the five key business dimensions, *capital* was the top priority for most respondents (56%), followed by *cost* (34%). The other three dimensions were prioritized much lower: *growth* (8%), *technology* (2%), and *talent* (0%).

Technology enablement during bankruptcy or emergence was uncommon. Among the companies surveyed, roughly a third or less used digital technology (such as enterprise resource planning (ERP), cloud and automation) to enable key functions: customer service centers (34%), technology/IT (32%), finance (32%), and supply chain (28%). Technology enablement in other parts of the business was even lower.

Technology implemented during bankruptcy was more for reporting and analytics than for transformation and modernization. The top focus area for technology implementation was financial reporting and analytics (58%), followed by reporting and analytics for risk (34%), and reporting and analytics for business/management (30%). Implementation levels were significantly lower for transformational technologies such as cloud (22%), IT modernization (22%), and enterprise data management (20%).

Focusing on Transformational Technology

When it comes to the bankruptcy process, there are a number of common myths or misconceptions that limit companies' ability to position themselves for post-bankruptcy success.[2]

For the technology dimension, the myth is that companies in bankruptcy already have adequate technology and cannot afford the time, money and effort to implement new and

[1] Available at https://www.fticonsulting.com/insights/articles/emerge-grow-market-playbook-profitability-post-bankruptcy.

[2] For further discussion, see the article "Five Bankruptcy Myths That Stifle Success for Emergent Companies," available at https://www.fticonsulting.com/insights/fti-journal/five-bankruptcy-myths-stifle-success-emergent-companies.

improved technologies that are truly transformational. However, in many cases the exact opposite is true. Often, a key reason companies enter bankruptcy is that their technical capabilities are insufficient to meet market needs and their IT operations are costly and inefficient, contributing to poor overall financial performance. Their emergence business plans are anchored on their need to solve these IT problems; however, the problems often go unaddressed during the bankruptcy process.

The majority of survey respondents (58%) said they had addressed financial reporting and analytics technology to a great extent during bankruptcy, presumably to help them get through the process more quickly and meet the reporting requirements of the process. However, a significantly smaller number implemented transformational technologies such as cloud (22%), IT modernization (22%), and enterprise data management (20%). Also, only 2% of respondents identified technology as their top priority during bankruptcy, and only 14% said they had substantially addressed technology issues or were substantially prepared to be a viable enterprise in this area.

The COVID-19 pandemic has exacerbated the problem, triggering many technology-related changes to the way companies do business, including dramatic increases in remote work and omnichannel commerce. Failing to keep pace with these changes is a key risk, particularly for emergent companies that require digital transformation in order to compete effectively through new services, products, channels, and business/operating models. For these companies, strategically addressing technology during or immediately after bankruptcy is not just a good idea: it is a business imperative.

Using an Emergence Playbook

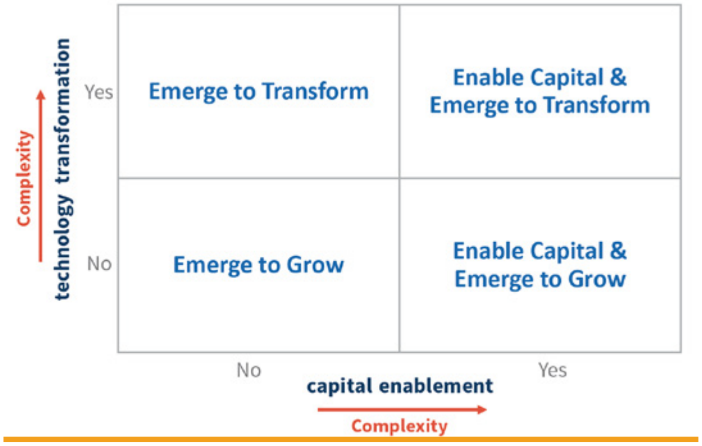
With a conventional bankruptcy, the optimal time to think about making a bankrupt business stronger is during the Chapter 11 process, not waiting until after it emerges. In bankruptcy, a company has unique opportunities to focus on the more profitable aspects of its business and establish a stronger foundation for healthy, sustainable growth.

An emergence playbook can help companies in bankruptcy quickly develop effective strategies, plans, and business/operating models to address all five core performance dimensions: capital, cost, growth, technology, and talent.[3] Of the five dimensions, the two that vary most widely — and therefore determine which playbook archetype is applicable — are technology and capital.

- **Technology**. In some situations, profitable and sustainable growth is achievable through traditional mechanisms such as organic growth, market expansion and acquisition (an "Emerge to Grow" model). In other situations, however, profitable and sustainable growth can only be achieved through longer-term technology transformation — using innovative technologies to dramatically improve a company's performance and competitiveness (an "Emerge to Transform" model).
- **Capital**. Under either model, an emerging company might need to closely manage its liquidity and capital needs, particularly credit availability, before it can consider an aggressive growth or transformation strategy.

[3] *Id.*

Exhibit 1: Four Archetypes for Successful Emergence



The resulting emergence playbook features four different archetypes that increase in complexity, risk and duration depending on a company's need for technology transformation and/or capital (Exhibit 1).

Each of these archetypes provides a valuable starting point for post-bankruptcy planning that fits a company's unique needs and ultimately can help it thrive and grow after emerging from bankruptcy.

Putting the Playbook into Action

Each archetype in the emergence playbook requires a unique three-phase approach, but with numerous elements that are common across archetypes.

- The first phase focuses on stabilizing the business and generating immediate cost savings that can help the entire emergence process become self-funding.
- The second phase focuses on improving profitability and initiating organizational readiness.
- The third phase focuses on achieving profitable and sustainable growth (Exhibit 2 on next page).

Drilling down on the technology dimension, many companies make the mistake of limiting their technology focus to reporting and analytics, instead of looking for ways that technology can be used to dramatically improve and transform the business through IT infrastructure investments and, especially, digital enablement.

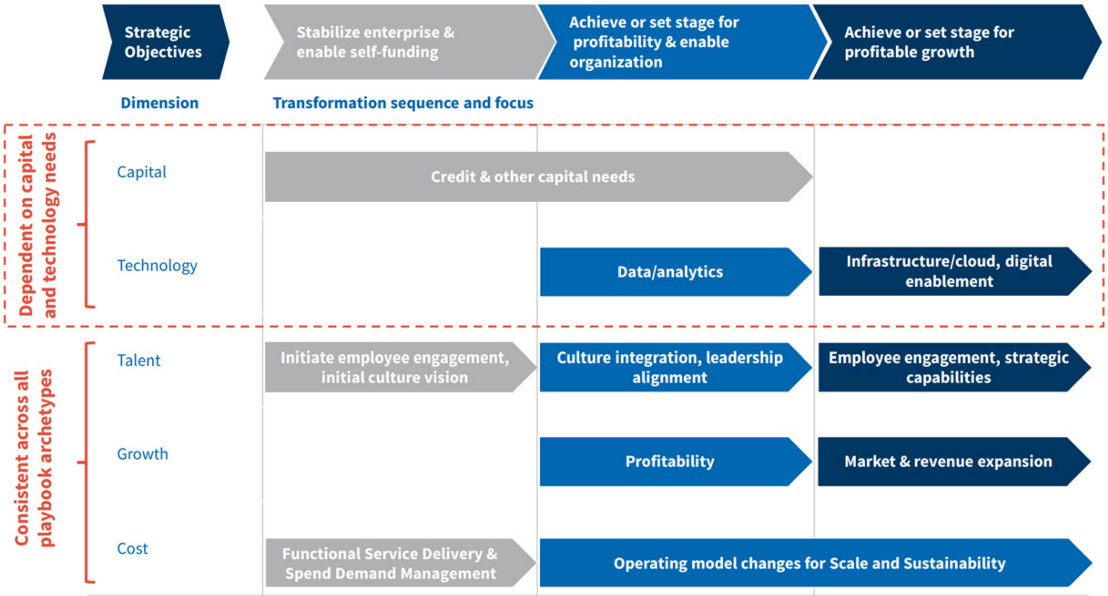
How to Address Technology Issues During Bankruptcy

To plan efficiently for emergence, companies in bankruptcy need to assess the current state of their information technology quickly and realistically. The two key factors are:

- **Technology capabilities** — the extent to which the company's current-state technology and data capabilities support its business needs in the context of its strategy (including plans for business transformation as part of emergence). Technology investments need to be prioritized, as there is only a finite amount of dollars to invest; that is, investment must be prioritized on *strategic technology capabilities*.

Continued from p.21

Exhibit 2: The Emergence Playbook In Action



- **Technology cost** — the cost structure (CapEx vs. OpEx) required to operate the current state and support the buildout of additional functionality (if required by the emergence business plan). This also may imply that it is critical to have a transformation plan that is *self-funding*.

A company in bankruptcy must start with an honest assessment of its current-state IT in order to understand what needs to be done. In layman's terms, this can be thought of as evaluating the technical "debt" that the company has accumulated over time (*i.e.*, what additional IT capabilities are needed to support the company's current business requirements adequately and efficiently, and also to achieve its post-bankruptcy business plan).

In the past, the company's IT capabilities might not have kept pace with its changing business needs. Over time, the gap grew between "what's possible" (given the company's existing technology) and "what's available" in the technology marketplace.

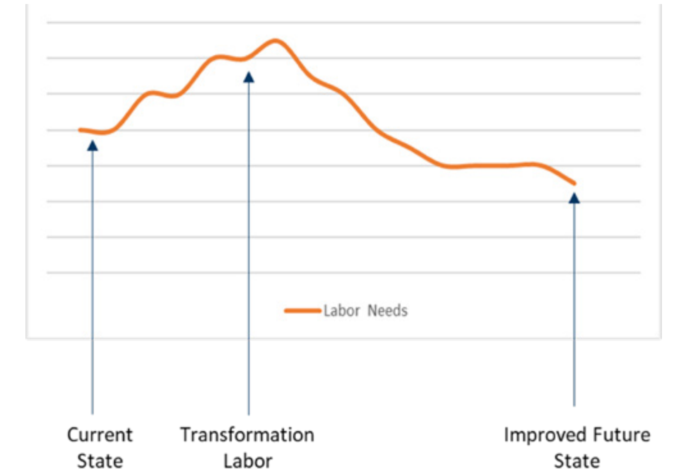
- Technical debt does not just affect how much effort and investment will be needed to support the evolving needs of the business; it also affects the flexibility and ease with which a company's current IT platforms can be modernized and adjusted.
- If the company's current IT environment has a lot of complexity and on-premise legacy applications, considerable effort will likely be required to adjust course. Also, a company saddled with older technologies might not be able to pivot or scale as quickly to support its new, post-bankruptcy business plan.
- Depending on the size and nature of a company's technical debt — and the level of effort required to close the gap — the company's ability to take headcount out of IT might be limited, especially if custom solutions will need to be developed. However, the work must be done (*i.e.*, the technical debt must be paid before the company can successfully move forward).
- As business plans for emergence and growth are developed, they should be evaluated against the company's current-state IT capabilities. For example, if the company's growth plan includes a shift to e-commerce and access to global markets, it is critical to understand the company's technical capabilities in those areas. *Does the company have flexible and robust e-commerce tools? Are its financial and transactional systems ready to handle currency challenges and complexities?* If the answer to either question is no, then technology enhancements will be needed.

Significant technology investment is often required to achieve transformational change; however, that investment will presumably enable the company to move to a lower-cost support structure over time (Exhibit 3). Too often, emergent companies overlook, or neglect to make, the "catch-up" investment required to get to a better baseline for future operations. In these cases, both transformation self-funding and further "capital enablement" may be required to support these strategic needs (*i.e.*, the "enable capital and emerge to transform" transformation archetype indicated on Exhibit 1).

When large-scale transformation is not needed, the required technology investments are generally much lower. In this situation, the key decision drivers will likely be cost structures associated with tools and resources; opportunities for outsourcing; and/or potential efficiency improvements from increased use of data and analytics. In this situation, simply having a transformation program that allows for self-funding may be sufficient (*i.e.*, the "emerge to transform" transformation archetype of Exhibit 1).

In either case, the key to efficiently tackling whatever technology changes are required by the business plan is to have a realistic picture of the current state. Without that informed perspective, it is nearly impossible to properly scope and design the future state (or even to understand if growth is possible with the company's existing systems and tools).

Exhibit 3: Labor Reduction Over Time as Transformation Occurs



An accurate current-state assessment enables the development of an effective roadmap for the future. Also, it can enable right-sizing of IT resources, and it helps identify tools or applications that can be decommissioned (or de-customized by shifting to commercial off-the-shelf (COTS) software).

A current-state technology assessment typically includes:

- A detailed and realistic assessment of the overall IT architecture (current and planned), including an analysis of functionality and risk
- A detailed inventory of systems, tools, applications, data stores, resources, and infrastructure (including cyber)
- An overview of organizational and cost structures that support the business

If the company's current-state technology capabilities are sufficient to support the post-bankruptcy business plan, then large-scale transformation will likely not be needed. However, if major gaps exist, then the business plan (and investment plan) must reflect the larger-scale transformation initiatives that will be required to enable the emergent company to execute its plans and achieve its post-bankruptcy objectives. Under this scenario, the transformation plan may require a transformation that is self-funding, or, if not sufficient, further "capital enablement" may be required to successfully emerge post-bankruptcy (Exhibit 1).

Conclusion: The Importance of Focusing on Technology

Since companies that undergo bankruptcy are taking the necessary and challenging steps to realign their businesses and maximize value for stakeholders, it is important that they emerge stronger and healthier. Yet the bankruptcy process has many legal and practical limitations that do not necessarily help emergent companies achieve the best possible outcomes during and after bankruptcy.

In particular, the survey shows that companies in bankruptcy need to focus more attention and resources on technology transformation and digital enablement. This is particularly relevant, as about 17% of companies are "repeat filers" in the bankruptcy process. These repeat filers are more prone to be companies that have not addressed structural issues post-bankruptcy, in particular if structural technology or capital issues are not addressed (*i.e.*, those companies under emergence archetypes defined by "enable capital" and/or "emerge to transform"). We hope the findings presented here can help stakeholders challenge commonly held assumptions and norms about bankruptcy that might not be relevant to their situations — and enable them to make more informed decisions — using the emergence playbook to help a company position itself for post-bankruptcy success.

The views expressed herein are those of the author(s) and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals.

FTI Consulting, Inc., including its subsidiaries and affiliates, is a consulting firm and is not a certified public accounting firm or a law firm.

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DON'T LET WORLDS COLLIDE: A GUIDE TO THE DIFFERENT STANDARDS FOR FAIRNESS AND SOLVENCY OPINIONS

KENNETH J. MALEK, CIRA, CDBV and KIERA BERKLEY DURGAN, JD
MalekRemian

Heavily leveraged balance sheets with multiple tranches of debt, combined with illiquidity, needs to meet payroll, and the "melting ice cube" paradigm in Chapter 11 cases represent combined market and legal forces placing downward pressure on recoveries for trade creditors and junior lien holders in Chapter 11 cases. Except for the largest Chapter 11 cases, essentially gone are the days when the commencement of a Chapter 11 case gave the debtor "breathing room" and an opportunity to fix its operations for the benefit of unsecured creditors. Instead, in significant part Chapter 11 has become an opportunity for the holder of the fulcrum security to cleanse the debtor of lower-priority claims for second-lien debt, unsecured debt, trade payables, and equity.[1]

Until recent years, holders of trade and other lower-priority claims negotiated for relief from these harsh consequences by seeking assignment of recoveries from post-confirmation litigation claims, typically including fraudulent conveyance claims brought under federal or state law against insiders and other participants in prepetition transactions with the prepetition debtor. Participants in these transactions often secure solvency opinions as a pre-emptive defense to potential recovery actions.

Depending upon the Federal Circuit, the prospects for successful fraudulent conveyance recoveries have diminished in recent years by cases holding that § 546(e) of the Bankruptcy Code provides a broad safe harbor from avoidance actions (other than intentional fraudulent conveyances) for transfers that are (i) settlement payments or (ii) payments related to a securities contract, provided such transfers are "made by or to (or for the benefit of)…financial institutions."[2] The Second Circuit applied the broad safe harbor interpretation in the *In re Tribune Company Fraudulent Conveyance Litigation* case.[3] Subsequently, courts in the Second Circuit have approved this broad application of the § 546(e) safe harbor to deny fraudulent conveyance recoveries for transfers made in leveraged recapitalizations,[4] leveraged buyouts,[5] and transfers implicated in the Bernie Madoff Ponzi Scheme.[6] Outside the Second Circuit, courts are reluctant to apply § 546(e) so broadly.[7]

In the earlier *Merit Management* case, the U.S. Supreme Court rejected the approach adopted by many Circuit Courts that the mere presence of a financial institution as a transfer conduit (for example, through wire transfer of funds to or from an account at a U.S. financial institution) was sufficient to invoke the § 546(e) safe harbor. Under *Merit,* acting as a "mere conduit" is not enough; courts must look at the "over-arching transfer." Since the parties to that transaction had not argued that they met the definition of "financial institutions," the transfer fell outside the safe harbor of § 546(e).

On April 19, 2021, the U.S. Supreme Court denied a petition for *certiorari* from the Second Circuit's decision in the *Tribune Company Fraudulent Conveyance* case. The petitioners had argued that the Court should address whether or not their state fraudulent conveyance claim was preempted by § 546(e). In an

1 This article does not debate the fairness of this result. Some will argue that the fulcrum security holder's upside is fair compensation for its capital investment that is subject to the business plan execution risk of proposed fixes to the debtor's business model. Depending upon the facts and circumstances, others may argue that the upside is an unfair windfall.

2 Financial institutions include commercial or savings banks, trust companies, and such entities when they are acting as agent or custodian for a customer in connection with a securities contract. 11 U.S.C. §101(22)(A).

3 The United States Court of Appeals for the Second Circuit had affirmed the dismissal of state law fraudulent conveyance claims based on preemption by § 546(e) that the payments at issue were performed by intermediaries subject to § 546(e). *Note Holders, Deutsche Bank Trust Co. Americas v. Large Private Beneficial Owners*, 818 F.3d 98 (2d Cir. 2016). While appellant's petition for certiorari was pending, the Supreme Court issued its opinion in *Merit Management Group, LLC v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018), and the Supreme Court suggested that the Second Circuit "recall its mandate or provide other relief in light of *Merit Management*." Subsequently, the Second Circuit issued an Amended Opinion, finding that the Tribune was, for purposes of § 546(e), a "financial institution." *Note Holders, Deutsche Bank Trust Co. Americas v. Large Private Beneficial Owners*, 946 F.3d 66 (2d Cir. 2016).

4 *Holliday v. K Rd. Power Mgmt. (In re Bos. Generating LLC)*, 617 B.R. 442 (Bankr. S.D.N.Y. 2020).

5 *In re Nine W. Lbo Sec. Litig.*, 482 F. Supp. 3d 187 (S.D.N.Y. 2020).

6 *Fairfield Sentry Ltd. v. Theodoor GGC Amsterdam (In re Fairfield Sentry Ltd.)*, No. 10-13164 (SMB) (Bankr. S.D.N.Y. Dec. 14, 2020).

7 *E.g., Kelley v. Safe Harbor Managed Account 101, Ltd.*, 2020 WL 5913523 (D. Minn. Oct. 6, 2020)(appellate court reversed lower court's granting of motion for summary judgment pursuant to § 546(e), holding that triable issue of fact existed regarding whether investment fund transfers were made "in connection with" a securities contract). *See also, Buchwald Capital Advisors, LLC v. Papas (In re Greektown Holdings), LLC*, 621 B.R. 797, 827 (Bankr. E.D. Mich. 2020)(appellate court reversed lower court's granting of defendants' motion for summary judgment in an adversarial complaint arising out of a buy-out after the Supreme Court issued its opinion in *Merit Management); Petr v. BMO Harris Bank (In re BWGS, LLC)*, 2022 WL3568045 (Bankr. S.D. Ind., Aug. 18, 2022)(Indiana bankruptcy court denied motion to dismiss, allowing trustee to continue suit to potentially avoid and recover payoff of LBO bridge loan as a constructively fraudulent transfer, rejecting 546(e) safe harbor arguments).

amicus brief, the Acting Solicitor General recommended denying *certiorari* on the basis that, even though the Second Circuit was wrong about preemption, there was no *per se* conflict between the circuits on the issue plead by the Petitioners.[8]

From a standpoint of venue and for other reasons, there is ongoing uncertainty regarding application of *Merit*. Well-advised transaction participants will continue to pursue, thorough solvency analyses (internal business plans) and solvency opinions, protection of their transaction proceeds.[9] While historically many financial advisors issued solvency opinions pursuant to engagement scopes and workplans largely mirroring those employed for fairness opinions, the adequacy of this approach has been subject to challenge in the courts.

This article compares and contrasts the somewhat narrow engagement scope and protocols for fairness opinions to the wider engagement scope of solvency opinions and expert testimony that have proven successful in fraudulent conveyance litigation. These protocols are relevant to both the defense and the challenge of solvency opinions.

FAIRNESS OPINIONS

In 1985, the Delaware Supreme Court was asked to review a board's business judgment in a cash-out merger. In the case of *Smith v. Van Gorkom,*[10] the Court addressed the issue of fairness opinions stating that,

> "[w]e do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law…. [rather] the issue is whether the directors informed themselves as to all information that was reasonably available to them."[11]

The directors should have before them "adequate information regarding the intrinsic value of the Company, upon which a proper exercise of business judgment could be made."[12] A "thoroughly prepared valuation study or a fairness opinion would satisfy…the board's duty of care to be duly informed as to corporate value"[13] -- "such directors may be fully protected in relying in good faith upon the valuation reports of their management."[14]

[8] Brief for the United States as Amicus Curiae, in *Deutsche Bank Trust Company Americas, et al. v. Robert R. McCormick Foundation, et al.*, No 20-8, (Mar. 12, 2021); https://www.supremecourt.gov/DocketPDF/20/20-8/171849/20210312182244408_20-8%20DeutscheBank.pdf.

[9] Solvency, in many courts, is deemed a question of fact. *See, In re McCook Metals, L.L.C.*, No. 05 C 2990 (N.D. Ill. Dec. 4, 2007). Assembling of more factual evidence (including contemporaneous solvency opinions) bolsters the defense, but in the absence of a contemporaneous solvency opinion the facts will still speak for themselves.

[10] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

[11] *Id.* at 876 -877.

[12] *Id.* at 881.

[13] Steven M. Davidoff, "Fairness Opinions", *Am. U. Law Review*, 1557, 1571 (2006).

[14] *Van Gorkom*, 488 A.2d at 876-877.

The opportunity to be "fully protected" made fairness opinions all but mandatory after Van Gorkom. If directors were claiming they acted pursuant to the business judgment rule[15] and hoped to be shielded from litigation and liability regarding their decision(s),[16] a fairness opinion was necessary.

Unlike solvency opinions, fairness opinions do not dictate price, nor are they an indication of market value. They are not appraisals.[17] In particular, fairness opinions do not address other potential issues, such as solvency.[18] Fairness opinions simply put are "the opinion of a financial advisor that a specified transaction is within a range of values encompassing financial fairness."[19]

Generally provided by investment banks to boards of directors, there is no academically agreed-upon definition of what constitutes "fairness."[20] Similarly, courts have neglected to specify what definition of "fairness" advisors should use.[21] Various legal scholars and financial experts have attempted to define "fairness" as any of the following: "a minimum range of values that the corporation's unaffiliated stockholders would otherwise receive in a board-run auction process conducted in a fair, open, and equivalent manner,"[22] the value of a company as an independent entity or the value shareholders would receive if the company was auctioned off,[23] the price arrived at through independent bargaining between the acquiree and the acquirer, the acquiree's liquidation value, or the value of the sum of the acquiree's businesses.[24]

In providing a board of directors with a fairness opinion, financial advisors should do the following:[25]

1. Disclose any prior relationship(s). Financial Industry Regulatory Authority Rule 5150 states that if an issuer knows, or has reason to know, that a company's public shareholders will be made aware of the fairness opinion, then the issuer of the opinion must disclose if the issuer has acted as a financial advisor to any of the parties to the transaction that is the subject of the opinion.

[15] The business judgment rule is a presumption 'that in making business decisions, the [board] acted on an informed basis, in good faith, and with the belief that the actions taken or decisions made were in the best interest of the corporation. It is essentially the codification of the "benefit of the doubt" given to corporate directors.' Monique D. Hayes, "When the Tides Turn: Fiduciary Duties of Directors and Officers of Distressed Companies", *Business Law Today*, July 2015, at 1.

[16] FINRA Regulatory Notice 07-54, SEC Approves New NASD Rule 2290 Regarding Fairness Opinions, states, "[a]lthough not required by statute or regulation, fairness opinions have become commonplace in change of control transactions following the 1985 Delaware Supreme Court case of *Smith v. Van Gorkom*." (effective Dec. 8, 2007).

[17] Davidoff, *supra* note 13, at 1565.

[18] FINRA Regulatory Notice 07-54, *supra* note 16.

[19] Davidoff, *supra* note 13, at 1565. It is helpful to keep in mind that "*value* is the intrinsic worth of an asset, while *price* is what a buyer has actually paid for it." Stanley Foster Reed, Alexandra Reed LaJoux & H. Peter Nesvold, *The Art of M&A: A Merger Acquisition Buyout Guide* 79 (4th ed. 2007).

[20] Davidoff, *supra* note 13, at 1567.

[21] Lucian Arye Bebchuk & Marcel Kahan, "Fairness Opinions: How Fair Are They and What can be Done About It?", *Duke L. Rev.*, 27, 30 (1989).

[22] Davidoff, *supra* note 13, at 1557.

[23] Bebchuk, *supra* note 13, at 31, 33.

[24] Davidoff, *supra* note 13, at 1566, n. 33.

[25] Please note, FINRA rules only apply to FINRA members but issuers that are not FINRA members would be wise to follow the FINRA rules to shield their clients from potential suits and liability.

Continued from p.25

The issuer of the opinion must also disclose if it has had any "material relationships...during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship" between the issuer and any party to the proposed transaction that is the subject of the opinion.[26] Current and ongoing relationships should also be disclosed.[27]

2. Regardless of a prior relationship, disclose if issuer's compensation is contingent on success of the transaction. FINRA Rule 5150 subsection 2, states that even if the issuer of a fairness opinion does not have a prior relationship with any of the parties to the transaction, the issuer must disclose if its compensation for rendering an opinion is contingent upon the successful completion of the proposed transaction.[28]

3. Provide the fairness opinion to the board of directors, only. Language should be included in the engagement letter and the fairness opinion itself that the issuer is providing the fairness opinion to and for the Board of Directors, only.[29]

4. Indicate that the opinion offered does not include an opinion as to whether or not shareholders should approve the proposed transaction. The fairness opinion should also explicitly state that it is *not* providing an opinion regarding whether or not shareholders should vote in favor of or against the proposed transaction.

In *Joyce v. Morgan Stanley Co., Inc.,*[30] plaintiff shareholders, some of whom had served on the board of the target company, filed suit claiming that Morgan Stanley's fairness opinion submitted to the target company's board had also been submitted to the shareholders, with Morgan Stanley's consent. The Court noted that both the engagement letter and the fairness opinion "expressly disclaimed any intent to confer a benefit to…[the] shareholders."[31]

5. Disclose if the opinion was approved or issued by a fairness committee. If a FINRA member is issuing the fairness opinion,[32] then the issuer needs to disclose if the opinion was approved and/or issued by a fairness committee. The term "fairness committee" means any committee or group that approves a fairness opinion pursuant to FINRA Rule 5150(b) regardless of whether or not it is called a fairness committee.[33]

6. Disclose if an opinion regarding the fairness of compensation to directors, officers and/or employees is included in the fairness opinion. The issuer is not required to render an opinion about the fairness of any compensation to the company's officers, directors and/or employees relative to the public shareholders, but, if the issuer does render an opinion about the fairness of compensation, the issuer must disclose said opinion.[34]

7. Use appropriate valuation techniques. The value of a fairness opinion often depends on the accuracy of the valuation analyses and methods used.[35] More than one method may be used, with the most common being the discounted cash flow method, analysis of comparable companies, and analysis of comparable transactions.[36]

Discounted cash flow (DCF) is defined as "[t]he value of any operating asset…is equal to the present value of its expected future economic benefit stream."[37] In the view of one author, the DCF method is "the only proper way to value an operating company. Any company is worth the going value or NPV [Net Present Value] of its present earnings stream taken out to infinity and discounted at some rate that approximates the risk."[38]

It is important to note that SEC Rule 13e-3 requires disclosure of analyses made by a financial advisor including the methodologies used in the analyses. The failure to consider and describe indications of value under each of the three methods, although "arguably less than ideal…does not necessarily constitute a fraudulent or misleading valuation effort"[39] for a fairness opinion purposes.

8. Do not make any objectively or subjectively false statements. Federal securities laws prohibit the issuance of proxy solicitation materials that contain any false or misleading statements or omissions as to any material fact.[40] An issuer of a fairness opinion that knows the opinion will be used in a proxy solicitation may be held to be engaged in a proxy solicitation. As such, issuers of fairness opinions can be held liable under federal securities laws if they allow their fairness opinion to be included in proxy solicitation materials if they lack a "genuine belief or reasonable basis for concluding that the economic assumptions upon which the fairness opinion was based were accurate."[41]

Depending on the facts, fairness opinions are not "get out of jail free" cards for boards of directors. In the pending case of *Goldstein v. Denner, et al.* before Vice Chancellor Laster, the Court of Chancery for the State of Delaware denied the Defendants' Motion to Dismiss. Pertaining to fairness opinions, the Plaintiff alleged that the Board acted "outside the range of reasonableness by working with Company management to make a series of last-minute modifications to the Company's projections designed to support the agreed upon price…per share."[42]

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26 FINRA Rule 5150(3).
27 *Baum v. Harman International Industries, Inc*., 408 F. Supp. 3d 70 (D. Conn. 2019)(failure to disclose a prior *and ongoing* relationship used by the court to deny a target company's motion to dismiss a shareholder lawsuit).
28 FINRA Rule 5150(2).
29 John Casey, "Fairness Opinions: Liability Issues an Investment Bank Should Consider – Part Two", *Bloomberg Law Reports*, Sept. 6, 2011, at 2.
30 *Joyce v. Morgan Stanley Co., Inc*., No. 06 C 4754 (N.D. Ill. Mar. 29, 2007).
31 *Id.* at 10.
32 There is no requirement that the issuer of a fairness opinion be a FINRA member.
33 Rule 5150(b) requires written procedures be in place for approval of a fairness opinion issued by a FINRA member. The written procedures must include the type of transactions that will typically warrant the use of a fairness committee, the means of selecting the appropriate personnel to be on the committee, the required qualifications of said personnel, the processes in place to provide a balanced review, and process to determine in valuation methods used were appropriate. FINRA Regulatory Notice 07-54, *supra* note 16.
34 FINRA Rule 5150(6).
35 Davidoff, *supra* note 13, at 1573.
36 Gilbert Matthews, "Valuation Methods in Fairness Opinions: An Empirical Study of Cash Transactions", *Bus. Valuation Rev., Vol. 31: No. 2/3 (2012), 55, 57*. Daniel G. Lentz, Grant W. Newton & Lynda H. Schwartz, *The Troubled Business and Bankruptcy, Litigation Services Handbook* 25.3, 25-29 (6th ed. 2017).
37 James R. Hitchner, *Financial Valuation: Applications and Models* 138 (4th ed. 2017).
38 Reed, *supra* note 19, at 108-109.
39 *City Partnership Co. v. Lehman Bros*, 344 F. Supp. 2d 1241, 1250 (D. Colo. 2004).
40 Securities Exchange Act of 1934 § 14(a).
41 *City Partnership Co.,* 344 F. Supp. 2d at 1246. (citation omitted).
42 *Goldstein v. Denner, et al.*, Court of the Chancery of the State of Delaware Case No. 2020-1061, Memorandum Opinion Addressing Motions to Dismiss Counts I and II, May 26, 2022 at 84.

9. State in the opinion that reliance is made upon information supplied by the company and that the information has not been independently verified. Rule 5150 does *not* require that the drafter of a fairness opinion independently verify any of the information provided to it by its client or by company management. However, if the drafter does independently verify any information, Rule 5150 does require the disclosure of what information was verified.

This last point is significantly different from both jurisprudence and professional guidance in the solvency opinion area. For fairness opinions, the courts have followed the FINRA guidance and consistently approved of disclaimers in fairness opinions that the issuer of the opinion is relying, without any investigation, upon the achievability of the business plan and other representations provided by management, and the issuer has no obligation to independently verify that information.[43] Thus, standard contractual terms in a fairness opinion and fairness opinion engagement letter disavow any responsibility for the issuer of the fairness opinion to investigate business plan execution risk.

SOLVENCY OPINIONS

"There are things a solvent firm may do – such as pay dividends – that an insolvent firm may not....Testing solvency is key to finding the dividing line."[44]

The Bankruptcy Code delineates that a company is insolvent when its "financial condition is such that the sum of such entity's debts is greater that all such entity's property, at fair valuation."[45] If a company is bordering on insolvency, then any transfers of assets or cash could be deemed fraudulent and subject to avoidance if the company subsequently files for bankruptcy. Bankruptcy Code section 548(a)(1)(A) defines transfers that are actually fraudulent as those incurred by the debtor "within 2 years before the filing of the [bankruptcy] petition, [that] the debtor… made…with actual intent to hinder, delay, or defraud" creditors. A constructive fraudulent transfer is defined as a transfer made within two years of filing a petition for which the debtor "received less than a reasonably equivalent value in exchange for such a transfer or obligation" and was either insolvent on the date of transfer, became insolvent after the transfer, was left with unreasonably small capital, or would be unable to pay debts as they became due.[46] Comparable rules apply under state fraudulent transfer laws, although many states have longer look-back periods.[47]

In preparing a solvency opinion, the financial advisor should:

1. Determine the standard of value. The first step in preparing a solvency opinion is to ascertain the appropriate standard of value. A *standard of value* is a definition of the type of value being measured, which often is legally mandated or described by statute or case law. Valuations of companies usually use a fair market value, fair value or an investment value standard.[48] Similar to the Bankruptcy Code, section 2(a) of the Uniform Fraudulent Transfer Act states that, "[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at fair valuation." The UFTA provides no definition of *fair valuation,* which, when evaluating solvency or insolvency, the courts frequently analyze similarly to *fair market value*.[49] The accepted definition of the term *fair market value*, as a standard of value, is:

> 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.[50]

For example, in *Andrew Johnson Properties,*[51] *fair valuation* for purposes of the Bankruptcy Code was the fair market value of the property between willing buyers and sellers or the value that can be made available to creditors within a reasonable period of time. In *Lamar Haddox Contractors*[52] and *Pennbroke Dev Corp. v. Commonwealth Sav. & Loan Ass'n.,*[53] the fair market value is determined by "estimating what the debtor's assets would realize if sold in a prudent manner in current market condition." When the company is experiencing distress or changing market or industry conditions, it is common for the valuation analyst to critique and determine achievability of projections presented by management.[54]

The AICPA Practice Aid suggests various tools that provide insight into a company's financial condition at a valuation date, such as statements of cash flows, ratio and benchmark analysis, and various bankruptcy risk models. For example, a statement of cash flows might indicate that a company was not conducting business as usual and was needing to fund operating cash requirements from taking on more debt or living off its balance sheet by downsizing or selling assets to generate cash to fund operations that were otherwise cash flow negative. A list of ratio analyses and financial factors that can be used to measure distress include the following:

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43 *In re Global Crossing Securities Litigation*, 313 F. Supp. 2d 189 (S.D.N.Y. 2003) (issuer of fairness opinion took information "at face value and opined only that, *if that information was true,* the [transaction] was fair"); *In re AOL Time Warner Sec. & "ERISA" Litig*., 381 F. Supp. 2d 192, 244 (S.D.N.Y.) 2004 ("It would be nonsensical to attach … liability to the issuer of a fairness opinion for failure to investigate the financials of the underlying company, when the issuer has expressly stated that it relied on the integrity of the information provided by the company"); *The HA2003 Liquidating Trust v. Credit Suisse Securities (USA) LLC*, 517 F.3d 454 (7th Cir. 2008)(Ernst & Young told management that its projections were unrealistic, but management ignored its advice, and the court allowed the investment banker to follow the industry norm and its contract to rely upon management's numbers without investigation).

44 J. B. Heaton, "Solvency Tests", *The Business Lawyer, Vol. 62, No. 3 (2007), 983-1006, available at https://ssrn.com/abstract.* See, *e.g., In re The Chemours Co. Sec. Litig.*, Civil Action 19-1911-CFC (D. Del. Feb. 24, 2022)(under Delaware law board cannot approve spin-off unless it is established that spin-off will be solvent).

45 11 U.S.C. § 101(32)(A).

46 11 U.S.C. § 548(a)(1)(B)(i) – (ii)(III).

47 Most states have adopted the Uniform Voidable Transactions Act. 37 Am. Jur. 2d *Fraudulent Conveyances and Transfers* § 4 (Supp. 2021).

48 Assoc. of Int'l Certified Professional Accountants, *Providing Bankruptcy and Reorganization Services, Vol. 2 – Valuation in Bankruptcy* 10 (2020).

49 *Id.* at 17-18.

50 Revenue Ruling 59-60, 1959-1 C.B. 237; Treas. Reg. §25.2512-1; Assoc. of Int'l Certified Professional Accountants, *supra* note 48, at 15 (2020).

51 *Andrew Johnson Properties,* CCH Dec. ¶65,254 (D.C. Tenn. 1974).

52 *Orix Credit Alliance, Inc. v. Harvey (In re Lamar Haddox Contractor, Inc.)*, 40 F.3d 118 (5th Cir. 1994).

53 *In re Pembroke Development Corp.,* 124 B.R. 398, 402 (Bankr. S.D. Fla. 1991).

54 Assoc. of Int'l Certified Professional Accountants, *supra* note 48, at 48-50.

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• Excessive or growing trade debt	• Chronic shortages of working capital
• Nonpayment of payroll taxes	• History of holding vendor payments
• History of operating losses	• Low or negative levels of equity
• Cycle of loan defaults and forbearances	• Loss of customers and suppliers
• Excessive litigation	• Acceleration of collection efforts
• Repeated restructurings	• Liquidation of strategic assets
• Inability to refinance debt or raise capital	• Delaying capital expenditures[55]

The AICPA Practice Aid cites *Business Valuation and Bankruptcy*, in which authors Ian Ratner, Grant Stein and Kit Weitnauer state in the table above.

> Depending on the information available, the expert can use the asset approach, the income approach, or the market approach, to arrive at an opinion of value. For example, in *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co*., 910 F. Supp. 913, 939, 942 (S.D.N.Y. 1995), in determining that a leveraged recapitalization[41] was not a fraudulent transfer because the debtor was solvent after the transaction, the court relied on the discounted cash flow and market methods of valuation and reasoned as follows:[56]
>
>> *Both the plaintiffs and the defendants presented evidence of the value of VDAS based on discounted cash flow. This is an appropriate method of determining the going concern value of a company that is not in imminent danger of collapse. See Moody, 971 F.2d at 1067; Vadnais Lumber 100 B.R. at 131-32. … the wide variance in valuations is attributable to differences in initial earnings figures, in the growth rate applied to those figures, and in the discount rate selected.*
>>
>> *A number of witnesses also performed valuations using comparable companies or comparable transactions. Because there is legitimate disagreement over how "comparable" one business is to another, these analyses incorporate additional variables. Accordingly, there are best utilized to corroborate valuations obtained by other methods.*

Some cases express strong preferences for the discounted cash flow approach, generally based on the concept that it is the prime approach used to price acquisitions, provided that there is evidence of a realistic and achievable business plan.[57]

Other courts have preferred the market approach to the income (discounted cash flow) approach. For example, also cited in the AICPA Practice Aid is *In re Nextwave Personal Communications, Inc., 235 B.R. 277, 294* (Bankr. S.D.NY. 1999). In *Nextwave,* the court described discounted cash flow as "widely if not universally used in the business and financial world as a tool to assist management in making decisions whether to invest in or dispose of business or major assets. It is generally not used as a tool for determining fair market value, particularly when that determination can be made using either replacement cost or market comparables." As support for its preference of the market approach over the income (discounted cash flow) approach, the *Nextwave* court cited *Keener v. Exxon Co.,* 32 F.3d 127 132 (4th Cir. 1994), *cert. denied,* 513 U.S. 1154 (1995), which held that "fair market value is, by necessity, best set by the market itself. An actual price, agreed to by a willing buyer and a willing seller, is the best accurate gauge of the value the market placed on a good. Until such an exchange occurs, the market value of an item is necessarily speculative."

2. Determine the Premise of Value. Once the financial advisor has determined the standard of value, the advisor must establish the premise of value. The premise of value establishes the foundation for valuing a company's assets. Generally, companies are valued as a going-concern unless the circumstances require a liquidation premise of value, such as performing a valuation based upon the best interest of creditors. *Going concern* is defined as the value of a business enterprise that is expected to continue to operate into the future, pursuant to which its value may include the value of intangible assets such as the assemblage value of assets and tradename, goodwill, and going concern value, to the extent a purchaser would pay for those assets in a transaction at fair market value. Premises of value that may be applicable to measuring solvency or insolvency include *going concern, assembled group of assets, orderly liquidation,* and *forced liquidation.*

When a business is a going concern, its value is determined by the "fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts."[58] Two main cases relevant to the premise of value are *Taxman Clothing* and *TOUSA*.

Under *Taxman Clothing*, 'unless a business is "on its deathbed,"' the proper valuation standard is a going concern basis.[59]

However, in TOUSA, a case involving a residential real estate developer, the court agreed with the assertion of the plaintiff's expert that, under the market conditions contemporaneous with the start of the housing crisis and the Great Recession, "the most likely hypothetical willing buyer would be another developer or homebuilder [not purchasers of homes for occupancy by the purchaser] that would purchase communities or groups of assets

[55] Assoc. of Int'l Certified Professional Accountants, *supra* note 48*,* at 35-37.

[56] Ian Ratner, Grant T. Stein, & John C. Weitnauer, *Business Valuation and Bankruptcy* 132-133 (Wiley 2009).

[57] *In re 203 North LaSalle Street L.P.,* 190 B.R. 567, 574 (Bankr. N.D. Ill. 1995)("The preferred method of valuing a business as a going concern is by performing a discounted cash flow analysis"); *In re Longview Aluminum, L.L.C.,* No. 03 B 12184, Adversary Proceeding Nos. 04 A 00276, 04 A 00279, 04 A 01051 (Bankr. N.D. Ill. July 14, 2005), *aff'd* 2007 WL 4287507, *aff'd Baldi v. Samuel Son & Company*, 548 F.3d 579 (7th Cir. 2008).

[58] *In re Roblin Industries, Inc*., 78 F.3d 30, 35 (2d Cir. 1996).

[59] *Matter of Taxman Clothing Co., Inc.*, 905 F.2d 166, 169-170 (7th Cir. 1990).

from TOUSA or the Conveying Subsidiaries."[60] The plaintiff's expert applied a set of discount rates to the computed future cash flows to derive the net present value of each residential community project in TOUSA's portfolio. The discount rates were within the range used by market participants in mid-2007 and averaged twenty percent overall.

Once the standard of value and premise of value have been established, the financial advisor needs to run three different solvency tests to determine if the company is solvent. The three generally accepted tests are the cash flow test, the balance sheet test, and the reasonable capital test.[61] The company must pass all three tests or it will be considered insolvent.[62]

3. Perform a cash-flow test. The *cash-flow* test (also referred to as the *ability-to-pay solvency*) ascertains whether or not a company can reasonably be expected to pay its debts at they come due. The ability to pay test does not contemplate or require a cushion. Ability or inability to pay must be based on all information that the debtor could reasonably have believed contemporaneous with the proposed financial transaction, and not based on 20:20 hindsight.[63]

The analysis of projections and ability or inability to pay debts should cover at least one business cycle (generally four quarters) unless a different period is more relevant to the industry. Sensitivity testing is relevant to determining facts, circumstances and reasonably foreseeable risks at the date of the challenged transfer.[64]

4. Perform a balance sheet test. The balance-sheet test determines if the fair value of a company's assets, as of a particular date, exceeds the face value of its debts.[65] A balance sheet test requires an evaluation of whether a company will operate as a going concern or is it on its "deathbed"[66] and will be liquidated. A company is considered to be operating as a going-concern if it is paying its bills; it will be able to continue to operate and generate cash flow.[67] Elements of going concern value include assembled and trained workforce, operational plant, procedures in place, tradename, customer list, goodwill and going concern value.

5. Perform a capital-adequacy (unreasonably small capital) test. The unreasonably small capital test is a subjective measurement intended to "assess when a debtor's assets (*and the associated cash flow from those assets),* in relation to its liabilities (and the cash requirements associated with those liabilities), are sufficiently small that it no longer possesses a reasonable amount of capital."[68] The test looks to whether there is a sufficient cushion of cash flows, working capital, equity capital, and access to capital, to enable the debtor to have a "reasonable prospect of avoiding bankruptcy through the normal ebbs and flows of economic cycles."[69] Thus, *unreasonably small capital* is a condition where the debtor is left just barely solvent after a transaction, with difficulties that "are short of insolvency in any sense but are likely to lead to insolvency at some time in the future."[70]

Practitioners may employ ratio and benchmark analysis to evaluate the unreasonably small capital test, and they may consider difficulties that are likely to arise, such as economic and market fluctuations, to determine whether business plans and projections incorporate some reasonable margin for error.[71]

6. Beware those who fail to evaluate business plan achievability. This is the area most significantly different from fairness opinion protocols. The engagement letter or retention contract of the issuer of the solvency opinion or the opposing expert may be a treasure trove of helpful information, especially if it employs standard fairness opinion protocols for acceptance without due diligence of the business plan presented to the expert. The graveyard of solvency opinions and expert opinions rejected by the courts is filled with those who did not independently test business plan achievability and business plan execution risk, or whose testimony was not accompanied by fact witness testimony that established the reasonableness and achievability, based on economic and company-specific conditions, of underlying projection assumptions.

The *Moody* court adopted a test based on reasonable foreseeability, which requires an objective assessment of the firm's financial projections.[72]

In his course materials for Certification in Distressed Business Valuation, Professor Grant Newton stated as follows:

> If the projections used to perform the valuation have been provided by management, it is important for the appraiser to assess the reasonableness of the projections. The assumptions used by management regarding growth in revenues, operating performance, and reinvestment needs should be reasonable in line with historical operating performance. Improvements in operating performance based on cost-cutting measures, operational restructuring, or improvements in technology should be supported with documentation of analysis and the expenditure required for the improvements should also be incorporated into the forecast. In addition, when management projections are used, management's ability to forecast should

60 *In re Tousa, Inc.* This article primarily addresses the Southern District of Florida Bankruptcy Court's opinion dated Oct. 30, 2009 and found at 422 B.R. 783, 806 (S. D. Fla. 2009).

61 *Scalia v. Reliance Tr. Co.,* No. 17-cv-4540, 26 (SRN/ECW) (D. Minn. Mar. 2, 2021).

62 *Blixseth v. Kirschner (In re Yellowstone Mountain Club, LLC),* 436 B.R. 598, 628, 667 (Bankr. D. Mont. 2010).

63 This is similar to the balance sheet test, whereby an entity is not treated as insolvent so long as the value of assets exceeds liabilities by at least $1. *WRT Energy Corp.,* 282 B.R. 343, 414-15.

64 Assoc. of Int'l Certified Professional Accountants, *supra* note 48, at 104-05.

65 Grant W. Newton, *Bankruptcy and Insolvency Accounting: Practice and Procedure*, 565 (7th ed, 2010).

66 *Wolkowitz v. American Research Corp. (In re DAK Industries),* 170 F.3d 1197, 1199-1200 (9th Cir. 1999) citing *In re Taxman Clothing Co.,* 905 F.2d 166, 169-70 (7th Cir. 1990). The *Taxman* court noted, "caution should be taken not to consider property as `dead' merely because hindsight teaches that the debtor was traveling on the road to financial ruin." (*citing 2 Collier on Bankruptcy*, ¶ 101.31 at 101-94 (King 15th ed. 1989)).

67 Heaton, *supra* note 44, at 991-992.

68 Assoc. of Int'l Certified Professional Accountants, *supra* note 48, at 99.

69 Assoc. of Int'l Certified Professional Accountants, *supra* note 48, at 99.

70 *In re Doctors Hospital of Hyde Park, Inc*, 360 B.R. 787, 870 (Bankr. N.D. Ill. 2007), *vacated and remanded on other grounds,* 619 F.3d 588 (7th Cir. 2010).

71 *Moody v. Security Pacific Business Credit, Inc*., 971 F.2d 1056, 1073 (3rd Cir. 1992); Assoc. of Int'l Certified Professional Accountants, *supra* note 44, at 100.

72 *Id.*

Continued from p.29

be assessed by comparing prior forecasts with actual performance.[73]

Cases most relevant to the need for business plan due diligence to support solvency opinions are *Spansion,*[74] *Mirant,*[75] *Iridium,*[76] *Long View Aluminum,*[77] *TOUSA*[78] *and Tribune*.[79]

Spansion: In this case, the court stated as follows:

> Since [solvency determination] require[s] a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. 7-1129 Collier on Bankruptcy ¶1129.05[3][c], quoting *Consolidated Rock Prods. Co. v. du Bois,* 312 U.S. 510 (526 (1941).[80]

Mirant: This decision elaborates on the need for business plan due diligence, stating as follows:

> Those who would prepare future cash flow analyses and discount them to present values are not oracles. The opinion evidence they present…should be taken as a set of assumptions that are factored into a model *and critical analysis then employed to test those assumptions.* The evidence in the exercise is hardly clear, is highly judgmental and consists largely of inferences (emphasis added).

Iridium: This opinion is especially critical of experts who failed to test their conclusions:

> The Committee's experts have been unable to account for, to adequately explain or to reconcile the abundant market data that conflicts with their opinion, other than to question what the market knew about service limitations and to claim market judgments were not meaningful for a start-up company….They elected not to test and validate their valuation opinions by utilizing any accepted methodologies other than the discounted cash flow approach to value, and based their opinion on restated cash flow projections that were tailored for litigation purposes well after commencement of this adversary proceeding….The Committee's experts have created their own projections that have been cut drastically to account for overly optimistic projection of subscribers with the category of professional business travelers, but there has not been a persuasive showing that the methods used and the adjustments made are appropriate….

Longview Aluminum: The plaintiff's expert in *Longview Aluminum* made two errors in failure to perform due diligence. First, he ignored a block power sales agreement for highly favorable purchases of low-cost hydroelectric power, and instead grossly inflated Longview's projected electricity costs by using marginal spot market costs.[81] Second, he ignored the fundamental indication of value derived from sophisticated investors based on their conducting independent pre-transaction due diligence and evaluating business plan achievability.[82]

TOUSA: The court in *TOUSA* focused on the engagement letter of the issuer of the solvency opinion, effectively dismissing the opinion because the issuer expressly disclaimed any responsibility for conducting business plan due diligence; the letter stated that the advisor would not confirm the accuracy of information provided to it by the company. As such, the advisor relied predominantly on the assumptions and projections provided by the company; it did not take a "bottoms-up" approach. The court accepted the opinion of the plaintiff's expert who opined, based on his knowledge and analysis of the homebuilding industry, that the adjusted selling price projections used in TOUSA's forecasting model were overly optimistic. Key TOUSA management personnel believed that the true state of the housing market was significantly worse than what TOUSA had included in its projections that the issuer of the solvency opinion had accepted without due diligence.[83] The court also took issue with the financial advisor's fee arrangement – the advisor was to be paid $2 million if the advisor rendered an opinion that the company was solvent; if the advisor rendered an opinion that the company was not solvent, the advisor would be paid its fees and costs, a considerably smaller amount.[84]

Tribune: Finally, the Court in *Kirschner v. Shareholders (In re Tribune Co. Fraudulent Conveyance Litig)*[85], took a slightly different approach. The case was ultimately decided for the defendant on the basis of the § 546(e) exemption for certain transactions made by or to (or for the benefit of) financial institutions. Tribune was the subject of a two-step leveraged buyout at a time when, according to later plaintiff's experts, the U.S. newspaper industry was in or about to be in a state of systemic decline due to loss of advertising revenue and print customers. Creditors brought recovery actions not only against shareholders who cashed out their investments, but also against the issuer of the pre-transaction solvency opinions. The case record is replete with description of the valuation protocols and

73 Ass'n of Insolvency and Restructuring Advisors, CDBV Study Course Part 2: *Advanced Business Valuation* 21 (Grant W. Newton ed., 2009). AIRA (of which Professor Newton was a founder and long-time Executive Director) has published comprehensive professional standard guidance for restructuring valuation opinions, as a leading standard setting organization in the field. The guidance does not apply to opinions issued for litigation purposes (including solvency opinions formed for the purposes of litigation); it addresses services provided to support restructuring negotiations, bankruptcy disclosure statements, and fresh start accounting. Ass'n of Insolvency and Restructuring Advisors, *Standards for Distressed Business Valuation,* www.aira.org/pdf/standards/AIRA_Standards_2014.pdf.

74 *In re Spansion*, 426 B.R. 114 (Bankr. De. 2010).

75 *In re Mirant Corp.*, 334 B.R. 800 (Bankr. N.D. Tex. 2005).

76 *In re Iridium, Operating LLC,* 373 B.R. 283 (Bankr. S.D.N.Y. 2007).

77 *In re Longview Aluminum*, No. 3 2005 WL 3021173.

78 *In re Tousa*, 422 B.R. 783 (S. D. Fla. 2009).

79 *Kirschner v. Fitzsimons (In re Tribune Co. Fraudulent Conveyance Litig.),* Multidistrict Litigation No. 11-md-2296 (RJS) (S.D.N.Y. Jan. 6, 2017).

80 *In re Spansion, Inc.*, 426 B.R. at 130.

81 *In re Longview Aluminum*, No. 3 2005 WL 3021173 at *20.

82 *In re Longview Aluminum*, No. 3 2005 WL 3021173 at *13.

83 *In re Tousa*, 422 B.R. 783 (S. D. Fla. 2009).

84 *In re Tousa*, 422 B.R. 783 (S. D. Fla. 2009).

85 *Kirschner v. Shareholders*, 10 F.4th 147 (2d Cir. 2021), *cert denied*, (U.S. Feb. 22, 2022)(No. 21-1006).

limited scope of work performed by the issuer of the solvency opinions. Two financial firms declined to offer solvency opinions before the Tribune was able to hire a financial advisor willing to provide a solvency opinion, and that advisor agreed to use a "non-standard approach in formulating its solvency opinion."

After rendering an opinion that the Tribune would be solvent after Step One of a two-part LBO, the Tribune's management realized that the projections provided to the advisor were no longer accurate. No one told the advisor, including two other firms retained to assist with the LBO. The advisor provided a second solvency opinion as to Step Two of the LBO. The Trustee, in his complaint, argued that the advisor used an "allegedly non-standard definition of fair value," that the Officer Defendants misled the advisor and misrepresented crucial information, that the advisor failed to seek or confirm another advisor's view of the transaction, and that it chose to omit debt to be incurred during Step Two of the LBO.[86] The advisor performed only limited due diligence on the management's superseded business plan that served as basis for the solvency opinions, and never addressed the updated business plan with material downward adjustments in profit and cash flow expectations.[87]

CONCLUSION

In conclusion, the role of the financial advisor to protect value received by transaction participants has never been more important. The analysis and protocols delineated above will hopefully help financial advisors address this complex area, as they work to defend or challenge the validity of solvency opinions.

[86] *Kirschner v. Fitzsimons (In re Tribune Co. Fraudulent Conveyance Litig.),* Multidistrict Litigation No. 11-md-2296 (RJS) (S.D.N.Y. Jan. 6, 2017).

[87] *Id.*

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NAVIGATING THROUGH THE NEXT RESTRUCTURING CYCLE: THE UNTESTED IMPACT OF PRIVATE CREDIT

TERO JÄNNE
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While the non-bank market of collateralized loan obligations (CLOs) and private credit has been in existence for decades, its influence on how corporations are able to restructure their balance sheets is largely untested. Given the tremendous growth of this asset class in recent years, the next cycle of distress may be very different from past ones. Understanding how this evolving corporate debt landscape dynamic will influence lender group decision making is critical for borrowers and their advisors, so that they can successfully navigate through future balance sheet challenges.

How Did We Get Here?

On September 15, 2008, Lehman Brothers filed for Chapter 11, the largest U.S. bankruptcy in history. The event signaled to some the end to years of growth in corporate leverage and financial excess, as well as the commencement of a prolonged cycle of corporate restructurings. Except Lehman's bankruptcy turned out to be nothing of the kind. With unprecedent Federal Reserve intervention, financial excesses of the late 2000s were quickly rescued, and then ultimately repeated in greater volume. Between 2008 and April 2022, the Fed's balance sheet grew from less than \$1 trillion to almost \$9 trillion[1] in the name of credit market stability and long-term interest rate management. At the same time, the Fed Funds Rate moved from 2.00% to zero by December 2008 and remained there for the next seven years (with a subsequent two-year return to near zero, following a period of small upticks).[2]

While many have focused on how the Fed's actions pushed investors into riskier assets such as speculative stocks and cryptocurrencies, another by-product of the Fed's actions occurred on the credit market side. At the end of 2008, following the Lehman bankruptcy, private credit had approximately \$234 billion of assets under management (AUM).[3] By the end of 2021, private credit reached over \$1.2 trillion of AUM,[4] including \$850 billion of CLO AUM.[5]

To appreciate the impact on the new debt issuance market, CLOs are estimated to account for 65% -70% of investor demand for leverage loan products today.[6] What were previously just occasional participants in corporate balance sheets, are now anchor investors to almost every new debt issuance. These participants are, as a result, increasingly critical parties to every future debt restructuring.

A False Test – The Pandemic

While default rates in CLOs have been exceptionally low to date, it's less certain that those low rates can be maintained in the future. As CLOs are simply buying new debt market issuances, it stands to reason that over time their portfolios should experience market levels of defaults. However, the ability of CLO managers to digest significant portfolio stress is not well tested and may in fact lead to unforeseen consequences. During the peak of the pandemic panic in March 2020, CLOs came close to being tested, as economic and market uncertainty created significant portfolio pressures and the pricing of BB rated loans dropped to 78.15[7] – signaling the likely prospect of significant losses in holdings for most portfolios. But the Fed's massive influx of liquidity into the market quickly also rescued the loan markets, which snapped back in pricing. By April 18, 2020 (less than a month later) the same loan pricing index had recovered to 93.54,[8] and private credit resumed its AUM growth. So, in effect, the sample size of how CLOs would react was too short to evaluate their impact on corporate restructurings. AUM for private credit is now almost \$400 billion (or 46%) larger than it was right before the onset of the pandemic at the end of 2019.[9]

How CLO Motivations Can Influence Outcomes

To appreciate why CLOs may act differently than other traditional debt holders requires an understanding of their behavioral motivations and organizational structure. CLOs are by design asset managers, and as such their principal motivation is to increase assets under management and, as a result, management fees. A key driver of asset growth is the ability to demonstrate low levels of portfolio losses. As such, avoiding defaults on loans, not selling holdings below par, and long hold periods are critical components to attract future capital. This contrasts with traditional credit hedge fund behavioral motivations, who tend to view loan defaults as favorable events that provide triggers that allow them to maximize returns on invested capital. So, what is a 'good' credit event for one loan market participant is very much a 'bad' credit event for CLOs and their asset accumulation model. As a result, a CLO's response to a potential credit event is by its very nature different from traditional distressed loan participants such as credit hedge funds.

Similarly, organizational differences can come to play in the behavior of CLOs and similarly diverge from traditional credit hedge funds. While traditional funds generally focus on a handful of large positions, with teams of seasoned professionals analyzing every debt basket and potential point of legal leverage with a borrower, CLOs are structured very differently. Under a CLO structure, debt holdings are typically spread widely across sectors in order to manage exposure and credit risk. As such, oversight of the loan portfolio is much more limited, and focused on keeping an eye on overall credit quality across a large number of holdings. The

1 Federal Reserve Bank of St. Louis.

2 Federal Reserve Bank of New York.

3 Sebastian Pellejero, "CLOs Wrap Up Record Year," *Wall Street Journal,* updated January 1, 2022, https://www.wsj.com/articles/clos-wrap-up-record-year-11640637572.

4 Source: Preqin.

5 Sebastian Pellejero, "CLOs Wrap Up."

6 *Bloomberg News*; Putnam Investments, podcast, June 29, 2022, https://www.putnamperspectives.com/a-look-at-leveraged-loans-and-clos.

7 BB loan pricing index, March 23, 2020. Source: LCD.

8 Source: LCD.

9 Source: Preqin.

resulting 'light touch' loan portfolio management model works well in a low default environment, when limited time is required to be dedicated to any specific borrower.

Size Isn't Necessarily Bandwidth

During times of high distress and potential defaults, the 'light touch' model can quickly come under strain. The impact is further magnified when repeated across multiple CLOs holding loan positions of the same borrower. The CLO model is also strained if the individuals responsible for portfolio monitoring are not only time constrained, but also lack debt restructuring experience and understanding of bankruptcy law (as is often the case). In one recent market analysis, just three troubled corporate credits had CLO manager counts of 78, 50, and 21 respectively, representing approximately $2 billion in total CLO exposure.[10] There are a number of other constraints impacting a CLO's ability to respond to a distressed situation, but they only further amplify these behavioral and organizational challenges.

Refreshing the Playbook

How will the evolving non-bank lender landscape influence outcomes in the next restructuring cycle? The answer is uncertain, but clearly some traditional restructuring playbook assumptions will need to be refreshed.

First, bigger is not always better. While having a large institution as a debt holder may generally be a positive, it may not be the case if that holder is a passive CLO that is unable to dedicate the time or the effort to structuring a transaction. Second, viewing CLOs as being more borrower friendly may actually be largely dependent on the issue at hand. For example, the desire to obtain emergency incremental financing from an existing lender group is likely much more difficult with a CLO heavy lender base that is generally not equipped to function in that manner. Third, the perceived benefit of large passive CLO holdings keeping debt away from 'unfriendly' credit funds may in fact be a recipe for balance sheet paralysis. CLOs want to remain debt holders, and that motivation may result in a growing class of zombie capital structures - no matter the desire of a borrower to deleverage.

So, how should borrowers prepare for the next cycle of distress? Much of the answer rests in properly understanding how the non-bank market of CLOs and private credit has changed the traditional lender landscape, and in hiring the right advisors who also appreciate that dynamic.

[10] Bank of America Securities, August 24, 2022 CLO Alert.

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NEGATIVE EQUITY AND SOLVENCY OPINIONS IN TODAY'S MARKET

JENNIFER MULLER,
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Introduction

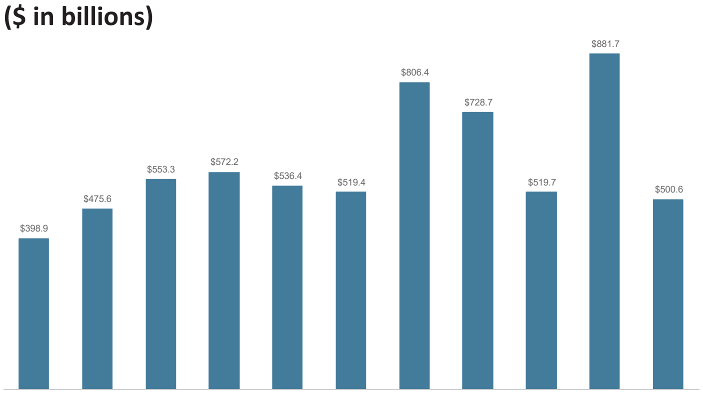
Historically low interest rates over the past few years, along with a vast accumulation of cash on corporate balance sheets, have pressured companies to increase distributions to stockholders through dividends and stock repurchases. Owing to such pressure, S&P 500 companies paid out a record $278 billion in dividends and repurchased a record $501 billion in shares in the first half of 2022 (see Exhibit 1). In particular, stock repurchases are expected to remain strong, even as prices have declined, as reduced prices will increase the number of shares purchased and, as a result, increase earnings per share.

Perhaps surprisingly, such record stockholder distributions have been effected against a backdrop of

- geopolitical risks stemming from the Russian invasion of Ukraine,
- residual issues from the pandemic,
- supply chain bottlenecks,
- a strong U.S. dollar, and
- soaring inflation that has rocked the equity markets and led the Fed and other central banks to raise interest rates.

For many companies, these troubling headwinds are having (and may continue to have) a deleterious impact on their businesses, potentially leading to the need to take goodwill impairments, which may result in negative stockholder equity on their balance sheets.

Exhibit 1: S&P 500 Share Repurchases 2012 – Q1 2022 ($ in billions)



Companies considering dividends or repurchases, and whose financial situation have been materially impacted by the pandemic and the recent macroeconomic and market headwinds, will need to carefully consider the prudence of paying dividends or repurchasing the company's shares.

Under Delaware law (the applicable corporate law for most publicly traded U.S. corporations), the power and authority to declare dividends resides exclusively with the board of directors of the corporation (the "Board").

Section 170 of the Delaware General Corporation Law (the "DGCL") permits the Board to declare dividends out of two available sources: either surplus or, if there is no surplus, out-of-net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. "Surplus" is the amount by which a corporation's capital is exceeded by its net assets as determined in accordance with DGCL Section 154. "Net assets," in turn, is defined by that Section as "the amount by which total assets exceed total liabilities," and "capital" is the aggregate par value of the company's previously issued (*i.e.*, outstanding and treasury shares).

Unlike the declaration of dividends, however, stock repurchases do not necessarily require Board action; the Board almost invariably approves any material repurchases. In that regard, Section 160 of the DGCL prohibits a Delaware corporation from purchasing its own shares if the company's capital is "impaired" or the purchase would impair its capital. This prohibition has been interpreted to mean that a corporation may use only its surplus for stock repurchases. Thus, the ability of a corporation to affect either a dividend or a stock repurchase is limited by the amount of that corporation's surplus.

The responsibility for determining appropriate values for net assets (and hence whether there is a surplus) ultimately falls to the Board, and unfortunately, the DGCL does not specifically address how a corporation's assets and liabilities should be valued for purposes of a Board's determination of surplus.

While the value of the net assets of the corporation may be indicated on its balance sheet (based on generally accepted accounting principles), the company's financial statements do not necessarily reflect the current market value of its assets and liabilities. The Delaware courts have recognized this anomaly and

Exhibit 2: Recent Transactions Involving Solvency Opinions

have permitted directors to "revalue" the assets and liabilities of the corporation (to present value) when determining whether there are sufficient assets to make a lawful dividend under the surplus test.[1]

Properly and accurately revaluing a company's assets and liabilities should be of great importance to the Board because Section 174 of the DGCL provides that directors may be jointly and severally liable for approving and paying a dividend or repurchasing stock in contravention of the applicable provisions of the DGCL.[2]

Solvency Opinions

Fortunately, DGCL Section 172 provides that directors will be "fully protected" in determining the existence and amount of surplus if (among other things) the directors rely in good faith on outside experts that are selected with reasonable care by, or on behalf of, the corporation.

In connection with the declaration and payment of a dividend, or the repurchase of company shares, directors can demonstrate that they have met the requirements of Delaware law (and otherwise fulfilled their fiduciary duties) by obtaining an opinion from an independent solvency opinion expert. Additionally, such an opinion can help mitigate the Board's exposure to the potential risk of fraudulent conveyance liability in actions brought by the company's creditors.

A solvency opinion can be relied on by the Board to demonstrate that:

1. the company's assets will exceed its liabilities immediately after the dividend or repurchase,
2. the company's projected cash flow will be sufficient to cover its ongoing debt payments,
3. the company will retain a capital cushion sufficient to weather any foreseeable problems in the future, and
4. the dividend or repurchase is made from the company's surplus.

The tombstones in Exhibit 2 represent a selection of transactions which involved solvency opinions from 2018 and after.

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[1] In this regard, the Delaware Supreme Court indicated in Klang v. Smith's Food & Drug Centers, Inc., 702 A. 2d 150 (Del. 1997) that "[d]irectors have reasonable latitude to depart from the balance sheet to calculate surplus, so long as they evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values, and arrive at a determination that is not so far off the mark as to constitute actual or constructive fraud."

[2] While Section 102(b)(7) of the DGCL permits a corporate to exculpate its directors from monetary liability for breaches of the duty of care, that section expressly carves out exculpation of liability under Section 174.

FEDERAL TAX CONSEQUENCES OF AN EXPECTED INCREASE IN PRE-PACKAGED CH. 11 AND SECTION 363 ASSET SALES

MICHAEL BARTON, CIRA, and LIAM DUFFY
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A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts. The Supreme Court made this point about the purpose of the bankruptcy law in a 1934 decision:[1] "[I]t gives to the honest but unfortunate debtor…a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."[2]

The Internal Revenue Code (IRC) similarly allows corporate taxpayers special tax benefits to facilitate a "fresh start" upon emergence from Chapter 11 bankruptcy. This is accomplished through specific provisions in the IRC that are designed to preserve tax attributes of the debtor, as well as to ameliorate cancellation of debt income from creating taxable income once the Chapter 11 Plan of Reorganization is confirmed.[3]

Current efforts by the Federal Reserve to aggressively combat inflation may usher in a new wave of corporate bankruptcies. If present trends continue, it is expected that relatively fewer "conventional" reorganizing Chapter 11 cases will be filed. Rather, more "pre-packaged" and/or Bankruptcy Code 363 asset sales ("363 asset sales") may occur due to the benefits they offer corporate bankruptcy filers.

Tax attributes such as net operating losses (NOLs) can be a valuable attribute of a distressed or bankrupt corporation. The form in which a corporation discharges its liabilities, through bankruptcy or out of court negotiations, can have a large impact on the amount of tax attributes that survive, and whether cancellation of debt income is recognized.

This article describes the current economic outlook and the expected increase in debt workouts and bankruptcies. In addition, this article discusses how the tax consequences may differ between out of court workouts, traditional "reorganizing" Chapter 11 bankruptcies, "pre-packaged" bankruptcies and 363 asset sales.

1 *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

2 United States Courts, Services and Forms, "Process—Bankruptcy Basics," accessed online at https://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/process-bankruptcy-basics.

3 See IRC sections 382(l)(5) and (l)(6) as well as IRC section 108(a)(1)(A) – as discussed further below.

Economic Outlook

In response to the Covid-19 pandemic, an unprecedented amount of countercyclical fiscal and monetary stimulus was introduced to support the US economy. As indicated in the Federal Reserve of St. Louis graph (Exhibit 1),[4] the M1 (broadly, the available US money supply) dramatically increased from a then historic high of $4 trillion in January of 2020 to $20.8 trillion in March of 2022.[5]

While the deleterious effects of this stimulus are being experienced currently, it should be noted that the government was addressing a very different situation at the onset of the Covid 19 pandemic that led to such profligacy of liquidity. For example, from February 2020 to March 2020, unemployment alarmingly increased from 3.5% to 14.7%[6]. See the Federal Reserve of St. Louis graph[7] in Exhibit 2.

Corporate Debt

Non-financial business debt (*i.e.,* debt issued by non-financial institutions) has increased steadily for the past few decades, surging to record levels during the pandemic. For example, in 2020, outstanding non-financial business debt increased at an 18 percent average annual rate as compared to 2019.[8]

The increase in corporate debt is partially attributable to the issuance of Paycheck Protection Program (PPP) loans. Despite most PPP loans later being forgiven, about $28 billion of PPP debt still remains.[9] The majority of the $28 billion unforgiven debt relates to loans that are below $25,000 and primarily affect small businesses. Small business advocates claim these loans are often denied forgiveness because the business owner does not understand or is unable to comply with confusing loan terms and conditions.[10]

PPP loans, which were largely expected to be tax-free, gave businesses more liquidity to seek additional debt. In total, the confluence of such economic stimulus and unprecedented debt, combined with the current downturn, is expected to result in an increase in debt workouts and bankruptcy filings.

4 Beginning May 2020, M1 is defined as (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) demand deposits at commercial banks (excluding those amounts held by depository institutions, the U.S. government, and foreign banks and official institutions) less cash items in the process of collection and Federal Reserve float; and (3) other liquid deposits, consisting of OCDs and savings deposits (including money market deposit accounts). Seasonally adjusted M1 is constructed by summing currency, demand deposits, and OCDs (before May 2020) or other liquid deposits (beginning May 2020), each seasonally adjusted separately. https://fred.stlouisfed.org/series/M1NS

5 *Id.*

6 https://fred.stlouisfed.org/series/UNRATE#0. Note that unemployment quickly fell to 6.9% in October of 2020 and then to 3.6% by April of 2022.

7 *Id.*

8 Office of the Comptroller of the Currency (OCC), "High Debt Does Not Represent a Bubble," OnPoint Economic and Policy Insight, June 1, 2021, https://www.occ.gov/publications-and-resources/publications/economics/on-point/pub-on-point-business-debt.pdf.

9 Amy Yee and Andre Tartar, "Small Businesses Still Face $28 Billion of Unforgiven PPP Loans," *Bloomberg,* Feb. 17, 2022, https://www.bloomberg.com/news/articles/2022-02-17/small-businesses-still-face-28-billion-of-unforgiven-ppp-loans. https://www.occ.gov/publications-and-resources/publications/economics/on-point/pub-on-point-business-debt.pdf.

10 *Id.*

Exhibit 1: Level of US Money Supply (M1)

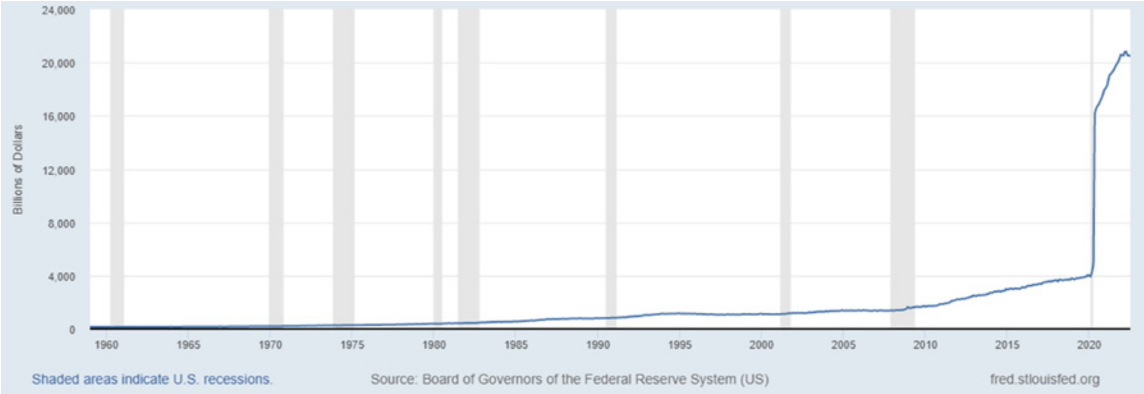


Exhibit 2: US Unemployment Rate

See the Office of the Comptroller of the Currency's chart in Exhibit 3 (on page 38).[11]

U.S. Nonfinancial Business Debt Share of GDP

Despite the increase in corporate debt, low interest rates increased corporate liquidity as interest payments on expanding debt loads were not then a material draw on cash. However, low interest rates potentially encouraged many businesses to borrow beyond their means. There has been a significant increase in BBB[12] rated bonds and junk-rated bonds. BBB bonds made up 40 percent of the investment-grade market during the 2008 recession but currently make up around 57 percent of the market.[13]

The junk bond market rallied in late summer of 2022 but has since started to decline. The decline in the junk bond market can be attributed to the persistent efforts by the Federal Reserve to quash inflation by raising interest rates.[14] A weakened junk bond market will make it difficult for companies to issue more debt or refinance, in particular as cash flow difficulties increase during the current economic downturn.[15]

Moreover, total asset-backed security issuances as of August 2022 were down by 33.9% as compared to the prior year.[16] As reflected in Exhibit 4, the market for collateralized debt obligations (mostly mortgages) and collateralized loan obligations (mostly corporate debt) has dramatically contracted.[17] This suggests that the perceived riskiness of the underlying mortgages and corporate loans has substantially increased - as the market to securitize such obligations has essentially disappeared. The inability to "offload" these obligations may disproportionately burden companies holding lower or junk—rated assets and reflects the overall increased riskiness of these obligations in the current economic environment.

We thus appear to be entering a "perfect storm" of high debt levels, monetary tightening and uncertain economic conditions. It is anticipated that any resulting bankruptcy filings will reflect an increase in quicker "pre-packaged" bankruptcies and section 363 sales, as compared to traditional reorganizing Chapter 11 bankruptcies.

11 OCC, "High Debt."

12 "Bonds with a rating of BBB- (on the Standard & Poor's and Fitch scale) or Baa3 (on Moody's) or better are considered "investment-grade." Bonds with lower ratings are considered "speculative" and often referred to as "high-yield" or "junk" bonds." Fidelity.com, Bond Ratings, "How Bond Ratings Work," https://www.fidelity.com/learning-center/investment-products/fixed-income-bonds/bond-ratings.

13 OCC, "High Debt."

14 Adam Sanson, Harriett Clarfelt, and Eric Platt, "US Jund Bond Sell-off Resumes after Fed Snaps Summer Rally," *Financial Times,* Sept. 3, 2022, https://www.ft.com/content/e162b61b-7b92-4ea2-b6fd-635b99c2d06c.

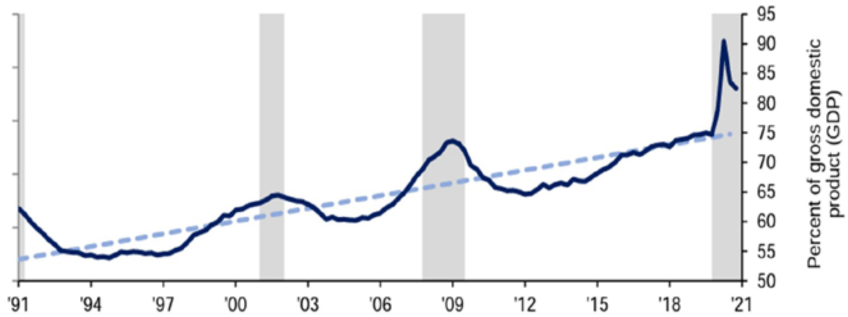
15 Junk bond issuers with an average credit rating of B3 or B- rating could see an 80% reduction in free cash flow as a result of the interest rate increase, according to AllianceBernstein Holding L.P.; Matt Tracy, "Analysis: Overstretched U.S. Companies Feel Pinch Of Higher Borrowing Costs," *Reuters,* Sept. 20, 2022, https://www.reuters.com/markets/us/overstretched-us-companies-feel-pinch-higher-borrowing-costs-2022-09-20/.

16 Sifma.org, "US Asset Backed Securities Statistics," October 5, 2022, https://www.sifma.org/resources/research/us-asset-backed-securities-statistics/.

17 *Id.*

Continued from p.37

Exhibit 3: U.S. Nonfinancial Business Debt Share of GDP.



Internal Revenue Code Provisions Relating to Corporations in a Chapter 11

Cancellation of debt provisions

IRC Section 61(a)(11) provides that taxable income includes income from the cancellation of indebtedness ("COD"). For example, if a corporation owed $100 of debt to its creditors – but satisfies the debt for $60, the corporation would generally have $40 of taxable income (and the creditors would have a correlative $40 bad debt deduction).[18]

To the extent a debtor is insolvent, IRC section 108(a)(1)(B) generally provides that COD is excluded from taxable income. In the example above, if the debtor was insolvent by $10 – then $30 of COD would taxable and $10 would be excluded from income.[19]

One issue relating to reliance on IRC section 108(a)(1)(B) is that the taxpayer must prove to the IRS that they were insolvent. The taxpayer may, for example, argue they were insolvent to the extent the debt was forgiven, as the debtor would not have otherwise discharged the debt by that amount.[20]

Another issue arises when various debts are forgiven over time, it is possible that at some point the taxpayer may become solvent, or the amount of insolvency may differ from the COD income recognized.

To avoid this factual issue, one advantage of a chapter 11 filing is that IRC section 108(a)(1)(A) provides that *all* debt discharged in a "title 11 case" is excluded from gross income. However, despite the legal and tax advantages available in bankruptcy; it is often taken as a last resort and a choice that should be carefully considered.

Section 382 provisions

When more than 50% of the ownership of a company changes hands (generally over a 3-year rolling period) IRC sections 382 and 383[21] limit the utilization of NOLs and other tax attributes, respectively. The "base" section 382 limitation is based on the equity value of the company immediately before the 50% change in ownership, times a prescribed rate.[22] As such, if an insolvent corporation is sold in exchange for debt, the pre-change value of the company would be $0 and thus the "base" section 382 limitation would be $0, which could result in the effective elimination of the corporation's NOLs (and potentially other tax attributes).

IRC Section 382 provides two bankruptcy exceptions to the general section 382 rules.

Under IRC section 382(l)(5), if certain conditions are met, there is no section 382 ownership change upon emergence from a title 11 or similar case, but certain interest deductions paid to creditors who become shareholders are eliminated from the post-emergence NOL.

Under IRC section 382(l)(6), an ownership change occurs, but the limitation is based on the value of the corporation after taking into account any surrender or cancellation of creditors' claims in a title 11 or similar case.

These special bankruptcy provision generally allow taxpayers to preserve a far greater amount of their net operating losses, IRC section 163(j) carryforwards and general business credits than under the general IRC section 382 and 383 rules (but only to the extent such attributes are not otherwise reduced under IRC section 108(b) upon emergence from Chapter 11).[23]

For tax years beginning after December 31, 2017, the deferral of excess interest expense under "new" IRC section 163(j) disproportionally affects distressed debtors. While these

18 The character of which is outside the scope of this article.

19 However, to the extent COD is not taxable under IRC section 108(a), attribute reduction is required under IRC section 108(b). In this example, the $10 of COD that is excluded from taxable income might decrease, for example, the corporations net operating losses by $10. Under this "fresh approach," excluded COD does not result in immediate taxation - but might reduce tax attributes that could have otherwise reduced federal income taxes in the future.

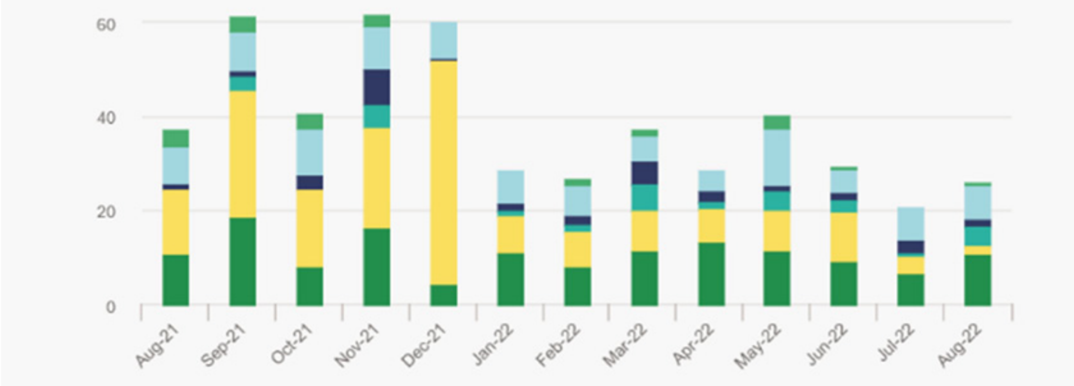
20 This argument becomes less persuasive when the original debt has been sold. For example, if the debt were sold at a discount to a "vulture fund" – the acquiror of the debt may accept a quick payoff that would result in a gain to them – even if the borrower was not insolvent by the entire amount of the debt that is forgiven.

21 Section 382 limits NOLs and 163(j) carryforwards. Section 383 similarly limits general business credits and other tax attributes.

22 Every month, the IRS publishes a Revenue Ruling that include the applicable federal rate (or "AFR") or section 382 ownership changes. The AFR for October of 2022 is 2.6% (see Rev. Rul. 2022-18, Table 3). For example, if the equity value of a loss corporation is $1 million and experienced an ownership change in October of 2022, subject to certain adjustments, the "base" limitation would be $26 thousand per year relating to that ownership change. As such, the loss corporation could use $26 thousand of pre-change NOLs on an annualized basis relating solely to the "base" limitation. See further, "A Primer in Section 382 Built-in Gains and Losses", AIRA Journal Volume 34, No. 4, page 22, that discusses how recognized-built gains, if any, can increase the "base" section 382 limitation.

23 Although section 108 does not require certain taxpayers to include discharge of indebtedness income in gross income, it does require the reduction of tax attributes. Section 108(b)(1) provides that if a taxpayer excludes an amount from gross income under section 108(a)(1)(A), (B), or (C), the taxpayer must reduce its tax attributes by the amount excluded. Such attribution reduction occurs to the extent of all debt forgiven in a chapter 11 bankruptcy, or to the extent the taxpayer is insolvent if the debt is reduced outside of a chapter 11 bankruptcy.

Exhibit 4: US Asset Backed Securities (ABS) Issuance, Aug. 2021 – Aug. 2022 (in $billions)



deferred interest carryforwards can be carried forward indefinitely, they are subject to the same section 382 limitations as net operating loss carryforwards.[24]

Chapter 11 Reorganizations and Section 363 Asset Sales

In a traditional chapter 11 bankruptcy, the debtor usually proposes a plan of reorganization to keep its business alive and pay creditors over time.[25]

A case filed under chapter 11 of the United States Bankruptcy Code is frequently referred to as a "reorganization" bankruptcy. Usually, the debtor remains "in possession," has the powers and duties of a trustee, may continue to operate its business, and may, with court approval, borrow new money. A plan of reorganization is proposed, creditors whose rights are affected may vote on the plan, and the plan may be confirmed by the court if it gets the required votes and satisfies certain legal requirements.[26]

These "reorganizing" chapter 11 filings historically can be quite lengthy and expensive for all parties involved. For example, the Sears bankruptcy that was filed in October of 2018 and the J.C. Penney bankruptcy that was filed in May 2020 – collectively generated more than $150 million in combined legal fees.[27]

In order to prevent the time and expense of these extended chapter 11 reorganizations, an increasing number of recent bankruptcies were "pre-packaged" and/or involved Bankruptcy Code section 363 asset sales, as described below.

Pre-Packaged Bankruptcies

A pre-packaged bankruptcy is a Chapter 11 bankruptcy proceeding that has been pre-negotiated with creditors prior to the Bankruptcy Court filings. Through the use of a pre-packaged bankruptcy, a debtor can simplify and accelerate the bankruptcy proceedings. Pre-packaged bankruptcies come with substantial cost savings over a traditional chapter 11 proceeding. Further, pre-packaged bankruptcies are often used by companies to renegotiate specific classes of debt while preserving the structure of the debtor's business operations.[28]

Despite the benefits of pre-packaged bankruptcies, they are not without critics. The Justice Department has raised concerns over pre-packaged bankruptcies' lack of transparency and fairness to creditors. In some cases, pre-packaged bankruptcies can be approved within days and may not give adequate notice to creditors or shareholders.[29] However, advocates of pre-packaged bankruptcies note that these proceedings enable the United States to better compete with insolvency proceedings in foreign countries.[30] Advocates also note that the more efficient proceedings help preserve money for shareholders and creditors.[31]

Section 363 Asset Sales

A section 363 asset sale occurs when a court grants a corporation the power to satisfy its credit obligations through the sale of a corporation's assets, rather than pursuant to a Plan of Reorganization. Thus, unlike a traditional Chapter 11 filing, a 363 sale gives a company (or trustee, as applicable) more control over the sale process. Additionally, the purchaser of assets sold through a 363 sale generally takes title free and clear of any encumbrances.

In general, 363 sales are treated as taxable transactions. As such, any debtor tax attributes would generally not transfer to the acquiror. If the debtor liquidates after the 363 asset sale, all of the tax attributes would thus be lost after the debtor's final tax return is filed.

The consideration for a section 363 asset sale may in the form of a "credit bid". "In the bankruptcy context, a credit bid is where a secured creditor in connection with a Section 363 sale uses (or "bids") all or a portion of its secured debt as full or partial

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[24] IRC section 382(d)(3).

[25] United States Courts, "Process—Bankruptcy Basics."

[26] *Id.*

[27] Dan Roe, "Kirkland and Weil's Fees in Chapter 11 Work Highlight Big Law Allure to Bankruptcy," *The American Lawyer*, May 6, 2021, https://www.law.com/americanlawyer/2021/05/06/kirkland-and-weils-fees-in-chapter-11-work-highlight-big-law-allure-to-bankruptcy/?slreturn=20220821022014.

[28] David Skeel, "Bankruptcy and the Coronavirus," Economic Studies at Brookings, April 2020, https://www.brookings.edu/wp-content/uploads/2020/04/ES-4.21.2020-DSkeel-1.pdf.

[29] Some pre-packaged bankruptcies have been approved within hours. To date, Belk Inc., holds the title for the fastest Chapter 11 bankruptcy proceeding. Belk's pre-packaged plan was approved by Courts within 16 hours of filing. See Daniel Gill, "Federal Watchdog Wants to Put the Brakes on High-spead Bankruptcies," *Bloomberg Law*, April 5, 2021, https://news.bloomberglaw.com/bankruptcy-law/federal-watchdog-wants-to-put-brakes-on-high-speed-bankruptcies.

[30] See, *e.g.*, Walter Frisk, "Can Zombie Firms Survive Rising Interest Rates," *Harvard Business Review*, Sept. 7, 2022, https://hbr.org/2022/09/can-zombie-firms-survive-rising-interest-rates.

[31] *Id*.

Continued from p.39

consideration for the debtor's assets."[32] If structured properly, such a transaction may qualify as a tax-free "G" reorganization.[33] In such case, the debtor's tax attributes would transfer to the acquiring corporation.

Summary

Rising interest rates and tightening credit conditions are expected to result in an increase in distressed debt, debt workouts and bankruptcy filings. Due to their high cost and length, the prevalence of traditional Chapter 11 reorganizations is expected to continue to decrease relative to the filings of pre-packaged bankruptcies and section 363 asset sales.

The form of the debt workout or reorganization can result in dramatically different tax results, as well as non-tax consequences, to the parties involved. The earlier a debtor can identify potential cash flow and insolvency issues, the more control the company may have over the ensuing process. Distressed debtors should thus consult tax and bankruptcy counsel as soon as practicable to maximize their options in navigating these difficult issues.

Pre-packaged bankruptcies and section 363 asset sales may offer advantages over traditional reorganizing Chapter 11 bankruptcies, based on a debtor's specific facts and circumstances, though all of these options are generally preferable to waiting too late and "falling" into a liquidating Chapter 7 bankruptcy.

[32] Stuart J. Goldring, "Structuring a Section 363 Sale as a G Reorganization," Weil tax blog, Feb. 2, 2022, https://tax.weil.com/latest-thinking/structuring-a-section-363-sale-as-a-g-reorganization/.

[33] Section 368(a)(1)(G) provides that a "G" reorganization requires "a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but **only** if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356." (emphasis added).

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ARE NFTS VALUABLE DIGITAL ASSETS OR NEAR-WORTHLESS ILLUSIONS?

ANDREW PIMLOTT
Ankura Consulting

Public awareness of non-fungible tokens (NFTs) has increased as more digital assets are created and sold, often for huge sums. Interest in them took off so quickly last year that it was dubbed "The NFT craze." The artist Beeple sold a collection of his digital art as an NFT for $69m at a Christie's auction last year, with 22 million people watching live online. Around the same time, Twitter boss Jack Dorsey sold an NFT of his first tweet for $2.9m.

Ukraine's Metahistory Museum issued a collection of NFTs in March this year depicting the war against Russia. On the first day, it sold 1,282 digital works of art for more than $600,000, the proceeds of which went into the crypto wallet of the country's Ministry of Digital Transformation. Not to be outdone, Rishi Sunak, whilst Chancellor of the Exchequer, in April asked the Royal Mint to create an NFT by the summer, as "an emblem of the forward-looking approach" of the government to crypto-technologies and crypto assets.

What Are Non-Fungible Tokens and How Are They Traded?

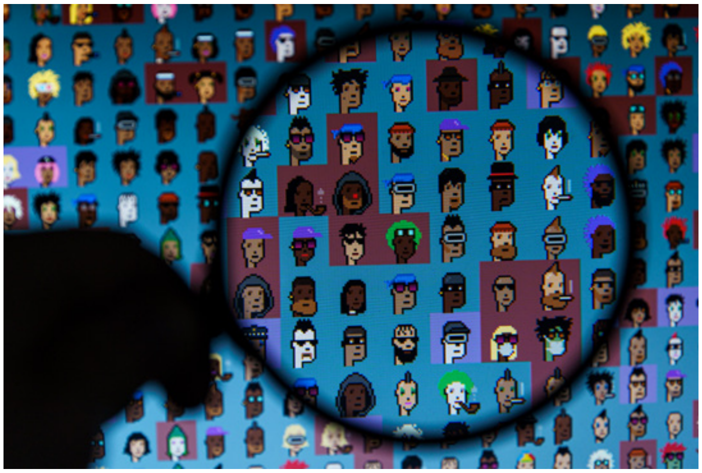
> Non-fungible tokens are seen by some as an exciting new way to own digital assets such as art but seen by others as a global confidence trick akin to "The Emperor's New Clothes."

What exactly is a non-fungible token? In this context, the "token" is a digital unit of data stored on a blockchain – a digital ledger – that represents a digital asset or a physical asset. The digital asset can be something like a digital work of art, video, or music. The physical asset can be something like a painting, house, or other real object.

"Fungible" means "interchangeable," "non-fungible" means "non-interchangeable." An NFT is non-fungible because the token is unique; it is proof of authenticity and ownership of a specific digital asset, although copyright is not usually granted. This makes an NFT different from a bitcoin which is the same as, and fungible with, all other bitcoins.

Most NFTs are on the Ethereum blockchain, which means you buy them with the ether cryptocurrency. Ether (ETH) can be bought with dollars, pounds, or other fiat currencies on crypto exchanges like Coinbase or payment apps like Revolut. Purchasers then set up a crypto wallet, like MetaMask, to buy, receive, store, and sell NFTs. The wallet must be linked to an NFT marketplace like OpenSea, SuperRare, Foundation, or Decentraland. You also must pay a transaction fee, called a "gas" fee, to pay for authentication through blockchain.

One of the most popular NFT artwork collections is CryptoPunks. Created in 2017, it is a limited run of 10,000 pixelated images that



sell for hundreds of thousands of dollars. The website describes them as "one of the earliest examples of a non-fungible token on Ethereum" and the "inspiration for the ERC-721 standard that powers most digital art and collectibles."[1]

The original CryptoPunks were issued free to anyone with an Ethereum wallet and no more have been produced. They can only be bought and sold via the secondary marketplace. The statistics on the website show that, at the time of this writing, the current lowest-priced available CryptoPunk costs 59.99 ether ($170,806), 8,217 have been sold in the last 12 months, and the total lifetime value of all sales is 620,550 ether ($1.97bn). The most expensive sold was an Alien punk that sold for 8,000 ether ($23.7m) in February 2022.[2] The seller had acquired it four-and-a-half years earlier for the equivalent of only $1,678, so they made a massive profit.

Another NFT collection is Bored Ape Yacht Club, a collection of 10,000 NFTs of cartoon-like primates, which the platform describes as "unique digital collectibles living in the Ethereum blockchain."[3] A Bored Ape NFT is not only "a provably-rare piece of art," according to the website, but serves as a Yacht Club membership card and the buyer's avatar for moving around the "club." Access is granted to members-only benefits, "the first of which is access to The Bathroom, a collaborative graffiti board." The cost of a Bored Ape is 0.08 ether, or about $200 at the time of writing, so it is in a much lower league than a CryptoPunk.[4]

Another venue for purchasing NFTs is Decentraland, a browser-based virtual reality world on the Ethereum blockchain which opened to the public in 2020. It is a version of the metaverse, as championed by Meta Platform's Mark Zuckerberg. People enter Decentraland as avatars, walk around, chat to others, and buy NFT land, property, art, and items from shops using the MANA cryptocurrency.[5] The cheapest plot of land is around 4,000 MANA, or about $5,900, which can be sold at some future date to someone else, hopefully for more than the original price. However, if you only want to buy a pair of "colourful urban

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1 "CryptoPunks," LarvaLabs.com, https://www.larvalabs.com/cryptopunks.
2 "Crypto Punk 5822," Yuga Labs, cryptopunks.app, https://cryptopunks.app/cryptopunks/details/5822.
3 "Bored Ape Yacht Club," Open Sea, https://opensea.io/collection/boredapeyachtclub.
4 *Id.*
5 "Decentraland Player Documentation," Decentraland.org, https://docs.decentraland.org/player/.

sneakers," of which there are 91 of 100 left, then they are yours for only 3.49 MANA, or about $5.[6] During the recent Metaverse Fashion Week in Decentraland in March 2022, famous brands like Tommy Hilfiger and DUNDAS sold digital clothing as NFTs.[7]

Attractions of NFTs for Creators and Buyers

Despite their intangible qualities, plenty of people are attracted to NFTs. Creators of NFTs are primarily interested in selling them to make money. Other motivators include gaining professional satisfaction from creating original digital artwork, as a traditional artist would; publicizing a cause or a business, as the Ukrainian Metahistory Museum is doing and as Twitter's Jack Dorsey did; or forming an online network of like-minded people, where the NFTs also provide access to a club, as the creators of the Bored Ape Yacht Club did.

As for buyers of NFTs, they are also interested in making money. They hope that their digital asset will appreciate in value and can be sold at some point in the future for a profit. Overall, NFT values are gradually rising. The average NFT price in April 2021 was around $600 and in March 2022 it had risen to around $1,300, according to nonfungible.com, the world's largest NFT data resource.[8] By contrast, over the same period the price of ether fell from around $3,500 to $3,000. According to Nonfungible's *NFT Market Quarterly Report Q1-2022*:

> The price of NFTs is increasingly decorrelated from the price of cryptocurrencies. NFTs are now a sub-asset dependent on the health of bitcoin or ether. They have reached a critical mass from which they can have their own trends, without directly suffering the volatility of the crypto markets.[9]

Other reasons people buy NFTs include the pleasure of owning and looking at an enticing piece of digital artwork, as well as the social media status that comes with sharing it; making a donation to a worthy cause, such as the Ukrainian digital war artifacts; gaining access to a club, such as Bored Ape; or being granted privileges not available to the general public, such as the ability to buy special merchandise or video clips.

Drawbacks of NFTs for Buyers

NFTs have several downsides. First, they are highly speculative and volatile investments, with a serious risk of asset bubbles being created and then bursting.

NFT sceptics compare them to the fashionable clothing in the parable of "The Emperor's New Clothes,"[10] where the emperor is tricked into thinking he is wearing real clothes, but they do not exist, and he is in fact naked. Similarly, NFTs are not real. They do not exist, except as images that can only be seen on a smartphone, tablet, or computer.

Crypto-sceptics regard NFTs and other digital assets in general to pyramid selling and Ponzi investment scams, where new investors drive prices up, existing investors sell and get out, and when the number of new investors dries up prices fall and the scheme collapses. That is what happened with "Tulipmania" in Holland in the 1600s, the "South Sea Bubble" in Britain in 1720, and the U.S. housing bubble that caused the global financial crisis of 2007-8.

The UK's Financial Conduct Authority[11] describes all crypto assets as "very high risk, speculative purchases" with little consumer protection, and advises "if you invest in crypto assets you should be prepared to lose all your money." It also warns that "the crypto asset marketplace is a target for fraud and scams so you should be extremely cautious before investing."

For an extreme example of how much money can be lost on an NFT, look no further than crypto entrepreneur Sina Estavi, the man who paid $2.9m for the NFT of Jack Dorsey's first tweet last year. He tried to re-sell it at auction this April, at a starting price of $48m, but the highest bid he received was $6,800.[12]

As already mentioned, NonFungible's Q1 report showed a healthy rise in average prices of NFTs over the previous year, but the report does add some notes of caution. It says there has been a decline in speculative purchases of NFTs "following the losses recorded by many buyers." There have been many press reports saying "the NFT bubble has burst." Weekly profits from global NFT trading have declined from successive peaks of $400m a week in October, January, and February to $100m at the end of March.[13]

The second drawback can be the poor quality of the visual imagery in the metaverse where many of these transactions take place. These virtual worlds are promoted as fantastic experiences, but the reality is often more prosaic and disappointing. After a recent visit to Decentraland, *Financial Times* Global Tech Correspondent Tim Bradshaw described it as "underwhelming," more like the children's games Minecraft or Roblox than "the slick immersive future envisioned by Mark Zuckerberg."[14] It is "heavy on the pixels and Lego-like digital blocks…something from a late-1990s Nintendo or PlayStation game."[15]

Third, NFTs use a lot of fossil-fuel generated electricity to validate and secure transactions which contributes to climate change. Environmental groups are campaigning against Bitcoin for this reason, although the Ethereum blockchain on which NFTs are based is in the early stages of transitioning to a different software code which will use 99.9% less electricity.

Fourth, NFTs are lightly regulated. This exacerbates financial crime risks, such as insider trading, money laundering and tax evasion. It also means there is less protection for consumers from fraudsters and hackers; and if an NFT platform or wallet closes down, do the NFTs in them disappear?

6 "Marketplace Overview," Decentraland.org, https://market.decentraland.org/.

7 Tim Bradshaw, "Virtual Worlds Are Still More Minecraft than Metaverse," *Financial Times,* April 2, 2022, https://www.ft.com/content/030f55f4-0b95-4e89-a903-6b9a48070f4c.

8 Quarterly NFT Market Report Q1-2022, nonfungible.com, April 28, 2022, https://nonfungible.com/news/corporate/nft-market-report-q1-2022.

9 *Id.*

10 Leah J. Williams, "Are NFTs the Emperor's New Clothes?" ArtsHub.com, Jan. 14, 2022, https://www.artshub.com.au/news/opinions-analysis/square-enix-konami-nft-backlash-2524423/.

11 Financial Conduct Authority, "Cryptoassets," fca.org.uk, last updated May 23, 2022, https://www.fca.org.uk/consumers/cryptoassets.

12 "Man Who Paid $2.9m for NFT of Jack Dorsey's First Tweet Set to Lose Almost $2.9m," theguardian.com, April 14, 2022, https://www.theguardian.com/technology/2022/apr/14/twitter-nft-jack-dorsey-sina-estavi.

13 Quarterly NFT Market Report Q1-2022, nonfungible.com, April 28, 2022, https://nonfungible.com/news/corporate/nft-market-report-q1-2022.

14 Tim Bradshaw, "Virtual Worlds."

15 *Id.*

Continued from p.43

For instance, in the UK, crypto assets are defined as security tokens or electronic money are regulated, but those defined as cryptocurrencies or NFTs are unregulated.[16] However, the 2019 anti-money laundering and terrorist regulations do apply to crypto asset exchanges, custodians and wallets, including those handling NFTs. Those businesses need to register with the Financial Conduct Authority and comply with all regulatory requirements. The anti-money laundering regulations also apply to businesses participating in the art market, and that could include digital art represented by NFTs, in which case they would have to register with HM Revenue and Customs and comply with the regulations.[17]

The Verdict: The Jury Is Out

There is no doubt that NFTs are popular, and their use has increased immensely in the past 12 months. People are buying and selling them in the hope of making big profits. There seems to be no sign yet to the end of the NFT craze. Yet critics believe that being a craze is the problem. They fear that the irrational obsession with them is global hype likely to end in tears.

So, are NFTs an exciting innovation with numerous benefits, or just a fad with little inherent worth? Will they steadily evolve and become mainstream, or will they come to a sudden end with an almighty pop as the bubble bursts? The answers are, for the time being, anyone's guess.

The views expressed herein are those of the author(s) and not necessarily the views of Ankura Consulting Group, LLC., its management, its subsidiaries, its affiliates, or its other professionals. Ankura is not a law firm and cannot provide legal advice.

[16] "Non-fungible Token (NFT) Regulation in the UK," Gherson.com, April 5, 2022, https://www.gherson.com/blog/non-fungible-token-nft-regulation-uk/.
[17] *Id.*

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THE CRACKS ARE BEGINNING TO SHOW

MICHAEL KRAMER
Ducera Partners

In June 2022, Mike Kramer was interviewed by Aaron Weinman of Insider, sharing his thoughts on what sectors are most exposed to restructuring, the evolving crypto space, and the tools companies can utilize to adjust to higher interest rates and a Federal Reserve focused on cooling the economy stifled by inflation. This article is a summary of key points of that discussion.[1]

Most investment bankers are down about the end of the easy-money era that fueled sky-high stock valuations and record-breaking M&A volumes. But after years of little activity, some see it as their time to shine.

Companies face a world of rising rates that will strain their balance sheets. Some—like Revlon—have already filed for bankruptcy. Other companies may default on their debt, seek rescue financing, or undertake other forms of corporate overhaul to survive.

Although actual bankruptcy filings may take months to start seriously piling up, the cracks are already beginning to show.

Heightened inflation has consumer-facing industries like retail, entertainment, travel, and leisure poised for a slowdown as discretionary spending is pared back. Industries like these, alongside those exposed to commodity price swings, present a bevy of opportunities for restructuring work.

The hot topic is inflation. Any type of business that touches the consumer is going to feel pressure. Hard goods and entertainment will feel pressed as consumer spending goes down; businesses that have exposure to oil or gas and do not have the ability to pass that on will have trouble.

And while restructurings are an expensive exercise—comprised of costly loans and collateral-backed or securitized financings—they are necessary for companies under duress.

As companies are faced with challenges and not generating as much profit, they are going to need capital to refinance their existing capital structures. Liquidity is the lifeblood of any company and access to capital is vital.

Options include debtor-in-possession (DIP) financings. This debt is usually senior to other financing a company owes to its creditors, meaning the DIP lenders will get repaid first. Because DIP financings are provided to a company during its most uncertain time, they often come with high interest rates.

Another option is equity injections from creditors. This could be from existing shareholders or new investment firms that are willing to invest in a distressed company in exchange for shares and perhaps board seats. Private-equity firms, for example, can come to the rescue—sometimes opportunistically—and take stakes in vulnerable companies.

There are many opportunities for private equity to help companies deleverage. We are coming out of a period over the last two to three years where there was unprecedented availability of debt capital, allowing companies to carry high amounts of leverage. And although it is low-cost capital, companies still have to pay that back.

And if companies are trying to repay lenders when their earnings are impaired, it becomes increasingly difficult for them to justify maintaining such high amounts of leverage.

Crypto, and the entire digital assets space, is another sweet spot providing opportunities to restructuring firms to help shore up distressed businesses. For example, the recent slump in crypto prices has led industry lenders Celsius and Babel Finance to stop users from withdrawing their holdings, while Coinbase laid off more than 1,000 staff earlier this month.

There is no question, that when prices go down it is harder to get people excited about investing in the product. But volatility need not dampen interest in the space. If anything, volatility has led to reinforced commitment, on the part of many restructuring firms, to crypto companies and others feeling the pinch of weaker prices.

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1 Aaron Weinman, "Mike Kramer, Who Made His Name Battling Bankrupt Entities from Hertz to Puerto Rico, Outlines the Types of Companies in Greatest Peril as Inflation Squeezes Consumer Spending," *Insider*, June 27, 2022, https://www.businessinsider.com/mike-kramer-ducera-restructuring-bankruptcy-investment-banking-2022-6. Excerpts used with permission.

THE BENEFITS AND COSTS OF THE TEXAS TWO-STEP

BORIS STEFFEN
Province

INTRODUCTION

Johnson and Johnson (J&J) is facing over 40,000 lawsuits for its talcum-powder (talc) based baby powder. Plaintiffs in these lawsuits allege that asbestos present in the baby powder caused ovarian cancer.[1] Talc is an earth mineral and often mined in areas close to asbestos.[2] An investigation by Reuters discovered that Johnson and Johnson executives were aware of the presence of asbestos for years and hid this knowledge from regulators.[3] According to the World Health Organization there is no safe level of asbestos, exposure to even a small amount can lead to cancer years later.[4]

To date, the lawsuits against J&J have had mixed results. Plaintiffs must overcome the burden of convincing a jury that baby powder was the cause of their ovarian cancer; a difficult task considering 1 in 78 women will be diagnosed with ovarian cancer.[5] However, there have been some successful lawsuits. In 2021 the Supreme Court rejected an appeal from J&J, affirming a $2.11 billion verdict in favor of women who claim to have developed ovarian cancer from the use of baby powder.[6] In an attempt to reduce its liabilities, J&J is employing a controversial bankruptcy method known as the "Texas Two-Step."

WHAT IS A TEXAS TWO-STEP?

A Texas Two-Step has the potential to allow companies to avoid or significantly reduce liabilities. The Texas Two-Step, as the name suggests, occurs under Texas law. Texas law allows a business to split into two entities by means of a divisional merger, subsequently allocating its assets to one company ("OpCo") and its liabilities to the other ("TortCo").[7] TortCo subsequently declares chapter 11 bankruptcy. In theory this should block creditor's access to the legacy company's assets by restricting their recovery to the assets in the newly formed TortCo.[8]

HISTORY OF THE STRATEGY

J&J is only the fourth company to attempt a Texas Two-Step. Notably, Georgia-Pacific used a Texas Two-Step in 2017 to minimize asbestos liabilities. Now five years later, asbestos lawsuits against Georgia-Pacific have not been able to proceed. Georgia-Pacific has pledged to put $1 billion in trust for people who Georgia-Pacific exposed to asbestos, although this is hardly generous, considering Georgia-Pacific was spending up to $200 million a year to defend or settle asbestos cases.[9]

J&J AND THE TWO-STEP

Johnson and Johnson created a subsidiary known as LTL Management LLC and transferred its talc-based tort liabilities into it. LTL Management was also provided $2 billion to settle all talc claims through a bankruptcy trust.[10] The newly formed company filed for chapter 11 bankruptcy only a few days after its formation. LTL Management's bankruptcy declaration has put a pause on the nearly 38,000 talc lawsuits against it.[11]

While there is debate as to whether J&J's Texas Two-Step will succeed, it has yet to be struck down by Courts. Judge Michael Kaplan, a U.S. bankruptcy judge for the District of New Jersey, determined that LTL Management's bankruptcy case was not

1 Johnson and Johnson is switching to a cornstarch-based baby powder. Peter Hoskins, "Johnson & Johnson to Replace Talc-Based Powder with Corn Starch," *BBC News*, August 12, 2022, https://www.bbc.com/news/business-62514263.

2 *Id.*

3 Lisa Girion, "Johnson & Johnson Knew for Decades that Talcum Lurked in its Baby Powder," *Reuters*, December 14, 2018, https://www.reuters.com/investigates/special-report/johnsonandjohnson-cancer/.

4 *Id.* It should be noted that most people exposed to asbestos do not develop cancer.

5 According to the American Cancer Society, "Ovarian cancer ranks fifth in cancer deaths among women, accounting for more deaths than any other cancer of the female reproductive system…. This cancer mainly develops in older women. About half of the women who are diagnosed with ovarian cancer are 63 years or older. It is more common in white women than African American women." *Key Statistics for Ovarian Cancer*, https://www.cancer.org/cancer/ovarian-cancer/about/key-statistics.html#:~:text=Ovarian%20cancer%20ranks%20fifth%20in,is%20about%201%20in%20108.

6 Kevin Dunleavy, "Johnson & Johnson's last-ditch appeal of $2B talc verdict falls short at Supreme Court," fiercepharma.com, June 1, 2021, 11:14 am, https://www.fiercepharma.com/pharma/supreme-court-tells-j-j-to-take-a-powder-over-2-1b-missouri-talc-verdict.

7 Michael A. Francas, "Texas Two-Stepping Out of Bankruptcy," *Michigan Law Review*, June 2022, https://michiganlawreview.org/texas-two-stepping-out-of-bankruptcy/.

8 To note, the newly formed corporation could contain only liabilities and have no assets. Jason Fernando, "Texas Two-Step Bankruptcy," *Investopedia*, April 28, 2022, https://www.investopedia.com/texas-two-step-bankruptcy-definition-5225888.

9 It should be noted that the lawyer who orchestrated the Georgia-Pacific Texas Two-Step now represents J&J. He claims that the Texas Two-Step benefits both the company and the victims. His argument is that the Texas Two-Step prevents unreasonably high jury awards and guarantees that victims are compensated from the bankruptcy trust, rather than having to take their chances with a jury.

10 Tim Povtak, "U.S. Court of Appeals Hears Challenge to J&J's Bankruptcy Plan, Asbestos.com, last modified October 3, 2022, https://www.asbestos.com/news/2022/09/28/johnson-johnson-appeal-talc-bankruptcy/.

11 Dietrich Knauth and Brendan Pierson, "U.S. Judge Temporarily Blocks Two State Lawsuits over J&J Talc Marketing," *Reuters*, October 5, 2022, https://www.reuters.com/markets/us/us-judge-temporarily-blocks-two-state-lawsuits-over-jj-talc-marketing-2022-10-05/.

filed in bad faith.[12] Further, in October 2022, Judge Kaplan blocked New Mexico and Mississippi from pursuing lawsuits against J&J while the Federal Appellate Court determines whether LTL Management's bankruptcy claim is valid.[13]

WHY DOES THIS MATTER?

If J&J can successfully implement a Texas Two-Step to avoid full liability, both bankruptcy and consumer liability protection laws might be significantly altered. In theory a company could completely ignore consumer protection laws and transfer their liabilities into a subsidiary when the lawsuits start to accumulate. The benefit to the company is that by isolating and transferring its mass-tort liabilities from its ongoing business operations, and subjecting only TortCo to the bankruptcy process, the value of OpCo, which ultimately will have to pay the mass-tort obligations, likely pursuant to a funding agreement between itself and TortCo, is enhanced by avoiding the direct and indirect costs of bankruptcy. At the same time, however, while the bankruptcy process has the potential to result in the settlement of mass tort obligations more effectively and efficiently than in an alternative, multi-district litigation ("MDL") under the federal MDL statute, the risk, though perhaps acceptable where the magnitude of the disputed claims threatens the ability of a company to continue as a going concern and make full payment of all claimants, is that the bankruptcy process will result in systematically undercompensating claimants relative to that achievable in a MDL, particularly for claimants in the future.

[12] James Nani, "J&J's 'Texas Two-Step' Talc Bankruptcy Strategy Remains in Doubt," *Bloomberg Law*, April 8, 2022, https://news.bloomberglaw.com/bankruptcy-law/j-js-texas-two-step-talc-bankruptcy-strategy-remains-in-doubt.

[13] Knauth and Pierson, "U.S. Judge."

ABOUT THE AUTHOR

Boris J. Steffen, CDBV
Province, LLC

Boris J. Steffen, CDBV, is a Managing Director with Province, Inc. With over 30 years experience as a financial advisor and expert witness to holders of interests and claims on matters of accounting, finance, valuation and solvency, he has consulted in over $100 billion of mergers, acquisitions and restructurings. As such, his practice has included Special Litigation Committee service, acting as the independent accounting expert in post-closing working capital disputes, evaluating asset acquisitions and serving as an expert witness with respect to issues including the interpretation of accounting principles, allocation of costs, specificity of merger synergies, actual and constructive fraudulent transfers, and fair value, including before the Delaware Court of Chancery.

LEARN MORE ABOUT CREDIT ABUSE RESISTANCE EDUCATION

TAMMY HETTINGER
CARE

In 2020, only one in six high schoolers across the country were required to take a personal finance course prior to graduation and this number decreases to 1 in 26 in low-income schools.

Credit Abuse Resistance Education (CARE) knows we can do better. CARE is committed to ensuring all young people have access to the information they need to make smart choices with their money as they enter adulthood.

CARE was founded by now-retired U.S. Bankruptcy Court Judge John C. Ninfo II in 2002. He was frustrated by the many young consumer debtors who would appear in his bankruptcy courtroom. They simply lacked the necessary tools and knowledge to manage their finances and avoid falling prey to financial fraud scams. As a result, Judge Ninfo founded CARE to teach high school and college students about the responsible use of credit and the consequences of credit card abuse. Judge Ninfo shared his successful program with fellow bankruptcy judges across the country and quickly grew the organization into a nationwide presence.

With chapters in 35 states, D.C. and Puerto Rico, CARE is dedicated to empowering the next generation for financial success through volunteer-led education. CARE is the only financial literacy organization working with professionals in the insolvency, restructuring, and financial advisory industries who see firsthand the consequences of severe financial problems. Our volunteers include bankruptcy judges and trustees, federal and state receivers, insolvency and fraud recovery lawyers, financial advisors, and other members of the financial services industry who give presentations and share real-world examples in schools across the country. From New York to California, CARE volunteers teach students how to avoid being a victim of easy and deceptive credit traps and fraud scams, and how to manage their finances responsibly.

CARE volunteers nationwide visit schools, colleges, youth organizations, and parents' groups, giving presentations both virtually and in-person on personal finance. Our program is 100% free. Our curriculum is focused on the following topics: budgeting, credit, student loans and financial fraud scams.

We envision a nation where young adults are prepared to manage their finances and secure a better future for themselves. There are many ways to support our mission by volunteering, being a sponsor, or connecting us to schools and youth organizations in your community. We welcome your involvement in our work. Learn more about CARE at care4yourfuture.org.

ABOUT THE AUTHOR

TAMMY HETTINGER
CARE

Tammy Hettinger, Director of CARE, joined the organization in April 2019 as its executive director. In her role, she leads CARE's efforts to advance the financial literacy of America's youth with the support of 50 volunteer-run chapters in 35 states, D.C. and Puerto Rico. Her professional experience includes over 25 years working for a range of organizations within the nonprofit arena. Tammy holds a B.A. in political science from the University of Minnesota and an M.S. in public policy from University College London in the U.K. She also completed her Certificate in Women's Leadership from Cornell University in October 2018. She can be reached at thettinger@care4yourfuture.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

IN MEMORY OF DONALD ROY BARG

June 16, 1947 – October 11, 2022

Andrew R. Barg, CPA, CIRA
Barg & Henson CPAs, PLLC

It is with great sadness that I report the passing of my dad, Donald R. Barg.

Dad first cut his teeth in bankruptcy as a tax director for Touche Ross in the early 80's. He wrote his master thesis on tax provisions of the Bankruptcy Act of 1984 about the time the law was first passed. He was one of the early pioneers of bankruptcy taxation as a niche practice and one of the early members of the AIRA and CIRA program. At a time when CPA advisory services did not exist, Dad was on the cutting edge of financial and tax advisory services to debtors seeking to reorganize. When given the opportunity to be partner at a national firm, he turned it down because he did not want to be conflicted out of cases—instead, he opted to start his own firm so he could continue his passion of helping people with serious problems who often had no one else to turn to, even if that sometimes meant not getting paid.

Dad launched his own firm in 1984 and served the bankruptcy community for over 37 years, primarily in the Northern District of Texas. He volunteered for the AIRA for years, frequently speaking at the annual tax toolbox on a variety of tax topics. He was a true advocate for all taxpayers and debtors; in the bankruptcy tax world, Dad was a lion. He attended nearly every annual AIRA conference for as long as I can remember. He had tremendous admiration and respect for all the AIRA professionals and earned the friendship of many.

Dad was also a true public servant and volunteered on many boards. In Mansfield, TX, growing up there were very few public parks and even fewer public use sporting facilities. Dad was part of a team of local leaders and was instrumental in passing a sales tax increase earmarked for building and maintaining parks and recreation for the city of Mansfield. After the sales tax passed, Dad served for 15 years as Treasurer of the Mansfield Parks Board overseeing the financing of many parks that followed in that time, helping to transform the city with one of the best park programs in the country. He was honored with a park in his name.

Looking back, of all his professional accomplishments, the one he was likely most proud of was the level of work-life balance he achieved that allowed him to be a wonderful husband, father, grandfather, public servant, and man of faith. He would frequently remind me, "Son, anyone can be a slave to the job; that's easy."

Dad will be very much missed by all. I was honored to have worked with him for 14 years. He loved so much to help people and he took on some of the biggest problems. I miss my dad so much. I will also miss the *AIRA Journal* as a wonderful tax resource over the years and regret this will be my first and last contribution to it.

Thank you to Grant Newton, all the staff at AIRA, and the wonderful friends we've made along the way.

—Andy Barg

At many of the AIRA's tax conferences over the past 20 years, Don provided in-depth training on complex bankruptcy tax issues. More importantly, the AIRA tax group greatly benefited from Don's joyous and gregarious welcoming of newcomers, and his deep relations with long time members. The AIRA tax group is an effective professional networking and educational group because of the tightknit fellowship that Don helped grow. As co-chair of the annual tax conference, Don's son Andy continues the Barg family's continuing service to AIRA.

—Jay Crom, CIRA, Bachecki Crom & Company LLP

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

THE RECIPIENT OF AIRA'S 2022 JUDICIAL SERVICE AWARD: HON. ALAN S. TRUST, CHIEF JUDGE, U.S. BANKRUPTCY COURT, EDNY

The Honorable Alan S. Trust ascended to the bench on April 2, 2008 and sits in the Eastern District of New York. He became Chief Bankruptcy Judge on Oct. 1, 2020.

Judge Trust has been an adjunct professor of law at the St. John's University School of Law since 2009. He served a 2-year term as President of the Eastern District of New York Chapter of the Federal Bar Association and serves as CLE Committee co-chair. He is a past Chair of the Bankruptcy Law Section of the Federal Bar Association, a member of the Board of Directors of that Section and has served as the CLE Committee chair. He is also a member of the Editorial Board of the *ABI Journal,* is a coordinating editor for the Journal, and for several years has had responsibility for the Dicta column. He is also a member of the American Bankruptcy Institute and the National Conference of Bankruptcy Judges.

Judge Trust has been previously designated by the Second Circuit Court of Appeals to mediate cases in the Southern District of New York and to sit in the District of Connecticut bankruptcy court. Judge Trust has continued to serve as a judge mediator in EDNY.

Judge Trust has been selected by the Federal Judicial Center on several occasions to serve as a faculty member for national bankruptcy judge workshops and has spoken on issues such as evidence and the power of the bankruptcy courts to regulate its proceedings through sanctions and contempt. He also serves on the Judiciary Data Working Group under the auspices of the Administrative Offices of the United States Courts.

Judge Trust remains a frequent speaker and contributor for numerous CLE events and seminars, addressing bankruptcy, mediation, trial practice and ethics issues, and has participated in a number of civics programs. He was instrumental in the creation of the Pro Bono Mediation Program and the formation of the Consumer Lawyer Advisory Committee adopted by the Eastern District of New York Bankruptcy Court.

Judge Trust attended Syracuse University, graduating *summa cum laude* in 1981, and as a member of Phi Beta Kappa. He attended New York University School of Law, where he served on the Law Review from 1982-83, and graduated *cum laude* in 1984. After graduation, he relocated to Dallas, Texas to begin his law practice. Judge Trust opened his own law firm in Dallas in December 1995, and managed that firm until appointed to the bench.[1]

[1] Biography source: https://www.nyeb.uscourts.gov/content/chief-judge-alan-s-trust.

A Letter from Hon. Alan S. Trust

To whom much is given, much will be required[1]

I want to thank the Association of Insolvency and Restructuring Advisors for presenting me with their 2022 Judicial Service Award. It has been the privilege of my lifetime to serve as a federal bankruptcy judge since 2008, and for the past 2+ years as the chief judge for the EDNY Bankruptcy Court.

It has always been important to me that we recognize the obligation we each have to serve our country and our communities in the manner we are best able. Throughout our history, many have been called upon or volunteered for military service or as first responders. Others teach our children and the next generations of leaders. Still others treat us when we are sick or care for us when we are no longer able to do so. There is always more need for help than availability of helpers.

As a judge, there are limitations on what I can do in service of others. So, I have tried to give back by helping to train and encourage the current and next generation of lawyers and insolvency professionals. I do this through my interactions with my law clerks and interns, now numbering over 40. For the past 15 years, I have been an adjunct professor at St John's University School of Law. I speak at numerous CLE events, and have even been given the honor of teaching at national workshops held for my fellow bankruptcy judges.

In addition, as part of my work for our court, I have helped design and/or implement a number of bench bar activities. Consistent with our mission of enhancing the level of practice as well as our provision of services, we interact on a regular basis with both our Chapter 11 Lawyers Advisory Committee and our Consumer Lawyers Advisory Committee. We conduct workshops that afford junior lawyers the opportunity to practice their courtroom skills by arguing actual motions to our judges that were filed in now-closed cases. We hold brown bag programs on substantive topics as well as on practice related issues, and have enlisted the help of our sister state court judges. Our court has partnered with local attorneys and pro bono groups to help expand the scope of resources available to pro se filers, and to provide mentoring to attorneys who appear before us. I have always appreciated the willingness of our practitioners to give of their time and energy in service of these wonderful projects.

There is plenty that each of us can do. As stated at the opening, to whom much is given, much will be required. I thank the AIRA for this opportunity to share my philosophy on this vital subject.

[1] Attributed to Luke 12:48, King James Bible. I use this expression in a public service sense, not in a religious sense.

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