AIRA Journal

VOL 37: NO 1
2024
AIRA.ORG

PUBLISHED BY THE ASSOCIATION OF INSOLVENCY & RESTRUCTURING ADVISORS

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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.

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From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

I hope everyone's year has started off well. Here at AIRA we are looking back and recapping 2023 activity as well as looking forward to another year of service to the membership and the restructuring community.

Recently, AIRA sent out its annual press release naming and congratulating the 51 members who completed CIRA certification in 2023 and Ann Marriott Payne, CIRA, who added CDBV to her credentials. Congratulations to all of you!

The expectation that professionals proffering expert testimony have an appropriate certification has gained increasing importance since the 1993 Supreme Court ruling in *Daubert* (Daubert v. Merrell Dow Pharm., Inc. 509 U.S. 579, 597 (1993)). While the *Daubert* opinion focuses on factors of reliability, relevance, and acceptance when judges evaluate whether to admit testimony, the underlying qualifications of the proposed expert are also at the forefront. As a profession, that training and expertise are in high demand, and those qualities specified for experts in the *Daubert* ruling can serve as a broader guide for us all.

Based on a recent continuing education session focused on providing expert testimony, it is clear to me that the courts pay careful attention to the education and experience of those making appearances to provide expert testimony. It is also clear that judges look for a frame of reference in weighing the information supporting a professional's qualifications. Work experience, publication credits, academic credentials—these are all important indicators of expertise; however, these factors seem to lack a consistent frame of reference. What is an appropriate certification? What certification provides the best specialized training and frame of reference for our line of work?

Two professionals with similar academic background and number of years working on restructuring matters may have very different levels of expertise. Certifications such as CIRA and CDBV provide an indication—through specific testing and experience requirements—that the holder of the credential has met rigorous, established standards encompassing a recognized body of knowledge.

Establishing programs with rigorous standards, ethics, and experience through certification represents only part of the effort. It is just as important to know the credential is being recognized and accepted, further establishing its relevance and bona fides. Recently, Professor Jack Williams, CIRA, CDBV, conducted a search on Westlaw and Lexis focusing on reported cases in bankruptcy courts. Jack found no fewer than 32 different references to CIRA crede in important written bankruptcy opinions. Jack concluded in his note to me that the CIRA credentials seems to play a significant role in pure bankruptcy or restructuring matters and stands along with the CPA, CFF, and CFE in forensic accounting and fraud roles. Google and other searches reveal hundreds of references to CIRA, CDBV, and AIRA. These credentials and AIRA are also appearing in numerous textbooks, and dozens of authors and presenters at leading conferences and in leading journals include them in their biographical qualifications.

Personally, I recall at least one instance where a judge interjected while counsel was establishing my credentials prior to testimony to say that he was familiar with the CIRA certification and likened attaining it to the rigors of becoming a CPA.

Since the advent of the CIRA certification program in 1992, AIRA and you, the membership, have worked hard to successfully establish and reinforce CIRA as the recognized standard for a credentialed financial professional in the insolvency and restructuring environment. The continuing enrollment and participation each year in the CIRA program as well as the CDBV program confirms the market's recognition of the value in becoming a Certified Insolvency and Restructuring Advisor and obtaining a Certificate in Distressed Business Valuation for today's insolvency and restructuring environment.

We have started off 2024 with a CIRA 1 class that includes more than 40 participants. As in prior years, I will be teaching three rounds of CIRA 1, 2, and 3 during the year. You can find the schedule of CIRA classes at AIRA.org/CIRA. The next CIRA 1 class will be Group Live In-Person on June 3-4, preceding AIRA's 40th Annual Restructuring and Bankruptcy Conference in Baltimore, MD.

As you have come to expect, another informative and timely set of articles follows.

Read, enjoy, learn.

Keep well. Jim Lukenda

CDBV

2024 COURSES

Part:	Dates:	Location:
1	Feb 07-15, 2024	Online
2	Mar 05-14, 2024	Online
1	Jun 03-04, 2024	Baltimore, MD
3	Aug 20-29, 2024	Online

More information and registration at www.aira.org

A Letter from AIRA's President

DENISE LORENZO, CIRA
AlixPartners, LLP

On January 1, 2021, Congress enacted the Corporate Transparency Act (CTA) as part of the William M. (Mac) Thornberry National Defense Authorization Act of 2021. Enacted as part of Congress's ongoing anti-money laundering efforts, CTA requires companies to disclose their ultimate beneficial owners to the Financial Crimes Enforcement Network (FinCEN). These disclosures are aimed at eliminating the anonymity of shell corporations. The information is expected to assist in efforts to uncover, prevent, and punish terrorism, drug trafficking, tax fraud, and other illicit activities that have been facilitated through corporate entities.

As of January 1, 2024, the initial filing requirements under the CTA have become effective. Who must file, for what types of entities, what exemptions may exist, and what the penalties for failure to comply may be, are all relevant questions to which company shareholders, boards of directors, management, and advisors such as ourselves should know the answer.

To that end, on March 21, 2024, AIRA will be hosting a webinar on CTA. Sheryl Giugliano, Alexandra McCormack, and Russell Stern from the law firm Ruskin Moscou Faltischek P.C. and Kevin Clancy, CIRA, a partner with CohnReznick, LLP and an AIRA Director, will present a 1 ½ hour program, "Corporate Transparency Act, What Financial Professionals Need to Know About Beneficial Ownership Reporting". We are hoping this will be the first of an ongoing series of timely webinars focusing on current and important matters about which restructuring professionals should be familiar. Registration is open. Please see https://aira.org/conference/webinar/cta24 for program, continuing education, and registration details.

AIRA's ability to provide timely continuing education and thought leadership is partially dependent on input from our membership. Just as the articles that appear here in the AIRA Journal provide educational content to the overall membership and opportunities for the members to share their knowledge, so too, topics for webinar presentations depend on ideas presented by you. Please don't hesitate to share your ideas for presentation content with any of AIRA's board members or the AIRA staff. Your contributions will be a benefit to you and to the rest of the membership.

— Denise Lorenzo

CIRA

2024 COURSES

Part:	Dates:	Location:
1	Feb 07-15, 2024	Online
2	Apr 17-25, 2024	Online
3	May 15-23, 2024	Online
1	Jun 03-04, 2024	Baltimore, MD
2	Jul 09-17, 2024	Online
3	Sep 03-11, 2024	Online
1	Oct 15-23, 2024	Online
2	Nov 06-14, 2024	Online
3	Dec 10-17, 2024	Online

More information and registration at www.aira.org

Resident Scholar Column

JACK F. WILLIAMS, PHD, JD, CIRA, CDBV, CTP

Bankruptcy Busters

Those Things Worth Believing: Character Building as Professionalism

Allow me to set the scene. It is 1860 in Philadelphia, Pennsylvania. A group of law students are gathered to hear words of wisdom from a special guest. Their speaker, George Sharswood,[1] a former attorney, law professor, dean, legislator, judge, and soon to be Justice and Chief Justice of the Pennsylvania Supreme Court, sits before them, a scion of humility and understated exceptionalism. Absolute silence shrouds the room as their mentor begins his remarks. Sharswood, recently turned 50 years old, understood the importance of this gathering. Everyone in that room, at least those that would survive the war, recall these words of wisdom.

> Let it be remembered and treasured in the heart of every student, that no person can ever be a truly great lawyer, who is not in every sense of the word, a *good person*. A lawyer, without the most sterling *integrity*, may shine for a while with meteoric splendor; but his light will soon go out in blackness of darkness. It is not in every person's power to rise to eminence by distinguished abilities. It is in every person's power, with few exceptions, to attain *respectability, competence, and usefulness*. The temptations which beset a young person in the outset of his professional life, especially if he is in absolute dependence upon business for his subsistence, are very great. The strictest principles of integrity and *honor* are his only safety. Let him begin by swerving from *truth or fairness*, in small particulars, he will find his character gone – whispered away, before he knows it.[2]

Sharswood, an exceptional scholar and mentor, possessed strong opinions on the art and science of teaching. He held strong to the view that teaching students in a professional school was not so much about communicating knowledge, but to teach young people how to be life-long students, how to think critically, and how to excite them to love to study. He shied away from a broad curriculum and urged that teachers should refrain from teaching too much and too many subjects. He embraced critical thinking and the acquisition of accurate knowledge of the first elements of any doctrine or body of knowledge. But at the heart of his theory of teaching lies that which would resonate with his students and those who have followed them who are aware of his words shared that day. A professional must acquire and nurture good habits of mind and heart, that is, good character.

For Sharswood, a good person, the predicate of being a great professional, possesses good character. He shares with us the attributes of good character: **goodness, integrity, respectability, competence, usefulness, honor, truth, and fairness.** These are the watchwords of his professional faith.

Sharswood has had a profound effect on me, although I came to his work later in my career. His attributes or badges of good character resonate in professional codes like the American Bar Association Model Rules (although more so in the Model Rules' antecedent, the ABA Model Code of Professional Conduct), the Association of Insolvency and Restructuring Advisors' (AIRA) Code of Professional and Ethical Conduct, and the Turnaround Management Association's (TMA) Code of Ethics. What Sharswood saw as attributes of good character and, in turn, attributes of a great professional, I see as simulacrums of what I would suggest as the first principle of any profession – trust, especially trust's role in building good character.

Trust. Hard to gain; easy to lose. Yet, trust lies at the center of what we do as professionals. Trust is an art that we develop and form as we develop and form our character. At its root is vulnerability. We can trust too much or trust too little and, in both cases, will have trusted incorrectly. Many decades past, we moved from professionalism learned at the knee of an exemplar, our mentor, towards learning ethics from codes, conferences, and social media. In that process, we lost the human touch.

In this essay, I plan to build on the words of wisdom shared by Chief Justice Sharswood and will explore a bolder view of the subject matter, drawing from the virtues (particularly the virtue of trust) in a search for what makes for a virtuous bankruptcy professional and a rewarding career.

Professionalism in a sea of codes

Bankruptcy professionals operate in a sea of codes and rules often dependent on background of the professional and the nature of the work. They must comply with the Bankruptcy Code, Bankruptcy Rules, Internal Revenue Code, and potential multiple ethical codes, such as the ABA Model Rules and the AIRA Code of Professional and Ethical Conduct. These codes harbor complex and nuanced sets of rules, often conflicting, that construct the tapestry of ethical professional behavior. But have you as a bankruptcy professional ever contemplated and attempted to gain perspective on what these codes seek to accomplish, what professional and ethical role do you play, or what does it mean to be a fiduciary to the bankruptcy estate; or do you, like me, often find yourselves at full speed just trying to keep up with the demands of the practice and the times? Often, practitioners fail to appreciate the difference between professionalism and professional ethics. Our professional ethics focus on action guidance where acts are primary and character derivative. Good is what good does. For example, the fundamental standards of the AIRA Code of Professional and Ethical Conduct are **competence, confidentiality, integrity, objectivity, and due care**. But do these clusters of codes speak of, or to, good character? This is your opportunity to step back, gain perspective, and ponder a few of those questions, especially the question of the greater "why" and the role and hierarchy of character in an understanding of professionalism, and what does all that mean to you as a professional. Let's begin with virtue and the role in play on character and professionalism.

---

[1] For an excellent essay on Judge Sharswood, see George W. Wickersham, *Judge Sharswood,* 62 Penn. L. Rev. & Am. L. Reg. 615-620 (1914).

[2] George Sharswood, An Essay on Professional Ethics, 111-112 (T. & J.W. Johnson 1860)(emphasis added).

Virtue's say on the matter

Many professions have struggled with a professional ethic that provides action guidance to its individual members while maintaining the profession's collective integrity (*e.g.*, AIRA Code of Professional and Ethical Conduct; ABA Model Rules of Professional Conduct). As previously discussed, these professions have sought comfort in elaborate codes of conduct that purport to regulate and inform members of the profession and, simultaneously, protect the integrity and separateness of the profession.

Bankruptcy is no different. Numerous bankruptcy and bankruptcy-related organizations have crafted elaborate codes of conduct, fascinating artifacts in their own right, to inform, and in limited formal means, regulate members of the profession. These professional codes generally emphasize a professional's interaction with the bankruptcy estate, the client, third parties, opposing counsel, the US Trustee, and the court.[3] These codes of conduct may provide a floor to ethical conduct, but do they inspire a greater sense of professionalism and of good character in the sense suggested by Sharswood? I don't think so. Character needs to be primary and not derivative. That does not mean that action guidance is irrelevant. It is important but not all important. Think of it as derivative, and not primary, in the quest for becoming a good person and great professional.

Both deontology and consequentialism primarily focus on the actions of humans; character or motives are either irrelevant or, most often, derivative. These approaches help us understand who, what, when, where, and how. In contrast, virtue ethics emphasizes virtue or moral character.[4] As an ethical system, it focuses on what makes a *bankruptcy professional* good, rather than what makes an *action in a bankruptcy setting* good.[5] As a character-centric normative ethic, virtue ethics provides the basis for the development of a dynamic and organic moral philosophy process that informs and guides a professional and his or her profession in the panoply of human relationships that make up the praxis of bankruptcy. It makes explicit and primary the "why" of a profession. Virtue ethics revolves around questions of character, and places emphasis not on professional codes that rest on deontological or utilitarian foundations, but on the subjectivities of social and political interactions.[6] Virtue ethics' primary focus is on character and seeks to explore and demonstrate on what makes a professional good rather than on what makes an action by a professional good. In sum, the most universal concept of the many varieties of virtue ethics is the primacy of character or virtue where action guidance is derivative and, yet virtue ethics has its limitations.

Virtue ethics may be traced back to at least ancient Greece, beginning with the writings of Plato and Aristotle.[7] In his *Republic*, Plato devotes considerable discussion to four cardinal virtues that make good moral character.[8] These virtues are **courage, temperance, wisdom, and fortitude**.[9] Central to his moral theory, Aristotle engages in a discussion of virtues.[10] The stoics then apply a body of knowledge developed by a consideration of virtues as indicators of good moral character to their philosophy on ethics. Meanwhile, during the scholastic period, Christian thinkers, particularly St. Thomas Aquinas in his *Summa Theologiae* and his *Commentaries on the Nicomachean Ethic,* embrace Aristotle's virtues as essential to Christian moral theology.[11]

After the stoics and the passing of the scholastic period, virtue ethics as a form of normative ethics largely moved into a period of neglect.[12] During this time, other forms of normative ethics eclipsed its importance. Virtue theory was not considered a viable ethical theory for over 2000 years.[13] Recently, because of the perceived fundamental inadequacies of other ethical theories, virtue ethics has experienced a rebirth of sorts, particularly in the context of the development of a meaningful professional ethic.[14]

In sum, the primacy of character is the core concept of modern virtue ethics theories. Of course, that does not mean that there is one type of primacy; in fact, there are many different understandings of primacy. However, diversity does not detract from the fundamental role character plays in virtue ethics.

The importance of the greater "why"

Why do we do this? Why do we take on the responsibility of a lawyer or accountant or financial advisor or other restructuring professional - aside from a paycheck, and Lord knows there are easier ways to get one of those. Here is a sampling of our challenges when we do, and they are not easy.[15] First, we must wear so many hats, not like a person who replaces a hat on his head with another off the shelf; more like the Cat in the Hat, hats stacked to the heavens. Second, we have a special responsibility for the quality of justice, particularly when it comes to insolvency and bankruptcy proceedings. With that responsibility comes a lot of attention, focus, and sometimes outright hate directed at us simply because our job is to seek to uphold the rule of law and to ensure the pursuit of justice, even when a mass or mob prefers the expediency of punishment before process. Third, we are required to be honest. That is laudable and harder than it appears. In a world where everyone seems to have a spin, where beliefs and feelings are often advanced as if fact, where financial loss is prevalent and accountability often lacking, it is incumbent on us to hold the line on the importance of truth, on what is just, and right, and good. It is not for the faint of heart. Fourth, we are required to be competent, loyal, objective, prompt, Resident

Continued on p.45

[3] *cf.* Sarah Tarlow, *Decoding Ethics*, 4 Public Archaeology 249 (2001), Sarah Tarlow, *The Ethics of Archaeology: Philosophical Perspectives on Archaeological Practice*, in The Ethics of Archaeology: Philosophical Perspectives on Archaeological Practice, 199-216 (C. Scarre & G. Scarre eds. 2006).

[4] Baron *et al.* at 1-9.

[5] *Id.* at 175.

[6] *Id.* at 177-179; Roger Crisp and Michael A. Slote, Virtue Ethics, 24 (1997).

[7] Greg Pence, *Virtue Theory*, in A Companion to Ethics, 251-2 (P. Singer ed. 1991).

[8] *Id.* at 251.

[9] *Id.* at 252.

[10] Aristotle, Politics, 11-17, 28-47, 63-78, 137-58 (C.D.C. Reeve (trans) 1998).

[11] Pence at 252.

[12] Baron *et al.* at 175.

[13] *Id.*

[14] R.A. Duff, *The Virtues and Vices of Virtue Jurisprudence*, in Values and Virtues: Aristotelianism in Contemporary Ethics, 90-104 (T. D. Chappell ed. 2006); Christine Swanton, Virtue Ethics: A Pluralistic VIEW, 207-224 (2006); Justin Oakley and Dean Cocking, Virtue Ethics and Professional Roles, 71-94 (2001).

[15] Drawn from the ABA Model Rule, Preamble.

THE CREDITOR RIGHTS COALITION REPORTS ON *PURDUE PHARMA* AND SCOTUS[1]

Martin Bienenstock, Marshall Huebner, and Clifford P. White III

The Supreme Court heard oral argument in the highly anticipated Purdue Pharma bankruptcy case on December 4, 2023. At stake, $6 billion of payments by the Sackler family to compensate victims of the opioid crisis in exchange for releasing the Sacklers from all opioid-related claims, and future litigation.

The Creditor Rights Coalition, a thought-leadership advocacy organization, asked its expert Contributors to weigh in on what happened and what to expect next. Contributors Martin Bienenstock, Chair of the Restructuring practice at Proskauer Rose LLP, and Clifford P. White III, the former head of the US Trustee program, argue against third-party releases in the CON camp. Contributor Marshall Huebner, Co-Chair of the Restructuring practice at Davis Polk and lead debtor counsel for Purdue, argues in favor of affirming the bankruptcy plan in the PRO camp. The views expressed are those of the authors only. Learn more at www.creditorcoalition.org.

CON

By Martin Bienenstock

The Supreme Court's oral argument on December 4, 2023 demonstrated the Supreme Court, as a whole, very much appreciated the business sense of the Sackler deal and was concerned about the uncertain consequences of eliminating it, but wrestled with two main issues, namely (i) how the words "appropriate" and "not inconsistent" in Bankruptcy Code section 1123 can be interpreted to allow coerced releases, and (ii) whether a majority or even super-majority vote of creditors can deprive the minority of constitutional rights.

The Statute: The statutory interpretation question was approached from opposite extremes. Justice Thomas asked how the broad scope of "appropriate" can be narrowed to exclude coerced releases, while Chief Justice Roberts asked why the major question doctrine did not apply. That doctrine would deprive the bankruptcy court of power to make up the rules for coerced releases and would defer to Congress on such an important question. Justice Alito took both sides by asking whether the question should be resolved by Congress or by the Supreme Court. Notably, Justice Alito suggested that if the Sackler's funds are unreachable, the court ought to be able to do something about it. Justice Kavanaugh suggested the use of coerced releases the last thirty years can make them "appropriate" when confined to claims for which the released parties would have indemnification claims against the debtor, but conceded the good faith limitation on the Sacklers' indemnification claims could make a difference. Justice Kavanaugh also asked why "appropriate" should not be read narrowly because of its great economic significance that the Supreme Court would not assume Congress lightly assigned. Justice Jackson noted coerced releases were not allowed under *Calloway v. Benton* under the Bankruptcy Act, and also stated the Sacklers can settle with 97.5% of creditors, but it is they who demand a release from the others. Justice Barrett attacked the entire relevance of indemnification claims by suggesting the estate would be distributed on liquidation and nothing would be left to pay the Sacklers' indemnification claims. Justice Barrett also observed bankruptcy courts "stretch the Code" with coerced releases. Justices Gorsuch and Barrett pointed out the Sacklers would not be discharged of fraud claims in their personal bankruptcies, showing an inconsistency with the Bankruptcy Code. Justice Jackson asked that even if coerced releases are allowable, why wouldn't this be a clear case not to allow them where the Sacklers took their money out of the debtor. Justice Barrett also asked why Congress needed to enact Bankruptcy Code section 524(g) for asbestos cases if section 1123(b)(6) already authorized coerced releases. Justice Jackson asked why section 1123(b)(1)-(5) are necessary if section 1123(b)(6) is so broad.

The Constitution: In respect of some of the constitutional issues, Justice Sotomayor implied that in view of the impracticality of obtaining consents from thousands of victims, perhaps the coerced releases are the only answer and override due process concerns. Of course, that does not speak to those creditors who affirmatively denied consent. Justice Kagan volunteered (later supported by Justice Gorsuch) that one of the US Trustee's stronger arguments is the basic bankruptcy bargain requires the debtor to put all its assets on the table to get a discharge, and the Sacklers may not have provided "anything near their entire pot of assets." Justice Kagan reasoned: "it would be a kind of extraordinary thing if we gave the power to — to basically subvert this basic bargain in bankruptcy law." Justice Gorsuch added that even if the Sacklers put all their current assets on the table, they are still getting a release from claims against their future assets. Justice Gorsuch also confirmed the government agrees with the *amici* briefs contending the Sackler deal deprives creditors of jury trials under the Seventh Amendment.

It is too treacherous to predict the outcome. But, it appears that if the Supreme Court affirms confirmation of the Purdue Pharma chapter 11 plan, the Supreme Court will issue an ultra-narrow ruling designed to avoid wholesale elimination of constitutional

[1] This article is reprinted with permission from the Creditor Rights Coalition.

rights in other cases. Given the fundamental and constitutional rights at issue, to affirm, the Supreme Court will have to hold the constitutional bankruptcy power is broader than it has ever before ruled because it would allow a majority vote to deprive a minority of fundamental and constitutional rights.

PRO

By Marshall Huebner

We won't know until the Supreme Court rules, but there is substantial reason to hope that the Court "got it" — that the DOJ's solo crusade is profoundly adverse to the needs, desires, and best interests of the victims of Purdue/the Sacklers. For many very good reasons, EVERY state attorney general and EVERY victim group — who spent years litigating and mediating against the Sacklers — supports the entirely lawful chapter 11 settlement which is consistent with and supported by hundreds of years of legal authority. Nothing less than American lives are at stake.

Very little time was spent on constitutional issues, which is no surprise because those weak arguments would invalidate both 524(g) and over 450 years of common law on the release by the estate of fraudulent transfer claims owned by third party creditors under state law. The focus was primarily on whether it was a good deal or a bad deal. (This was rather bizarre, because it was never contested at a 41-witness trial that (a) it was a good and fair deal, negotiated by 48 attorneys general, the UCC and the Debtors opposite the Sacklers and (b) the alternatives are all terrible and tragic for victims.) Here are the critical quotes:

> **Justice Kavanaugh**: [W]hat the opioid victims and their families are saying is you, the federal government, with no stake in this at all, are coming in and telling the families, no, we're not going to give you payment, prompt payment, for what's happened to your family . . . the federal government is not going to allow all this money to go to the states for prevention programs to prevent future overdoses and future victims and in exchange, really, for this somewhat theoretical idea that they'll be able to recover money down the road from the Sacklers themselves.
>
> **Justice Kagan:** I mean, it's 3 percent [of creditors opposed]. You know, what if it were 1 percent, .1 percent? And your — your position would still say, well, no, the Trustee can come in here and blow up the deal and should blow up the deal.
>
> It's overwhelming, the support for this deal, among people who have no love for the Sacklers, among people who think that the Sacklers are pretty much the worst people on earth, they've negotiated a deal which they think is the best that they can get . . .it seems as though the federal government is standing in the way of that as against the huge, huge, huge majority of claimants who have decided that, if this provision goes under, they're going to end up with nothing.
>
> **Justice Thomas**: I'm just wondering what exactly is [your] role and why is it that you're able to come in and undo something that has such overwhelming agreement.

And in the words of the official creditors' committee:

> The U.S. Trustee does not speak for the victims of the opioid crisis. Quite the opposite, the Trustee [as required by statute] appointed the official committee, my client, as the fiduciary representing their interests. Every one of the creditor constituencies in this case comprising individual victims and public entities harmed by Purdue overwhelmingly supports the plan. Indeed, it was the creditors that insisted on the release of the creditor claims against the Sacklers for the same injuries to avoid a value-destroying victim-against-victim race to the courthouse that would result in no recovery for virtually all except the United States. That unrebutted finding grounded in a massive record built on years of creditor victim-led efforts refutes the Trustee's eleventh hour speculation of some magic alternative permitting an equitable victim recovery.

Now we wait, with fingers and toes crossed.

CON

By Clifford J. White III

Let's do a vote count. Here are some highlights of the Justices' questions that may give us a clue :

Chief Justice Roberts: In his first question, he inquired about the Major Questions Doctrine and whether there is clear statutory authorization for the bankruptcy court to exercise sweeping authority to approve non-consensual releases in favor of the Sacklers. The Biden Justice Department is not enthusiastic about the Doctrine so the Government did not use it as a basis for striking the Purdue Pharma releases. Nonetheless, the Chief led with that question because it may be dispositive. That is very good news for the Petitioner. VOTE: Chief Justice Roberts leans strongly toward REVERSAL.

Justice Thomas: Right out of the box, Justice Thomas asked about the authority of the bankruptcy court to approve even consensual releases. And he came back to it in other questioning. He also acknowledged the Respondents' opposition to UST standing, asked a question about it, but did not press. VOTE: Justice Thomas leans strongly toward REVERSAL.

Justice Alito: Similar to the Chief Justice, Justice Alito began by asking whether Congress should decide the issue of third-party releases. He also expressed skepticism about a plan to "redistribute others' property right because we think that's the best deal available and it would serve the greatest good for the greatest number." VOTE: Justice Alito leans strongly toward REVERSAL.

Justice Sotomayor: Most of Justice Sotomayor's questions went to practicalities, such as how consent could be obtained with such a large number of victims. She came back to similar points throughout her questioning. She also asked about the possibly pivotal issue of derivative vs. direct claims not owned by the estates and suggested that almost all of the claims are really derivative and under bankruptcy court authority. Interestingly, she inquired about how the Court could make a decision that would not affect related exculpation issues, including the pending *Highland Capital* case. Towards the end, she also asked one of the Respondent's how to counter the Government's position

Continued from p.9

that denial of the releases will change the leverage of the parties, but not doom a deal. VOTE: Justice Sotomayor leans toward AFFIRMANCE.

Justice Kagan: In some of the most hard-hitting questioning of both sides, Justice Kagan expressed skepticism that a deal can be reached without the releases. The former Harvard Law School Dean said the Government was relying on “hifalutin principles of bankruptcy law” without recognizing that maximizing payment to creditors is also an important principle. But she gave the Respondents an equally hard time justifying releases to those who never submitted themselves to the bankruptcy process. VOTE: Justice Kagan is UNDECIDED.

Justice Gorsuch: Justice Gorsuch was true to form throughout in noting the extraordinary relief being given to the non-bankrupt Sacklers, including relief from fraud claims, at the expense of the interests of the hold-outs, including their right to a jury trial. He also focused on the statute and how a general provision of the Bankruptcy Code could be read as authorization to do what otherwise seems at odds with the basic construct of the bankruptcy system. VOTE: Justice Gorsuch leans strongly toward REVERSAL.

Justice Kavanagh: Perhaps the most surprising of all the Justices in this case, Justice Kavanaugh focused on the fact that the overwhelming majority of voting creditors favored the plan and there was thirty years of precedent for bankruptcy courts to approve non-consensual releases. He expressly asked about the UST’s standing and said the Respondents’ argument was strong. Near the end of his questioning, however, he expressed his view that the Major Questions Doctrine may be suitable to apply in this case. VOTE: Justice Kavanaugh leans toward AFFIRMANCE.

Justice Barrett: Most of Justice Barrett’s questions seemed designed to enlighten, but some also betrayed a certain skepticism about granting broader relief to the Sackler family than they could obtain as individuals in bankruptcy. (Justice Kagan and others also made similar points.) Justice Barrett said it might be better to have “Congress do it rather than bankruptcy courts trying to stretch the code.” VOTE: Justice Barrett leans toward REVERSAL.

Justice Jackson: Justice Jackson was consistent throughout in noting the statutory impediments to the releases. She seemed to pointedly reject Justice Kagan’s reference to “nut case” holdouts and instead posited that the problem was the Sacklers’ insisting on forcing the deal on all victims. Next to the Office of Solicitor General, she may have been the clearest advocate for the Government’s position. VOTE: Justice Jackson leans strongly toward REVERSAL.

With all said and done, it is still possible that the Petitioner/Government wins 9-0, but likely will win by at least 6-3.

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DOES FINANCIAL INNOVATION DO MORE HARM THAN GOOD?

Richard J. Shinder
Theatine Partners

The trial of FTX founder Sam Bankman-Fried on fraud charges offers yet another example of seemingly promising financial innovation culminating in dire consequences, both for those directly impacted and for the greater financial ecosystem, of which cryptocurrency until recently had been a burgeoning part.

The jury's conviction tells us that FTX — and perhaps, by extension, cryptocurrency markets generally — constituted a willful fraud or some sort of confidence game that relied upon participants' willing suspension of disbelief to keep the wheel turning. Regardless of blockchain technology's underlying merits, the failure of FTX and some of its brethren fits neatly among several recent examples of financial crises, large and small, created or exacerbated by innovation.

Although industry advances gone awry are nothing new, consider the financial sector over the past few decades. The savings and loan crisis of the 1980s derived from myriad causes, but the rise of a significant new-issue "junk" bond market was certainly a factor. Similarly, 1987's Black Monday stock market crash was accelerated by program trading "portfolio insurance" strategies, designed to hedge risk in falling markets. The global financial crisis of 2007-2008 began with a steep decline in mortgage-backed securities prices (and related derivatives) tied to American residential real estate, before spreading contagion throughout worldwide capital markets. And the "Crypto Winter" is with us; cryptocurrency prices have cratered and — in the case of FTX and other failed exchanges — investors who lost money are left to wonder from whom they might seek restitution.

In economic literature, financial innovation is typically considered an unalloyed good, a defensible view to the extent that it reduces the cost of capital for productive investment and eliminates friction costs associated with middlemen and the other toll collectors rife in modern finance. Creativity of this type may even realize other societal goods; to the extent that greater access to capital and more level playing fields are achieved — particularly through democratized, peer-to-peer channels that circumvent institutional gatekeeping by subject-matter experts — greater confidence in the economy and financial system logically follows. However, these benefits can be difficult to quantify and are perhaps more hypothetical than real.

Might it be that financial innovation actually does more harm than good, via the negative consequences that can overwhelm any gains associated with widening access to, and reducing the cost of, capital? Or, as with other new technologies, like VCRs, might it be that such innovation is occasionally put to less savory uses (in the case of home video, pornography) before being "tamed" and eventually contributing to a net societal advantage?

The current evolution of commercial lending in the U.S. illustrates the potential for systemic risk and net societal loss resulting from innovation. For centuries, commercial lending was a straightforward affair involving bank and borrower. A broadened regulatory framework in the 20th century instituted greater oversight of commercial banks' lending activities given lenders' responsibility for managing the risk they initiated.

The development of syndicated finance, of both loans and bonds, severed origination from the distribution and warehousing of risk in pursuit of lower borrowing costs. Specialization among parties led to greater efficiency because the ultimate holders of risk had lower cost structures, lighter regulatory strictures, or greater expertise in managing risk. Unfortunately, distributed finance also gave rise to more aggressive financing terms and borrower-friendly provisions — those structuring the deals did not have to live with them — resulting in company and financial sponsor machinations designed to advantage borrowers at the expense of creditors, along with other unanticipated consequences.

As such, lending markets are reverting to originating, structuring and holding risk under one roof with the explosive growth of private credit or "direct lending." Morgan Stanley estimates the private credit market, having grown from $875 million in 2020 to $1.4 trillion by the start of 2023, will expand to $2.3 trillion by 2027. There is an important distinction in this new banking architecture, however: Direct lenders and other fund-based providers of private credit are not regulated the way depository institutions are. It requires little imagination to consider a future 2008-style "Lehman moment," with the New York Fed unsure of exactly whom to call to get a read on market conditions, determine where the greatest systemic risks reside, or to offer financial support.

Without predicting exactly what, when and how a systemic crisis might unfold because of private credit's growth, market signals can provide a clue about how innovation may lead to mispriced risk and its ramifications. The rapid growth of private credit as an asset class risks spawning a bubble, as it increasingly displaces regulated commercial lending due to more competitive pricing, lower cost structures and regulatory arbitrage. Direct lenders'

almost limitless access to institutional investor capital will facilitate further growth as banks recede from corporate lending activities.

This growing competition among alternative lenders for opportunities threatens adverse credit selection and mispriced risk; credit spreads should reflect risk of loss, but the supply/demand dynamic from funds that are structurally incentivized to deploy capital — unlike banks, which can elect to lend into other sectors or simply buy Treasuries with depositor funds — may suppress prudential risk management and loan pricing. Moreover, estimating defaulted loan recoveries in a new-ish market with little liquidity, opaque pricing, heterodox financing terms and no prior history of navigating instability is an impossible task, leading to further mispricing and misallocation of capital. When the inevitable sector-wide distress occurs, socializing losses will be even more toxic than they were after the 2008 financial crisis.

As with "progress" of any kind, one need not impute fraud or nefarious intent to ask *cui bono* — in whose interests is such creativity deployed? In financial services, are adaptations mostly intended to achieve their stated purpose on behalf of clients or counterparties, or does the "alpha" ensuing from innovation accrue almost exclusively to the innovators? The purported efficiencies of innovation should be set against larger systemic impacts that frequently result from badly conceived and self-interested innovation.

As the financial sector has evolved from a service function for commerce into a prominent industry unto itself, it is critical to retain sight of its essential utility function — one in which the broader economy and society have an interest, alongside those of direct economic stakeholders, customers and counterparties. To fully account for and internalize the costs and consequences of any new financial product or invention, we need not stifle creativity; to the contrary, limiting the number and severity of future financial crises will breed greater confidence in the financial plumbing necessary to sustain free enterprise and maximize benefits for all.

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A VALUATION FRAMEWORK FOR LITIGATION FINANCE ASSETS

Terence Tchen
Houlihan Lokey

Third-party litigation finance (TPLF) is a growing asset class. Estimating the fair value of TPLF assets can be difficult due to the lack of publicly traded comparables and the bespoke nature of individual litigation claims. The valuation of these assets can be extremely complex. This white paper provides a framework that could be useful when valuing single-case, equity-like TPLF assets under ASC 820 for financial reporting purposes and should not be viewed as guidance on the valuation of these assets for any other purpose. A simplified example is also provided to illustrate the mechanics of this framework.

Introduction and Background

Litigation matters have challenging economics, as costs are incurred throughout the course of the litigation with typically no incoming cash flows until the matter is settled or finally adjudicated. These economics have contributed to the growth of the third-party litigation financing market, where an investor provides capital on a nonrecourse basis to a law firm or litigant in exchange for a negotiated share of any recoveries from the matter. Law firms use TPLF to increase their caseload, and corporate plaintiffs use TPLF to fund the litigation or to partially monetize an otherwise illiquid asset. TPLF is typically geared toward commercial claims (e.g., breach of contract, patent infringement, fraud, class actions) and consumer claims (e.g., personal injury). There are typically two types of TPLF funding arrangements: single-case and litigation portfolio, where the financing is used for multiple cases.

The valuation of TPLF assets (the "Assets") can be challenging. Traditional valuation approaches, such as the market approach and the transaction approach, are typically not applicable due to the lack of relevant metrics to capitalize and the bespoke nature of the underlying claims. Unlike a business that can be valued as a multiple of revenues, EBITDA, or earnings, the Assets typically do not have representative metrics that can be easily capitalized. Individual Assets are often highly customized with structured payoffs to the financier, resulting in noncomparable economics across litigation matters. In addition, the value of an Asset over time can be lumpy based on the outcomes of conditional events (milestones), such as settlements, court rulings, and appeals. As a result, the income approach (such as the discounted cash flow approach) is commonly used to value the Assets.

Possible Valuation Framework for TPLF Assets

We provide the following framework as a possible approach to valuing equity-like investments in single-case Assets. This framework has four steps:

Step 1: Underwriting Assumptions

Start with underwriting assumptions[1] regarding the ultimate amount that would be won if successful (the "Unadjusted Expected Value" or "UEV"), time to payment, the nature and timing of milestones, and other relevant factors. The UEV may represent the TPLF provider's (the "Investor") best guess as to, or probability-weighted estimate of, the final award.

Step 2: Discount Rate and UEV Discount Estimation

Estimate a discount rate (or range of discount rates) and calculate an implied Unadjusted Expected Value discount (UEV Discount).

Determination of Discount Rate

It is easier to conceptualize the discount rate by working backward from the case timeline (i.e., starting with the final award in the case), assuming that the litigation has a successful outcome for the Investor. We ask ourselves what discount rate should be applied to this award. This should reflect the riskiness of the counterparty's ability to pay the judgment, the structure of the payout, the difficulty of collection, and other factors. The discount rate may also be impacted by other factors, such as the structure of the payout and the difficulty of collection. It may also be appropriate to adjust the discount rate for lack of liquidity of the Asset.

Estimation of a UEV Discount at the Time of Investment

We define a UEV Discount as the discount to the expected final award due to risks of losing the litigation and uncertainty of the amount of the final award. Since we have an estimated UEV, time to award, discount rate, and purchase price for the Asset, we can estimate a UEV Discount based on the premise that the present value of the Unadjusted Expected Value after the UEV Discount should equal the purchase price, or:

$$(\text{Unadjusted Expected Value} * (1 - \text{UEV Discount})) / (1 + r)^t = \text{Purchase Price}$$

where:

r = discount rate,

t = time to award.

Rearranging, we get:

$$\text{UEV Discount} = 1 - (\text{Purchase Price} * (1 + r)^t) / \text{Unadjusted Expected Value}$$

[1] If there is a more recent fair value transaction, assumptions from that transaction should be used. However, as Assets typically do not trade, this article assumes no additional transactions after initial underwriting.

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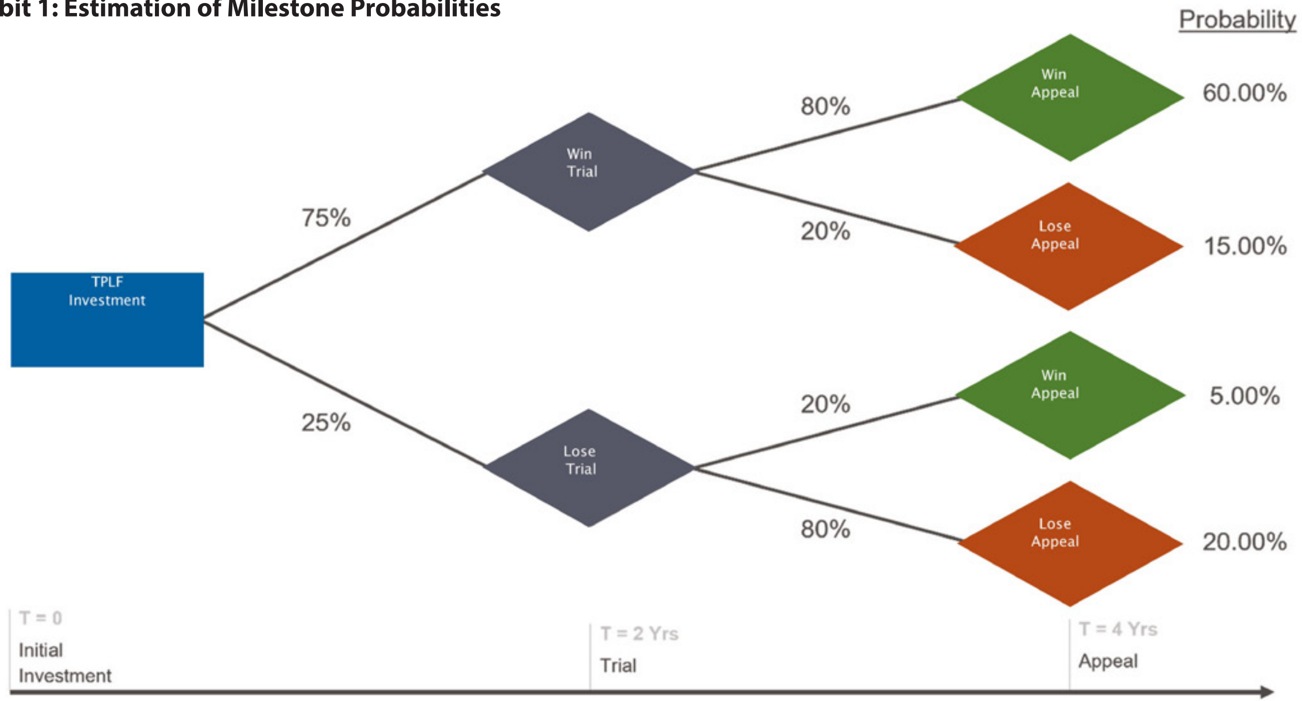
Exhibit 1: Estimation of Milestone Probabilities



Step 3: Milestone Probability and Litigation Risk Discount Estimation

Based on the implied UEV Discount, estimate the probabilities of winning or losing at each remaining milestone and Litigation Risk Discount.

In Step 2, we started with the equation:

$$(\text{Unadjusted Expected Value} * (1 - \text{UEV Discount})) / (1 + r)^t = \text{Purchase Price}$$

We now consider what "1 – UEV Discount" represents from a conceptual standpoint. This formula reflects a reduction in the UEV. Two possible reasons for the reduction are the probability of losing the litigation (P_L) and the uncertainty of the UEV estimate. An overstated UEV estimate can be reduced by a Litigation Risk Discount (LRD). We can incorporate these two factors as follows:

$$(1 - \text{UEV Discount}) = (1 - P_L) * (1 - \text{LRD})$$

Substituting into the first equation, we get:

$$(\text{Unadjusted Expected Value} * (1 - P_L) * (1 - \text{LRD})) / (1 + r)^t = \text{Purchase Price}$$

We now need to estimate the probability of losing the litigation and the LRD. We believe it is better to start by estimating the litigation win/loss probabilities. Typically, prior to making an investment, an Investor will assess the merits of a potential case. Often, the Investor will have estimates (perhaps derived from their history of investments in litigation assets or conversations with the underlying law firm or consultants) of the likelihood of success of each milestone event. The Investor may also have a view on the riskiness of the UEV, which may impact selected UEV Discount and LRD. After the probability of winning/losing the litigation has been estimated, the LRD can then be calculated.

The LRD and probability of winning the litigation are not necessarily static numbers and should be revised based on case developments and other relevant factors.

Step 4: Fair Value Estimation

Fair value at subsequent valuation dates is estimated via a present value calculation:

$$\text{Fair Value} = (\text{Unadjusted Expected Value} * (1 - P_L) * (1 - \text{LRD})) / (1 + r)^t$$

Here is a simplified illustration of this framework to show the interplay of the variables in the framework.

Example

Step 1: Underwriting Assumptions

Time until final judgment: Four years

Milestones: (i) The initial trial with a ruling in two years and (ii) an appeal with a ruling in an additional two years. After the ruling in the appeal, any award is deemed final.

Unadjusted Expected Value: $100 million.

Investor purchase price: $40 million, which is paid up front and expected to fully fund the trial and appeal.

Step 2: Discount Rate and UEV Discount Estimation

The appropriate discount rate is estimated to be 7%.

The implied expected future cash flow is approximately $52.4 million[2], which implies a UEV Discount of 47.6%.

Step 3: Milestone Probability and Litigation Risk Discount Estimation

In this case, it is believed that the UEV Discount is composed of the risk of loss at the milestone events as well as uncertainty on the final award. After consideration of the UEV Discount, comparable case experience, and other relevant factors, the Investor estimates the milestone probabilities, which are shown in the flowchart in Exhibit 1.

[2] $52.4 million / 1.07^4 = $40 million.

These probabilities indicate that the probability of ultimately losing the case is 35%. Since the UEV Discount was determined to be 47.6%, the implied LRD is 20%.[3]

Step 4: Fair Value Estimation

Fair Value Estimation One Year After Investment

Assuming no changes in a market participant's view of the litigation or the discount rate, the fair value of the Investor's share of the litigation would be calculated to be $42.8 million.[4]

Fair Value Estimation Two Years and Three Years After Investment: Win at Trial Scenario

Assume that two years after the investment, the plaintiff has been successful at trial and awarded $100 million, but the matter has been appealed. Also, assume that the probability of winning the appeal is estimated to be 80%. Given the amount awarded by the court, the appeal, and after considering other relevant factors, the LRD is reduced from 20% to 10%. Thus, the total UEV Discount is 28.0%.

The corresponding valuation inputs are:

- Unadjusted Expected Value: $100 Million
- LRD: 10%
- Litigation Loss Probability: 20%
- Discount Rate: 7%
- Time to End of Case and Receipt of Judgment: Two Years

The resulting fair value indications are:

Time Since Investment	Fair Value
Two Years	$62.9 Million[5]
Three Years	$67.3 Million[6]

Fair Value Estimation Two and Three Years After Investment: Lose at Trial Scenario

Assume that two years after the investment, the plaintiff has lost at trial and filed an appeal. The probability of losing on appeal is still believed to be 80%. Additionally, the LRD has been increased to 30% based on the facts and circumstances of the case.

The corresponding valuation inputs are:

- Unadjusted Expected Value: $100 Million
- LRD: 30%
- Litigation Loss Probability: 80%
- Discount Rate: 7%
- Time to End of Case and Receipt of Judgment: Two Years

The resulting fair value indications are:

Time Since Investment	Fair Value
Two Years	$12.2 Million[7]
Three Years	$13.1 Million[8]

Fair Value Estimation at Year Four

Once the case has been finally adjudicated, the fair value would be $0 if the plaintiff loses and the fair value of the final judgment if the plaintiff wins.

Settlements, Drawdowns, and Other Considerations

This example is very simplistic as it assumes that the Asset is fully funded at the start; it is more common for funds to be drawn upon as needed. The example also does not consider settlements, which are typically a key milestone. The framework can be expanded to handle these and other considerations.

Valuation of Debt-Like Assets

So far, our valuation framework has been focused on equity-like investments where the Asset represents a pro-rata share of ultimate litigation recoveries; however, TPLF can also be debt-like. For example, the litigation asset may entitle the holder to the first distributions up to a multiple of their investment or up to a stated rate of return (the "Debt-Like Assets"). Debt-Like Assets may also be a part of an asset that has a waterfall. For example, distributions from litigation cash flows may be allocated as follows: (i) first, to the Asset in an amount equal to the capital provided plus a return (the "Initial Distribution"), (ii) second, to the law firm or corporation up to a certain amount, (iii) third, split 75%/25% between the parties until a certain return is made by the Investor, and (iv) fourth, any remaining cash flows would be split 50%/50%. The framework can be adjusted to value Debt-Like Assets; however, this may still require the estimation of variables from an equity perspective.

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[3] (1 - 35%) (1 - LRD) = (1 - 47.6%).
[4] $52.4 million / 1.07^3.
[5] ($100 million x (1 - 20%) x (1 - 10%)) / 1.07^2.
[6] ($100 million x (1 - 20%) x (1 - 10%)) / 1.07.
[7] ($100 million x (1 - 80%) x (1 - 30%)) / 1.07^2.
[8] ($100 million x (1 - 80%) x (1 - 30%)) / 1.07.

DEMYSTIFYING POST-CLOSING STATEMENTS: YOU'VE CLOSED ON A DEAL— NOW WHAT?

Ted Stafford
AlixPartners, LLP

In my prior article, "Demystifying Post-Closing Statements: Great Deals Are Often Made After the Handshake,"[1] I introduced the concept of the post-closing balance sheet adjustment and highlighted key deal characteristics that can increase the likelihood of potential disagreements after closing. Once the ink on the deal is dry, it is time for the parties to work through the agreement and determine the amount of any purchase price adjustments. In this article, we will go deeper into this phase, looking closely at what happens in a balance-sheet dispute, and how to prepare for and navigate the process.

What Does the Post-Closing Process Look Like?

While purchase agreements and their related post-closing language are unique, the process to determine the final net working capital ("NWC") adjustment—sometimes referred to as a "true-up"—follows a common pattern and cadence. An illustrative overview and timeline of key steps and alternatives appears on the next page.

Pre-closing

The process typically begins a few days prior to closing when the seller provides a final estimate of the closing balance sheet (see illustration, section 1). For example, if a deal is closing on December 31, the purchase agreement may require the seller to deliver an estimated closing statement on approximately December 28. The balance sheet will contain details for items like net working capital, cash on hand, transaction expenses, and debt, depending on the relevant deal metrics.

Post-closing

After closing, the buyer typically takes ownership of the accounting records (see illustration, section 2). Purchase agreements frequently provide the buyer with a discrete amount of time (usually between 30 and 90 days) to examine business records and deliver a calculation of the final balance sheet at the closing date.

Following the buyer's submission of the closing balance sheet, the seller is provided with a set amount of time to review the buyer's calculations (again, often 30 days or longer). Depending on the purchase agreement terms, the seller is sometimes also able to request additional information or access to more detailed accounting records. If the seller does not identify any discrepancies (or does not respond within the allotted timeframe), the parties will confirm the final deal price and the post-closing balance sheet process will conclude at this stage.

However, the seller can also respond with a formal counter to the buyer's closing balance sheet (a "dispute notice"), which results in a fresh round of negotiations.

Resolving a Post-Closing Balance Sheet Dispute

If the parties cannot agree upon the final closing balance sheet, the purchase agreement consideration remains up in the air. It's time to buckle up for round two of negotiations (see illustration, section 3), which is likely to be more contentious as nerves fray, pressure mounts, and the risk of miscommunication and distrust increases.

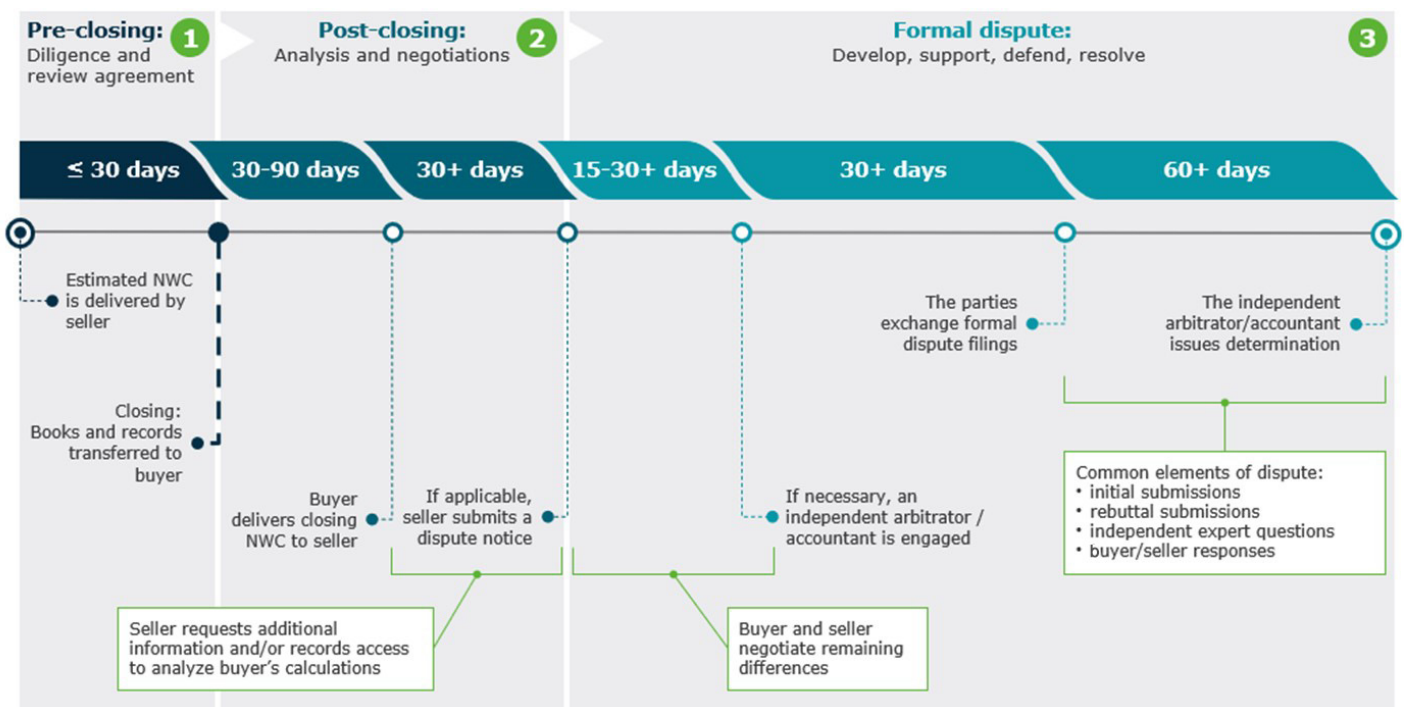
Purchase agreements are highly bespoke and heavily negotiated agreements and the language related to the resolution of post-closing accounting disputes is no exception. The following sections cover common elements for coming to an ultimate resolution.

Use of Private Arbitration and a Neutral Expert to Resolve the Dispute

A central characteristic of a post-closing balance sheet dispute is the selection of, and reliance upon, a neutral expert to decide the outcome of the parties' disagreements. The nomenclature used to describe this role in a purchase agreement varies (possible terms include independent accountant, accounting firm, accounting expert, arbitration firm, neutral accountant, etc.). These roles function in the same general capacity, though there are certain legal distinctions not addressed here.

Because balance-sheet disputes often revolve around complex and/or nuanced technical accounting issues, the neutral role is not usually filled by a judge, jury, or panel of attorneys. Rather, the parties negotiate to agree on a partner or firm with accounting and financial expertise to resolve the remaining disputed issues between the parties.

[1] "Demystifying post-closing statements: Great deals are often made after the handshake," October 17, 2023, https://insights.alixpartners.com/post/102ipu5/demystifying-post-closing-statements-great-deals-are-often-made-after-the-handsh?



Timeframes presented are illustrative of contractually negotiated durations. The contractual periods may also be modified or extended by agreement of the parties.

The selection of the neutral expert may itself represent a new negotiation. While some purchase agreements specify a certain firm to serve in this role, parties often find the selection more difficult in practice when parties uncover previously unknown or potential conflicts of interest between the named firm and either the buyer or the seller. For this reason, the buyer and seller should come prepared with a list of experts with requisite experience to confidently select a neutral for resolving their post-closing disputes.

Iterative Exchange of Positions and Timing

Selecting the neutral expert is the first step, as the buyer and seller also need to lay out the structure of the process for resolving post-closing balance sheet differences. This step frequently occurs in tandem with the appointment of the neutral expert and specifies the format and structure the parties are expected to provide in support of their respective calculations.

During this process, the buyer, seller, and neutral expert will set out the following areas:

- The overall timelines for the dispute—This includes details such as when the process will start and how much time will elapse between the parties' various submissions to the neutral expert.
- The format of information to be provided to the neutral expert—For example, the parties may file letters, briefs, and/or expert reports in connection with accounting analyses or the process may include oral arguments and interviews.
- The number and cadence of the submissions—Commonly, both the buyer and seller can provide two position statements (whether an initial statement, response, or rebuttal to the other side's position statement). The parties may decide to provide their submission sequentially (i.e., one party first, then the other) or simultaneously.
- Whether an in-person hearing will take place or not and, if so, the format and parameters for the hearing.

The process of selecting a neutral expert and outlining the dispute framework can be time-consuming and result in a negotiated proceeding as unique as the purchase agreement itself.

Starting the Process Before the Sale

Typically, neither buyers nor sellers look forward to a post-closing dispute during deal negotiations. However, starting early with the right team—while keeping an eye toward the potential post-closing application of the purchase agreement—can maximize the value of deal diligence and preparation. This preparatory work will help you avoid a protracted conflict at the worst possible time or, should one occur, put you in the best possible position to chart your way through it.

Solid preparation means starting discussions early.

To get under the hood and really understand the relevant accounting practices, parties should allow time for robust due diligence. Before the sale, parties need to determine key accounts, and establish agreed-upon measurements and clear definitions that align with strategic priorities. For example, does one party prefer certainty of value at the expense of potential upside? This may be reflected in the decision to use a "target" or "peg" value, as opposed to a figure derived from interim or estimated financial statements.

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Assemble your dream team.

This is when the team who will take the company through closing negotiations should take shape. That means bringing on accounting advisors with dispute experience alongside existing deal teams, finance and accounting professionals, and legal teams.

Documentation is worth its weight in gold.

Potential red flags can be identified, along with the nuts and bolts of the transaction that could later become contentious. Some of the specifics to capture include:

- Listing the financial statement accounts to be included or excluded from the calculation of the closing balance sheet and relevant net working capital calculations—Address the nuance and relationship (or lack thereof) within the target amount and post-closing balance sheet. This may include the use of an example calculation or a detailed exhibit outlining the format, contents, and trial balance-level accounts to be included in the calculation.
- The methodology for estimating key accounts (significant estimates or assumptions).
- The hierarchy of accounting frameworks when sorting through how to treat certain transactions or practices—Importantly, the language should address the priority between generally accepted accounting principles (GAAP/IFRS), and the consistent application of accounting practices used by the target prior to closing.
- The format, structure, and timing of the buyer's closing balance sheet and the seller's dispute notice communications—Address the level of support to be provided and the detail in which potential adjustments need to be disclosed.
- Guidance on how disputed calculations are to be decided by the neutral expert—Should the decision be limited to only a decision between the buyer or seller positions (often referred to as "baseball arbitration"), is the neutral expert able to determine an amount within the range of the buyer and seller positions, or is the neutral expert able to calculate any number deemed to be correct under the purchase agreement?

Consistency is key.

Aim for consistency between closing mechanisms, if applicable (i.e., net debt and net working capital), and with other provisions, such as indemnifications provided under the purchase agreement.

The team charged with preparing for and managing deal negotiations will track all the moving pieces that generate value and liability. Having these keys top of mind during the early legwork on closing statement language provides solid ground from which to adjust the framework for calculating the final balance sheet. In the end, effective preparation and diligence will keep you from spinning your wheels in place and get the deal moving.

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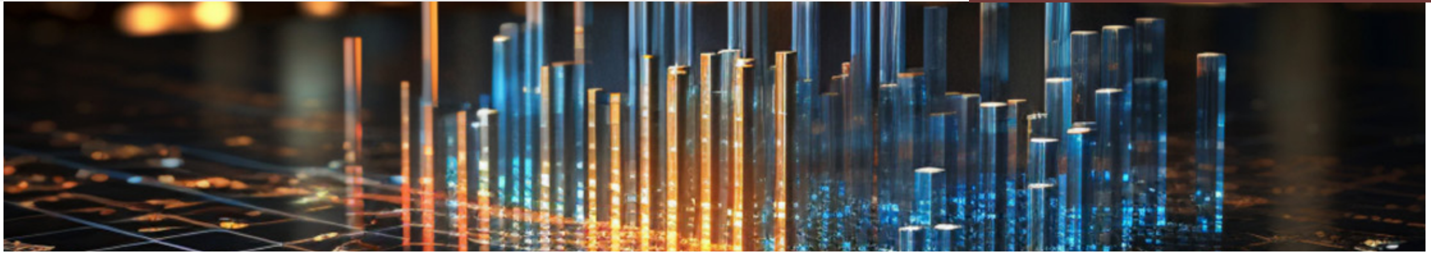

CONVERTIBLE BONDS IN DISTRESSED OR TURNAROUND SITUATIONS

Keegan M. Pando and Weston C. Kirk
Willamette Management Associates

Convertible bonds may provide distinctive benefits within the private company capital structure, especially in distressed or turnaround situations. In these circumstances, convertible bonds may be issued as bridge loans from investors to support operations. That way, as operations rebound, those investors could elect to convert their bond holding into stock. Establishing the stated yield of these bonds at issuance or subsequently estimating the fair market value of a convertible bond for investor reporting or accounting may require an independent valuation. This discussion summarizes the unique elements and valuation fundamentals of convertible bonds.

Introduction

Convertible bonds are hybrid investment instruments that have features of a straight bond and common stock.[1] Like straight bonds, convertible bonds provide investors with a consistent and low-risk source of income; however, convertible bonds uniquely offer investors (or in the case of a forced conversion, the issuer) the option to convert the bond into a specified number of shares of stock in the issuing company. As is the case with debt and equity instruments, hybrid instruments, such as convertible bonds, are used to raise capital from investors when traditional avenues are exhausted, such as in distressed or turnaround situations.

Convertible debt typically receives lower market yields (smaller coupon payments) than are typical in conventional straight bond issuances due to the upside potential of converting to common stock. If the option to convert is exercised, the company eliminates the debt associated with the convertible bond issuance and issues shares to the investor.

A convertible bond may be favorable to an investor if he or she seeks business downside protection while having the upside capital appreciation benefits of conversion.[2]

The hybrid element that convertible debt provides is useful because it combines a call option with a fixed-income bond. When compared with common stock or straight stock options, returns are limited by the number of shares an investor is able to convert, but the investor is simultaneously protected against the same loss of principal to which a common-stock investor is exposed.

[1] John D. Finnerty and Mengyi Tu, "Valuing Convertible Bonds: A New Approach," *Business Valuation Review* 36:3, 2017.

[2] Ibid.

Convertible Debt in Distressed and Turnaround Financial Situations

As a business becomes financially distressed, its access to the capital markets diminishes. Typically, private equity firms and competitors view distressed businesses as candidates for acquisition and restructuring.

Capital raises for distressed businesses may require the issuance of equity or debt with enhanced upside potential. One such option may be convertible debt. Investors typically favor investments in stable companies. However, in the case where an investor wishes to take a calculated risk in a distressed business with a potential equity upside, convertible debt may provide a suitable solution.

When an investor considers convertible debt securities, the investor should understand in what tier of the company capital investment stack the investor would be. There are four primary tiers: (1) senior debt, (2) mezzanine debt, (3) preferred equity, and (4) common stock equity. Convertible debt resides in the second tier, mezzanine debt.[3]

Companies predetermine the conversion price and typically set it higher (out of the money) in private deals because of the adverse reaction by the existing equity investors in issuing convertible debt.[4]

Valuation of Private Company Convertible Bonds

The valuation of private company convertible bonds can be summarized in two components: (1) the value of a plain-vanilla bond plus (2) value of the convertibility election premium. The convertibility election premium is often measured by the Black-Scholes option pricing model ("BSOPM").

Bonds are often considered a subset of promissory notes, with longer periods of maturity. A promissory note is characterized as a negotiable instrument that can be transferred with the borrower's permission. Promissory notes can be considered as written promises that the borrower will follow the stated

[3] "Senior and Subordinated Debt – Learn More About the Capital Stack," Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/commercial-lending/senior-and-subordinated-debt/.

[4] Anna Pinedo, Syed Imteaz, and Anna Shearer, "Understanding Structured Debt and Structured Capital," January 20, 2023, webinar, https://icrcapital.com/resources/understanding-structured-debt-and-private-convertibles/.

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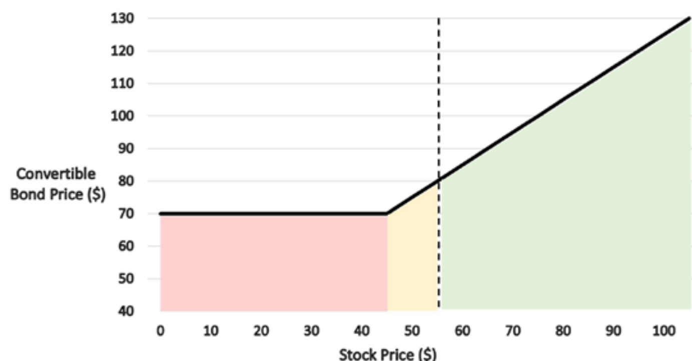
Exhibit 1: Convertible Bond Price v. Stock Price



repayment schedule for the principal plus interest. The payments for interest and principal may occur together or separately on a daily, weekly, monthly, quarterly, or annual basis or at maturity—or some variety thereof. The value of bonds, like the value of promissory notes, results from summing the expected accumulated interest payments over the period of maturity and the repayment of the bond's principal.

A conversion premium measures the optionality (both extrinsic and intrinsic) of the right to convert. The difference between the conversion price and the current stock price, in the private convertible debt market, is typically set at issuance between 20 percent and 25 percent more than the current stock price.[5]

The conversion price is determined by the company board of directors at issuance; it typically is set higher than the current common stock share price. Once the issuer sets the conversion price, the conversion ratio is determined: the par value of the convertible bond divided by the conversion price. The conversion ratio can be thought of as the number of shares of common stock the investor will receive after choosing to convert the bond.

Exhibit 1 illustrates the market price of a convertible bond as the underlying stock price increases.

Suppose that an investor, in a hypothetical world that has no transaction fees and where the issuer cannot force conversion, holds a convertible bond where the par value is $70. The conversion price is set at $55 per share, so the bond's conversion ratio (number of shares the investor will receive after converting) is 1.27 (rounded).

The shading in Exhibit 1 represents the value of converting such a convertible bond as the stock price increases. Converting to common stock would start "out of the money"—having no intrinsic value—until the stock price increased to $45 per share (red shading).

Beyond $45 per share, the bond price increases as the stock price approaches the conversion price. This is because of the inherent optionality of the convertible bond. As the stock price rises, the option to convert becomes more valuable and so does the convertible bond (yellow shading). When the stock price equals the conversion price, the investment is "at the money."

If the stock price exceeds the conversion price, the investor has the option to convert the underlying bond to common stock. In the case above, if the stock price increases beyond $55 per share (green shading), the option to convert would now be "in the money" and present a profit opportunity for the convertible bondholder.

Before a conversion event, the investor receives a coupon on the bond itself. The coupon rate typically is within the mid-single-digit range.[6] Since this is a private transaction, the terms of the coupon payments are flexible. Issuers may pay coupons using cash or payment in kind ("PIK"). PIK payments are a cash alternative where the issuer pays the lender in additional equity or debt securities. The PIK coupon rate is typically higher than if it were paid in cash, and restrictions often are embedded into the convertible debt issuance that limits the PIK used.

After a stock conversion, the issuing company no longer is responsible for the remaining coupon payments or the repayment of the bond's principal, but the newly issued shares decrease the existing shareholders' ownership stake in the company while also decreasing earnings per share. Shareholders may view this dilutive event as negative because it may have a slimming effect on earnings per share and voting power.

However, from the perspective of the bond investor, converting to an equity stake often provides the investor with enhanced voting privileges and the capital gains associated with increases in share price. Nevertheless, the investor also loses the security of consistent coupon and principal payments and is now exposed to the company's share price fluctuations and downside equity risk. By adopting the higher risk after conversion to equity, the investor's expected return increases as well.

If the underlying stock price remains below the conversion price, however, the investor would likely not convert to common stock. In the absence of transaction fees, a convertible bond's break-even point is where the underlying stock price equals the conversion price set by the issuing company.

Under fair market value principles, a discount for lack of marketability ("DLOM") is often considered to account for the lack of liquidity in trading convertible bonds on the private market. The DLOM can be described as the difference in price that a hypothetical investor will pay for a liquid asset compared with a comparable illiquid asset.

According to Judge Laro in the landmark *Mandelbaum* case,[7] an analyst should consider nine factors when applying a DLOM to a subject interest: (1) financial statement analysis; (2) dividend distributions; (3) company history, positioning, and outlook; (4) company management; (5) degree of control in the transferred shares; (6) transfer restrictions; (7) estimated holding period for the stock; (8) company redemption policies; and (9) costs associated with a public offering. Based on the degree of illiquidity (or lack of marketability), convertible bonds may offer a higher yield as compensation for these additional risk factors.

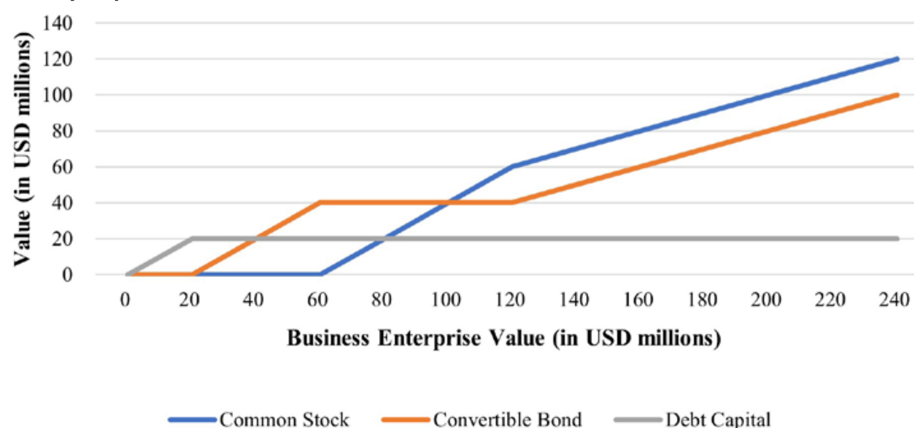
In the context of valuing a privately held convertible bond, the DLOM is factored into the selected yield to estimate the straight bond and the price of the underlying security stock in the BSOPM that is relied on in the conversion premium component to value. Further, careful considerations are made to the BSOPM formula

[5] Ibid.

[6] Ibid.

[7] Estate of Bernard Mandelbaum v. Commissioner, TCM 1995-255, affirmed 91 F. 3d 124(3rd Cir., 1996).

Exhibit 2: Claim on Assets by Capital Class



inputs in each convertible bond valuation, recognizing the known assumptions and limitations of the BSOPM.

Convertible Debt in Distressed Financial Situations

As previously mentioned, convertible debt investments in turnaround situations may provide high potential equity upside for a more risk-tolerant investor. However, an investor should consider where they fit into the capital stack, especially when investing in distressed businesses that are at risk of default.

Exhibit 2 is an illustrative example of how the business enterprise value is distributed to the different capital classes as the enterprise value of the business increases. In the illustrative example, debtholders are first to be allocated/paid the $20 million due. Then, convertible debtholders would be the next class of investor to be allocated/paid a claim on the business enterprise value. Lastly, the residual allocation/payment would be to the common stockholders. Note that, prior to conversion, a convertible bond first behaves like debt, with a fixed value receivable of $40 million. However, at the break-even point (i.e., the point of intersection between convertible bond and common stock), the convertible bond would be preferential (i.e., in the money) for the investor to elect conversion and thus partake in the equity upside.

Takeaways

- The fair market value of a private company convertible bond is equivalent to (1) the value of the bond plus (2) the value of the call premium to convert to equity.
- Distressed businesses may encounter difficulties when attempting to raise capital from traditional debt and equity financing sources because of poor financial circumstances. The issuance of convertible debt may provide investors with a hybrid alternative to traditional capital placement while opening distressed companies up to new classes of investors.
- Traditional banks are wary of distressed companies; mezzanine lenders typically do not lend for a long enough period of time for the distressed companies to recover and want a punitive equity PIK for longer investment horizons. Convertible debt buyers, however, including private equity groups, hedge funds, and private investors, are willing to assume greater risk than traditional banks while being more patient than typical mezzanine lenders.

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UNIQUE ISSUES FOR WEWORK'S LANDLORDS IN THE EVENT OF A GLOBAL RESTRUCTURING

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Baker McKenzie

WeWork filed chapter 11 cases for its US and Canadian entities on November 6, 2023. Although the restructuring currently is focused on addressing operations in the US and Canada, the potential for a broader global restructuring remains if conditions further deteriorate. This article explores some unique issues landlords may face under their WeWork leases, with a focus on how courts around the world might address them.

Key Takeaways

Landlords have built spaces that specifically cater to WeWork's focus on co-working arrangements. As WeWork attempts to shed leases in a restructuring, landlords may be left with specially built spaces that are difficult to re-let. This may be particularly difficult when landlords have agreed in their WeWork leases not to compete for a period after termination of the lease. Landlords will have to study their leases closely to develop strategies for addressing this issue. Landlords also will need to understand what actions they can (and cannot) take during any formal proceeding to protect their interests. A recurring theme in the advice in this article is that landlords may need to get creative.

Background

Much electronic ink has been spilled about WeWork's problems. Leading up to the WeWork chapter 11 filing, commentators freely speculated about what such a restructuring might look like. The actions taken with respect to the US and Canadian properties since the filing confirm that one of the goals of the restructuring will be to enable WeWork to shed leases for unprofitable co-working spaces. Although the restructuring community has seen many retail restructurings in which landlords deal with commercial tenants walking away from their spaces, the WeWork situation may pose unique challenges for commercial landlords.

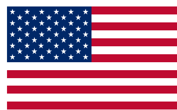
Many of WeWork's landlords have spaces that have been specifically built out to accommodate the types of co-working arrangements promoted by WeWork to its customers. If WeWork uses a restructuring to walk away from some of these leases, one solution for landlords may be to reach out to competitors of WeWork or even to continue to use the space to promote their own co-working business deals. But will former WeWork landlords be able to do this?

One unusual feature of some WeWork leases is an exclusivity provision that continues after the termination of the lease. Among other things, this provision restricts a landlord and its affiliates from engaging in a competing business within a defined territory for a specified period after the expiration of the lease (say, one year), prevents the landlord and its affiliates from entering into any lease with a WeWork competitor within the restricted territory during such period, and even gives WeWork a right of first refusal on leases or other arrangements with competitors **outside** the territory. The lease characterizes these covenants as severable and distinct from the other agreements in the lease.

The potential that landlords have agreed with WeWork to be bound by broad covenants not to compete even after the termination of their WeWork leases presents a new challenge for commercial landlords. Given WeWork's global presence, it is worth considering not just whether local restructuring laws pose any obstacles to an attempt by WeWork to avoid its lease obligations, but also whether in a potentially broader global restructuring commercial landlords face the possible double whammy of having WeWork reject or terminate a lease, but then still seek to enforce a covenant not to compete contained in the lease.

A landlord not being able to use space that it has constructed to accommodate co-working arrangements also raises a question for landlords that are in the middle of constructing tenant improvements for a WeWork space: can the landlord suspend such activities pending WeWork's formal acknowledgement that it will be retaining that lease in its restructuring?

In this piece, Baker McKenzie's Global Restructuring & Insolvency and Real Estate teams provide insights into what may happen under some of the local laws governing WeWork's leases.



United States

The principles of lease and contract rejection in the US are well-established. Rejection by a debtor only constitutes a "breach" and not a termination of a commercial lease, even though section 365(d)(4)(A) of the Bankruptcy Code requires a debtor tenant to surrender the premises "immediately" if a commercial lease is "deemed rejected" as a result of the debtor's failure to assume the lease within the time period prescribed by the Bankruptcy Code. This provision sounds a lot like termination, but the provision does not expressly apply to the typical scenario — a court-ordered rejection of a commercial lease at the debtor tenant's request.

It seems unlikely that a breaching debtor tenant would be able to enforce a covenant not to compete in its favor after the rejection of its lease. Nonetheless, a landlord will have to carefully review the terms of its lease, the applicable state law, and any language

in the lease about the post-termination survival of covenants to determine the effect of such a provision. In particular, a landlord will want to confirm what constitutes a competitor and if the landlord can structure a new lease to avoid a violation, what the actual restrictions are, how the restrictions can be limited, and whether any other limitations in the lease would protect the landlord. Landlords may need to get creative, based on the particular language contained in their lease.

Faced with this uncertainty about re-letting a co-working space, can a landlord that is in the process of constructing tenant improvements or that is providing tenant allowances suspend these activities upon the commencement of a WeWork chapter 11 case? A landlord may have the ability to preserve setoff rights in relation to tenant improvement allowances, but, generally speaking, the automatic stay likely prevents the landlord from unilaterally suspending performance. The landlord may ask WeWork to agree to a suspension pending WeWork's decision to assume or reject a lease. In the absence of such an agreement, the increased exposure of the landlord resulting from any uncertainty might constitute "cause" for the US bankruptcy court to compel WeWork to decide whether to assume or reject the lease. For completed build-outs, landlords may also consider repurposing their existing spaces to optimize the value of such spaces. This may involve identifying new ways of using the real estate by capturing (and recapturing) value through changing its use, thereby preventing the landlord's real estate from becoming obsolete.

Hong Kong

WeWork rented its first co-working space in Hong Kong in 2016 and this later grew to a total of 12 locations in the city. Due to the pandemic, the subsequent prevalence of remote working arrangements and operational challenges, as in many other cities, WeWork has scaled back its operation in Hong Kong. As of August 2023, WeWork had six locations in Hong Kong, taking up about 300,000 square feet. In Hong Kong, commercial parties are generally free to negotiate the terms of a commercial lease. Landlords in Hong Kong often have strong bargaining power and are reluctant to make substantial amendments to standard lease terms. It is unusual to see non-compete clauses in commercial leases, especially where such clauses are binding after the termination of the lease.

Australia

In Australia, the use of the voluntary administration regime to relinquish leased sites, where negotiation with the landlords has failed, and which are no longer a viable part of a business, is a well-worn path. WeWork landlords should be prepared to anticipate these scenarios and seek early advice where warning signs show that WeWork may adopt this course.

Restrictive covenants that seek to prevent a competitor from taking over the premises or to prevent a landlord from granting a lease to a competitor for any other space within the same building are not common in commercial office leasing. If this restriction has been agreed, it is often documented in a side deed, and landlords and/or property managers should act prudently to review any ancillary documents to identify any possible restrictive covenants before determining next steps. Any restrictive covenant requires careful consideration and advice to understand the ramifications of the restriction and the strategies to pursue to overcome it. It is also worth noting that such provisions restricting the ability of a prospective competitor to operate could be expected to raise issues under competition laws, in particular sections 45B and 47(8) of the Competition and Consumer Act 2010 (Cth). Further investigation and advice need to be taken in the particular context of the lease, the business in question, and its location.

Brazil

The majority of Brazilian courts' decisions understand that clauses that allow agreements, including lease agreements, to be terminated due to the filing of a chapter 11 case in Brazil (a *Recuperação Judicial* (RJ)) are null and void. This is because terminating agreements may adversely impact the attempt to surpass the economic crisis that justified the filing of a RJ.

In an RJ that currently is pending with respect to one of the largest retailers in Brazil, the impacts of the filing on leases are being discussed. Based on the assumption that the retailer needs to maintain stores to obtain revenue — and to carry out its corporate purpose — the court declared that the leases continue to be valid and effective regardless of the filing and the existence of a clause stating the opposite. Furthermore, the retailer is successfully avoiding eviction orders based on the same grounds (i.e., it is necessary to keep stores open for the RJ to succeed).

Regarding the non-compete clause, as a general rule, the enforcement of such provision requires compensation. In other words, the lessee would have to compensate the lessor for demanding compliance with these clauses, especially after the lease has been terminated.

Canada

Prior to its chapter 11 filing, WeWork was among the largest co-working space providers in the country with locations in Canada's four largest cities. Although Canada was a market targeted for growth by WeWork, many of Canada's most high-profile restructurings of late have involved the disclaimer of expensive commercial leases entered into with optimistic growth projections that failed to materialize. A Canadian debtor undergoing a restructuring under the Bankruptcy and Insolvency Act (BIA) or Companies' Creditors Arrangement Act (CCAA) typically will be allowed to disclaim an unwanted commercial lease where it is necessary for the restructuring. The resulting damages from the disclaimer become an unsecured claim held by the landlord. While close consideration would have to be given to the specific agreements of the parties, the concept of partially disclaiming an agreement has not been accepted in Canada. It is therefore unlikely that a debtor would succeed in attempting to enforce a non-compete or similar restrictive covenant with the landlord, even if described as distinct and severable, when it disclaims a commercial lease. A challenging practical and legal issue for landlords would be planning to lease their properties prior to a disclaimer with these unresolved issues hanging over their heads.

Continued from p.25

Singapore

In 2023, WeWork had 14 co-working sites in Singapore, including at 21 Collyer Quay – the largest co-working location in the WeWork portfolio in Asia Pacific.

If WeWork were to repudiate or refuse to perform its obligations under a lease, it would be difficult to see how it could, on the other hand, successfully enforce the non-compete covenant against the landlord. Further, for a restraint of trade clause to be upheld in Singapore, WeWork would have to demonstrate that the covenant is necessary to protect a legitimate proprietary interest and that the scope of the restriction is reasonable and proportionate in relation to the parties' interests. That said, landlords will have to carefully review the terms of their leases, particularly the post-termination survival of covenants, to determine the effect of these clauses.

To compromise on its obligations under the lease agreements, it is possible that WeWork will seek a scheme of arrangement in Singapore, or seek recognition in Singapore of any chapter 11 case. For context, for a scheme of arrangement to be approved in Singapore, WeWork would have to obtain the approval of creditors holding at least 75% in value and a majority in number in each of the classes of creditors. WeWork (and potentially its subsidiaries or holding entities) also could be entitled to moratorium protections against adverse proceedings being brought against it.

Mexico

WeWork has a strong presence in the most influential cities in Mexico, and given the novelty of its business model, it has managed to rapidly grow and secure very coveted locations under beneficial terms and conditions.

Under Mexico bankruptcy law, the bankruptcy declaration of the tenant does not terminate the lease. Additionally, this declaration does not entitle the tenant to stop paying rent, especially if paying rent is part of the ordinary course of business, as would be the case for WeWork. Therefore, if WeWork breached its payment or any other obligations under a lease, it should not have the right to claim a breach of a non-compete clause while being in breach of its own duties under the same lease.

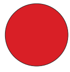
It is relevant to consider that Mexican leases typically contain a clause that provides that a filing by a tenant or the guarantor for bankruptcy or insolvency constitutes a breach and will entitle the landlord to terminate this lease under Mexican law. A tenant's breach of obligations should deprive it of its right to raise any claim, including the non-compete violations, and generally trigger a penalty for the payment of rent for the remainder of the mandatory term. WeWork landlords should anticipate these potential scenarios and seek advice at an early stage where warning signs are shown that WeWork may extend its restructuring to include its operations in Mexico and trigger this breach.

On the non-compete clauses, the Mexican Supreme Court has issued criteria stating that unlimited or broad non-compete clauses are void. For them to be valid and enforceable, these clauses must comply with some requirements, such as being limited in time, geographic space, particular activities, particular competitors, etc. The non-compete clause typically included in this type of lease would normally include a number of the above-mentioned requirements, such as a time limitation (i.e., one year after termination), geographic limitations and limited particular activities for the landlord to avoid. These limitations might suffice to comply with the Mexican Supreme Court criteria for such clauses to be considered valid and enforceable. It is important to remember that the main purpose of a non-compete clause is to prevent commercial damages to one party (the tenant) after termination of the agreement. If, as a result of a bankruptcy, the tenant ceases to exist and will have no further commercial activities in a market, the landlord can soundly argue that the main purpose of the non-compete clause has been lost, especially where the tenant cannot claim damages for a non-compete breach, because it will not have any more commercial activity.

Germany

The opening of insolvency proceedings generally would not affect WeWork's leases. Although WeWork may not pay its rent in full during the usual three months of so-called "preliminary insolvency proceedings" (a typical strategy would be to pay just as much so that a termination right for the landlord is not triggered), the rent obligations WeWork incurs after the opening of main insolvency proceedings are considered to be preferential claims against the estate. These preferential claims must be paid (provided that there is enough money in the estate to pay). However, in the insolvency of the tenant, the insolvency administrator has the right to terminate the leases with a three-month notice period irrespective of the contractual notice periods. The landlord would then have a damage claim against WeWork due to the early termination, which would rank *pari passu* with other unpreferred insolvency claims.

It is unclear whether WeWork's German contracts contain non-compete clauses. In the past, courts have quite often declared non-compete clauses as void. According to the established case law of the Federal Court of Justice (BGH), a non-competition clause may not unduly restrict the obligated party in the exercise of its profession and, thus, may not go beyond the interests of the beneficiary that are worthy of protection. In particular, it must not lead to an unreasonable restriction of the obligor's economic freedom of movement in terms of location, time and subject matter. If WeWork insisted on such clauses despite its own termination of the leases in the insolvency proceedings, the court would have to determine whether, under the particular facts, the clause is void or not, but we would see a relatively high likelihood for voidness. Furthermore, these clauses could be classified as general terms and conditions and therefore void if they are unreasonably disadvantageous, especially if they did not provide for a financial compensation to the landlord.



Japan

If WeWork commenced insolvency proceedings in Japan, either WeWork in its capacity as a debtor in possession or its trustee, if appointed by the court, has the option to continue or terminate a lease to which it is a party. Typically, in a liquidation of the debtor, the termination of a lease would be the most likely scenario. However, in a civil rehabilitation proceeding, aimed at revitalizing the debtor's business, if a lease is found essential for the debtor's business, this lease would likely be retained to continue.

Is it common for a lease governed by Japanese law to contain a non-compete clause extensively prohibiting a landlord from doing any business competing with the tenant's business, e.g., by letting the leased premise to a competitor of the tenant? We sometimes encounter a non-compete clause in Japanese commercial building leases that prohibits a landlord from letting any premises **in the same building** other than the leased premises to certain competitors of the tenant expressly listed therein, during the term of the lease, i.e., until the lease terminates. However, it is not common for the parties to include such a non-compete clause surviving even after the expiration of the lease in lease agreements. Additionally, note that a clause granting the tenant a right of first refusal on leases with competitors would scarcely be found in Japanese commercial lease documents.

The validity of such a non-compete clause with survival effect may possibly be challengeable if the landlord can argue that it is not reasonable. Judging from a number of judicial decisions issued in the past with respect to the validity or legality of non-compete clauses, Japanese courts may, when adjudicating whether such clause is reasonable or not, take into consideration various factors, such as (i) the activities the clause prohibits, (ii) the extent to which such activities are prohibited (e.g., whether there is a reasonable limitation of period, geographical area or type of business to such non-compete obligation), (iii) the purpose of the prohibition, (iv) the way the clause regulates such activities, and (iv) the effect or implication the non-compete clause may have on each party's interest.

United Kingdom

As of the chapter 11 filing, WeWork operated from 50 locations in London, representing approximately 4 million square feet (1%) of the capital's office space. Any shedding or renegotiating of WeWork's leased-offices portfolio would significantly impact London's commercial office market.

A few of the UK's larger commercial landlords already have shown their willingness to accept surrenders of serviced-office leases and to continue to run those spaces under their own co-working platforms. This model is unlikely, however, to be the case for the majority of WeWork's landlords, who will be facing difficult decisions. Although tenants cannot unilaterally require a landlord to accept a lease surrender or renegotiate existing lease terms, landlords will be considering the consequences of their agreement or refusal in a difficult letting market.

Tenants wishing to vacate lease space in the UK without landlord approval have the option to pursue, among other routes, a Company Voluntary Arrangement (CVA) to restructure their leasehold liabilities. This can include rent reductions (including to below market value levels), new tenant turnover rents, increased or new break rights, an opportunity for landlords to accept surrenders, and a compromise of dilapidations sums, which would traditionally arise at the end of a lease term. The estimated outcome must show that unsecured creditors will receive more through a CVA than an alternative administration. Notwithstanding, all unsecured creditors under a CVA vote on the company's restructuring proposals as a single class, which can enable non-landlord creditors (whose claims may be left unimpaired by the CVA) to provide the requisite 75+% vote in favor of the CVA against the wishes, and often to the detriment, of dissenting landlords. Although CVA decisions are challengeable through the court if unfairly prejudicial, recent CVA decisions have shown that, despite certain CVA provisions being patently prejudicial to landlords, the court may still allow them if they are considered justifiable in the overall context of the CVA.

CVAs are not the only restructuring tool, and the Part 26A Restructuring Plan introduced by the Corporate Insolvency and Governance Act 2020 can be utilized to reduce or mitigate the adverse effect on a company's ability to continue trading. Such plans are, like CVAs, subject to voting by its unsecured creditors. However, unlike a CVA, creditors vote in classes (subject to a power to exclude (or cram down) dissenting creditors). Each class must vote in favor of the restructuring plan, and the plan must then be sanctioned by the court.

Non-compete clauses in leases are relatively uncommon in the UK, especially those that purport to bind either party after the lease has come to an end. Leases fall within the restrictions on non-competitive arrangements and abuses of dominant positions imposed by the Competition Act 1998 (as amended). Any purported restrictions on competitive use within the building, either during or after the expiry of the lease, would need to be reviewed in the context of that legislation and common law.

Poland

As of its chapter 11 filing, WeWork had five co-working locations in Poland (all of them in Warsaw).

Polish law has no specific regulations that apply to the termination of lease agreements in the event of tenant out-of-court workouts. General principles apply to them, and they are well-established and differ depending on whether an agreement has been concluded for a definite or an indefinite term. Our experience shows, however, that lease agreements for commercial buildings in Poland are usually concluded for a definite term. In the case of a definite term agreement, the agreement may be terminated by a landlord or by a tenant prior to the termination date only for reasons expressly indicated in the agreement. Moreover, regardless of how an agreement is worded, Polish law provides landlords with an additional tool for terminating a lease before its end date if the tenant is in arrears with rent payments for at least two full payment periods, despite the landlord having given the tenant, by way of written notice, an additional one month

Continued from p.27

within which to pay the overdue rent. Additionally, of course, both parties may terminate the agreement at any time by mutual agreement.

If the tenant initiates semi-court or court restructuring proceedings in Poland, then some additional, statutory restrictions on a landlord's right to terminate a lease agreement apply. Generally, to terminate a lease agreement early, consent is required (depending on the circumstances or type of proceedings that are pending) from the creditors' council, the restructuring judge, or the restructuring court (unless an event of default under the lease agreement arose during the proceedings). On the other hand, in the case of a semi-court or court restructuring, Polish law generally does not provide the tenant with any dedicated right to terminate a lease early. If the tenant plans to terminate a lease agreement as a restructuring measure, the landlord's approval is necessary. However, in remedial proceedings (*postępowanie sanacyjne*, a type of court restructuring offering the widest range of restructuring tools), a tenant (precisely speaking, an appointed insolvency office holder acting in its favor and with the approval of the restructuring judge) may decide to effect the unilateral termination of a lease early.

An insolvent tenant can also file for bankruptcy in Poland. However, according to the law, the bankruptcy process usually results in the liquidation of the bankrupt party. The insolvency office holder appointed for the bankrupt is entitled to terminate the lease agreement even if the tenant was not entitled to do so (assuming that the leased space was already made available to the tenant before the date of bankruptcy). On the other hand, the landlord can only terminate the lease for the reasons expressly indicated in the agreement or in the law.

Polish law invalidates a party's contractual right to modify or terminate an agreement in the event of filing of bankruptcy or restructuring application, commencement of a court restructuring or bankruptcy proceeding, or some other semi-court restructuring-related events.

In each of these situations, a landlord should consider an appropriate strategy regarding the lease agreement and the pending proceedings in Poland, including ways of recovering overdue and current rent, the possibility of using the security to which the landlord is entitled to by law or possesses under the agreement (e.g., a cash deposit), or the feasibility of seeking damages.

If the parties have agreed to non-compete restrictions, our local experience indicates that such restrictions usually do not remain in effect after the lapse of the lease term. However, when they do, the usual period is around two months or so after the lease term. Any longer non-compete arrangements would be quite unique in the Polish market. Moreover, the Polish Competition Authority currently has no clear position regarding non-compete clauses in leases. If a lease contains a non-standard non-compete clause, the landlord might consider whether such clause could be unenforceable as an agreement limiting access to a specific market or an anticompetitive arrangement. The enforceability of such clause or its early termination could also be discussed with the appointed insolvency officeholder.

Spain

In Spain, a restructuring may be carried out either by filing a communication of the commencement of negotiations with creditors, or by the approval and homologation of a restructuring plan (articles 597 and 618 of the Spanish Insolvency Law). The general principle is that the communication of the commencement of negotiations or the homologation of the restructuring plan does not *per se* affect those contracts with reciprocal obligations pending performance (as is the case with leases). Therefore, any contractual provisions providing for the possibility of suspending, modifying or terminating a lease contract merely as a consequence of the filing of the communication or its approval, or as a result of the request for approval of a restructuring plan or its approval, will be disregarded and deemed as not written.

However, during the negotiation of a restructuring plan, a debtor may request the modification or termination of contracts with outstanding reciprocal obligations (including a lease) when it is necessary for the successful completion of the restructuring and to prevent insolvency. If the parties do not reach an agreement on the terms of the modification or the consequences of the termination, the restructuring plan may still provide for the termination of the contract, in which case the indemnity claim arising from the termination may be affected by any haircuts or stays contemplated in the restructuring plan.

The non-debtor lessor may suspend, modify, resolve, or terminate its lease with a debtor that has filed a communication of commencement of negotiations with creditors as long as the action is based upon a contractual breach **other than** the filing or admission of the communication. If a lease is deemed necessary for the continuation of the debtor's activity, though, the lessor may not exercise such power during the term of effectiveness of a communication of commencement of negotiations with creditors (three months with a potential extension of an additional three-month term).

If the court determines the debtor to be insolvent, this, by itself, is not cause for the early termination of a lease agreement, and any contractual provisions to the contrary will not have any effect.

In Spain, as in the rest of EU member states and many other jurisdictions worldwide, competition rules need to be taken into account when assessing any non-compete covenant in a contract, as it may be incompatible with the prohibition of agreements that have the object or effect of restricting competition in the market, contained both in Spanish and EU competition law. The compatibility of non-compete clauses with competition law is to be interpreted always in a restrictive manner, as they constitute an exception to the principle of free competition in the market. Thus, to be compliant from a competition law standpoint, any non-compete clauses in a WeWork lease would have to be considered necessary and directly related to the contracts to be justified. To that end, their scope should be proportionate to their aim and not go beyond what is necessary. From this perspective, a post-termination obligation not to compete could be construed as too far-reaching, depending on the duration, the rest of the circumstances of the contract and the reality of the market.

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Debra Dandeneau is a partner in Baker McKenzie's New York office. Debra served as Chair of Baker's Global Restructuring & Insolvency Group from 2016 through 2022. Debra's practice has involved representing clients throughout the world at all levels of the capital structure in high profile distressed situations, including chapter 11 debtors and acquirers of troubled businesses. Debra also has represented major parties in municipal bankruptcies under chapter 9 of the US Bankruptcy Code. Debra has received numerous awards for her work in restructuring. In 2023, she was named the Restructuring & Insolvency Lawyer for the Americas from *Women in Business Law*, honored as a Notable Woman in Law by *Crain's New York*, named as one of the Top Women in Dealmaking (Restructuring) by *The Deal*, and included in Lawdragon's list of 500 Leading US Bankruptcy & Restructuring lawyers. Debra regularly speaks on restructuring issues and is frequently quoted in the media, including *The Economist*, *The Wall Street Journal*, and *BBC Radio*.

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EARNOUT PROVISIONS IN PHARMACEUTICAL TRANSACTIONS: KEY CHALLENGES AND STRATEGIES TO MITIGATE RISK

Jen Maki

FTI Consulting

The pharmaceutical industry operates within a dynamic and complex landscape for reasons including market volatility, innovation, and uncertain approval timelines for drugs. Owing to the challenges associated with this sector, start-ups and small companies often look to sell their businesses or drugs at a relatively early stage, when compared with other sectors, to larger, more established companies that are better equipped to go to market. The number of biotechnology and pharmaceutical sector M&A deals nearly quadrupled between 2000 and 2022.[1] Although many sectors saw growth in the number of such deals during the same period, this increase dwarfed other major industries like banking (where the number of deals grew by nearly one-third) and energy and power (where deal volume grew by a little more than two-thirds). As for 2023, according to GlobalData, in Q2 the pharmaceutical industry saw 242 deals with recorded value of USD $54billion, followed by 221 deals worth USD $28 billion in Q3.[2]

As heightened activity levels have combined with innovation and the search for increased returns in a challenging economic environment, parties entering deals require sophisticated and complex contracts and structuring arrangements. In these more difficult times, parties seek to bridge valuation gaps and align incentives by establishing earnout provisions, through which sellers reap economic rewards when the sold business performs as well as forecasted or better.

However, these earnout provisions carry inherent risks, whether driven by an unpredictable regulatory landscape, industry dynamics or market forces. The fallout from things not going according to plan can be meaningful and ranges from litigation to regulatory intervention. Professional and financial services firm SRS Acquiom reports that of the deals it has helped facilitate, biotechnology and pharmaceutical earnout milestone achievement rates have dropped from 34 percent in 2021 to 22 percent in 2023, while unpaid potential earnouts under dispute have grown by 50 percent.[3]

Here, we examine these provisions and provide a high-level overview of some of the risks they present. We also touch on structuring and other considerations for dealmakers to minimize risks and best capture the desired economic results.

Potential Risks

In an earnout, transacting parties agree on specific payout terms at a future date; however, those arrangements are vulnerable to unpredictable outcomes as well as the potential for gamesmanship. Taking some of these in turn:

- **Regulatory factors**: Unforeseen safety concerns can emerge during an approval process and new legislation can create unexpected hurdles for drugmakers. Drug approval timelines can be uncertain due to the required input of numerous stakeholders, stringent approval guidelines and the need for quality data. Furthermore, during a black swan event like the COVID-19 pandemic, when regulators are forced to prioritize according to need, timelines can be increasingly unpredictable.[4]
- **Overall market conditions**: While drugmakers are subject to strict regulation and approval processes, they must also navigate the landscape of competitive business, including companies that may emerge quickly. New market entrants can present competitive challenges, and as the market evolves, pricing structures can change quickly in the United States and abroad, potentially causing a significant impact on businesses with an actual or desired cross-border footprint. One example is the Chinese government intervention in 2019, when a centralized procurement program required hospitals to buy in bulk and price became the determining factor, meaning brand name drugs or any business that was differentiated by factors other than price suddenly lost significant market share.[5] These types of developments in major markets can significantly impact projected revenue that would otherwise be undisrupted.
- **Macroeconomic conditions**: In the current macroeconomic environment, from interest rate rises and inflation to energy and labor costs and even global conflict, there is increased unpredictability compared to the median years, particularly for businesses that have financed recent growth with debt or M&A. Aymen Mahmoud, co-head of London finance, restructuring and special situations for law firm McDermott Will & Emery, notes that limited capital due to macroeconomic pressure is impacting buyouts and causing disparity between buy-side and sell-side expectations, "bridging that gap either

[1] IMAA, "M&A Statistics by Industries," M&A Biotechnology & Pharmaceuticals (chart), imaa-institute.org, https://imaa-institute.org/mergers-and-acquisitions-statistics/ma-statistics-by-industries/.

[2] "Pharmaceuticals Industry Mergers and Acquisitions Deals by Top Themes in Q3 2023 – Thematic Intelligence," November 13, 2023, https://www.globaldata.com/store/report/healthcare-industry-m-and-a-deals-by-theme-quarterly-analysis/#:~:text=Key%20Highlights,M%26A%20deals%20in%20Q2%202023. Accessed January 26, 2024.

[3] "2023 SRS Acquiom Life Sciences M&A Study," September 2023, https://www.srsacquiom.com/our-insights/life-sciences-m-and-a-study/.

[4] "Can I Speed Up the Pathway to FDA Approval of My New Drug?" FTIConsulting.com, August 16, 2023, https://www.fticonsulting.com/insights/fti-journal/can-speed-up-pathway-fda-approval-new-drug.

[5] Yuan-jin Zhang, et al, "The impact of national centralized drug procurement on health expenditures for lung cancer inpatients: A difference-in-differences analysis in a large tertiary hospital in China," *Frontiers in Public Health*, Vol. 10, August 12, 2022, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC9412196/#:~:text=In%20March%202019%2C%20the%20Chinese,health%20expenditures%20of%20cancer%20patients.

structurally with an earnout or with some other form of capital will be an even more key consideration for parties to M&A transactions in the short and medium term."[6] Amid these challenging economic headwinds, businesses may need to be financially and operationally restructured. Indeed, pharmaceutical companies accounted for nearly a quarter of bankruptcies between 2019 and 2022.

The uncertainty stemming from these situational risks is not the only challenge that drugmakers face. In M&A, the integration of firms can produce novel risks, particularly as large pharmaceutical businesses are often bought by trade buyers, meaning they are integrated into existing large pharmaceutical businesses rather than through a private equity model structured specifically for that acquisition. Merging two firms can result in delays, disruption, and the loss of key personnel, all of which can impact development timelines and sales, particularly in a market driven by significant growth in carve-outs. It is critical to have the right teams in place to oversee integration effectively.

One difficult consideration in the structuring of earnouts is the misalignment of incentives. Executives in the target business are likely incentivized to indicate high-level performance, which may not be sound from an accounting standpoint and increases the scope for gamesmanship. On the sell side, there may be a desire to show increased revenues, and buyers should scrutinize sudden upticks in performance prior to a sale. For buyers, there may be a desire to downplay performance, adjust discounts or pricing structures or adjust sales efforts to avoid a payout, and for management executives, the opposite dynamic can exist given their own compensation structures.

Risk Mitigation Strategies

Despite the risks associated with earnout provisions, there are many ways to mitigate risk and ensure that risk is fairly allocated. Before looking at true mitigation, the first question should be allocation. For example, who is properly positioned to accept the macroeconomic risk associated with debt financing or geographic conflict? After moving past the question of allocation, which is driven mostly by bargaining power, data-driven strategies can be meaningfully implemented to reduce unpredictability.

Comprehensive diligence can be transformative for a buyout process; assessing the target company, market conditions, competitive landscape and pipeline gives insight into market evolution in the post-earnout era. Comprehensive diligence guards against asymmetric information, enables the development of better-negotiated protections and creates more informed expectations for the feasibility of reaching key milestones. For example, when a buyer commissions a commercial due diligence report, they benefit from receiving detailed information regarding the market, including anticipated regulatory changes, disruptors, and holistic views from customers and other stakeholders that can serve to validate their investment thesis while also identifying any risks or information gaps.

[6] Aymen Mahmoud, e-mail message to author, October 6, 2023.

Firms can also improve their understanding of the wider market by building collaborative relationships with other parties. Communication and regular data sharing can be highly effective in reducing risk and proactively addressing challenges, leading to better outcomes for both parties while reducing the likelihood of disputes.

As the above strategies suggest, data is key for companies entering a deal. Those entering a deal cannot control the future, but they can use data to make better judgments about the other party and current and future risks that may arise from a transaction. Earnouts play a critical role in bridging the value gap in an uncertain deal environment, so Harris Siskind, partner and global head of transactions at McDermott Will & Emery, notes that buyers and sellers "should exercise caution in crafting earnout provisions, which can range from a very simple top-line revenue-based earnout to a highly complex EBITDA-based earnout that discounts for future add-on acquisitions and is dependent on a multitude of factors."[7]

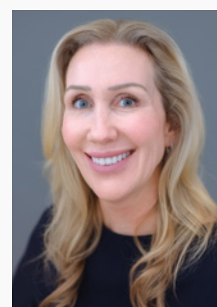
Conclusion

Knowing that earnouts are subject to uncertainty is important, but it does not render those provisions unworthy of consideration. Are they any worse than agreeing on an up-front price that is unfair and based on the same assumptions that the earnout is based on? Likely not. As with all facets of buyouts and integration, understanding the risks allows for better preparation and, therefore, a better outcome.

The usefulness of earnouts in bridging valuation gaps has been demonstrated, particularly in the current environment. We have noted the additional risks, which might be heightened by the approach in a particular geography to warranties and indemnities in M&A. In markets subject to structural unpredictability, such as the pharmaceutical industry, parties agreeing to earnout provisions can be exposed to risks ranging from uncertain drug market performance to integration challenges and misleading data. As with any business risk, the approach to risk management means that buyers and sellers can benefit from these provisions in a thoughtful way where everyone wins.

[7] Harris C. Siskind, e-mail message to author, October 12, 2023.

ABOUT THE AUTHOR



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A TALE OF TWO CHAPTERS – "RECOGNIZING" THE SIGNIFICANT DIFFERENCES BETWEEN CHAPTER 15 AND CHAPTER 11 BANKRUPTCY CASES

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One key question that often arises is how Chapter 15 recognition proceedings differ from cases under other chapters of the Bankruptcy Code (where the main proceeding is in the U.S.). The answer is particularly relevant to ensure that international stakeholders and observers do not blur the meaningful distinctions between the two processes. While Chapter 15 cases are governed by the same underlying statute as cases under other chapters of the Bankruptcy Code (e.g., Chapter 7 liquidation proceedings and Chapter 11 reorganization proceedings), they are worlds apart.

In contrast to a case under Chapter 11 of the Bankruptcy Code, which centralizes a company's debt adjustment efforts in the U.S. and provides for expansive oversight and supervision by a U.S. court, a Chapter 15 recognition proceeding is an ancillary proceeding in which the U.S. court acknowledges the foreign proceeding and gives it effect under applicable U.S. law. As many "common law" jurisdictions look to the governing law of the debt to determine whether there is effective compromise (the so-called Rule in *Gibbs*), a Chapter 15 recognition proceeding is a legal step for the U.S. court to formally recognize the effectiveness of the restructuring in the relevant jurisdictions.

This article will highlight the key distinctions between Chapter 15 proceedings and Chapter 11 proceedings.

Bankruptcy Code Basics

Article I, Section 8, of the U.S. Constitution authorizes Congress to enact "uniform Laws on the subject of Bankruptcies." In 1978, Congress passed a statute, title 11 of the U.S. Code[1] (the "Bankruptcy Code"), to statutorily govern federal bankruptcy law in the U.S. The Bankruptcy Code has since been amended multiple times and, together with federal case law that has developed interpreting the Bankruptcy Code, serves as the framework that governs all bankruptcy cases.

Cases under the Bankruptcy Code

The Bankruptcy Code is divided into sub-chapters, which generally govern different types of proceedings. Chapters 1, 3, and 5 provide general provisions applicable across various types of proceedings. Chapter 7 generally covers liquidation proceedings, while Chapter 11 governs reorganization proceedings. Chapters 9 (municipal bankruptcy), 12 (family farmers and fishermen), and 13 (individual reorganization) provide rules for specific types of debtors.

The main types of cases under the Bankruptcy Code are Chapter 7 cases, which are liquidation proceedings in which a trustee (similar to a liquidator) is appointed to take control of the company's assets and sell them for distribution to creditors, and Chapter 11 cases, which are reorganization proceedings in which the company's management stays in control and develops a plan for repayment of debts over time.

In a case commenced under Chapters 7, 11, 9, 12, or 13, a bankruptcy "estate" is created upon the commencement of the proceeding, and the provisions of the Bankruptcy Code will govern the debtor's conduct following the commencement of the case, the rights of creditors (for instance, to vote on the proposed plan of liquidation or reorganization) (to the extent applicable), and the disclosure required to be provided by the debtor. The U.S. court will oversee the liquidation or restructuring of the debtor and the continuation or cessation of its business during the proceeding.

Cases under these chapters provide significant protection to the debtor, although they also impose significant burdens. There will be extensive disclosure by the debtor in the proceeding, and typically dozens, if not hundreds, of filings and hearings before the U.S. Bankruptcy Court.

Recognition Proceedings under the Bankruptcy Code

Chapter 15 is the codification of the U.S. adoption of the Model Law on Cross-Border Insolvency, promulgated by the United Nations Commission on Internal Trade ("UNCITRAL"). In adopting the UNCITRAL Model Law on Cross-Border Insolvency, Congress intended Chapter 15 "to be the exclusive door to ancillary assistance to foreign proceedings."[2] The principle objective of Chapter 15 is to grant comity to the orders of foreign courts, provided those rulings are not contrary to public policy.[3] The main directive of Chapter 15 is to promote cooperation among U.S. courts and parties in interest as well as courts and other competent authorities of foreign countries involved in cross-border insolvency cases.

A Chapter 15 case is ancillary to, and recognizes, a foreign proceeding that is the principal proceeding governing the debtor and adjustment of its debts. The Chapter 15 recognition would be granted only after approval (sanction) of the underlying foreign proceeding (although sometimes the recognition proceeding will be filed in tandem with the foreign proceeding to streamline the process). Often there are no material assets of the company in the U.S., and the only liabilities are U.S.(often New York)-law governed bonds.

The U.S. court's role in a Chapter 15 case is significantly more limited than its role in a main case under the Bankruptcy Code. The U.S. court will review the request for recognition to ensure

[1] 11 U.S.C. §§ 101–1532.

[2] H.R. Rep. No. 109-31, 109th Cong., 1st Sess. 110 (2005).

[3] The public policy exception is intended to be invoked only under exceptional circumstances concerning matters of fundamental importance for the U.S. For example, if recognition of an order from a foreign proceeding might subject the foreign representative to U.S. criminal liability, the court may deny relief under the public policy exception.

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it complies with the requirements of Chapter 15, which are (broadly) that:

1. the foreign proceeding sought to be recognized is either a foreign "main" proceeding (*i.e.*, is proceeding where the debtor has its center of main interests ("COMI"), which is essentially where the debtor has a principal place of business ascertainable to third parties) or foreign "non-main" proceeding (*i.e.*, where the debtor maintains an "establishment," and carries out "non-transitory economic activities");
2. the foreign representative applying for recognition on behalf of the debtor is a person or body authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding; and
3. the petition for recognition is accompanied by the required administrative filings.

If the requirements of Chapter 15 are met, the U.S. court will "recognize" the foreign proceeding and terms of the restructuring, including the discharge of debt, giving it effect in the U.S. under applicable federal and state law.[4] **With this legal step, there will be formal effect given under U.S. law to the compromise or arrangement in the underlying foreign proceeding.** To be clear: In the Chapter 15 recognition proceeding, the U.S. court will not independently determine whether the company in question should be liquidated or the restructuring plan should be approved—this question will be for the foreign court overseeing the main proceeding.

Key Differences between Chapter 11 and Chapter 15

The chart on the next page summarizes certain key differences between a Chapter 11 proceeding and an ancillary Chapter 15 recognition proceeding.

[4] *See, e.g.*, *In re Modern Land (China) Co*., 641 B.R. 768, 776 (Bankr. S.D.N.Y. 2022) (holding that so long as a foreign court "properly exercises jurisdiction over the foreign debtor in an insolvency proceeding, and the foreign court's procedures comport with broadly accepted due process principles, a decision of the foreign court approving a scheme or plan that modifies or discharges New York law governed debt is enforceable" under New York and federal law).

Summary

Cases under Chapter 11 of the Bankruptcy Code and recognition proceedings under Chapter 15 are both mechanisms used by companies seeking to address their debts, but their differences (both procedural and substantive) are vast. Crucially, the Chapter 15 proceeding principally enforces the orders of a foreign proceeding. Chapter 15 proceedings, which recognize and give effect to the orders in a foreign proceeding under applicable U.S. law, are a normal step in foreign restructurings and are becoming increasingly prevalent as the number of cross-border international restructurings continue to rise.

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Key Differences between Chapter 11 and Chapter 15

	Chapter 11	Chapter 15
Characterization of Proceeding	In a Chapter 11 proceeding, the U.S. court has authority over all assets of the debtor and the debtor's estate. The U.S. court supervises and approves the outcome of the debtor's debt adjustment plan.	Chapter 15 is ancillary to, and recognizes the foreign proceeding, which is the principal proceeding that will govern the debtor and adjustment of its debts (e.g., a scheme of arrangement).
Commencing a Case	A petition is filed commencing the Chapter 11 case, along with supporting "first day motions" seeking relief for a wide range of administrative and operational issues (e.g., use of cash, payment of employees / vendors).	A petition is filed for recognition of a foreign proceeding, along with evidence of the foreign proceeding.
Bankruptcy Estate & Operations	The filing of a Chapter 11 petition creates a bankruptcy estate. The debtor has broad authority to manage its assets in the ordinary course. Outside of the ordinary course activities they must receive bankruptcy court approval.	Chapter 15 does not create a U.S. bankruptcy estate. The U.S. court does not govern the operations of the company.
Stay Against Creditor Collection Actions	The automatic stay against creditor collection actions immediately applies upon filing for bankruptcy protection and has effect worldwide. Upon confirmation of a plan, a worldwide injunction replaces the automatic stay.	The automatic stay does not apply immediately upon filing a recognition proceeding. Upon recognition of the foreign scheme, the U.S. court will enforce any compromises or discharges granted in the underlying foreign proceeding in the territorial jurisdiction of the U.S.
Required Disclosures	The debtor must file robust disclosures related to its financial condition, including an initial filing of statements of financial affairs and periodic reporting of operations.	Disclosure is provided with respect to the foreign proceeding; there is no periodic reporting obligation (as the U.S. court is not controlling or supervising the company's operations).
Dismissal	A Chapter 11 proceeding may be dismissed as a "bad faith" filing.	A Chapter 15 proceeding can be dismissed for cause or in the interest of the debtor and its creditors (but not for "bad faith" – as the Chapter 15 requirements are generally formulaic rather than equitable).
Role of the U.S. Trustee	The U.S. Trustee has an active role in overseeing the debtor's proceeding, including convening a meeting of creditors, monitoring the requests made by the debtor, and objecting thereto, and it can move to convert a Chapter 11 case to Chapter 7 or appoint an examiner or trustee.	The U.S. Trustee has minimal involvement in a Chapter 15 case.
Noticing	The debtor must provide broad notice of key dates and deadlines, including the deadline for filing proofs of claim, to all potentially affected parties.	Notice is typically provided of the recognition hearing and time for objection thereto to creditors affected by the foreign scheme. No proofs of claim must be filed.
Recovery Actions	The Bankruptcy Code provides broad powers to recover property and bring actions against creditors to maximize the value of the company.	The foreign proceeding generally governs any litigation or recovery actions, with the U.S. court acting in a supporting role.

TRENDS IN CHANGE IN CONTROL BENEFITS

J.D. Ivy, Brian Cumberland, and Allison Hoeinghaus
Alvarez & Marsal

Looking back, 2023 was a relatively slow year for mergers and acquisitions (M&A). M&A activity in 2023 reached a ten-year low, with global M&A activity falling approximately 20 percent year over year. 2023 was an especially down year for private equity and venture capital firms, which saw 39 percent and 35 percent declines, respectively, in deal making from 2022 to 2023.[1]

It appears a primary cause of this slowdown has been the interest rate hikes by the Federal Reserve. Higher rates have led to debt financing becoming more expensive – dropping projected enterprise value for acquisition targets – and shaking confidence in the economy, leading to disagreements on price between potential buyers and sellers. However, currently as interest rates begin to decrease along with corporate earnings increasing, many are expecting to see deal-making ramp up in 2024.[2]

In mergers and acquisitions, executive compensation and, in particular, executive change in control (CIC) benefits are often hotly debated items that are heavily scrutinized and negotiated between the various parties. Before a deal is even on the table, it is important for the board of directors to conduct holistic reviews of CIC provisions and make sure they are in line with market practices to comply with heightened scrutiny from stakeholders, regulators, and advisory groups. It is also critical to understand the potential exposure under the Golden Parachute tax rules as well as consider potential mitigation alternatives to ensure tax compliance and efficiency for both the corporation and key executives in connection with the CIC. When a bankruptcy filing is added to the mix, unique issues arise around executive CIC benefits, both during and following a chapter 11 filing.

[1] "Global M&A Report 2023," Bain.com, retreived from https://www.bain.com/insights/topics/m-and-a-report/.

[2] "What Happened in M&A in 2023, and What's Ahead, in Five Charts," *The Wall Street Journal*, December 29, 2023, https://www.wsj.com/articles/what-happened-in-m-a-in-2023-and-whats-ahead-in-five-charts-236b2dbf.

Market Trends in Executive CIC Benefits

In recent years, stakeholders, regulators, and advisory groups have continued to advocate for greater transparency and change with respect to executive compensation. One area of executive compensation that is often embattled with criticism is CIC provisions.

Prior to the enhanced proxy disclosure rules and the Dodd-Frank Act's Say-on-Pay advisory vote, executive change in control arrangements had often remained "under the radar" until shortly before a change in control. However, public companies must quantify and disclose the magnitude of any potential parachute payments to top executives (such as severance payments, acceleration of equity awards, fringe benefits, "gross-up" payments for excise tax, etc.). As a result of the Say-on-Pay advisory vote, shareholders have a louder voice with which to communicate their satisfaction or displeasure with the company's compensation programs.

In this environment of heightened scrutiny, boards and compensation committees may not want to be perceived as providing excessive change in control benefits relative to their peers or offering benefits that conflict with maximizing shareholder value. By benchmarking existing compensation arrangements against those of other companies, public company boards, their compensation committees, and management may validate existing change in control benefits or identify opportunities for change. Creating greater transparency around CIC arrangements can be a positive step for companies if they have the data needed to perform a comparative analysis.

A study by Alvarez and Marsal (A&M), in partnership with ESGAUGE, of executive CIC arrangements of 100 companies in the S&P Composite 1500 Index, analyzes the benefits received by the CEOs and CFOs at 25 companies from each of the following market capitalization (market cap) sizes: Small-Cap, Mid-Cap, Large-Cap, and Mega-Cap.

Common benefits received in connection with a CIC include severance, annual bonus, acceleration of long-term incentive awards, retirement, and other benefits (comprised of health and welfare benefits, outplacement services, life insurance, financial / legal services, etc.).

Based on the 2023 disclosures required by the SEC, the average value of typical parachute payments was calculated for CEOs and CFOs – finding the average CIC benefit provided was $22,933,383 and $7,326,661, respectively (see Exhibits 1 and 2).[3]

Observations from average CIC benefits for CEOs and CFOs:

- As expected, the average total value of CIC benefits tends to correlate with market cap. In the aggregate, the total value received by CEOs and CFOs was 0.2 percent of market cap.

[3] See 2023 / 2024 Alvarez & Marsal Executive Change in Control Report, ("2023 / 2024 A&M CIC Report"); https://www. alvarezandmarsal.com/insights/2023/2024-executive-change-control-report.

Exhibit 1: Average Change in Control Benefit Values – CEOs

Capitalization Size	Severance	Annual Bonus	Long-Term Incentive	Retirement Benefits	Other	Average Value
Small	$3,065,078	$873,258	$5,676,855	$622,114	$47,210	$10,284,515
Mid	$5,446,712	$288,177	$10,011,970	$0	$261,695	$16,008,554
Large	$5,688,382	$763,459	$16,894,327	$243,173	$83,387	$23,672,727
Mega	$6,235,838	$1,622,771	$32,027,417	$1,084,760	$796,952	$41,767,737
Average	**$5,109,002**	**$886,916**	**$16,152,642**	**$487,512**	**$297,311**	**$22,933,383**

Exhibit 2: Average Change in Control Benefit Values – CFOs

Capitalization Size	Severance	Annual Bonus	Long-Term Incentive	Retirement Benefits	Other	Average Value
Small	$1,033,698	$453,650	$1,913,227	$89,708	$40,700	$3,530,983
Mid	$2,557,825	$80,251	$2,496,722	$0	$79,195	$5,213,994
Large	$2,214,300	$324,407	$4,827,447	$289,293	$245,604	$7,901,051
Mega	$2,310,723	$655,123	$8,631,280	$1,030,031	$33,460	$12,660,617
Average	**$2,029,136**	**$378,358**	**$4,467,169**	**$352,258**	**$99,740**	**$7,326,661**

- Long-term incentives represent the largest CIC component for the majority of market cap groups. Of these total CIC benefits, approximately 60 percent were attributable to accelerated vesting of equity awards and in many cases, long-term incentive values are nearly double those of cash severance payments.

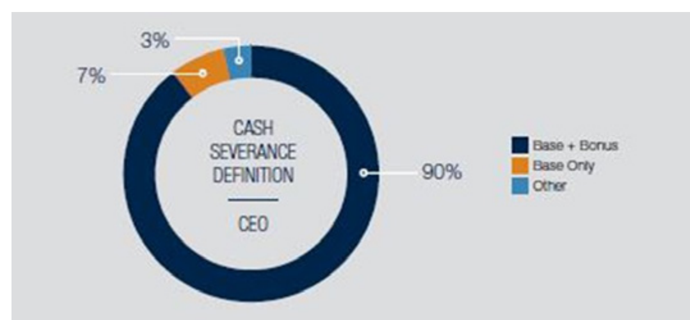
In 2021, the Institutional Shareholder Services (ISS) voted against 28.7 percent of all golden parachute payments; however, in 2022, ISS voted against 34.4 percent—with equity topping the list of ISS concerns.[4] The S&P 1500 rose by approximately 12 percent from December 2020 to December 2022; thus, the larger number of awards granted at depressed prices in 2020 are now valued higher. This has created a large increase in equity-based award values.

While the study found CIC benefit value to correlate with market cap size, it appeared that CIC benefit provisions may be more uniform.

Looking at 2023 SEC disclosures to discern common market trends with regards to severance, the study also found:

- Most agreements or policies with CIC protection provide for a cash severance payment; 84 percent of executives are entitled to receive a cash severance payment upon termination in connection with a CIC; 68 percent are entitled to severance upon a termination without a CIC.
- The most common definitions of compensation used to determine CIC cash severance payments are base salary plus annual bonus followed by base salary only (see Exhibit 3).
- Most companies utilize target bonus for purposes of calculating severance.
- The most common cash CIC severance multiple is between 2.0x and 2.99x, inclusive (see Exhibit 4). The energy industry provides the largest severance multiples.

Exhibit 3: Compensation Definition for Cash Severance Payments



[4] "U.S. Say-on-Golden Parachute Failure Rate & CEO Golden Parachute Values in 2022." ISS Insights, March 9, 2023, https://insights.issgovernance.com/posts/u-s-say-on-golden-parachute-failure-rate-ceo-golden-parachute-values-in-2022/.

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Exhibit 4: Cash Severance Payments

CASH SEVERANCE PAYOUT FOR CEOs BY CAPITALIZATION					
Capitalization Size	< 1x	≥ 1x and < 2x	≥ 2x and < 3x	3x	Other
Small	0%	5%	76%	23%	5%
Mid	0%	14%	81%	14%	5%
Large	0%	5%	42%	33%	5%
Mega	9%	5%	42%	42%	0%
Average	**2%**	**7%**	**60%**	**28%**	**3%**

CASH SEVERANCE PAYOUT FOR CFOs BY CAPITALIZATION					
Capitalization Size	< 1x	≥ 1x and < 2x	≥ 2x and < 3x	3x	Other
Small	5%	29%	54%	5%	9%
Mid	0%	54%	54%	10%	9%
Large	0%	15%	44%	20%	0%
Mega	10%	20%	54%	15%	0%
Average	**4%**	**29%**	**51%**	**12%**	**4%**

There are generally three types of CIC vesting triggers for equity awards:

- Single—only a CIC must occur for vesting to be accelerated.
- Double—a CIC plus termination without cause or resignation for "good reason" must occur within a certain period after the CIC. (Sometimes companies allow for single-trigger vesting if the acquiring company does not assume the equity awards, but require double-trigger vesting if the awards are assumed by the acquirer. For the purposes of the study, this treatment was included in the double-vesting category.)
- Discretionary—the Board has the discretion to trigger the payout of an award after a CIC.

Unvested equity awards with a double trigger (CIC and termination of employment) continue to dominate the market, while single trigger acceleration continues to be phased out. We have observed a steady increase in the prevalence of double trigger vesting over the years; we attribute the shift toward double trigger vesting to pressure from shareholders and shareholder advisory services. In fact, single trigger equity acceleration was the most prevalent reason cited by the ISS for voting against golden parachute payments in 2021 and 2022 (57 and 70 percent, respectively); however, in each case it was not the sole reason identified. Another key issue with respect to equity acceleration mentioned by the ISS was above-target acceleration of performance equity awards; many times, the company did not disclose a compelling reason for these awards to vest above target, according to the proxy advisory firm.[4]

Golden Parachute Tax Planning and Mitigation

Market-based CIC arrangements can be an effective way to attract qualified candidates and to have them invested in the success of the business, incentivizing executives to evaluate every opportunity (including a merger or acquisition) with an eye toward maximizing shareholder value, without worrying about how such an event will affect their personal circumstances.

However, when a CIC does occur, the CIC arrangements may trigger payments which could subject both the corporation and key executives to significant adverse tax consequences under the Golden Parachute provisions of the Internal Revenue Code (Sections 280G and 4999). Therefore, it is critical that in addition to benchmarking existing CIC arrangements, boards continuously monitor golden parachute payments and analyze excise tax mitigation alternatives to minimize the tax impact a CIC will have on the corporation and its key executives, particularly for public companies.

Before looking at excise tax mitigation alternatives, it is important to understand the Golden Parachute Rules. When a corporation is acquired by another company, both the corporation and certain employees (generally top executives) could become subject to significant adverse tax consequences under the Golden Parachute provisions of the Internal Revenue Code (the "Code"). Under these provisions, a payment to an executive exceeding the Golden Parachute safe harbor limit triggers significant or potentially large tax consequences to both the corporation and key executives. Depending on the circumstances and the number of executives affected, the cost to the company and the executives could be substantial.

The safe harbor limit is equal to 300 percent of the executive's average gross compensation over the five most recent calendar years ending before the date of the CIC. The most typical situations where the Golden Parachute penalties could be triggered include:

- a company has significant equity-based compensation awards outstanding (e.g., stock options, restricted shares, performance shares, stock appreciation rights) that accelerate upon a CIC;
- severance payments are triggered by a CIC; and

Exhibit 5: Excise Tax Scenarios

	Scenario 1 No Golden Parachute Penalty	Scenario 2 Golden Parachute Penalty
Total compensation paid in connection with the CIC	$ 1,499,999	$ 1,500,000
Average "Base Compensation" received in prior 5 years	$ 500,000	$ 500,000
280G Threshold	$ 1,499,999	$ 1,499,999
Over 280G Threshold?	No	Yes
Amount over/under 280G Threshold	$ -	$ 1
Excess parachute payment	N/A[1]	1,000,000
Excise Tax penalty to executive (20%)		200,000
Initial lost tax deduction to corporation (21%)		210,000
TOTAL COST TO EXECUTIVE & CORPORATION		$410,000[2]

[1] In scenario 1, excise tax is not imposed on the executive and the corporation retains the full tax deduction since payments do not exceed the golden parachute "safe harbor" limit.

[2] In scenario 2, the payment of an additional $1 causes the executive to be liable for a $200,000 penalty and the corporation to lose $210,000 in tax benefits.

- there are new hires or newly promoted executives whose base amounts do not yet reflect their current position.

When the executive receives payments exceeding the safe harbor limit, the Code imposes a 20 percent excise tax on the executive, and no deduction is allowed to the corporation. Consequently, the corporation would be liable for the excise tax penalty to the executive, the lost corporate deduction, and all federal and state income taxes that the executive would be required to pay related to the excise tax. These tax consequences could occur even if the key executive remains employed with the company.

Exhibit 5 illustrates how a parachute payment to an executive can potentially cost the corporation and / or the executive hundreds of thousands of dollars.[5]

In the past, key executives may have had a clause in their employment contracts stating the corporation must “gross-up” the executive for any Golden Parachute excise tax. However, due to external scrutiny, excise tax gross-up provisions have been steadily declining year over year; consequently, other excise tax mitigation concepts should be explored.

Reasonable compensation analysis is a commonly utilized mitigation tool, whereby a portion of the total parachute payments is attributed to reasonable compensation for services rendered either before or after the CIC.

Alternatively, rather than focusing on the value of parachute payments, base amount planning can help increase an executive’s safe harbor limit. This is only an option if it is known far enough in advance that a CIC will occur in a future calendar year. It would be advantageous to include as many payments as possible in a disqualified individual’s income in the calendar year prior to the calendar year in which the CIC is expected to occur. This will increase the base amount and Section 280G threshold of the disqualified individual, which can lower or possibly eliminate any excess parachute payments. Limitations imposed by Section 409A should be considered when accelerating any payments.

For private companies, the process can be less strenuous. If 75 percent of shareholders approve the payments, then the Golden Parachute payments may be paid in full without violating Code Sections 280G and 4999. However, the rules on this “cleansing vote” are very specific and adequate disclosure must be made to shareholders, therefore it is critical to plan ahead in order to not miss out on this planning opportunity.

The Intersection of Bankruptcy and Executive CIC Benefits

For restructuring professionals, executive CIC benefits will come into play in three key areas as they help companies through bankruptcy: (1) permissible severance in the chapter 11 context, (2) the development of management incentive plans (MIPs) to incentivize executives and other key employees of the go-forward entity, and (3) negotiation of appropriate compensation terms for go-forward employment arrangements, including severance and CIC benefits.

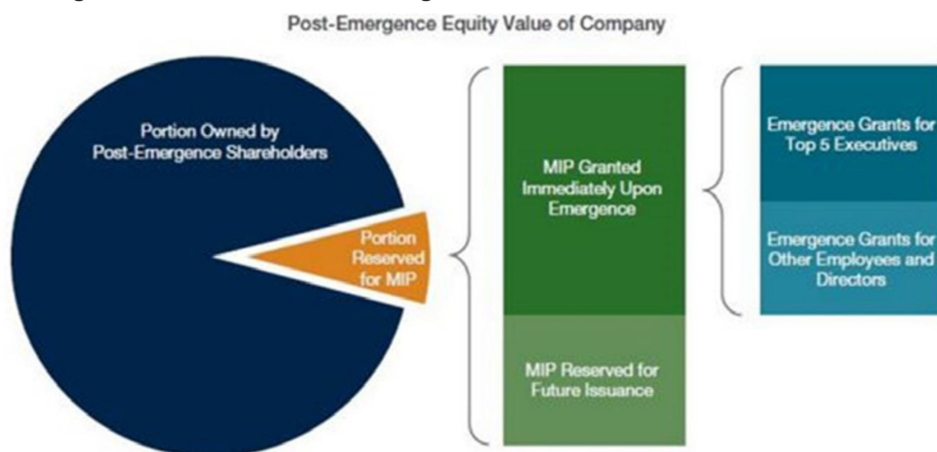
Boards of directors should familiarize themselves with the restrictions around severance in a chapter 11 context. The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), which passed in April 2005 and went effective in October 2005, greatly limits severance payments to insiders (which likely includes the top executives) during bankruptcy proceedings. A bankruptcy court may not approve severance payments to an insider unless the court determines that the following two criteria have been met:

- The severance payment must be part of a program that is generally available to all full-time employees; and

[5] J.D. Ivy, “Section 280G Excise Tax Planning and Mitigation,” Alvarez & Marsal | Management Consulting | Professional Services, May 6, 2021, https://www.alvarezandmarsal.com/insights/section-280g-excise-tax-planning-and-mitigation.

Continued from p.39

Exhibit 6: Illustration of Management Incentive Plan for Emergence



- The amount of the severance may not be greater than ten (10) times the average severance payment given to non-management employees during the same calendar year. [6]

Severance plans for non-insiders are fairly common in bankruptcy if they are the continuation of an existing broad-based program. Ahead of a potential bankruptcy filing, boards should evaluate whether or not (1) existing severance plans should be continued, (2) informal severance practices should be formalized and documented, and/or (3) new severance plans should be implemented to assist with retention efforts in a challenging environment.

The development of MIPs is a key consideration as equity incentives are typically wiped out as part of the chapter 11 process, leaving executive management with a lack of meaningful ownership in the emerging entity. To quickly align the interests of management and shareholders, companies typically establish a MIP that carves out a percentage of the company's equity to be reserved for grants to management at or after emergence (Exhibit 6).

Given that companies emerging from bankruptcy are more likely targets of potential acquirers as well as the recent uptick in consolidation in certain industries, executives are keenly aware of the risks of a takeover. When deciding the terms and provisions of executive MIP grants, it is prudent for advisors to keep the following in mind:

- Grants should be large enough to create a meaningful alignment between the interests of executives and shareholders.
- Consideration should be given to the appropriate accelerated vesting provisions in the event of involuntary termination following a change in control of the company.
- Market practices vary greatly depending on whether the company is publicly traded or not after emergence, its industry and its size, so it is critical to understand the market for the specific company.

MIPs generally consist of stock options, stock appreciation rights (SARs), time-vesting restricted stock or restricted stock units (RSUs), and performance-vesting awards (i.e., awards that vest upon satisfaction of some performance criteria rather than solely based on the passage of time). Some continuing trends with regards to these awards are:

- Time-vesting restricted stock / RSUs and performance-vesting awards remained the most prevalent vehicles year-over-year.
- Stock options / SARs are the least prevalent long-term incentive vehicles utilized, as they provide little to no value to an executive in a down or flat market, which reduces (or eliminates) the retentive value of this type of award.
- Most companies that utilize performance-vesting awards or stock options also grant time-vesting restricted stock or RSUs to maintain the retentive impact of their long-term incentive program.

If the board's strategy is to immediately solicit a buyer, additional consideration should be given to granting full value awards – such as restricted stock or restricted stock units – as opposed to stock options that generally require time to generate appreciable value. It may also make sense to choose to grant time-vesting, as opposed to performance-vesting, awards due to the favorable valuation rules available under the Golden Parachute regulations – potentially limiting additional excise tax on the executive and lost compensation tax deductions for the company.[7]

Finally, while equity awards may often provide the greatest benefit value to executives after emergence, severance payments should not be forgotten as executives will be focused on such provisions given the uncertainty around the company and their specific role. Companies looking to emerge may want

[6] See 11 USC § Section 503(c)(2).

[7] J.D. Ivy, Allison Hoeinghaus, and Brian Cumberland, "Trends in Distressed Compensation: Oil & Gas Companies Shift Focus to Retention as Covid-19 Remedy," *AIRA Journal* Vol.33: No.4 (2020), 18-21.

to benchmark their CIC provisions to ensure the programs being implemented align with market conditions and practices. This is vital in balancing demand from executives for proper incentives with support from new ownership, ensuring a smooth transition for the organization.

Conclusion

While CIC arrangements face increased scrutiny from regulators, shareholder activists, and others, additional strategic reasons exist for management and compensation committees to provide and benchmark executive CIC payments. By addressing CIC provisions in executive compensation packages, boards can be assured that executives will be more likely to approach the intricacies of deal negotiation without the distraction of personal considerations. However, it is critical to understand the impact of the Golden Parachute tax rules on such provisions and periodically reevaluate the potential tax exposures as circumstances shift over time. Bankruptcy adds another layer of complexity that must be addressed, but it is also a natural time to re-set CIC and severance provisions to ensure they are appropriate given the new go-forward entity.

Executive CIC benefits are likely to continue to be a hot-button issue for the foreseeable future, but with good planning and preparation, boards can ensure proper alignment among the various parties, maximizing value for all stakeholders.

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PRIMING TRANSACTIONS: POTENTIAL TAX CONSEQUENCES

Zamira Hussaini, Michael Barton, CIRA, and Patrick M. Phillips
RSM US LLP

In recent years, cash-strapped borrowers have begun using a new technique to increase liquidity, which is known as a "priming transaction."[1] In a priming transaction, the borrower negotiates with the majority debt holders to amend the existing debt/loan agreement to issue new senior debt.[2] In these transactions, the majority debt holders usually fund the new senior debt with cash or exchange their existing debt with new senior debt. These transactions are performed without the participation and consent of the minority creditors, resulting in the minority creditors' debt becoming subordinated to the new debt. As a result, some minority debt holders brought suits claiming breach of contract and "breach of the implied duty of good faith and fair dealing."[3]

In a few of these cases, the court sided the majority debt holders. In 2018, Murray Energy Holdings ("Murray"), through a modified Dutch auction, replaced its existing debt issued under its 2015 agreement with a new superior debt.[4] The agent representing the minority lenders brought suit challenging the 2018 agreement's validity as "a modified Dutch auction,"[5] and as such, the debt subordination required the consent of all the lenders.[6] With regard to the violation of the modified Dutch auction, the court stated that issue needed to be resolved at trial and not under a summary judgement motion.[7] However, the court concluded that the debt subordination was not equivalent to a collateral release that would require the consent of all the lenders, and that the parties did not specify such a requirement in the credit agreement.[8] As such, the "priming" was upheld.

In a similar case, *In re* TPC Grp. Inc. (TPC), the debtor issued a senior note, "the 10.875% Notes" which took priority to the lien securing TPC`s existing notes, "the 10.5% Notes.[9] Some of the minority noteholders of the 10.5% Notes challenged the uptiering transaction arguing that any changes to the existing debt required the vote or consent of all the 10.5% noteholders, because the change adversely affected them. The Delaware Bankruptcy Court, however, found that the issuance of the new senior note did not require the vote of 100% of the existing noteholders. The court in that case found that a "sacred rights" provision within the 10.5% Note agreements protected the rights *among* the 10.5% Note holders and did not rise to the level of an anti-subordination clause.

In contrast, the New York Supreme Court and the United States District Court for the Southern District of New York denied motions to dismiss objections to the uptiering transaction in the Not Your Daughter`s Jeans (NYDJ)`s case. In 2017, the minority lenders sued the majority lenders in the case, arguing that the majority lenders conspired to prioritize their own debt in bad faith and without the knowledge and assent of the minority lenders.[10] The court declined the majority lender's motion to dismiss, as they preliminarily found the uptiering arrangement to be unreasonable and unfair.[11]

Trimark,[12] Serta,[13] and Boardriders[14] also engaged in similar priming transactions where the minority lenders, among others, brought arguments of bad faith, violation of sacred rights, and most importantly, breach of contract claims. The courts in all three cases denied the motions to dismiss by the majority and mainly allowed the breach of contract claims to go forward.[15]

Debt Modifications

As discussed above, due to current economic or other challenges, debtors may negotiate with their lenders to amend existing debt

[1] *See* Douglas Mannal, Stephen Zide, and Isacc Stevens, "Liability Management Transactions (Part I): Uptier Transactions," *Dechert LLP*, November 2022.

[2] Daniel S. Shamah and Jennifer Taylor, "Priming Transactions Update: Boardriders," omm.comm, October 25, 2022.

[3] Ibid.

[4] Seth E. Jacobson, et al, "Unhappy Lenders Challenge Aggressive Debt Exchanges," Skadden.com, January 19, 2022.

[5] *See, e.g.*, https://seekingalpha.com/article/3913576-modified-dutch-auction-tender-offers-and-ways-to-profit, for a discussion regarding the mechanics of a modified Dutch auction.

[6] Douglas S. Mintz, Ned S. Schodek, and Peter J. Amend, "Recent Challenges to Uptiering Transactions," *American Bankruptcy Institute Journal*, December 2022, available at https://www.srz.com/resources/recent-challenges-to-uptiering-transactions.html.

[7] Ibid.

[8] Ibid.

[9] Kizzy Jarashow, et al, "TPC Bankruptcy and District Court Opinions Uphold Uptiering Transaction and Teach an Important Lesson on the Need for Express Lender Protections in Debt Documents," goodwinlaw.com, August 17, 2022, https://www.goodwinlaw.com/en/insights/publications/2022/08/08_17-tpc-bankruptcy-and-district-court-opinions.

[10] Octagon Credit Inv., LLC v. NYDJ Apparel, LLC., et al., No. 656677/17 (N.Y. Sup. Ct. 2018).

[11] Ibid.

[12] Audax Credit Opportunities Offshore Ltd., et al. v. TMK Hawk Parent, Corp., et al., 150 N.Y.S. 3d 894 (N.Y. Sup. Ct. 2021).

[13] LCM XXII Ltd., et al. v. Serta Simmons Bedding, LLC, No. 21-cv-3987, 2022 WL 953109 (S.D.N.Y. Mar. 29, 2022).

[14] ICG Global Loan Fund 1 DAC, et al. v. Boardriders, Inc., et al., No. 655175/20 (N.Y. Sup. Ct. 2018).

[15] Ibid; to read more about these four cases, please refer to the excellent article by Douglas Mannal and Stephen Zide, "Liability Management Transactions," *AIRA Journal* Vol 36: No 2, 2023, 44-49.

agreements or to exchange the existing debt with a new debt. To the extent that the debt amendment or the exchange leads to a significant modification, the debtor may incur Cancellation of Debt Income (CODI), as described below.[16]

Under Section 1.1001-3(c) of the Treasury Regulations (Treas. Reg.), modifications could include deferral of payments of interest and extension of maturity, interest holidays, changes in interest rate, subordination of debt, reduced collateral on debt, and change from recourse to nonrecourse.[17] Treas. Reg § 1.1001-3(b) states that a "modification is significant only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant."[18]

Significant modifications, among others, includes change in obligor or security.[19] Treas. Reg § 1.1001-3(e)(4) defines significant modifications for both recourse and non-recourse debt instruments. Based on Treas. Reg § 1.1001-3(e)(4)(iv)(A), a modification is significant when it "releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument" and it results in a change in payment expectations.[20]

Moreover, Treas. Reg § 1.1001-3(e)(4)(v) further specifies that a "*change in the priority* of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations."[21] Change in payment expectations occurs if the obligor`s capacity to satisfy the obligations that was speculative prior to the modification is substantially enhanced.[22] The change in payment expectations could also happen when there is substantial impairment in the obligor`s capacity to pay the debt obligation and the capacity is speculative while it was adequate before the modification.[23] Thus, a change to one debt instrument outstanding may impact the payment expectations of others, as could be the case if a majority lender enhances its priority.

The reason why it is important whether a debt modification is significant or not relates to the tax consequence of the modification. As mentioned above, if it is determined that a modification in a debt agreement is significant, it results in CODI. Note that if a modification is considered to be significant, it could result in CODI on *all* debt, even debt that is not modified.

Cancellation of Debt Income Concerns[24]

When a debt-for-debt exchange occurs, the old debt is treated as satisfied for an amount equal to the issue price of the new debt.[25] For debt that is not traded on an established market (i.e., is not publicly traded), the regulations provide a favorable rule to determine the issue price, which generally results in little or no CODI. When debt that is not publicly traded is modified, resulting in a debt-for-debt exchange, the issue price is generally equal to its principal amount, provided it bears adequate stated interest.[26] This generally results in debt being satisfied for the face amount even if the value is significantly less.

However, where the debt exceeds $100 million and is publicly traded, the potential for a CODI event increases significantly. The definition of publicly traded debt is much broader than some may think.[27] To the extent the debt is publicly traded, the debt is treated as satisfied for its fair market value, which if less than the face amount, will result in CODI. Assuming that the debtor is a solvent company that is not in a bankruptcy proceeding, this CODI is generally taxable income and not eligible for exclusion.

Application to Priming Transaction

It is unclear whether priming transactions could result in a significant modification of subordinated debt under the Treas. Reg. § 1.1001-3(e)(4). Based on the above analysis, a significant modification *may* occur in priming transaction, because, as stated under Treas. Reg. § 1.1001-3(e)(4)(iv)(A), the same collateral is used to secure the new debt results in subordinating the existing debt. As such, based on Treas. Reg. § 1.1001-3(e)(4)(v), the new debt in a priming transaction is given priority over the existing debt by giving the majority debt holders the right to a claim on the collateral before the existing or minority debt holders. Note that debtors may be variously (i) secured, (ii) partially secured, or (iii) unsecured, based on the FMV of the underlying collateral, which can shift in value over time.

In accordance with Treas. Reg. §§ 1.1001-3(e)(4)(vi)(A)(1) & (2), a priming transaction can also result in changing the expectations of the debt holders to be paid in full or in part. For the majority debt holders, as the holders of the new debt, the capacity of the issuer may be enhanced. However, for the minority debt holder(s), the capacity of the issuer is usually impaired as they will not be paid until the majority debt holders are paid. Though not a specific modification to the minority holders' debt instruments, arguably their payment expectations have changed. The substantial impairment of the debtor`s capacity relating to changes in payment expectations can be even more apparent in bankruptcy cases, two of which are discussed above: Murray and TPC. In such cases, the minority debt holders may not even be paid in part or in whole if the collateral is not sufficient to satisfy more senior claims.

In the event that a priming transaction results in a significant modification, the debtor likely recognizes CODI as a tax consequence if the debt is publicly traded.

For example, assume the adjusted issue price is $120M and the FMV on the transaction date is $20M. If the debt is publicly traded, and the debtor is not insolvent (or in bankruptcy), the debtor would recognize $100M of CODI and the creditor would likely receive a correlative bad debt deduction.

[16] Ibid, 12.
[17] Reg. section 1.1001-3(c).
[18] Reg. section 1.1001-3(b).
[19] Reg. section 1.1001-3(e).
[20] Treas. Reg. § 1.1001-3(e)(4)(iv)(A).
[21] Treas. Reg. § 1.1001-3(e)(4)(v).
[22] Treas. Reg. § 1.1001-3(e)(4)(vi)(A)(1).
[23] Treas. Reg. § 1.1001-3(e)(4)(vi)(A)(2).
[24] Adapted from https://rsmus.com/insights/tax-alerts/2023/tax-considerations-of-consent-fees-paid-to-modify-a-debt.htm.
[25] Section 108(e)(10).
[26] Sections 1273(b)(4) and 1274.
[27] For a more detailed discussion on this issue, refer to the following article regarding modifying debt over $100 million: https://rsmus.com/insights/tax-alerts/2020/debt-modifications-during-the-covid-19-crisis.html.

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However, please note that this analysis is very dependent on the facts and circumstances relating to a particular debt instrument and whether a debt is recourse or nonrecourse. Debt agreements are negotiated in arms-length transactions and the fact that a modification is significant or not depends on the terms and conditions of each agreement.

Conclusion

Priming / uptiering transactions are a new and evolving area of law. No cases have yet reached ultimate disposition relating to priming transactions—nor by inference is there meaningful guidance relating to the tax consequences if a plaintiff were to prevail in such a case. However, it is logical to assume that if a creditor prevails in such a case, there may be a significant modification to the underlying debt instrument—with resulting tax consequences to both debtor and creditor. The tax consequences would be very dependent on the facts and circumstances relating to a particular debt instrument. As such, consulting with experienced tax advisors and legal professionals would be critical in determining the tax consequences of significant modification relating to a priming transaction.

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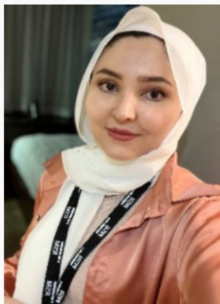

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Resident Scholar, *continued from p. 7*

diligent, careful of heart and deed, and protective of our client's confidences. That is asking a lot of someone, and we expect it from all of us. Fifth, while living our best life, we must be diligent in our business and personal affairs, to exercise our "superpowers" only for good, to refrain from harassing or intimidating people in person or online. Sixth, we must dedicate ourselves to respect the system in which we operate, for no system, no matter how intricate, complex, nuanced, or thoughtful in design, can be better than the people who work within it. Seventh, we must commit ourselves to further the "public's understanding of and confidence in the rule of law and the justice system because legal institutions in a constitutional democracy depend on popular participation and support to maintain their authority."[16] Finally, we play a vital role in the preservation of society. We are the guardians at the gates of justice and the rule of law, particularly where debtor and creditor confront each other. Kid you not, that fragile partition that rests between civilization and barbery can vanish in a wisp, leaving us to the whims of a society of injustice and, ultimately, inhumanity.

Now, are all those characteristics and attributes of who we are as a profession nothing more than myths, folklore, feel-good stories, stories of fantasy and not fact? Possibly. Even likely. Yet, we must believe because these are the things worth believing in. Nothing captures my feelings more eloquently on these questions than Robert Duval, speaking on a related topic in an enchanting movie entitled "Secondhand Lions." Hub McCann (Duval) speaks to his great nephew, Walter (played by Haley Joel Osment), about what a young person needs to know to become an adult in full. The problem is Walter has been lied to so often he does not know what to believe. This is what Hub shares with Walter:

> Sometimes the things that may or may not be true are the things a man needs to believe in the most. That people are basically good; that honor, courage, and virtue mean everything; that power and money, money and power mean nothing; that good always triumphs over evil; and I want you to remember this, that love... true love never dies. You remember that, boy. You remember that. Doesn't matter if it's true or not. You see, a man should believe in those things, because those are the things worth believing in.[17]

This is an introduction to the "Greater Why." What is your "Lessor or Personal Why?" What must you believe in, whether it is true or not, because those are the things worth believing in for you?

The importance of the lesser "why"

My personal refinement of the importance of professional character and virtues, echoing Chief Justice Sharswood, is anchored to the fundamental attribute of trust. I learn with my students that trust may be approachable from the perspective of several layers of refining attributes that magically open, like the enchanting matryoshka or nesting doll, as we explore professionalism. Trust's initial simulacrums are truth, candor, and collaboration. Both Sharswood and the ABA Model Rules would recognize these attributes of good character (Sharswood) or ethical behavior (ABA Model Rules). Trust's immediate simulacrums are accuracy and sincerity (derived from truth), good faith and kindness (derived from candor), and respect and vulnerability (derived from collaboration). As mediate simulacrums, accuracy begets competency and objectivity, sincerity begets genuineness and purity, good faith begets honesty and integrity, kindness begets beneficence and sympathy, respect begets humility and loyalty, and vulnerability begets sympathy and openness. Comforting, Chief Justice Sharswood's eight attributes of good character fit snuggly within the attributes of trust as I see it, as do many of the rules in the ABA Model Rules.

We can, if devoted, acquire considerable knowledge about character and ethics, the practice of law, accounting, finance, and many other things from books, social media, courses, and many other sources. While knowledge is necessary, it is not sufficient to lay the foundation of Sharswood's professionalism. Professionalism is dynamic and transformative. It represents a long slog from knowledge to experience, and, ultimately, to wisdom. But how does one proceed from knowledge to experience to wisdom. We all need a bridge that tutors us as we acquire our knowledge and experience and helps us forge that coupling into wisdom. That bridge, which influences but does not control us, is mentorship.

I began this essay by introducing Chief Justice George Sharswood and his eight attributes of good character on the road to legal greatness. He helped us explore the "greater why" and how that helps us as a profession develop and test good character and how to approach transformative mentorship. Let me share with you the "lesser why," my personal "why," as I strive to develop my character as a person and professional and guide my management of time and space between my students, colleagues, and me. I have eight rules that in subtle ways mirror Sharswood's eight attributes of good character and my taxonomy of eight entries depicting mentorship.[18] These eight friends are not mine alone, they have been developed and shared with me by my mentors, and I claim no ownership as I share them with you. I believe in them even if they may or may not be true because they are, to me, the things worth believing in.

1. **A wise person finds comfort in uncertainty.** Jonathan Sacks often shared, "I believe that faith is not certainty, but the courage to live with uncertainty."
2. **It takes few words to speak the truth.** Neetesh Dixit wrote, "The worst distance between two people is misunderstanding."
3. **The opposite of fear is not courage; it is faith.** As George Adair said, "Everything you have ever wanted is on the other side of fear."
4. **Make mistakes and never let those mistakes define who you are.** As Richard Feynman wrote, "Your mistakes don't define who you are. It's what you do after you have made the mistakes that makes all the difference. Every mistake

[16] ABA Model Rule, Preamble [6].

[17] Secondhand Lions (2003 comedy/drama, directed by Tim McCanlies, New Line Cinema).

[18] The number "eight" is not lost on me. Eight, across many cultures, represents the cosmic balance and central equilibrium. Jean Chevalier and Alain Gheerbrant, The Penguin Dictionary of Symbols 342 (John Buchanan-Brown (trans.) 1996). Neither is the *gematria* of the number of the last footnote in this essay.

Continued from p.45

you make is a learning experience. They don't make you less capable. But it's how you correct them or learn from them

5. **The goodness of a people cannot be undone by the deeds of a few.** My mentors often shared this with me, and I forget the original source. Its meaning is profound, and its wisdom grows with my age.

6. **Be kind; life is hard.** John Watson, better known by his *nom de plume* of Ian Maclaren, may have been the first to commit this idea to writing: "Be pitiful, for every man is fighting a hard battle."

7. **Leave no one behind - *Nemo resideo*.** I was taught we can thank the Roman Legion, hence the Latin, although I have no doubt in my heart it is much older than that era … much older.

8. **Although you will be tempted, don't take other people's word for what is at the top of the mountain; experience it yourself.**

Conclusion

Trust is the core of good character and the rock of professionalism. Let's take an example. Trustees are entrusted with the estate for the benefit of all parties in interest. It is not the estate that a trustee seeks to foster trust with; the beneficiaries of a trustee's acts of trust-making are the parties in interest, including the US Trustee and judiciary. A trustee administers the estate for their benefit acting as a virtuous agent, promoting the virtue of trust, being both trusting and trustworthy, and engaging in trust-making actions that promote attributes of competence, loyalty, good faith, and, where appropriate, obedience. To be sure, codes of ethics – many of which are mandatory – are not leaving the scene soon so that a trustee and other bankruptcy professionals must continue to abide by them. However, ethical codes – even mandatory ones – are not the full measure of professionalism. There may be something more, a practice of trust, that may give the practice of bankruptcy a human face and enrich our collective character as a profession and our individual character as a professional. It is a thing worth believing.

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