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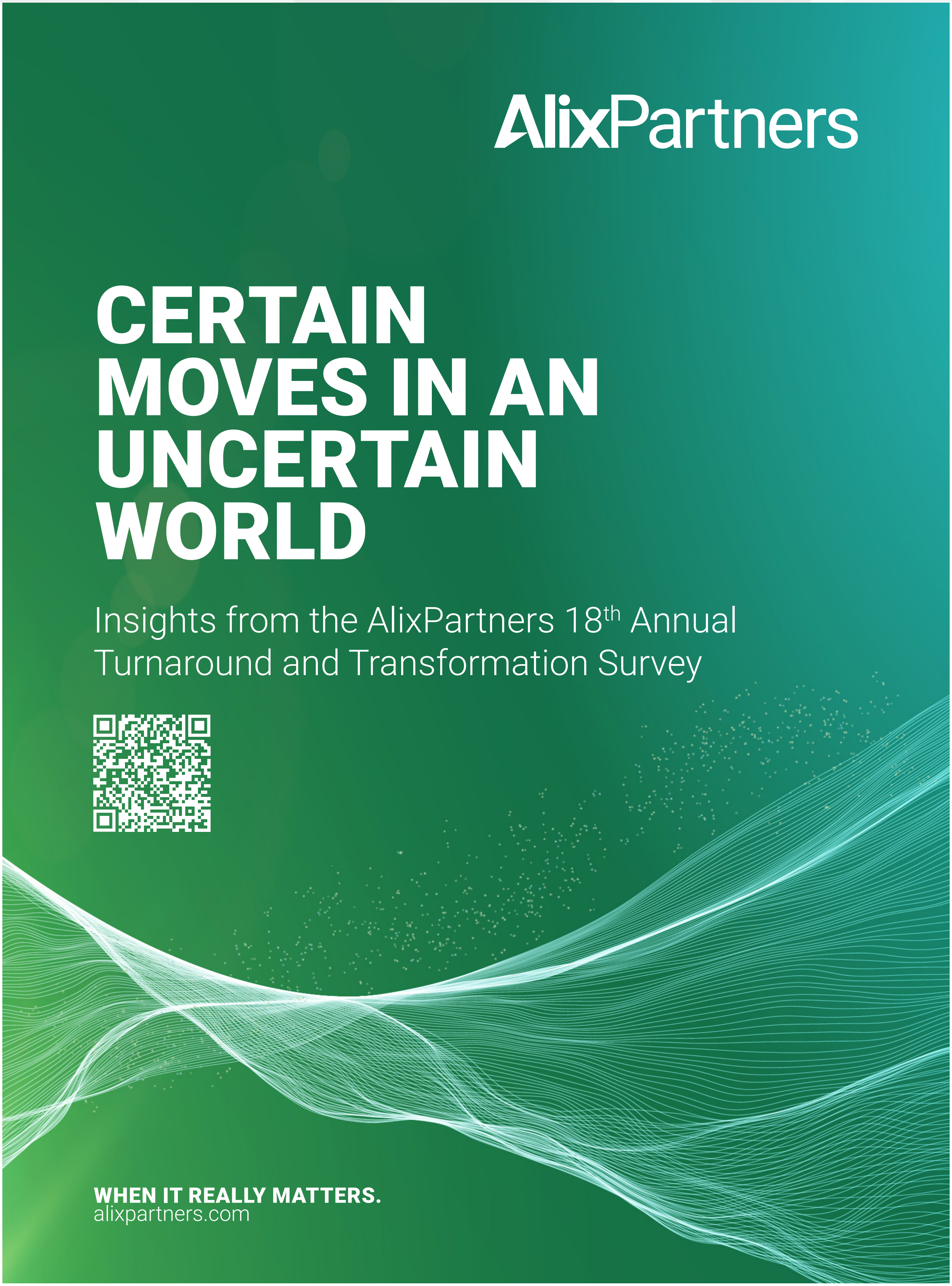
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From the Executive Director's Desk

James M. Lukenda, CIRA
AIRA

One thing we can all expect is the unexpected. Unexpected events can bring joy but just as often generate sadness, as the bankruptcy profession was reminded in April with the unexpected passing of Judge Kevin Carey. In addition to his many contributions to the legal profession and the bankruptcy court, AIRA counted Judge Carey as a friend and an AIRA Distinguished Fellow for his contributions to the association and our educational programs.

In their memorial statement Judge Carey's firm, Hogan Lovells, LLP, stated as follows:

> We are extremely saddened by the passing of our colleague, the Honorable Kevin J. Carey (ret.). Judge Carey, a lion of the bankruptcy bar, was most recently Senior Counsel in Hogan Lovells' Restructuring and Special Situations practice in the Philadelphia office. He joined the firm in 2019, following his retirement from the U.S. Bankruptcy Court for the District of Delaware, where he served for 14 years. Before being named to the Delaware Court, he served as a U.S. Bankruptcy Judge for the Eastern District of Pennsylvania from 2001-05. During his time on the bench, Judge Carey earned a reputation for being one of the leading bankruptcy judges in the U.S.
>
> Judge Carey was widely known throughout the bankruptcy bar. He was the Immediate Past President of the American Bankruptcy Institute (ABI) and sat on the Executive Committee of ABI's Board of Directors. He also was a Fellow of the American College of Bankruptcy and a member of the International Insolvency Institute, and he was the first judge to serve as global chair of the Turnaround Management Association. He lectured worldwide on bankruptcy and cross-border issues, and he taught several bankruptcy-related university programs, including at St. John's University School of Law, Temple University, and Villanova. He also was a contributing author to Collier on Bankruptcy, the leading treatise on U.S. bankruptcy law.

His colleagues at the Delaware Court characterized Judge Carey as one of the best bankruptcy judges in the history of the profession, deeply knowledgeable, and a valued colleague. Simply one of the very best people.

AIRA extends its condolences to Judge Carey's family. We will miss him.

— Jim Lukenda

A Letter from AIRA's President

Denis Lorenzo, CIRA
AlixPartners, LLP

Greetings,

The AIRA annual board meeting took place at the end of February 2024 where the Strategic Planning Committee presented potential strategies to AIRA's Board of Directors for review and approval. The Board of Directors approved that the President and President Elect move forward in selecting and establishing a Sub-Committee to move the next phase forward regarding the organization's strategic transformation. The Board will reconvene on June 5, 2024, at the Annual Bankruptcy & Restructuring Conference.

AIRA's 40th Annual Bankruptcy & Restructuring Conference will be held June 05 - 08, 2024 – Four Seasons Hotel, Baltimore, MD. The structure of the annual conference has been refreshed to provide attendees and guest speakers ample opportunity to meet and network with others in the industry with excursions being held on Thursday and Friday. The conference will provide continued in-depth education with three keynote speakers and 16 presentations on the latest trends in Bankruptcy and Restructuring.

I cannot believe it is already May and my term as President is nearly over. Eric Danner—a Partner at CohnReznick and AIRA Board member—will begin his two-year term as AIRA's President at the conclusion of the Annual Conference. I look forward to serving with Eric as Chairwoman during his term to continue to help with the next phase and implementation of the strategic plan.

In the summer of 2023, The United States Trustee Program has reached out through the AIRA BOD requesting candidates to participate in their Vignette Project of the Bankruptcy IDEAS Consortium. The Bankruptcy Inclusion, Diversity, Equity & Accessibility Consortium is a network of bankruptcy related judiciary, government, and professional organizations. This project is a compilation of interviews by bankruptcy professionals intended to provide prospective professionals a chance regarding opportunities and career options in the bankruptcy field. I would like to thank my colleague Kirsten Turnbull, Senior Vice President at AlixPartners for graciously participating in the first vignette series. The following link https://bankruptcyidea.org/insolvency-careers/ will take you to the website where you can view all the vignettes recorded.

Thank you for your continued support.

— Denise Lorenzo

Jack F. Williams, PhD, JD, CIRA, CDBV, CTP

Bankruptcy Busters

NURTURING HABITS OF THE HEART: OLD WAYS IN A NEW TIME

Professionalism is at the heart of what we do. As I have written before, to be a great professional you must first be a good person. Trust is the bedrock of professionalism, and an essential attribute at the core of good character. However, professionalism is not a destination; it is a process, a process of acquiring and nurturing good habits of mind and heart, that is, good character, and appreciating how one responds to failure and mistakes in deepening one's character. As professionals, we are humans *in* being, a work in progress, molded, like clay in the hands of a potter, by hard won and often bitter experiences, by our mistakes and how we learn from our mistakes, by those that love us and who we love in return, by those that have influenced us and who we have influenced in return, by those that care for us and for whom we have cared in return.

Professionalism and the path to wisdom

Ethical rules, milestones on the road of professionalism, help us identify the myriad of paths that lay before us, paths that are permissible and paths that are not. Ethics, however, can't answer which path to take. Which path we should take, among the multitude of ethical paths before us, is the essence of professionalism. The path we ultimately choose is influenced by our character, flavored by our teachers and coaches, and guided by our mentors. In this article, I want to share some thoughts on mentors and mentorship. I begin with the road to wisdom.

We can, if devoted, acquire considerable information and knowledge about character and ethics, the practice of bankruptcy, tax, 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 a hearty foundation of professionalism. Why not? How does one proceed from knowledge to experience to wisdom in developing good character and a robust sense of professionalism?

An answer is that professionalism is dynamic and transformative. It is the bushel of fruits harvested over a long journey from knowledge to experience, and, ultimately, to wisdom. I can think of two simple examples that help me illustrate the difference between knowledge and wisdom – they are found in Mary Shelley's *Frankenstein; or The Modern Prometheus,* and in an interview with Bruce Lee about his greatest fear.

From Mary Shelley's *Frankenstein*, that great gothic novel of horror and intrigue written by an 18-year-old, we learn to appreciate that knowledge is knowing that the monster is not Frankenstein; wisdom, however, is knowing that Frankenstein is the monster.

In a popular video interview with Bruce Lee, we learn much from his observation when he says: "I do not fear the man that knows 10,000 kicks; I fear the man that knows one kick and has performed it 10,000 times."

Thus, there is distance between knowledge and experience on the one hand, and wisdom on the other. My own experiences teach me that 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 and exemplars.

Mentorship on the transformative path to professionalism

Mentorship and exemplars, both a process and people we could trust to help us manage and master that distance from knowledge to wisdom as we mature in our profession and person. Mentorship is as old as time; recently, we have become all too comfortable with replacing mentorships with relationships (the two are not the same) and, dare I say, replacing people with technology in developing as professionals. Watching outstanding teachers imparting insights on a variety of subjects in the virtual space increases information and knowledge but will scantly move the needle when it comes to acquiring wisdom and reinforcing habits of mind and heart. Facebook mentors, like Facebook friends, are not.

Mentoring is not a new practice, but we live in a new time. It may be out of fashion, but it is not out of date. We draw from a richer, more diverse pool of immense talent with vibrant differences in personal backgrounds.[1] To add to those trials, mentees have a broader, more diverse range of alternative career paths that lead to novel challenges.[2] In the past, many of us—as mentors or mentees—viewed mentoring as an organic practice, effortless, like breathing. It is not, nor has it ever been. Mentoring is a purposeful process, a discipline applicable to all professions, neglected by many professions. It draws on a broad range of technical and analytical skills often unrecognized by even effective mentors.[3] It is service. And service, well done, is work; hard, shoulder-into-the-plow work. It is meant to be hard because good character is forged in the fires of life, and life is hard.

At some point in the development of our profession, we bypassed mentors on the road to wisdom.[4] Slowly, then quickly, we were directed away from professional relationships with people and replaced those personal mentoring relationships with codes and rules, impersonal classes, preparation courses on ethics, model multiple choice exams, continuing professional education courses, and social media. Ethics became the stuff of risk assessment and not character building. Nevertheless, many failed to yield their posts, re-dedicating themselves to continuing

[1] Kristin N. Safi, "Special Forum on Mentoring: Editor's Comments," *SAA Archaeological Record*, Vol. 14 (Sep. 2014), 15.

[2] Ibid, 15-16.

[3] Ibid.

[4] In a robust survey on the topic, 76% of people think that mentors are important, but 37% have one. For this and other fascinating empirical information on mentorship, see Grace Winstanely, "Mentoring Statistics You Need to Know – 2024," https://mentorloop.com/blog/mentoring-statistics/.

the mentoring process, dedicated to advancing and influencing the next great generation of professionals despite the strong headwinds prevalent in the obsession with ethics as a system of risk management and not as a process of building content of character.

Covenantal relationships change the character of people

Ours is a covenantal profession with our clients, other professionals, and the court. Mentorship is also a covenantal relationship. And covenantal relationships are based on something fundamentally greater than a promise. What's the difference?

A promise carries with it a moral obligation, as well as a legal one in some instances. We are taught to keep our promises, that it is moral and right and just to keep one's word. As important as keeping one's word may be, we don't think of the relationship borne of a promise as transformative. In contrast, a covenant is different. It is a performative utterance. It is a verbal act that is transformative, that changes the status of the parties to the covenant in fundamental ways.[5] Let me share with you a few examples that may flesh out what I mean.

Promise: I promise to pick up some milk and eggs on the way home from work. I should strive to keep that promise. If I fail, and we all do at times, I sincerely apologize and try to make it right. In a more formal setting, I may borrow some money and promise to repay that money, memorializing that promise in a promissory note that I signed. I should try to keep that promise and folks most often do. However, some do not. The law may provide a remedy. Both types of promises should be fulfilled, but if they are not, either by mistake or default, we try to make them right as best as we can and go on with life.

Covenant: I promise to love, honor and cherish until death do us part. I swear (or affirm) to tell the truth, the whole truth, and nothing but the truth. I do solemnly swear (or affirm) that I will support and defend the Constitution of the United States against all enemies, foreign and domestic … In all three cases, something more than a promise arises; the status of the individual has changed. That is the key difference between a promise and a covenant. A covenant is personally transformative.

Mentorship must be more than a promise for it to be sustainable as a force to influence good character and great professionals. Mentoring must be transformative to both mentor and mentee. It must be designed to change their status vis-á-vis each other.

Mentorship as a choice on the path of professionalism and wisdom

Mentorship is not the same as teaching or coaching, although more than one relationship may lead to another and often does. Teaching is detached and reflects a strong imbalance of positional power; and coaching often subordinates the goals of an individual to those of a team. A key characteristic of mentorship is intimacy borne of choice. As Michael Shaw has written in this context, intimacy is generated by choice, not by obligation or assignment. He further observes, "We've all had many teachers and coaches but only a few where such intimacy ever existed with *simultaneous commitment from each participant impacting each other on a deeper level*."[6]

Shaw continues with a series of keen observations that isolate mentorship from teaching and coaching.

> How then does one determine when a relationship moves from the stage of a teacher or a coach to that of a mentor? After several evenings of debate amongst friends and associates on this question of when does mentorship first take place, *I propose that a mentor/mentee relationship is born only upon termination of the initial positional authority relationship.* Only once all requirements to work or perform for someone are removed can both parties truly enter an association of intimacy. Now, this does not ignore or devalue the trust and development that existed during the initial term of professional engagement, just the opposite. Such time is critical to the development and future of the two parties. Instead, while under a hierarchical model, the passing of information or advice lacks the intimacy that must exist for mentorship to take root. Instead, teaching and coaching become the predominate and no less important or influential methods for the passing of advice and professional tools. *While we tend to want to throw the title of mentorship into this situation, the lack of choice from the advisee is the exact reason why mentoring is not taking place*.[7]

Thus, mentoring is a conversation in being between the mentor and mentee. The relationship is difficult to capture in words; it must be experienced through the application of all senses.[8] A meaningful definition is elusive; its presence is measured as much by what is absent as well as what is present. My experience has led me to develop a taxonomy of mentorship to help understand and to help implement the relationship. This taxonomy includes the following eight descriptors[9]:

- Trust and not obligation
- Intimacy and not detachment
- Influence and not control
- Transformation and not accretion
- Patience and commitment

[5] *See generally* Daniel J. Elazar, *Covenant & Polity in Biblical Israel, Volume I, Biblical Foundations and Jewish Traditions: Covenant Tradition in Politics* (Routledge: 1998).

[6] Michael C. Shaw, "What Do We Really Mean When We Say, Mentor?" April 11, 2019, https://www.greaterapplication.com/write/2019/4/11/what-do-we-really-mean-when-we-say-mentor (emphasis added).

[7] Ibid (emphasis added).

[8] David H. Dye and Marlin F. Hawley, "Mentoring Tom Lewis," *SAA Archaeological Record*, Vol. 14 (Sep. 2014), 17 – 22.

[9] To see these attributes explored in other professional contexts also struggling with mentorship, see Dye and Hawley, "Mentoring Tom Lewis"; Meghan Burchell and Katherine Cook, "The Changing Role of Mentorship in Archaeology," *SAA Archaeological Record*, Vol. 14 (Sep. 2014), 26 – 29; Joshua R. Trampier, "When the Student is Ready, The Teacher Will Appear," *SAA Archaeological Record*, Vol. 14 (Sep. 2014), 30 – 33; Kristin N. Safi, "Perspectives on Mentoring in Archaeology," *SAA Archaeological Record*, Vol. 14, (Sep. 2014), 34 – 37; Henry S. Lynn, "Training the Next Generation of Statisticians: From Head to Heart," *American Statistician*, 70: 2 (June 2016), 149-151; *see generally* "Special Section on Mentoring," *American Statistician*, Vol. 71 (March 2017), 1 – 60.

- Encouragement and guidance
- Integrity and not simply intelligence
- Character and not simply competence

Conclusion

So, the simulacrums of mentorship include trust, intimacy, influence, patience, commitment, encouragement, guidance, integrity, and character building. It is a transformative relationship that changes the very character and behavior of the mentor and mentee. It is a beautiful thing to behold. It creates a sense of inclusiveness and belonging. I dare think that many of the problems and challenges that our profession faces today are a result of the marginalization of mentorship, the nonchalant recharacterization of relationships of something much less to something much more, and the failure to value mentorship by our society. Mentoring is the most important gift we can give our profession. Let's share it in abundance. Only then do we continue to build and nurture habits of the heart.

Tell me what you think!

ABOUT THE AUTHOR:

AIRA Scholar in Residence Jack F. Williams is a professor at Georgia State University College of Law and the Middle East Studies Center. His current teaching interests include accounting & finance for lawyers; admiralty & maritime commerce; American Indian law; archaeology; bankruptcy & business reorganization; board governance & business ethics; business valuations; corporate finance; counterterrorism, intelligence & national security; forensic investigations; Islamic law & finance; mergers & acquisitions; remedies; and statistics & the law.

QUALITY OF EARNINGS ANALYSIS: WHAT BUYERS AND SELLERS NEED TO KNOW ABOUT QUALITY OF EARNINGS REPORTS

Travis W. Harms
Mercer Capital

SECTION 1: INTRODUCTION

Corporate earnings are an important guidepost to transaction prices negotiated by buyers and sellers. However, reported earnings — even when audited and presented in accordance with generally accepted accounting principles (GAAP) — have limitations. GAAP earnings are backward-looking: they report how a business has performed in the past under specific rules. GAAP earnings certainly have their uses, but buyers and sellers care about the view through the windshield, not the rearview mirror.

Credible perspectives on the future must be grounded in a reliable base of historical information. However, not every dollar of GAAP earnings is equally relevant to establishing that base. A quality of earnings ("QofE") report helps buyers and sellers discern that base of ongoing earning power relevant to establishing the transaction price. As shown in Exhibit 1, a QofE report is neither an audit, nor a projection of future results for the subject company but instead serves as a pivot between the two.

The objective of a quality of earnings report is to "translate" historical financial information into a relevant picture of earnings and cash flow that is useful in developing a credible view through the windshield.

What needs to be translated from historical performance to create a relevant picture of earnings and cash flow? There are **five broad categories of adjustments used in QofE analyses** to translate historical GAAP earnings to pro forma run rate earnings:

1. **Discretionary expenses**
2. **Unusual and nonrecurring items of revenue and expense**
3. **Timing / accounting policy adjustments**
4. **Major customer wins and losses**
5. **M&A run rate adjustments**

In Section 2 of this article, we illustrate each of these adjustment categories. Section 3 addresses the relationship between EBITDA and cash flow, illustrating working capital and capital expenditure analyses that are a critical element of QofE reports.

SECTION 2: QofE EARNINGS ADJUSTMENTS

In this section, we illustrate how earnings adjustments in QofE analyses translate historical GAAP earnings to a measure of pro forma run rate earnings that is relevant to buyers and sellers.

1. Discretionary Expenses

Private business owners occasionally commingle business and personal expenses. For example, some family businesses have employees-in-name-only that could be terminated with no effect on operations. Other businesses incur expenses that have more to do with owner lifestyle than business operations (automobiles, aircraft, vacation properties, event tickets, etc.). Such discretionary expenses depress historical earnings of the business and should be identified and documented in a quality of earnings report.

For example, Exhibit 2 summarizes reported and adjusted earnings for a family business. Three second generation family members, while titular sales managers of the business with handsome compensation packages, do not actually work in the

Exhibit 1: Audit, QofE Report, and Projections

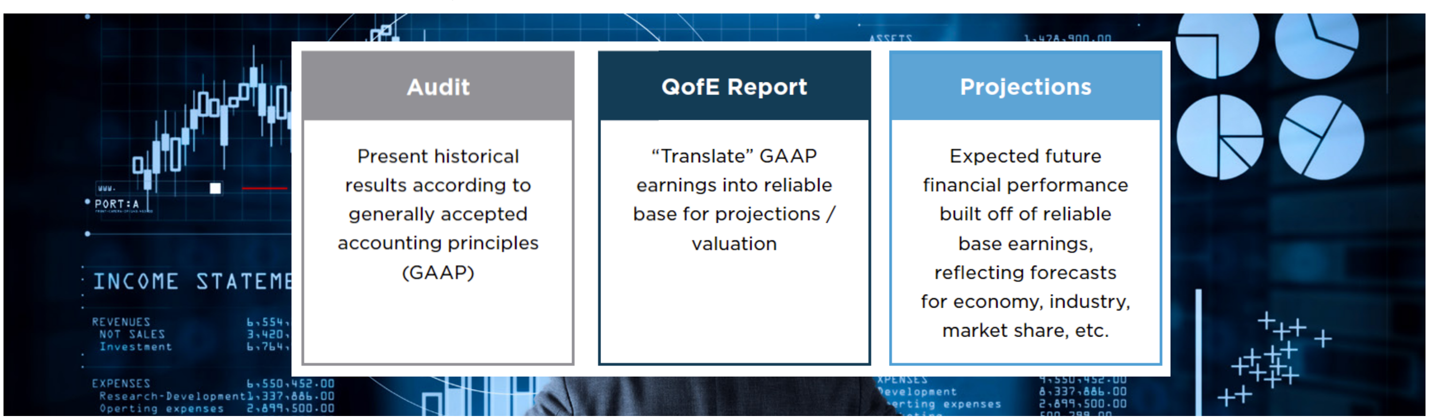


Exhibit 2: Adjusting for Discretionary Expenses

	As Reported	Discretionary Expenses	Adjusted for Discretionary Expenses
Net revenue	$249,253	$0	$249,253
Cost of goods sold	129,972	0	129,972
Gross profit	$119,281	$0	$119,281
Selling expenses	34,222	(1,500)	32,722
Research & development expenses	2,733	0	2,733
General & administrative expenses	62,582	0	62,582
Operating expenses	99,538	(1,500)	98,038
Operating income / EBIT	$19,744	$1,500	$21,244
Depreciation	5,132	0	5,132
Amortization	1,094	0	1,094
EBITDA	**$25,970**	**$1,500**	**$27,470**
EBITDA margin	*10.4%*	*nm*	*11.0%*

company and would not be retained by any buyer following a transaction. Eliminating compensation, benefits, and associated payroll taxes for these individuals from reported historical earnings yields a more accurate measure of the true earning power of the business.

2. Unusual and Nonrecurring Items of Revenue and Expense

As the maxim goes, "time and chance happens to them all." No business is immune to exogenous forces that can distort the company's reported financial performance. Business interruptions, revenue windfalls, casualty losses and the like influence historical earnings but do not affect the company's core ongoing earning power. Unusual and nonrecurring items can be either favorable or unfavorable from the perspective of historical results. A thorough QofE analysis should seek to identify such adjustments regardless of whether they increase or decrease adjusted EBITDA.

A word of caution is in order here. Identifying a business event as "unusual" or "nonrecurring" is inherently subjective. A regular or predictable pattern of unusual or nonrecurring events in the same direction can undermine the credibility of a QofE analysis. The QofE report should carefully describe the nature of the events identified as unusual or nonrecurring and offer a compelling rationale as to why the associated items of revenue and expense are not representative of the ongoing earnings of the subject company.

Exhibit 3: Adjusting for Unusual or Nonrecurring Events

	Adjusted for Discretionary Expenses	Unusual or Nonrecurring Items	Adjusted for Unusual or Nonrecurring
Net revenue	$249,253	$0	$249,253
Cost of goods sold	129,972	(10,000)	119,972
Gross profit	$119,281	$10,000	$129,281
Selling expenses	32,722	0	32,722
Research & development expenses	2,733	0	2,733
General & administrative expenses	62,582	0	62,582
Operating expenses	98,038	0	98,038
Operating income / EBIT	$21,244	$10,000	$31,244
Depreciation	5,132	0	5,132
Amortization	1,094	0	1,094
EBITDA	**$27,470**	**$10,000**	**$37,470**
EBITDA margin	*11.0%*	*nm*	*15.0%*

Continued from p.9

Exhibit 4: Adjusting for Timing/Accounting Policy Adjustments

	Adjusted for Unusual or Nonrecurring	Accounting Policy / Timing	Adjusted for Acctg Policy / Timing
Net revenue	$249,253	$0	$249,253
Cost of goods sold	119,972	1,236	121,208
Gross profit	$129,281	($1,236)	$128,045
Selling expenses	32,722	0	32,722
Research & development expenses	2,733	0	2,733
General & administrative expenses	62,582	0	62,582
Operating expenses	98,038	0	98,038
Operating income / EBIT	$31,244	($1,236)	$30,008
Depreciation	5,132	0	5,132
Amortization	1,094	0	1,094
EBITDA	**$37,470**	**($1,236)**	**$36,234**
EBITDA margin	*15.0%*	*nm*	*14.5%*

Continuing our previous example, the subject company wrote off $10 million of stale inventory to cost of goods sold during the fourth quarter. The written-off inventory was acquired as part of a failed product diversification bid that has since been abandoned. As shown in Exhibit 3 on page 9, removing the inventory write off as a nonrecurring event increases gross profit and EBITDA for the company.

3. Timing / Accounting Policy Adjustments

There is more than one way to comply with generally accepted accounting principles. Companies make a host of accounting elections (inventory accounting methods, capitalization thresholds, etc.) that do not represent deviations from GAAP, but may nonetheless warrant adjustment to enhance comparability with the accounting policies of potential acquirers.

Furthermore, despite the best intentions of GAAP, sometimes revenue and associated expenses are recognized in accounting periods that do not conform to the economic substance of a transaction. For example, if a company incurs operating expenses in one period which are reimbursed by customers in a subsequent period, it may be appropriate to adjust recognition of the events across time to represent more faithfully the economic substance of significant transactions. Such timing adjustments will, over time, net to zero.

Exhibit 4 illustrates the impact of an accounting policy adjustment. The subject company uses the LIFO (last-in first-out) method of accounting for inventory, while FIFO (first-in first-out) is the standard method in the company's industry. During the period under question, use of the LIFO method understated cost of goods sold (through liquidation of "old" LIFO layers) relative to the FIFO method favored by industry peers.

This example underscores the need for QofE analyses to consider interactions between the income statement and the balance sheet. In this case, use of the LIFO method has understated cost of goods sold on the income statement and the QofE analysis

Exhibit 5: Customer and Revenue Rollforwards

	Customer Count	Revenue	Customer Average
Prior Year Total	673	$225,634	$335
less: Lost customers	(72)	(7,436)	103
plus: Retained customers (increase)	*488*	15,992	33
less: Retained customers (decrease)	*113*	(3,167)	(28)
plus: New customers	180	18,230	101
Current Year Total	781	$249,253	$319
Lost customers / beginning total	-10.7%	-3.3%	
Revenue growth (increasing retained)		9.4%	
Revenue growth (decreasing retained)		-6.6%	
Y/Y change (excluding new customers)	-10.7%	2.4%	14.7%
Net Y/Y change	16.0%	10.5%	-4.8%

Exhibit 6: Adjusting for Mid-Year Acquisitions/Divestitures

	Adjusted for Acctg Policy / Timing	Pre-Closing Earnings of Acquiree	Pro Forma Run Rate Earnings
Net revenue	$249,253	$39,724	$288,977
Cost of goods sold	121,208	16,679	137,887
Gross profit	$128,045	$23,045	$151,090
Selling expenses	32,722	7,428	40,150
Research & development expenses	2,733	0	2,733
General & administrative expenses	62,582	8,964	71,546
Operating expenses	98,038	16,392	114,430
Operating income / EBIT	$30,008	$6,653	$36,661
Depreciation	5,132	622	5,754
Amortization	1,094	0	1,094
EBITDA	**$36,234**	**$7,275**	**$43,509**
EBITDA margin	*14.5%*	*18.3%*	*15.1%*

should evaluate whether a corresponding adjustment to the balance sheet is warranted.

4. Major Customer Wins and Losses

While nearly every business experiences some degree of "churn" in its customer base, for businesses with significant customer concentrations, adding or losing a major customer during the year may merit adjustment in a QofE analysis. To help unearth and support such adjustments, a QofE report should include a robust analysis of historical customer churn. The results of detailed customer analysis can be summarized in the form of customer count and revenue rollforwards, as illustrated in Exhibit 5.

The year-over-year revenue growth of 10.5% that can be read off the face of the income statement masks the underlying narrative that is of most interest to potential acquirers.

- Nearly 11% of customers from the prior year did not return in the current year. These lost customers were – on average – smaller than average ($103k average annual revenue vs. overall average of $335k).
- Of the customer accounts that were retained from the prior year, approximately 81% of them purchased more in the current year (an aggregate increase of 9.4%). The balance of the retained customer accounts generated less revenue in the current year (a 6.6% decrease).
- On a net basis, excluding the impact of new customers, total revenue increased 2.4% year-over-year, with the average revenue per customer increasing by 14.7%.
- The company closed on an acquisition that extended its geographic footprint and added new customers at the end of the third quarter. That acquisition accounted for a significant portion of the total number of new customers gained during the year. Since sales for the current year reflect only fourth quarter sales from the acquired customers, the average revenue per new customer ($101k) is lower than the overall average ($319k).

The company does not have any significant customer concentrations, with no single customer accounting for more than 3% of annual revenue. Aside from the impact of the acquisition, the observed customer churn was judged to be typical, so no discrete adjustment was warranted in the QofE analysis.

5. M&A Run Rate Adjustments

When companies make acquisitions, the GAAP financial results for the year of acquisition will include results for the acquired entity only from the closing date of the acquisition. Similarly, the results of divested operations are included in the financial results for the year through the effective date of the divestiture. As a result, the reported financials for the year of acquisition (or divestiture) will not reflect the true "run rate" of the business as of the analysis date.

Exhibit 6 illustrates the adjustment for the company's acquisition that closed at the end of the third quarter. To establish an annualized run rate, the income statement for the acquired company during the period leading up to the acquisition date is added.

Net Effect of QofE Adjustments

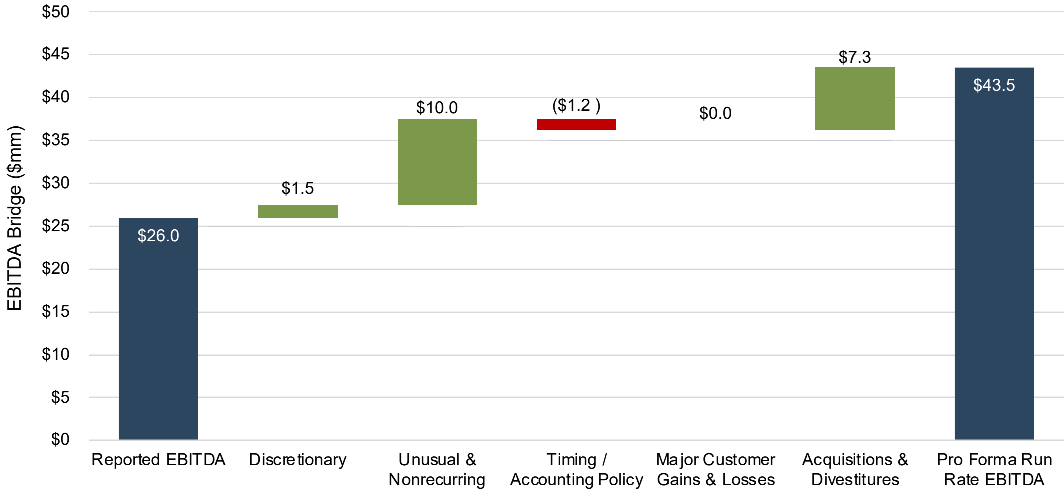
Having identified relevant (and material) adjustments of each type, it is instructive to step back and assess the overall direction and magnitude of the adjustments made. A "bridge" chart like that shown in Exhibit 7 on page 12 summarizes the adjustments made in deriving pro forma run rate EBITDA.

From reported EBITDA of $26.0 million, the QofE adjustments for discretionary expenses, unusual & nonrecurring events, and timing / accounting policy adjustments resulted in a net upward adjustment of $10.2 million to $36.2 million. Including full-year earnings for the company acquired at the end of the third quarter brings pro forma run rate EBITDA to $43.5 million.

While in compliance with GAAP, the reported EBITDA of $26.0 million was not an appropriate base from which to derive valuation indications (using guideline or single-period capitalization methods) or build an earnings forecast. For sellers, QofE analysis is an essential step in achieving transaction

Continued from p.11

Exhibit 7: Net Effect of QofE Adjustments



outcomes that reflect the true earnings potential of the business they have built. Likewise, a proper QofE analysis helps buyers maintain discipline by identifying the truly durable components of earning power for the target company.

SECTION 3: EBITDA AND CASH FLOW

EBITDA—The Principal Earnings Measure Analyzed in QofE Reports

Why do buyers and sellers focus on EBITDA?

First, EBITDA is the broadest measure of earnings and cash flow for the firm. As depicted in Exhibit 8, EBITDA is a proxy for cash flow available for a variety of purposes.

Second, referencing EBITDA promotes comparability across firms. Working up from the bottom of the income statement, EBITDA provides the most consistent measure of relative operating performance across companies by "normalizing" for how different companies are organized, financed, and assembled.

- **Income taxes.** Many private companies are organized as tax pass-through entities and therefore report no income tax expense on the income statement. Since EBITDA is calculated without regard to income taxes, C corporations and S corporations are on equal footing.
- **Interest expense.** The decision to finance operations with debt rather than equity does not directly affect the operating performance of the business. Since EBITDA is calculated without regard to interest expense, the operating performance of highly leveraged companies can be readily compared to that of companies with no debt.
- **Depreciation.** Depreciation is a non-cash charge that depends on various accounting estimates and fundamental business decisions, such as whether to own or lease productive assets. Nonetheless, while it is true that depreciation does not represent a cash flow in the current period, it does arise from a real cash outflow in a prior period, and one that will need to be repeated as the asset wears out.
- **Amortization.** Acquisitive companies recognize acquired intangible assets on their balance sheets that are subsequently written off through amortization charges on the income statement. Companies that grow organically do not incur amortization charges. EBITDA is unaffected by amortization charges, thereby putting companies that grow organically and those growing by acquisition on an equal footing. Unlike depreciable fixed assets, amortizable intangible asset generally do not need to be replaced through subsequent cash outflows.

Not all EBITDA dollars are equally valuable, however. That is why some prominent investors like Warren Buffett are dismissive of the measure. Transactions are ultimately built on cash flow, not EBITDA. Therefore, a useful QofE report will not stop at EBITDA, but will also analyze the capital investments that stand between EBITDA and cash flow.

Of the five potential uses of EBITDA noted on Exhibit 8, four are discretionary, meaning that the buyer of a business will choose how to allocate EBITDA to those purposes:

Exhibit 8: Potential Uses of EBITDA

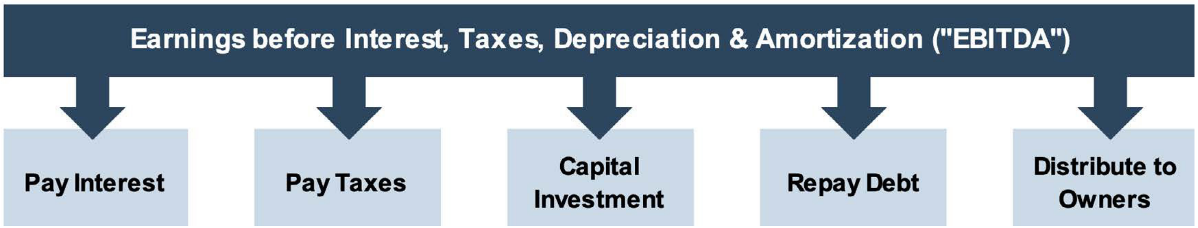


Exhibit 9: Fixed Asset Rollforward

	2018	2019	2020	2021	2022	Cumulative
Beginning balance - gross	$101,706	$121,654	$153,653	$171,019	$236,959	$101,706
plus: Capital expenditures	20,860	32,077	15,566	56,121	45,929	170,553
plus/less: Other, net	(912)	(78)	1,800	9,819	(22,279)	(11,650)
Ending balance - gross	$121,654	$153,653	$171,019	$236,959	$260,609	$260,609
Beginning balance - A/D	$27,923	$47,557	$71,043	$92,944	$117,915	$27,923
plus: Depreciation	19,573	23,197	24,616	25,732	32,889	126,007
plus/less: Other, net	61	289	(2,715)	(761)	(14,782)	(17,908)
Ending balance - A/D	$47,557	$71,043	$92,944	$117,915	$136,022	$136,022
Beginning balance - net	$73,783	$74,097	$82,610	$78,075	$119,044	$73,783
plus: Capital expenditures	20,860	32,077	15,566	56,121	45,929	170,553
less: Depreciation	(19,573)	(23,197)	(24,616)	(25,732)	(32,889)	(126,007)
plus/less: Other, net	(973)	(367)	4,515	10,580	(7,497)	6,258
Ending balance - net	$74,097	$82,610	$78,075	$119,044	$124,587	$124,587
Revenue	$778,833	$913,734	$1,091,721	$1,410,989	$1,595,222	$5,790,499
Capex / Revenue	2.7%	3.5%	1.4%	4.0%	2.9%	2.9%
Depreciation / Revenue	2.5%	2.5%	2.3%	1.8%	2.1%	2.2%
Net book value / Revenue	9.5%	9.0%	7.2%	8.4%	7.8%	
Depreciation / Beg bal (gross)	19.2%	19.1%	16.0%	15.0%	13.9%	
Accum depr as % of gross	39%	46%	54%	50%	52%	

- Interest payments depend on how a buyer elects to finance the business. If the buyer elects to finance the purchase with all equity, there will be no interest expense.
- While you can't really opt out of paying taxes, tax elections made by buyers will influence the form and magnitude of those payments.
- Debt payments depend on past and future financing decisions which are ultimately at the discretion of the buyer.
- The amount and timing of owner distributions are also at the buyer's discretion.

Since these four uses are a function of choices made by the buyer, they do not affect what a given dollar of EBITDA is worth. Capital investment, on the other hand, does influence the value of EBITDA since capital-hungry businesses with significant capital investment obligations to sustain operations generate less cash flow per dollar of EBITDA than their capital-light peers.

Capital investment consists of two components: capital expenditures and incremental working capital. A comprehensive QofE report should analyze each.

Capital Expenditures

Capital expenditures are essential to supporting a company's productive capacity. Broadly speaking, capital expenditures are required either to maintain existing capacity (i.e., maintenance expenditures) or add new capacity (growth expenditures). For capital-intensive businesses, a comprehensive quality of earnings report should distinguish between the two categories. Often, depreciation expense can serve as a proxy for maintenance expenditures when a more precise breakdown is not possible.

Exhibit 9 illustrates potential analyses around capital expenditures.

- Since capital expenditures are often lumpy, it can prove helpful to consider cumulative measure over longer periods of time. For the subject company in this example, five year aggregate capital expenditures represented 2.9% of cumulative revenue.
- For the same period, depreciation charges were equal to approximately 74% of capital expenditures, suggesting material growth expenditures.
- The efficiency of capital expenditures made can be measured by comparing the net balance of fixed assets to revenue over time. Over the period analyzed, this ratio declined from 9.5% to 7.8%, indicating improving capital efficiency.

Working Capital – Components and Cyclicality

The second component of capital investment is the annual change in working capital. Since working capital investment is sensitive to cyclical and seasonal factors, it is often appropriate to analyze working capital balances on a monthly basis. For illustrative purposes, we present a quarterly analysis for our sample company in Exhibit 10 on the next page.

The company's investment in working capital grew sharply over the two years analyzed, ballooning (as an annualized percentage of sales) from -2.2% at December 31, 2020 to 18.8% at September 30, 2022. The increase was primarily attributable to bloated inventory levels, which moderated during the fourth quarter of 2022, albeit at the expense of lower gross margin (37%, compared to 58% in 4Q21).

In addition to assessing the incremental working capital requirements over time, the working capital analysis in a QofE report is typically referenced when buyers and sellers are negotiating required working capital balances to be delivered at the closing of a transaction. These negotiations can lead to meaningful changes in the net proceeds received by sellers in transactions.

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Exhibit 10: Working Capital Analysis

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22
Accounts receivable, net	10,221	10,477	12,796	13,010	17,114	12,968	14,727	14,672	12,413
Inventory	21,892	28,738	34,635	41,558	49,823	64,537	76,565	68,663	58,033
Prepaid expenses & other	2,763	3,824	3,724	3,694	4,623	6,185	6,370	5,244	5,206
Accounts payable	(19,316)	(18,757)	(22,763)	(25,950)	(29,894)	(26,158)	(31,889)	(19,190)	(22,003)
Accrued expenses & other	(13,917)	(11,349)	(13,564)	(15,134)	(20,673)	(19,032)	(20,300)	(16,719)	(33,031)
Taxes payable	(2,862)	(3,090)	(2,489)	(1,073)	(2,268)	(2,736)	(2,662)	(1,185)	(2,389)
Accrued payroll	(4,033)	(1,572)	(3,120)	(3,830)	(4,819)	(1,163)	(668)	(506)	(757)
Net working capital	**($5,250)**	**$8,271**	**$9,219**	**$12,275**	**$13,905**	**$34,601**	**$42,141**	**$50,979**	**$17,473**
NWC / net sales (annualized)	-2.2%	5.3%	4.1%	5.4%	5.0%	18.9%	16.1%	18.8%	6.2%
Days sales outstanding	16	25	21	21	23	25	20	20	16
Days inventory on hand	85	165	137	157	156	268	222	191	122
Days payables outstanding	75	88	79	85	89	95	81	52	63
Cash conversion cycle	27	102	79	94	89	198	161	159	75

SECTION 4: CONCLUSION

Corporate transactions are "measure twice, cut once" projects. An independent quality of earnings analysis plays an important role in the transaction process for both parties.

- For buyers, a thorough quality of earnings analysis is an essential component of the due diligence process. A quality of earnings report helps the buyer maintain pricing discipline by isolating the underlying ongoing earning power from the "noise" that often accompanies historical reported earnings.
- For sellers, a quality of earnings analysis can help position the company to increase the likelihood of achieving a premium price. Commissioning a quality of earnings analysis in anticipation of a sales process helps sellers present a compelling narrative regarding the true underlying earning power of the business for competing buyers.

Quality of earnings analysis is a multi-disciplinary task, requiring expertise in financial reporting and forensics combined with the judgment and expertise possessed by professionals with decades of experience in valuation and investment banking.

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VALUING THE DEBT INTEREST TAX SHIELD[1]

Steve Cooper

The fact that the cost of debt finance is tax deductible, whereas the cost of equity is not, seems to give a structural advantage to debt finance. The value (if any) of this 'tax shield' is either an explicit or, more likely, implicit component of any equity valuation.

The most common calculation of the value of the debt interest tax shield understates value by ignoring growth but potentially overstates value by ignoring the effect of personal taxes. We explain how to incorporate these often-ignored factors in your analysis.

Many of you will be familiar with the capital structure theories of Modigliani and Miller (M&M), including the notion of the debt interest tax shield. M&M initially demonstrated that, under certain assumptions, including no taxation, capital structure does not affect value. Business or enterprise value, and consequently the combined value of debt and equity claims on that business, is unaffected by leverage.

Relaxing the M&M no-taxation assumption reveals that, in most tax jurisdictions, there is an inherent advantage to debt financing (and a value gain from higher leverage) due to debt interest payments being tax deductible, which is not the case for dividends and equity returns. A company with higher leverage pays less tax, thereby creating a value loss for government and a gain for shareholders.

In M&M's own expanded theory, the relationship between the enterprise value of a levered (V_L) and unlevered (V_u) business is given by:

$$V_L = V_U + D.Tc$$

V_L Enterprise value (value of an enterprise with financial leverage)

V_U Enterprise value of an equivalent business with all equity financing

D Market value of debt finance

Tc Rate of corporate tax

The term D.Tc is the present value of the tax savings due to the payment of debt interest, which is derived as follows:

- Interest payments on outstanding debt equal the amount of debt multiplied by the cost of debt (D.Kd).[2]
- Multiplying this by the tax rate produces tax savings of D.Kd.Tc.
- If debt is assumed to be constant in perpetuity, then discounting at the cost of debt, the tax savings has a present value of D.Kd.Tc/Kd which simplifies to D.Tc.

The discount rate is set equal to the cost of debt because the risk associated with the tax savings is assumed to be the same as the risk related to the interest payments themselves.

The problem is that, while commonly quoted in practice, the above is too simplistic.

The calculation D.Tc is based on an assumption of constant debt in perpetuity and a tax shield that only reflects corporate taxes. Neither assumption is realistic in practice. Furthermore, the calculation assumes that the cost of debt discount rate correctly reflects the risk of the tax shield, which may not necessarily be the case. Using the standard calculation may produce incorrect answers.

◊ *Getting the right value for the debt interest tax shield matters for several aspects of valuation.*

Getting the right value for the debt Interest tax shield matters. Sometimes the tax shield is explicitly referred to, such as in evaluating the value effect of a change in financing policy, or when using Adjusted Present Value (APV) techniques for business valuation or project appraisal.

However, the debt tax shield is also implicit in other aspects of finance and valuation, and you may not even be aware of when you are incorporating it (and certain related assumptions) into your analysis. For example, the tax shield affects leveraging and deleveraging calculations for equity beta and, potentially, also the risk-free rate and equity risk premium used to calculate cost of capital.

There are two factors that affect the value of the debt interest tax shield which may, under certain circumstances, mean that the calculation D.Tc is incorrect. These are (1) how expected changes in debt are dealt with and, related to this, the choice of discount rate; and (2) tax considerations beyond purely corporate taxes.

Debt Tax Shield – Growth and Discount Rate

The most commonly quoted calculation for the value of the debt interest tax shield (VTS) is the M&M formula based on constant debt in perpetuity and a discount rate equal to the cost of debt:

$$VTS = D.Tc.$$

The assumption that debt is constant is unrealistic in almost all valuation exercises. In business valuation long-term growth is probably accompanied by increasing debt if, as is likely, companies seek to maintain a target amount of financial leverage. In project

[1] To access this article with expanded views of equations, see https://www.footnotesanalyst.com/valuing-the-debt-interest-tax-shield/.

[2] This may not strictly be true. The calculation D.Tc is based on market value and market interest rates; however, the tax saving would more likely reflect book values and historical interest rates on outstanding debt. It is possible to allow for this difference, but the effect is unlikely to be material in practice.

appraisal, debt capacity only lasts as long as the project itself and may decline rather than increase over time.

◊ *The appropriate discount rate for debt tax savings may not always be the cost of debt.*

The problem is that there seems to be little agreement amongst academics or practitioners on how to modify the tax shield calculation to take varying debt amounts into account, and what discount rate should be used in this situation. Of particular concern in business valuation is whether it is appropriate to use the cost of debt as a discount rate for all debt interest tax savings when the amount of debt increases along with business growth. The additional tax shield arising from additional debt in future periods is linked to business risk, which suggests a higher discount rate may be appropriate for at least this component of the tax shield.

In our view, the best approach to growth and discount rate is one we think was first proposed by the academic Pablo Fernandez.[3] He produced the following calculation for the value of the debt interest tax shield, under an assumption of constant growth.

$$VTS = D.Tc + D.g.Tc / (Ku\text{-}g)$$

VTS	Value of debt interest tax shield
D	Market value of debt finance
Tc	Rate of corporate tax
g	Growth in the business and in the amount of debt
Ku	Cost of equity assuming zero leverage

In this approach part of the tax shield is discounted at the cost of debt, but the growth component is discounted at the higher unleveraged cost of equity.[4]

The first term in the calculation above (D.Tc) represents the value of the tax shield for the amount of debt currently in place, where the tax savings are discounted at the cost of debt. This is the same as the M&M no growth tax shield we explain above. We agree that the appropriate discount rate for this component is indeed the cost of debt. The tax saving simply reduces the interest cost of debt and with it the burden of debt for equity investors. Applying a factor (1 – Tc) to both interest and to the debt claim captures this effect. In so doing, the tax savings are discounted at the same rate as the debt itself.

[3] See Pablo Fernandez, "The Value of Tax Shields Is Not Equal to the Present Value of Tax Shields," https://papers.ssrn.com/sol3/papers.cfm?abstract_id=290727. Our formula above is mathematically the same as that given by Prof. Fernandez but rearranged to more clearly identify the components. This approach has certainly been criticised by other academics; however, we think this may be due to the unfortunate title of the paper (the calculation is very much a present value of the tax shield) and the way Prof. Fernandez presented the calculation. Out of all of the theories and suggested calculations, we think this approach most appropriately reflects the economics of the debt tax shield (subject to our extension described below).

[4] This means that the overall discount rate applied is somewhere between the cost of debt and the unlevered cost of equity. Disaggregating the tax shield into cost of debt and unleveraged cost of equity components provides for a more practical, and we argue realistic, approach.

The second term (D.g.Tc / (Ku-g)) is the present value at the unleveraged cost of equity of the incremental tax shields arising in future periods due to the assumed business growth. The incremental tax shield in year 1 (if debt grows by g% and is valued on the same M&M basis above) is D.g.Tc. These additional tax shield 'flows' will grow by g% p.a.

◊ *Incremental tax shields due to business growth have higher risk.*

By dividing (D.g.Tc) by (Ku-g), the future incremental tax shields due to business growth are discounted at the higher rate of Ku – the unleveraged cost of equity. The reason for the higher rate is that the incremental debt in future periods is related to business growth and hence each incremental tax shield can, in effect, be viewed as a component of enterprise free cash flow, with the same risks.

We think this dual discount rate approach is a good solution, which can be applied even where growth is not constant, using an explicit forecast of changes in debt.

The only problem is that not all changes in the amount of debt are necessarily related to business growth; some may arise from an expected change in funding policy. A more generalized approach would be to differentiate between the two, with the debt tax shield related to current debt and changes due to planned revised financing policy discounted at Kd, and other changes related to business growth discounted at the risk adjusted rate Ku.

In the case of business valuations, long-term growth in debt is likely to be linked to growth in the business, in which case the incremental tax shield benefits would all be discounted at Ku and the formula proposed by Fernandez would be appropriate. However, for project appraisal, debt (or debt capacity) changes may be more likely to simply relate to changes in planned funding.

Exhibit 1 on the next page presents our more generalized version of the dual discount rate approach.

Allowing for Investor Taxes

The effect of taxation on asset pricing and returns is not limited to corporate taxes. How returns to investors are taxed at the investor level is also relevant. Investors will accept a lower gross return on an asset, and hence pay a higher price, if the income from that asset is taxed at a lower rate than that from an alternative investment. It is important that this effect is built into valuation.

◊ *Lower personal tax rates for equity returns reduces the overall value of the debt tax shield.*

The difference between the effective personal tax rate on income from equity, compared with that for debt investment, affects the value of the debt interest tax shield. If equity returns are taxed at a lower rate than debt returns (which in many jurisdictions they are) the cost of equity should be lower than it would be without this tax advantage which, in turn, partly offsets the benefit of the corporate tax savings from debt interest. Lower personal tax for equity investors, in effect, creates an equity return tax shield

Continued from p.17

Exhibit 1: Calculation of the value of the debt interest tax shield

Tax shield component	Discount rate	Calculation
Debt in place	Cost of debt	D.T*
Change in debt due to a change in debt policy (change in leverage)	Cost of debt	PV at KD of $\triangle D_p$.Kd.T*
Change in debt due to new investment and business growth	Unleveraged cost of equity	PV at Ku of $\triangle D_g$.Kd.T*

$\triangle D_p$ and $\triangle D_g$ represent the change in debt each period due to a change in debt policy and business growth respectively. We use T* rather than Tc in the calculation for the reasons set out in the following discussion.

that offsets part, or potentially even all, of the debt interest tax shield.

Although the original M&M theory only allowed for corporate taxes, a subsequent paper by Miller[5] showed the importance of also considering different personal taxes on equity (Tpe) and debt (Tpd). Miller provided the following calculation of the net tax advantage of debt (often referred to as T*).

T* = 1 – [(1-Tc) x (1 – Tpe) / (1 – Tpd)]

T*	Effective tax advantage of debt after allowing for personal tax effects
Tc	Rate of corporate tax
Tpe	Effective rate of personal tax on returns from equity investments
Tpd	Effective rate of personal tax on returns from debt investments

If the personal tax rates on equity and debt are the same, the tax advantage of debt remains the rate of corporate tax (T* = Tc). However, if the personal tax payable by equity holders is less, this tax advantage for equity offsets the debt interest tax shield, which reduces the overall advantage of debt finance (T* < Tc).

◊ *Government has a claim on returns generated by a business.*

One way to appreciate why investor taxes affect value in addition to corporate taxes, is to think of government as having a claim on enterprise cash flows equal to the tax it receives. This tax collection includes not just corporate level taxes but also tax paid on distribution as to the providers of capital. Any change in the overall amount of tax received by government, both personal and corporate, must impact the value of the government claim and therefore the value attributable to the debt and equity claims on the business. Only if higher leverage reduces the overall tax taken by government can there be an increase in the value of the enterprise attributable to the providers of capital.

The net effective tax advantage of debt can perhaps be better understood by rearranging the above calculation. The personal tax advantage of equity (Tp’) is the amount by which post personal tax equity returns exceed those for debt (assuming the same pre-tax return).

Tp’ = (1-Tpe) / (1-Tpd) - 1

Substituting this into the equation for T* above and rearranging gives:

T* = Tc – Tp’.(1-Tc)

This shows the two opposing tax effects that alter the net interest cost of debt finance relative to the cost of equity (assuming equity has the same risk) ...

- Tc represents the reduced interest cost because interest payments are tax deductible.
- Tp’.(1-Tc) represents the higher interest payable for debt, compared with the return that would be demanded by equity investors (assuming the same risk), due to differences in personal tax, less the corporate tax saving that applies to this extra interest.

Estimating the overall tax advantage of debt - T*

Estimating T* is difficult. Many companies are subject to different tax regimes due to the international nature of their operations and the international spread of their investors. In addition, different investor groups, such as pension funds, corporate investors and private investors, are subject to different personal taxes. However, the challenge of estimating T* does not mean that the tax shield should necessarily be ignored, or that it should simply be assumed to be the rate of corporate tax on the basis that this is generally much easier to determine.

There are two extremes for T*, either T* = Tc or T* = zero. Understanding when each applies will enable a more informed decision about what value to use in practice.

Classical tax system: T* = Tc

A so-called classical tax system is where the personal taxation of debt and equity returns is the same and there is no ‘imputed’ tax credit provided for equity investors. In this environment Tpd = Tpe and the net personal tax advantage to equity (Tp’) is zero. The net tax advantage for debt financing is therefore only the tax deductibility of interest. This produces a tax shield value equal to the rate of corporate taxes.

However, even in a fully classical tax system there could be a difference between Tpd and Tpe if, for example, capital gains are taxed differently. Equity returns are more likely to be in the form of capital gains compared with returns on debt, and either

[5] Merton Miller, “Debt and Taxes,” first published May 1977, https://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.1977.tb03267.x.

a lower rate of tax on gains, or simply the benefit of deferring gains until realised, will result in an overall lower value of the debt tax shield.

Imputation tax system: T* = zero

In some jurisdictions corporate taxes are 'imputed' to equity investors. This means that corporate tax is treated as a part-payment of equity investor personal taxes, with an explicit tax credit given to investors. Alternatively, the same effect may be achieved by taxing equity investors at a lower rate on their income compared with that applied to debt investors, with the difference fully or partially based on the corporate taxes already paid.

In a full imputation system, the difference between Tpe and Tpd gives a value for the net personal tax advantage for equity that exactly offsets the tax deductibility of debt interest, which results in a tax advantage of debt of zero. However, imputation or differential tax systems, rarely fully impute corporate taxes to investors, such that tax advantage of debt may still be still positive, but less than the rate of corporate tax.

The challenge of estimating personal tax rates, and the net value of the debt interest tax shield, is why personal tax effects are often ignored in practice, and T* is assumed to equal Tc. That was certainly the approach we adopted at UBS.

Implications for Valuation

The absolute value attributed to the debt tax shield, and the estimated value of T* that determines its value, affects a number of different aspects of valuation. We will explain more on this subject in further articles,[6] but here is a high-level summary:

- **Beta leverage adjustment:** Where beta is delevered to determine an asset beta, or an industry asset beta is relevered to determine an equity beta, the calculations should include T* not Tc. For example, if debt is risk free (a common assumption, although not necessarily true in practice) and the tax shield (excluding the value attributable to business growth) is discounted at the cost of debt, the asset and equity beta relationship becomes:

  $$Ba = Be \times E / (D \times (1 - T^*) + E)$$

- **Risk free rate:** The risk-free rate used for the calculation of cost of equity (including the unleveraged cost of equity in APV calculations) should be lower than the rate observed in the debt markets if there is a personal tax advantage to equity and T* is less than Tc. The adjustment is:

  $$Rf(e) = Rf(d) / (1 + Tp'))$$

  or

  $$Rf(e) = Rf(d) \times (1\text{-}Tc) / (1 - T^*)$$

- **Equity risk premium:** The ERP should also allow for personal taxes. The relationship between the ERP applied to debt (assuming CAPM is used for the cost of debt) and the ERP for equity is the same as given above for the risk-free rate.
- **Adjusted present value:** APV valuations should include the value of the tax shield based on the expanded calculations we explain above.
- **Enterprise DCF based WACC:** Where DCF analysis uses WACC as the discount rate there is no need to explicitly include the value of the tax shield because it is implicit in WACC itself. However, remember to allow for the above effects of T* on beta leverage adjustments and the risk-free rate and ERP components of CAPM. If T* = Tc, no special adjustments are required.

Insights for Investors

- **The commonly quoted value for the debt interest tax shield of D.Tc is based on the assumption of constant debt and a classical tax system where the tax advantage of debt equals the rate of corporate tax.**
- **If debt is forecast to change, do not necessarily discount all of the tax shield at the cost of debt. Business risks are likely to be relevant in selecting an appropriate discount rate.**
- **The value of the debt interest tax shield to equity investors is less than the rate of corporate tax if equity investor personal taxes are reduced by imputed tax credits or lower rates of tax.**
- **Use the net tax advantage of debt (T*) rather than the rate of corporate tax when evaluating the value of debt financing and when delevering and relevering beta factors.**
- **If the net tax advantage of debt is less than the rate of corporate tax you will need to adjust CAPM inputs, including the risk-free rate.**

[6] Watch for future related Footnotes Analyst articles on leverage and equity beta, and an interactive model to show how the tax shield calculations affect cost of capital and DCF values at https://www.footnotesanalyst.com/.

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Steve Cooper

Steve Cooper completed a 10-year term as a member of the IASB in 2017. After retiring as a board member, Steve continued his involvement with accounting standard setting as an advisor to the IASB and as a member of the ICAEW financial reporting committee. He also provides education and advisory services for investors and is the author of The Footnotes Analyst blog. Prior to joining the IASB, Steve was a Managing Director in the equities division of UBS. He led the valuation and accounting research team and was a member of the global investment recommendation committee. Steve's earlier career includes auditing, corporate finance, and education and training.

AI AND STOCK MARKET VALUATION

Bradford Cornell, Shaun Cornell, and Andrew Cornell
Cornell Capital Group

In this article, we assume that AI, which we recognize has many different forms, will be a major economic success in that it will lead to greater productivity and rising GDP in the United States. The question for investors is how will it affect stock prices? That depends on whether you are talking about the stock prices of selected individual companies or the value of the aggregate market. We start first with the aggregate market and then turn to individual stocks.

Technological breakthroughs, of which we assume AI will be an example, increase social wealth by increasing the goods and services that can be produced from a given set of resources. This is measured by the growth rate in productivity. Productivity growth is the key determinant of real GDP growth per capita which, in turn, determines the standard of living. The primary source of productivity growth is technological innovation.

The chart below from the Federal Reserve (Exhibit 1) plots quarterly productivity growth, stated as an annualized rate, in the United States from 1960 through 2023. The first thing to note is that the rate of increase is not large, averaging only 2.0% per year. The second thing to note is that the growth rate has been highly variable, tending to fall in recessions and rise in recoveries with a good deal of added random variation. Despite the fluctuations, there has been little trend in the average growth rate since 1960. Furthermore, it is difficult to tie productivity growth to specific innovations such as the rise of computers and the development of the internet. Back in 1987, Nobel Prize winning economist Robert Solow famously noted that "*You can see the computer age everywhere except in the productivity statistics.*"

Considering the chart, even if the impact of AI is great, possibly greater than that of the computer revolution or the internet, it is hard to see U.S. productivity growing significantly faster than 2% in the long run. However, the growth rate is likely to remain bumpy as it always has been. Whereas AI will make people more productive *on average*, many people will lose their jobs and others will have their lives upended. This will lead to costly political battles that are likely to make the acceptance of AI uneven.

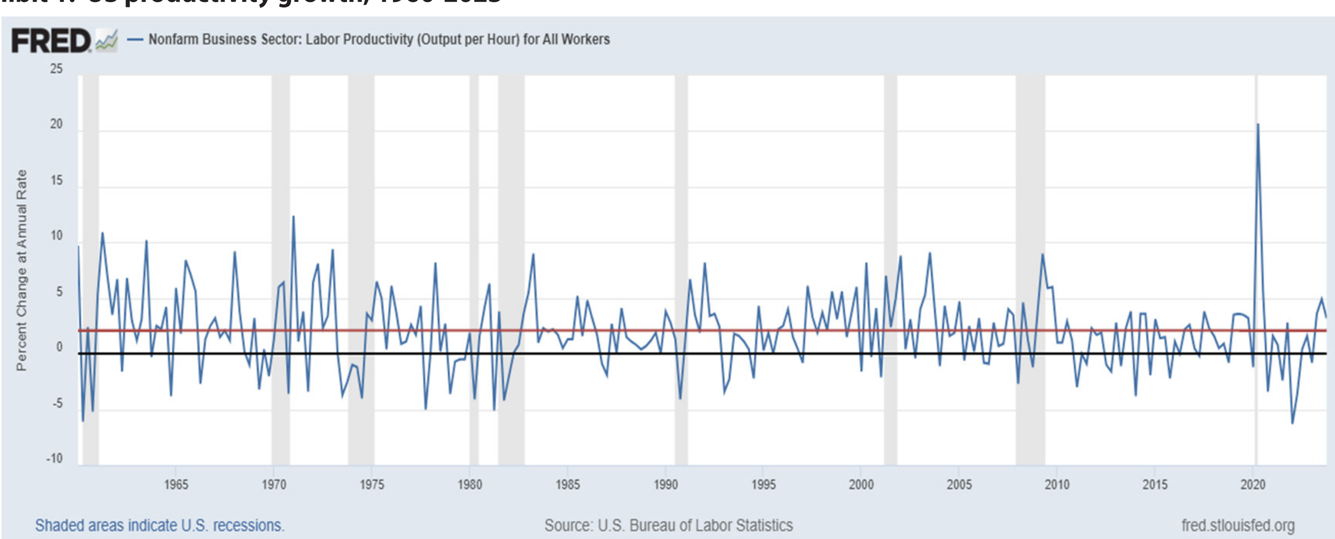
But stock prices do not depend on the social wealth a technology creates, they depend on corporate profits. As shown in Exhibit 2 on page 22, corporate profits have averaged slightly less than 6% of GDP from 1960 to 2023, although the fraction has been closer to 8% in recent years. This suggests that in the long run AI companies can expect to capture only about 8% of the wealth created by AI.

Putting the pieces together, the development of AI is unlikely to have a further pronounced impact on the level of stock prices generally, given that the market is forward looking and much of that impact has likely already been incorporated into prices. However, what is true in the aggregate need not be true for individual companies, such as Nvidia, which may potentially reap large profits from AI. However, in the case of individual companies, new problems arise.

First, as stressed by the authors in 2021,[1] a new technology does not translate into value creation for a company that adopts it unless it produces returns on invested capital (ROIC) in excess of the cost of capital. To earn excess returns, there must be barriers to entry that prevent competitors from adopting the technology, entering the business, and driving down the ROIC to the cost of capital. For instance, two of the great technological innovations of the 20th century were automobiles and airplanes. In tandem, they produced a vast amount of social wealth. Unfortunately, neither produced much wealth for investors because competition was brutal. Virtually every American car company and airline went bankrupt, some more than once. Regarding airlines, Warren Buffett quipped, "*if a far-sighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down*." The vast bulk of the wealth that was

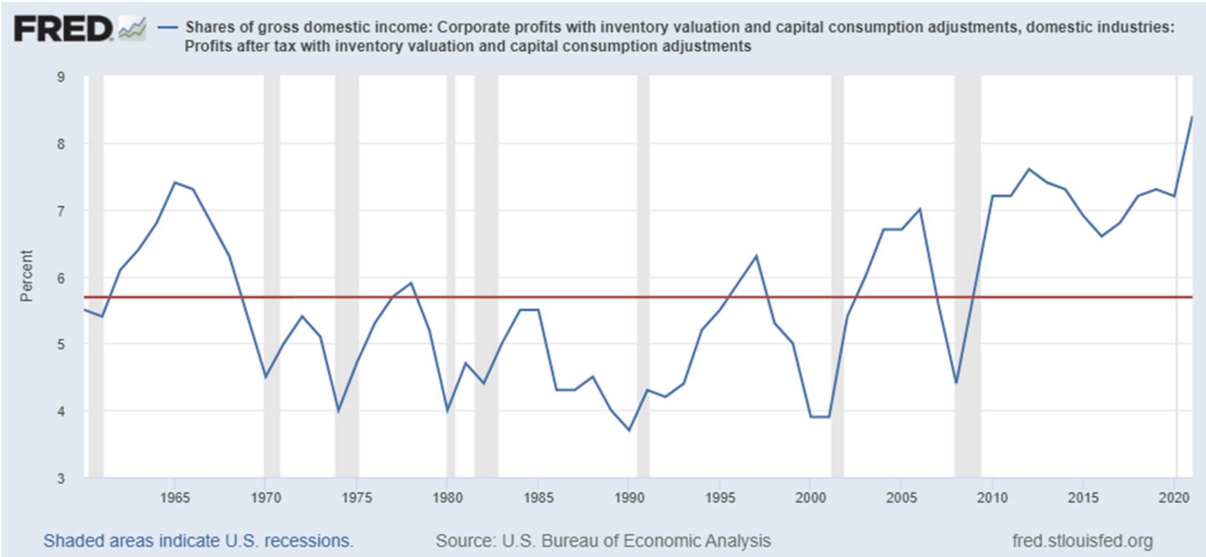
[1] Bradford Cornell, Shaun Cornell, and Andrew Cornell, "Valuing the Automotive Industry," November 11, 2021, https://www.cornell-capital.com/wp-content/uploads/2021/11/VALUING-THE-AUTOMOTIVE-INDUSTRY.pdf.

Exhibit 1: US productivity growth, 1960-2023



Continued from p.21

Exhibit 2: Corporate profits as shares of GDP, 1960-2023



created by automobiles and airplanes flowed to consumers, not investors. The fact that AI appears to be a general tool means that barriers to entry are likely to be limited. If so, it will be difficult for individual companies and their investors to reap much of the rewards in the long run.

Of course, there will be exceptions. While a majority of the startups that arose during the internet boom around 2000 failed, a few Amazons did emerge and produce great investor wealth. But there were precious few Amazons, whereas at the height of the boom virtually every company and their investors in the emerging internet space believed that it was going to be a big winner. This is an example of what Cornell and Damodaran (2020) call a big market delusion.[2] The hallmark of a big market delusion is when all the stock prices of firms employing a new technology rise together even though many are in direct competition with each other and with established firms in the industry. Investors become so enthusiastic about the new technology that each firm is priced as if it will be a major success story. As a result, the aggregate value of stocks of companies employing the technology exhibit a fallacy of composition in which the sum of the parts (the sum of the market values of the individual firms) exceeds any reasonable estimate of the total value of the new business.

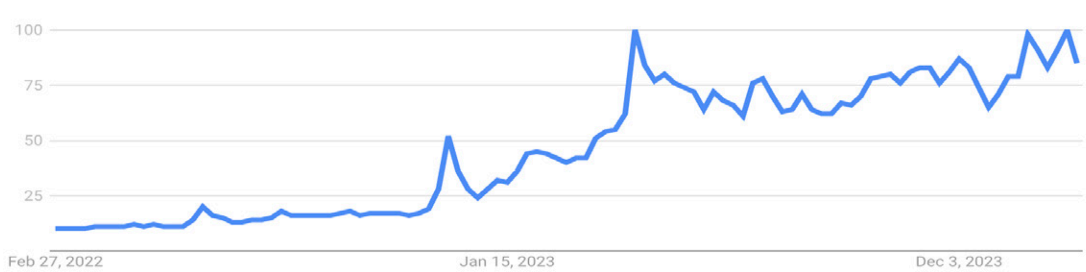
[2] Bradford Cornell and Aswath Damodaran, "The Big Market Delusion: Valuation and Investment Implication," *Financial Analysts Journal*, 2020, 76 (2), 15-25.

In our view, a big market delusion could be emerging in the case of AI. Virtually any company involved with AI in any way is talking up the opportunity. More generally, the financial media has been gushing about all the new doors that AI will open. A good indicator of the recent enthusiasm in AI is Google Trends, which measures the level of search interest for a particular topic. The chart in Exhibit 3 shows the surge in searches for the term "AI": AI goes from being an also-ran to being one of the most searched terms on the internet.

The second problem for individual companies is that along the value chain one company's profit is another company's cost. Nvidia has a unique position in the AI value chain because it currently designs chips for which there is a particularly high demand. Not surprisingly, analysts are predicting that Nvidia will sell a lot of chips at high margins. But that means that everyone who buys those chips for their hardware and related software applications pays a high price. That cuts into profits unless the high costs can be passed on. But if the high costs are passed on it is disadvantageous for final customers of AI products. Putting the whole value chain together, the social value created goes back to the increase in productivity.

Third, the foregoing assumed that at least some firms — Nvidia is a particular example — had barriers to entry that were sustainable in the long run. That is the only way they could continue to increase sales while retaining high margins. History suggests that that is a heroic assumption. It clearly proved to be

Exhibit 3: Google Trends results for "AI"



false for airlines and automobiles. But does it hold for Nvidia? Already doubts are surfacing. Will INTC, AMD, TSMC, and others sit on their hands, allowing Nvidia to forever own the super-chips industry? Not likely. AMD already claims to have a chip that's supposedly 25% faster than Nvidia's best, at one-third the price. The force that drove Nvidia valuation past $2 trillion is likely to attract a lot of competition.

Finally, we have yet to mention what may be the most important issue for investors in individual companies – pricing. Sticking with the Nvidia example, following a bullish earnings announcement on Thursday May 25, 2023, the company's market capitalization rose by more than $180 billion, the second largest dollar increase in history for any company. Nvidia then topped that with a record $275 billion increase in market capitalization following another earnings announcement on February 22, 2024. As a result of these run-ups, Nvidia's market cap exceeded $2 trillion, surpassing both Amazon and Google to become the fourth most valuable company in the world. For investors buying at that valuation, Nvidia's future must be remarkable indeed if they are to make a reasonable return.

Putting the pieces together, we fear that one of the doors that AI will open is an opportunity for investors to lose a lot of money. As was the case for electrical vehicle stocks in 2021, companies in the AI space are beginning to be priced as if they will all be big winners.[3] This is true even though some firms are customers of others. While AI is likely to be a major innovation, it is not likely to be a bonanza for investors buying in at current prices. Unfortunately, there is no way for Warren Buffett to protect those investors by shooting down AI.

What then are investors to do if they are considering AI related stocks, or at least stocks that are being touted as AI related even if the intended use of AI remains nebulous? We suggest using discounted cash flow (DCF) analysis to reverse engineer the stock price. By reverse engineering we mean estimating the future cash flows necessary to justify the market price. If those estimated future cash flows imply an implausible run-up in the company's performance that is a major warning sign. As an example from the EV world, when Rivian was trading at approximately $130 following its IPO in November 2021 our reverse engineering indicated that justifying the price required a rapid ramp-up in production with sales at high margins. Given the nature of the automobile industry that did not seem plausible, even though we loved the vehicles and considered ordering one. Since then, the market's assessment of Rivian's future cash flows has become much more realistic, perhaps even pessimistic, and the stock price has dropped to $11. We suspect that the enthusiasm for AI will produce quite a few similar episodes. While reverse engineering is not a panacea, we think it is a necessary first step when considering investment in stocks related to AI. No technology is so good that it cannot be overpriced.

[3] See Bradford Cornell, Shaun Cornell and Andrew Cornell (2021) for analysis of the electrical vehicle market.

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CORPORATE IP DIVESTITURES CONTINUE TO GAIN MOMENTUM, POWERED BY LEGAL FINANCE

Katharine Wolanyk and Christopher Freeman
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Companies with valuable intellectual property are increasingly turning to monetization for a myriad of reasons, ranging from strategic to tactical. Often, it is in response to uncertain economic conditions, where the company's legal team has been tasked with finding ways to reduce legal department costs and, if possible, to recover money for the business from legal assets. The latter is particularly true where the company is a long-established company or in a highly competitive industry and would benefit from new sources of revenue to supplement declining sales or profit margins.

In a frequent monetization scenario, a company concludes it should "right size" a patent portfolio that has grown substantially over time or has redundancies as a result of M&A activity. In other cases, a company may have exited a line of business and the related patents are no longer core to its portfolio. Yet other examples are unsuccessful startups seeking to sell an entire portfolio for the benefit of creditors and investors, and operating companies that were not able to compete at scale against the ultimate market leaders. And sometimes IP is monetized in furtherance of a corporate business objective, such as providing leverage in business negotiations, protecting the company's legal rights or restricting competitors from certain markets.

A number of recent transactions involving recognized innovators illustrate the growing trend of corporate patent monetization. In 2023, after a lengthy sale process, BlackBerry sold substantially all of its non-core assets, or approximately 32,000 patents and applications, for an upfront payment of $170 million and future cash and potential payments that could value the transaction at up to $900 million in the aggregate.[1] The year before, Intel sold nearly 5,000 patents relating to a broad range of semiconductor technologies for an undisclosed amount.[2] BlackBerry and Intel both sold to experienced patent monetization teams, thereby outsourcing and then participating in future monetization activity. And in the past few years, the list of repeat corporate

patent sellers includes ATT, HP, HPE, Huawei, NEC, Pioneer Corporation and Siemens Healthineers.[3]

Whatever the impetus for monetization, the patent owner seeks at least to recoup some of its considerable R&D investment in developing and patenting the technology, while also shedding the related carrying costs of patent office maintenance fees and ongoing patent prosecution legal fees and costs. Depending on the size and global reach of the portfolio, R&D and carrying costs can total millions of dollars annually.

Monetization Options

Once a company has made the decision to monetize its IP, what are its options for doing so?

This discussion is occurring with increasing frequency as businesses explore using legal finance to unlock the intrinsic but stranded value of legal assets. In the authors' experience, a majority of new business, including that from our IP group, has in recent years come directly from companies.

In short, there is no universally "right" option for how to monetize IP, as each company must balance factors and concerns specific to its business and stakeholders.

On the lowest end of the risk spectrum, monetization could simply entail abandoning some patents, which at least saves the related carrying costs. While perhaps unsatisfying, this option might be appropriate for patents that are nearing expiration or that do not relate to commercially viable technologies.

If the company wishes to do more, the next question we pose is whether the company prefers to monetize directly or indirectly. Monetizing directly can potentially generate the most revenue, with the additional benefits of the company maintaining full control over the strategy and keeping the patents within its portfolio. Importantly, with the aid of legal finance, the company can offload the legal fees and related costs (and perhaps some portfolio carrying costs) while retaining control over the strategy and having its choice of counsel.[4] However, monetizing directly can pose risk of countersuit and potentially affect important business relationships. Further, not all companies have the in-house expertise or desire to manage a monetization program.

If monetizing directly is not a fit for the company, another option is indirect monetization, through which the company divests the patents to a buyer that will either hold or further monetize

[1] BlackBerry press release, March 21, 2023, https://www.blackberry.com/us/en/company/newsroom/press-releases/2023/blackberry-announces-new-patent-sale-transaction-with-leading-patent-monetization-company-for-up-to-900-million.

[2] Dan Robinson, "Intel hands over nearly 5,000 patents in deal with IP management outfit," The Register, https://www.theregister.com/2022/08/15/intel_patents_tahoe_research/.

[3] Kent Richardson, Erik Oliver and Michael Costa, "The brokered patent market in 2022," April 19, 2023, https://www.iam-media.com/data/secondary-market-activity/secondary-market-activity/article/its-great-time-be-patent-buyer.

[4] For an in-depth discussion of legal finance, see "Introduction to Legal Finance: Key concepts in financing commercial litigation & arbitration," Burford Capital, https://www.burfordcapital.com/eu/introduction-to-legal-finance/.

the patents. In our experience, most companies ultimately choose this option—and legal finance can play a valuable role in facilitating IP divestitures.

The Benefits of a Financed Divestiture

Selling patents often involves retaining a broker, law firm or specialized IP banker to conduct a competitive sales process. The company then works with this advisor to analyze its portfolio, select the assets to be divested, and develop marketing materials that typically include high-level patent claim charts and licensing revenue projections. The company and its advisor then identify a list of potential buyers and proceed to converse with each of them. Such a sales process can be lengthy—months, at least—and even with nondisclosure agreements, some of the company's relevant industry and, likely, competitors will become aware of the transaction. In the end, the deal structure, economic value and perhaps the ability to ultimately close the transaction may be constrained by the availability and cost of capital and the buyer's access to it.

Legal finance can improve the sales dynamic in multiple ways. As a starting point, the finance provider can facilitate the sales process by working with a prospective bidder to evaluate the monetization potential, akin to how a funder would evaluate a typical litigation finance opportunity. If it seems promising, the finance provider can finance acquisition capital for the initial patent purchase, funding for the legal fees and costs to be incurred as part of the future monetization strategy and, if desired, working capital for the new patent owner's entity.

The finance provider might also introduce experienced legal counsel and other monetization resources to the potential buyer, thereby enhancing the prospects of future success. With the backing of a sophisticated and well-resourced financier, both the seller and the buyer can be confident that an agreed transaction will not subsequently fall apart due to lack of capital, and all can be confident that that seller's future monetization activities will be well financed over the long term.

For businesses that prefer the confidentiality of a private transaction, a financed divestiture can be even more valuable. In this approach, the company works directly with the legal finance provider to identify and evaluate patent assets and to develop a preferred deal structure. If the company has a large number of patents to divest, the transaction might be structured in repeatable parts, so as to smooth revenue over a longer financial period while reducing transaction friction that might otherwise come into play with multiple sales processes.

Forward looking companies have been quick to recognize the benefits of monetization, but given the relative novelty of financed divestitures, some examples may be instructive.

Case Study 1: Monetizing Non-Core Assets to Quarterly Revenue

***The challenge*—**A publicly traded, multinational corporation with a very large and diverse patent portfolio was seeking to monetize a group of eight related patent families. This initial offering was part of a strategic review process, through which the company had identified multiple groupings of high-quality patents that were no longer core to its business units or in technology areas where it had redundant patent coverage. Due to the complex nature of its global operations, the company declined any participation interest in the future monetization, preferring to fully divest the patents so as to minimize its future involvement.

***The solution*—**The legal finance provider initially evaluated the selected IP package, and then introduced an experienced monetization professional to serve as buyer, and a top-tier law firm to execute a monetization strategy. After diligencing the assets and the strategy internally, the provider facilitated a financed divestiture in which it provided acquisition capital (paid entirely via an upfront payment), working capital (for the buyer's patent maintenance fees, ongoing prosecution and general monetization support), and litigation funding for the future legal fees and costs associated with the monetization strategy, for a total commitment of $12 million.

***The outcome*—**The company's business unit was able to book $1.75 million in revenue before its quarter end while also eliminating substantial patent maintenance costs, and it did so without impacting its relationships with its business partners.

Case Study 2: Monetizing While Pivoting the Core Business

***The challenge*—**A successful startup with a modestly sized patent portfolio was pivoting to a new business focus and looking for additional revenue streams to bridge the transition. Although the company had developed valuable patents on technologies that were being used by some of the largest technology companies, it had no expertise in patent monetization. Further, the company could not afford the cost or distraction of being a named party in patent litigation, and it was concerned that countersuits from much-larger defendants, even those without merit, could be devastating.

***The solution*—**The legal finance provider engaged with the startup company to devise a monetization strategy that allowed the company to realize value for its patents, while being insulated from the costs and risks of litigation. The provider facilitated the company's divestiture of key patents into a special purpose vehicle (SPV), introduced an experienced monetization professional to run the campaign, and brought on top-notch counsel to litigate against infringers. The company opted not to receive an upfront payment for its patents but retained the right to a majority of proceeds achieved through the monetization. Funding was provided for SPV expenses and legal fees and costs associated with the monetization strategy. Because the company divested the patents and transferred complete control over the monetization to the SPV and its experienced manager, there was minimal risk of the company being the target of a countersuit.

***The outcome*—**The company paid nothing for the litigation, avoided a countersuit and received the benefit of an expert monetization team. That monetization team—

Continued from p.25

the capital provider, the SPV manager and the law firm—litigated the company's patents to a trial victory. The company is now exploring additional monetization opportunities with this team.

In both examples, the involvement of legal finance fundamentally improved and simplified the divestiture process, eliminating risk and generating liquidity. Though many patent-related entities can assess the commercial value of patents directly, few have the requisite legal expertise to understand the value of potential litigation connected to those patents, potentially disadvantaging patent holders that may not have visibility into the nexus of those two important considerations. And fewer still can combine that collective expertise with the capital to finance both the divestiture and the long-term monetization of the purchased assets.

Conclusion

Ultimately, in an uncertain economy, companies will need to be careful in their capital management and innovative in their pursuit of value. For patent holders, financed divestitures may well be the optimal option. For little to no risk, with minimal operational burden, companies can generate millions in working capital by enforcing their rights and pursuing meritorious IP litigation. Patent holders would do well to contact a legal finance provider to start thinking about how to extract value from their existing intellectual property.

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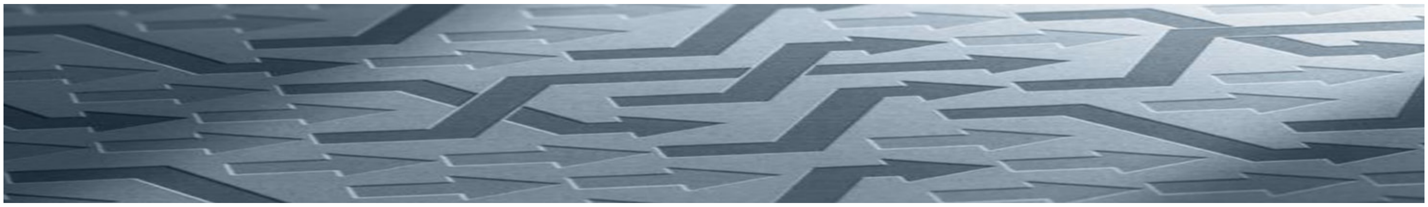

THE ZONE OF SAFETY: HOW TO BE AN ACTIVE AND CONFIDENT DIRECTOR DURING FINANCIAL DISTRESS[1]

Andrew G. Dietderich
Sullivan & Cromwell LLP

INTRODUCTION

A few recent corporate chapter 11 cases have drawn public and Congressional attention to corporate behavior in bankruptcy. And yet, much conventional advice to corporate directors about their fiduciary duties in circumstances of financial distress remains out-of-date. Delaware law and market conventions have both changed significantly over the past years. Today, the rules of the road for directors are clearer than they have been in the past. Directors can continue to be actively involved in the oversight of the corporation during a restructuring, confidently approving even risky transactions, without fear of liability, so long as they are aware of current law and take specific precautions. Indeed, active and engaged directors are the most effective way for a corporation to avoid criticism during a reorganization. This article dispels some old myths about the "Zone of Insolvency" and suggests practical steps to replace it with a modern "Zone of Safety," within which directors can defend and preserve corporate value with confidence.

The topic of director fiduciary duties is perhaps the most important one in restructuring law today. The American system of reorganizing corporations as going concerns depends upon management, overseen by the board, that is in the best position to decide what to do when a firm cannot pay its debts. This is not intuitive, and other countries take a different approach. Nevertheless, our American restructuring process remains solidly board-centered. When restructuring is done right, the boardroom—not the courtroom—is the first and primary venue where the fate of the corporation is determined. When the various classes of creditors have confidence in the board process, it is easier to find consensus on a restructuring path—even when some creditors initially disagree. When the court has confidence in the board process, the standard of review is usually more favorable and necessary approvals are easier to obtain. Conversely, when the board does not earn the confidence of stakeholders and, especially, the court, a restructuring plan can lose its way quickly. From a political perspective, if too many restructurings lose their way because too many corporate directors fail to follow best practices, our system of restructuring itself will weaken and change.[2]

THE ZONE OF SAFETY

The good news first. If you are an appropriately informed and involved director during a corporate restructuring today—whether appointed pre-restructuring or specifically in a restructuring context—the law has your back. It was common decades ago for restructuring lawyers to tell the board of directors of a distressed corporation that they had entered the "Zone of Insolvency," a confusing and dangerous place (reminiscent of the Twilight Zone) where normal fiduciary duties to the corporation changed and the risk of director liability increased exponentially. The "Zone of Insolvency" was a place of fear where the safe decision was to commence a prompt chapter 11 filing and turn the keys over to the most influential group of creditors. Taking risks that might increase creditor losses was discouraged, even when the pay-off of a successful rescue strategy was substantial. In other words, for a director, the Zone of Insolvency was a place where his or her ordinary expertise was no longer relevant and the smart director was the one who walked quietly down the path of least resistance.[3]

None of that is sensible advice today. Corporate law now protects legitimate corporate risk-taking by distressed corporations and their directors. We can confidently say the following for corporations organized in Delaware, or other jurisdictions to the extent they look to Delaware law:

1. There are no "new" fiduciary duties for directors when a corporation is insolvent. The fiduciary duties for directors are the same as they have been since incorporation: the duty of loyalty, the duty of care and the duty of good faith. The business judgment rule is available to protect directors who follow the rules, regardless of whether the corporation has sufficient liquidity and regardless of whether stockholders or creditors hold the marginal economic interest.
2. Fiduciary duties do not "shift" to creditors. In fact, there are no fiduciary duties of directors directly to creditors at all under (Delaware) corporate law.[4] Of course, boards on the eve of restructuring are still likely to receive correspondence

[1] This article appeared in the January 2023 issue of *The Review of Banking & Financial Services*, Vol. 39, No. 1, and is reprinted with the permission of RSCR Publications LLC.

[2] It has happened before. In the 1930s, outrage about corporate fiduciary misbehavior inspired Congress to pass the Bankruptcy Act of 1938 (the "Chandler Act"), which dismantled the robust private restructuring industry of the early 20th century and replaced it with a bureaucratic system dominated by court-appointed trustees. The "debtor in possession" did not reappear in large corporate cases until the Bankruptcy Act of 1978.

[3] Occasionally, a director would respond to this dismal picture by resigning prior to the restructuring. However, most directors stayed through the restructuring because of a belief among restructuring professionals that directors who resign (flee the sinking ship) are even more likely to become the target of litigation in a subsequent chapter 11 case.

[4] The Delaware Supreme Court confirmed this principle in 2007 in North American Catholic Educational Programming v. Gheewalla, 930 A.2d 92 (Del. Supr. 2007), and Delaware courts have applied it consistently since.

from creditor groups *alleging* a direct duty to creditors, but case law is clear that no such duty exists. Directors owe their fiduciary duties to the corporation.[5] Creditors are creatures of contract and, generally, adverse parties. The corporation can and should take appropriate action to defend itself against creditors, minimizing creditor liens and claims in good faith where doing so helps franchise value or is otherwise consistent with the corporation's business objectives.

3. Of course, creditors are still stakeholders affected by corporate decisions. If the corporation is actually insolvent, creditors with valid claims can become indirect beneficiaries of the director's fiduciary duties to the corporation for the simple reason that they are entitled to the marginal value of the corporation's assets. In certain circumstances, creditors (or an official committee of creditors) may even seek standing to bring a derivative action against directors to enforce the corporation's claims while "standing in the shoes" of the corporation. However, any such claims will succeed or fail based on the interests of the corporation and general principles of corporate law. The directors serve one master in a restructuring: the corporation.

4. The law also recognizes that directors sometimes need to pick winners and losers. This is inevitable and there is no fiduciary duty to make everyone happy. In a restructuring context, creditors and stockholders can have very different views of risk. Directors complying with their fiduciary duties may approve risky ventures that could benefit stockholders if successful, and harm creditors if not. Conversely, the same directors may decline to reach for stockholder value if they believe the risks to the enterprise and its creditors are unwarranted. Regardless of which group is disappointed, the business judgment rule applies and means that a court will not second-guess such directors simply because another business decision would have led to another result.

5. There is no fiduciary duty to file for chapter 11, whether the corporation is insolvent or not. The decision to file for chapter 11 (or to pursue another restructuring option) can be made in the same manner as any other difficult corporate decision: based on the facts and circumstances.

6. Finally, and perhaps most importantly as a practical matter, the same corporate governance conventions that protect directors from liability in ordinary transactions apply during a restructuring. There is a rich body of knowledge on director decision-making in M&A and other strategic circumstances, and all of this learning is at the fingertips of directors and their advisors. A restructuring transaction may feel chaotic and accelerated compared to an ordinary corporate transaction, but the governance principles for building a defendable record for the board are the same.

Putting this together, given the developments in the law in this area over the past decade, it is more accurate to speak today of a *Zone of Safety*, rather than a Zone of Insolvency. Within the Zone of Safety, protected by a solid board process, boards can take appropriate business risks—whether to avoid a chapter 11 filing altogether or to choose a more challenging path through chapter 11 in pursuit of corporate objectives.

ESTABLISHING THE ZONE OF SAFETY

The Zone of Safety does not arise automatically. It requires preparation and a compelling record that the board truly did comply with its fiduciary duties. In particular, a good corporate process must involve a critical mass of directors whom a court will regard as informed, involved and disinterested. In this respect, U.S. restructuring practice over the past years has a mixed report card. Restructuring professionals know chapter 11 conventions, but sometimes struggle to incorporate best practices from the broader corporate governance community. In addition, there is too often a view that "consensus" at the end of a restructuring will allow the debtor to sweep corporate governance concerns under the rug in the plan of reorganization—a proposition that works only until tested. These dynamics can be especially dangerous for directors of public corporations because many restructuring conventions arise from cases involving not public corporations, but private equity portfolio companies with more limited stakeholder constituencies.

One example of how corporate governance best practices have changed recently relates to failure-to-supervise claims under the *Caremark* doctrine. In *Caremark*, the Delaware Supreme Court held that, on sufficiently egregious facts, a failure by directors to establish reporting and oversight procedures could constitute a breach of the duty of loyalty.[6] For many years, practitioners had a sense that these claims would rarely survive a motion to dismiss. However, in the last three years, Delaware courts have allowed *Caremark* claims to survive a motion to dismiss in five cases where the plaintiffs alleged that the board ignored foreseeable risks, including risks related to food safety (*Marchand*), clinical drug trials (*Clovis*), oil pipeline reliability (*Inter-Marketing*), financial reporting (*Hughes*) and airplane safety (*Boeing*).[7] The risk of a successful *Caremark* claim is especially salient for directors because it would involve a breach of the duty of loyalty and, therefore, personal liability that is neither indemnifiable nor insurable. Boardroom advice is changing in response to this perceived risk. Corporate governance lawyers now routinely advise boards to identify specific risks material to the business and, where appropriate and necessary, document appropriate reporting and oversight procedures. In a restructuring context, the recent *Caremark* cases may caution against the board "checking out" and delegating decisions to management or professional restructuring directors without the board understanding—and establishing reasonable oversight procedures for—material risks specific to the restructuring context.

Accordingly, drawing from U.S. corporate governance best practices broadly, here are some reminders of best practices for

[5] There is some debate under Delaware law whether directors of a solvent corporation owe fiduciary duties to the corporation alone or also to stockholders, and it is prudent for the board of a solvent (or potentially solvent) corporation to consider the separate interests of stockholders. The nuance is not relevant for our purpose here; under no circumstances do directors have a duty to creditors.

[6] In re Caremark Int'l Inc. Deriv. Litig., 698 A.3d 959, 967 (Del. Ch. 1996).

[7] The five cases are Marchand v. Barnhill, 212 A.3d 805 (Del. 2019), In re Clovis Oncology Derivative Litigation, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019), Inter-Marketing Group USA, Inc. v. Armstrong, C.A. No. 2017-0030-TMR, 2020 WL 756965 (Del. Ch. Jan. 31, 2020), Hughes v. Hu, C.A. No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020), and In re The Boeing Company Deriv. Litig., 2021 WL 4059934 (Del. Ch. Sept. 7, 2021).

Continued from p.29

corporate directors during a restructuring—the boundary lines for the Zone of Safety. These practices will be important over the coming years for many directors, especially those faced with challenging transactions, aggressive stakeholders, or potential conflicts of interest.

1. **Involve the Entire Board in Process Discussions.** The entire board should be involved in deliberating and approving the corporate governance procedures by which the board will oversee the restructuring. If the corporation uses a Restructuring Committee, Conflicts Committee, or similar committee to assist in its duty of oversight, the board should determine the charter and constituency of that committee after discussing and weighing available alternatives. The board should seek management and professional advice about these matters but should make its own decision.

2. **Disclose Conflicts to the Board.** The board should pay special attention early in the case to the disclosure to the board of all facts that create actual or potential conflicts of interest involving directors. If a director is to be characterized publicly or in court as "independent" or "disinterested," the board of directors should review the relevant facts and make a determination on the record as to whether or not the board believes the director is appropriate for that role.

3. **Pay Special Attention to Conflicts Relating to New Director Candidates.** Before appointing new directors who have been recommended by stakeholders (e.g., controlling owners) or restructuring professionals, the board should review and understand all the facts relevant to the relationship between the proposed director, the recommending party and other stakeholders in the case. Many types of pre-existing relationships are not disqualifying, but all relationships should be on the table for discussion and no potentially material information withheld from the board. This step can be invaluable in the face of potential future challenges to director independence.

4. **Build a Record that the Board Considered Alternatives.** When considering a subcommittee of independent directors in order to address conflict of interest concerns, the board should review a range of options. It is not enough to accept a single approach without deliberation merely because it is conventional or suggested by expert advisors. Over-delegation to a subcommittee and under-delegation are both potential problems during a restructuring. In some situations, the full board is a more appropriate forum for decision-making, even in the face of certain conflicts of interest, so long as the conflicts are disclosed fully and deliberations are conducted appropriately. In other situations, a subcommittee should be delegated the authority to make a recommendation to the full board, but not to take corporate action. In still other situations, a subcommittee should be delegated full power to act for the corporation and the corporation should consider using other elements of “special committee” or “special litigation committee” practice from outside of a restructuring context. Usually, there is no single right answer, other than that the process be determined by the directors after discussion with counsel and deliberation.

5. **Balance Expertise on a Restructuring Committee.** A good Restructuring Committee (regardless of its name) includes more than restructuring expertise. Incumbent directors are often very valuable and engaged members of the board during a challenging restructuring process, and the board should consider including one or more incumbent directors on any relevant subcommittee. We believe there are both process and litigation advantages in doing so. In fact, the testimony of incumbent, generalist directors about the restructuring process—just like the testimony of managers who are not “bankruptcy experts”—can be extraordinarily compelling in bankruptcy court.

6. **Keep a Disciplined Record of Deliberative Material.** Formal board meetings should be convened with appropriate frequency and involve written board minutes and other materials that demonstrate the informational basis for the board’s decisions. Whenever possible, the board should make a final decision only at these meetings after appropriate time to review materials. Directors should avoid reaching conclusive decisions about substantive matters outside of the context of a board meeting or basing their decisions on materials that are not vetted for review by the board. When the board must act by written consent, the record for the decisions should be documented appropriately and made available to directors before the written consent is signed. Discipline about meetings, consents, and related materials greatly reduces the burdensomeness of discovery requests and any confusion about the information the directors considered before acting.

7. **Be Familiar with the Law.** The board record should be clear that the directors were briefed about their fiduciary duties under corporate law and had time to ask questions of counsel. In addition, the board should understand basic restructuring law, the corporation’s duties as “debtor in possession” during a chapter 11 case, and the standard of review of the corporation’s actions if challenged in bankruptcy court. In many circumstances, the board’s own involvement and view of the reasonableness of a corporate action will be critical evidence in support of a motion in bankruptcy court. The board should understand—before corporate actions are taken—how the board’s decision-making will be referred to publicly and used in court.[8]

8. **Incorporate Stakeholder Feedback into the Record.** It can be tempting to ignore angry letters from creditors, or even to respond in kind, during a difficult restructuring. Directors should avoid direct contact with stakeholders, unless authorized by the board or applicable subcommittee. However, the board should review appropriate input from creditors and other stakeholders and consider its relevance. However, review and discussion of stakeholder views can be a critical part of the formal record of board proceedings, especially when the corporation ultimately makes a decision

[8] Although the directors of a (Delaware) corporation do not have a direct fiduciary duty to creditors, the Bankruptcy Code does impose trustee-like fiduciary duties on the corporation itself during chapter 11 when the corporation acts as a “debtor in possession.” A violation of these trustee duties by the corporation may cause the bankruptcy court to deny approval of corporate actions, may be grounds to remove the corporation as “debtor in possession,” or may give rise to monetary claims against the corporation.

with which a complaining stakeholder disagrees. The point is not to convince stakeholders to support the board's decision, but to document that the board had full information in making the decision in the first place and weighed all reasonable dissenting views.

9. **Confirm Reasonableness of Reliance on Management.** The board of directors should be appropriately sensitive to any conflicts of interest involving management or advisors during a restructuring. The board is generally entitled to rely on management within areas of its competence, but to obtain the full benefit of such reliance the board should establish a record that it has considered the applicable facts related to any potential conflict of interest. Again, it is a mistake to jump to the conclusion that a conflict of interest necessarily requires the exclusion of an officer from the deliberative process or the creation of a separate line of reporting. What any potential conflict of interest situation requires in the first instance is disclosure, disclosure, disclosure—and then discussion aided by counsel about the procedural options available in response.

10. **Update Insurance, Indemnification, and Exculpation.** Even with perfect corporate governance, lawsuits can still happen. Directors should review with management the corporation's arrangements for directors and officers (D&O) insurance, indemnification, and exculpation, ideally well before restructuring discussions begin in earnest. These protective arrangements may include provisions that deprive directors of the full benefit of the expected protections during a chapter 11 case (that is, when the corporation may require court approval to take corporate action necessary to trigger coverage). In addition, the suggested scope and duration of D&O insurance can change during a restructuring, and coverage enhancements are typically less expensive when purchased in advance. Fortunately, excellent coverage is usually available and the relevant technical concerns simple to address with timely preparation.

11. **Focus on Compensation at the Outset.** Finally, a word about management compensation. Compensation issues are a common source of negative attention by the press, politicians, employees, creditors and the United States Trustee.[9] Bankruptcy courts are typically supportive of reasonable and well-justified arrangements when important to preserve franchise value, but courts also can face pressure in approving even the most sensible arrangements given scrutiny from stakeholders and the public. It is essential that the board understand the executive compensation

landscape early in the restructuring process and develop a comprehensive compensation plan, as well as related communication materials. On the one hand, adequate compensation is clearly necessary for management to be the strong fiduciary the Bankruptcy Code requires. On the other hand, a board that simply writes checks (or seeks court authorization to do so) without building a solid record based on *both* bankruptcy rules and general executive compensation principles risks disgorgement litigation or other unwarranted criticism that will hurt the executives it intends to protect.

* * *

These 11 points are neither new nor particularly difficult. Directors and their corporate governance advisors need only to remember them and tailor as appropriately to the facts of each case. With directors in the Zone of Safety who are comfortable making hard decisions and taking appropriate risks, the U.S. system of corporate reorganization—whether out-of-court or pursuant to chapter 11—can continue to be managed by boards rather than creditors or court-appointed officials. In other words, our uniquely American approach to restructuring can continue on its remarkable path of preserving distressed going concerns and creating value for stakeholders.

The information contained in this article should not be construed as legal advice or as representing the views of any client of the Firm.

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[9] In 2005, a few notorious examples led Congress to amend the Bankruptcy Code by adding special limitations on senior management compensation that debtors must now navigate. Recently, a handful of cases involving large executive retention bonuses paid prior to bankruptcy (to avoid application of the 2005 rules once the bankruptcy commences) have elicited additional calls for reform. Daniel Gill, *Pre-Bankruptcy Pay a New Target for Fairness Advocates* (November 2, 2021, 6:01 AM), https://news.bloomberglaw.com/bankruptcy-law/pre-bankruptcy-executive-pay-a-new-target-for-fairness-advocates.

CORPORATE BANKRUPTCY AND RESTRUCTURING: 2023–2024

Richard G. Mason and Emil A. Kleinhaus
Wachtell, Lipton, Rosen & Katz

The jump in restructuring activity that many market observers had been predicting for years finally arrived in 2023. Sustained higher interest rates increased pressure on businesses with high debt loads. While Chapter 11 filings increased more than 70% year-over-year, companies also increasingly turned to “out-of-court” solutions to extend maturities or restructure their balance sheets, with nearly half of U.S. corporate defaults in 2023—compared to 20-30% in the early 2010s—attributable to “distressed exchange” activity.

Increased activity produced significant developments in both bankruptcy law and the liability management “technology” deployed to achieve out-of-court restructurings. Familiarity with these developments will prove valuable for challenged companies and investors alike.

Liability Management Unleashed

“Liability management” transactions, in which new or existing debtholders coordinate with a challenged borrower to provide liquidity, maturity extensions, discount capture, or other benefits—all while working within the confines of the company’s existing debt agreements—took center stage in 2023. Commentators counted 21 liability management transactions in 2023, more than double the prior peak in 2020, including several by public companies.

The year 2023 represented a high-water mark for market acceptance of the “modern dynamic” in the credit markets, in which creditors compete to offer distressed companies the most attractive out-of-court alternatives. In turn, liability management transactions have continued to grow in sophistication, complexity, and variety. For instance, new “double dip”[1] and “*pari* plus”[2] transactions emerged in 2023 and gained momentum, with each structure providing a new pathway for lenders to obtain enhanced credit support. With an expanding toolbox, challenged companies have sought to maximize competition between (or among) their existing lenders, on the one hand, and direct lenders outside their capital structure, on the other. In that context, existing lenders often conclude that the best defense against getting “primed” by new money is to propose their own transactions.

Although liability management structures have gained broader acceptance in the marketplace, litigation challenges remain common, both in New York courts and in bankruptcy courts in situations where the borrower ends up in Chapter 11. The resulting court decisions are increasingly shaping the contours of ongoing and future transactions.

The major court decisions of 2023 concerned non-pro-rata “uptiering” transactions. In such transactions, a majority of existing lenders amend credit documents to permit the borrower to incur new debt with senior rights to collateral. The consenting creditors then lend new money on a senior secured basis while also, frequently, transferring their existing debt to the borrower in exchange for new debt which also has senior claims.

Open-Market Purchase: A common exception to the typical credit agreement requirement that all lenders share recoveries *pro rata* is the ability to sell debt to the borrower in an “open market purchase.” In a number of transactions, companies have invoked the open market exception to effectuate “uptier” transactions in which they exchange existing loans for new, more senior loans (often with longer maturities). Non-participating lenders have argued that such transactions are not “open market purchases.” In *Boardriders* and *Serta*, New York trial courts found that the issue could not be decided as a matter of law, and declined to dismiss such challenges. But after Serta filed for bankruptcy, the bankruptcy judge rejected the prior ruling of the New York district court, holding that it was “very clear” that Serta’s repurchases were indeed “open market purchases.” The *Serta* decision is on appeal.

Good Faith and Fair Dealing: Also in *Serta*, a district court in New York concluded, in a preliminary ruling, that an uptiering transaction might violate the implied covenant of good faith and fair dealing under New York law. But that decision has proven to be an outlier. In *Serta* itself, the bankruptcy court ultimately rejected the implied covenant claim, and similar claims were also rejected in cases including *Trimark*, *Mitel*, and *Incora*.

A notable trend in liability management is that, while “uptier” and similar transactions have attracted scrutiny and litigation, “drop down” transactions (including of the double dip and *pari* plus varieties) have faced fewer challenges. “Uptiers” have also come in various stripes, with some deals involving elements that others lack, such as “upsizing” a debt issuance prior to a vote and equity sponsors that also have debt holdings. Given the small and large differences that exist between debt documents and transaction elements, risks and opportunities can vary widely. In 2024, we are certain to see more developments in this area, both in terms of transaction structures and litigation outcomes.

Mass Tort Bankruptcies

Several closely watched mass-tort bankruptcy cases came to a close in 2023, with a range of outcomes. Some cases, like *Boy Scouts of America*, came to a successful close,[3] while others, like *LTL Management* (the J&J subsidiary), were dismissed as improper Chapter 11 filings. In the meantime, debtors and

[1] Liability management is coming to the point where it requires its own glossary: a “double dip” transaction is a transaction in which a creditor lends money to a company’s non-guarantor subsidiary, guaranteed and secured on a *pari passu* basis with the company’s existing debt obligations. The subsidiary borrower then onlends the proceeds of the initial loan to the company’s credit group, again guaranteed and secured on a *pari passu* basis with existing debt obligations. As a result, the new creditor has (1) a direct claim against the credit group through the initial loan (“dip” one), and (2) an indirect claim against the credit group via the intercompany loan (“dip” two).

[2] A “*pari* plus transaction” is one in which new-money lenders receive both a *pari passu* claim against the existing credit group and claims against an entity or assets that sit outside the existing credit group. This creates an obligation that is structurally senior to those of existing creditors on a portion of the enterprise.

[3] https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28316.23.pdf.

claimants await a highly anticipated ruling regarding non- debtor releases from the Supreme Court in *Purdue Pharma*. As these and other recent cases show, Chapter 11 remains an active forum for resolution of mass tort situations, but one accompanied by significant scrutiny.

Non-Debtor Releases: One of the most hotly disputed issues in recent mass tort bankruptcies has been whether plans of reorganization (outside of the asbestos context, where the Bankruptcy Code contains special provisions) can impose non-consensual releases of claims against persons other than the debtor ("non-debtor releases"). In 2023, the Supreme Court agreed to hear the *Purdue Pharma* case to address provisions of a plan, which was approved by the bankruptcy court, that would release members of the Sackler family from liability to claimants in respect of Purdue's opioid products. A ruling is expected in the first half of 2024.

While the ruling in *Purdue Pharma* is likely to provide important guidance regarding the permissibility of nonconsensual non-debtor releases, many questions will likely remain unanswered. If the Supreme Court affirms the plan, parties will need to consider whether non-debtor releases are likely to pass muster under whatever standard the Supreme Court articulates. If the ruling is reversed, companies facing mass tort liability will need to evaluate whether there are other tools available in Chapter 11 to address their exposure to large numbers of tort claims.

The "Texas Two-Step": Another big topic in the mass tort space has been the so-called "Texas Two-Step." The Texas Two-Step relies on a provision of Texas corporate law permitting "divisional mergers," whereby a company divides itself into multiple entities and allocates its assets and liabilities among them. In a Texas Two-Step, the operating assets are allocated to one entity, tort liabilities are allocated to another, and the entity with the tort liabilities then files for Chapter 11. The operating entity remains exposed to the tort liabilities through a "funding agreement" in favor of the bankrupt entity, but in the form of a contractual obligation to the bankrupt entity rather than direct liability to individual plaintiffs.

The Texas Two-Step was most prominently employed in the case of *LTL Management*. Early in 2023, the Third Circuit issued a ruling[4] finding that LTL, a Johnson & Johnson subsidiary, was not facing "financial distress" and thus could not avail itself of Chapter 11. But while *LTL* was dismissed based on its facts, the decision left open the question of whether the Texas Two-Step is *per se* an impermissible route to bankruptcy. And multiple Texas Two-Step bankruptcies remain ongoing in other jurisdictions.

While there have been significant innovations and successes in the mass tort bankruptcy space, complexity abounds and challenges are common. For companies with mass tort issues, careful consideration is required to assess whether Chapter 11 provides a more favorable forum for resolution of claims than is otherwise available.

[4] https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28269.23.pdf.

Securities Safe Harbor Continues to Be Inviting

The Bankruptcy Code's "safe harbor" provisions protect payments made by or to significant financial parties in connection with securities transactions from various bankruptcy- related litigation challenges. In *Nine West*, where the company's creditors alleged an LBO rendered the company insolvent and sought to avoid payments made to pre-LBO shareholders on fraudulent conveyance grounds, the Court of Appeals delivered a significant decision late last year.[5] The Second Circuit held that, because the purchase of stock from most pre-LBO shareholders was executed through a major bank, the payments were protected by the Bankruptcy Code's safe harbor provisions. The *Nine West* decision continues a trend of broad application of the safe harbor to protect securities transactions from attack in bankruptcy.

Developments in Allowance of Make-Wholes and Post-Petition Interest

Several disputes have emerged in recent years over whether unsecured creditors must receive post-petition interest and make-whole payments to be considered "paid in full" or "unimpaired" under the Bankruptcy Code, particularly where the debtor is solvent.

In insolvent cases, the trend has been toward not requiring such payments. In 2023, the Supreme Court declined to review the Second Circuit's 2022 ruling in *LATAM Airlines* that a Chapter 11 plan may, in an insolvent case, classify unsecured creditors as "unimpaired" without paying post-petition interest.

Even in solvent cases, outcomes have varied. *Hertz* was a solvent case in which common equity holders received material recoveries on account of their stock. The bankruptcy court ruled that Hertz's unsecured noteholders were entitled to post-petition interest, but only at the federal judgment rate, rather than the higher contract default rate. The court also disallowed the noteholders' claim for a make-whole. The noteholders appealed, and as of the time of this publication, are awaiting a ruling from the Court of Appeals for the Third Circuit, which includes Delaware. It remains to be seen whether the Third Circuit will join recent decisions from the Fifth[6] and Ninth[7] Circuits endorsing payment of contract-rate interest and make-wholes in solvent cases, or whether it will affirm the bankruptcy court's decision, creating a split in authority on this significant issue (thereby increasing the possibility of the issue reaching the Supreme Court).

Potential Trends for 2024

Below are other topics we are monitoring as we head into 2024:

Crypto Bankruptcies and the Rise of Examiners. Perhaps the greatest concentration of large Chapter 11 filings in 2023 involved cryptocurrency companies. In the largest of these cases, *FTX*, a request was made early in the case by the United States Trustee for the appointment of an examiner under a provision of

[5] https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28449.23.pdf.

[6] https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28196.22.pdf.

[7] https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.28172.22.pdf.

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the Bankruptcy Code providing that, if requested by a party, an examiner "shall" be appointed to investigate the debtor in any case where unsecured debts exceed $5 million. The bankruptcy court denied the motion. The Third Circuit recently reversed the bankruptcy court decision, holding that the Bankruptcy Code provision is in fact mandatory, and ordered the appointment of an examiner. We anticipate that this ruling will result in an increase in examiner appointments in large Chapter 11 cases.

All Eyes (Still) on Reinstatement. We wrote last year that the rapid rise in interest rates may tempt debtors to seek to reinstate fixed-rate instruments with below-market terms. We continue to believe participants in the Chapter 11 process would be well-served to evaluate the opportunity for (in the case of debtors) and risk of (in the case of lenders) reinstatement of company-favorable financing arrangements.

Rise of UK Restructuring Plans? The United Kingdom recently created a new type of insolvency proceeding called the "Restructuring Plan." This framework may offer greater flexibility than Chapter 11 to allocate value among constituencies, as a plan can be crammed down on creditors without regard to the U.S.-style absolute priority rule, provided non-consenting classes are no worse off under the plan than they would have been under the "most likely alternative," and the plan obtains 75% support from at least one class of creditors. While the law around this new kind of proceeding is still developing, it may in some cases enable constituencies that would be barred from recovering in Chapter 11, including equity-holders, to retain value through a Restructuring Plan.

We expect 2024 to be an active year as stressed and distressed companies grapple with a potentially "higher for longer" interest rate environment and, in some cases, approaching maturity walls. Navigating this environment will require careful planning and preparation.

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RESUMPTION OF STUDENT LOAN REPAYMENTS: WHAT DOES THIS MEAN FOR RETAILERS?

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Introduction

The reality of student loan debt repayment crashed onto borrowers after a three-year payment hiatus ended in the fall of 2023 when the Supreme Court struck down the Biden administration's one-time student loan forgiveness plan. As affected borrowers now grapple with a resurrected financial burden, on top of a tight budget due to inflation and increased borrowing costs, retailers should expect to see a disruption in consumer spending and weakened demand. To capture consumers' share of downsized wallets and protect their top and bottom lines, retailers require a greater understanding of their customer base, how customers are impacted by debt, and strategies to accommodate consumers' current challenges.

How Did We Get Here?

Federal borrowers[1] were the biggest beneficiary from the suspension of student loan repayments. The hiatus afforded borrowers $260 billion in waived payments over the forty-three months of forbearance.[2] Assuming an average of ~$6 billion per month, this equates to an incremental $140 per federal borrower per month[3] during the hiatus from March 2020 to September 2023, resulting in an uptick in discretionary spend in 2021 driven by the pause and economic stimulus.[4]

With student loan repayments returning in October 2023, JP Morgan forecast that repayments will hit federal student loan borrowers at ~$10 billion per month.[5] We estimate that once repayment commences, the average borrower will have ~$276 less per month of spending power—see Exhibit 1.[6]

With impacted borrowers hopeful that student loan debt would be forgiven, the three-year payment freeze resulted in increasing debt for non-student loans, particularly in credit card and auto loans. Since 2021 when consumers' savings peaked, delinquencies have been steadily increasing while savings have begun to decrease in aggregate, as seen in Exhibit 2. A recent survey estimated that approximately 60 percent of those who could afford loan payments prior to payment freeze now struggle to pay.[7]

Borrowers Below Median Income[8]

Repayments returning may disproportionately weigh down lower-income borrowers. Lower-income consumers saw a spike in spending in 2021, driven by increased disposable income, with 97 percent of lower-income households receiving economic stimulus.[9] In 2022, as stimulus ended and inflation kicked in, consumer spending decreased.[10] Financial hardships continue to fall primarily on lower-income consumers who are caught between increased prices and high interest rates on consumer borrowing.[11] In addition, lower-income consumers living paycheck to paycheck rose to nearly 80 percent in July 2023.[12] Exhibit 3 (on page 38) presents a look at how the behavior of lower-income consumers changed over the past four years.

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[1] Federal borrowers make up about 93 percent of all student loan borrowers. See Melanie Hanson, "Student Loan Debt Statistics," Education Data Initiative, accessed August 2023, https://educationdata.org/student-loan-debt-statistics.

[2] Raji Chakrabarti, Daniel Mangrum, Sasha Thomas, and Wilbert van der Klaauw, "Borrower Expectations for the Return of Student Loan Repayment," Liberty Street Economics, October 18, 2023, https://libertystreeteconomics.newyorkfed.org/2023/10/borrower-expectations-for-the-return-of-student-loan-repayment/#:~:text=As%20discussed%20in%20an%20accompanying,over%20the%20last%20three%20years.

[3] BRG analysis of "Federal Student Aid Portfolio Summary," Federal Student Aid (FSA), November 2023, National Student Loan Data System (NSLDS).

[4] US Bureau of Labor Statistics, "Consumer spending increased 9.0 percent in 2022," *The Economics Daily*, October 4, 2023, https://www.bls.gov/opub/ted/2023/consumer-spending-increased-9-0-percent-in-2022.htm.

[5] Jinjoo Lee, "Student-Loan Repayments Are Coming Back. Retailers Are in for a Big Shock." *Wall Street Journal*, June 16, 2023, https://www.wsj.com/articles/student-loan-repayments-deadline-economy-913acc34?st=4eu02or9565the0.

[6] BRG analysis; Melanie Hanson, "Student Loan Deby by Income Level," Education Data Initiative, last modified November 2023, https://educationdata.org/student-loan-debt-by-income-level.

[7] Lyss Welding, "Student Loan Forgiveness: 2023 Facts and Statistics," Best Colleges, July 14, 2023, https://www.bestcolleges.com/research/student-loan-forgiveness-statistics.

[8] In this article, households with annual earnings below the national median income of $52,000 are considered "lower income."

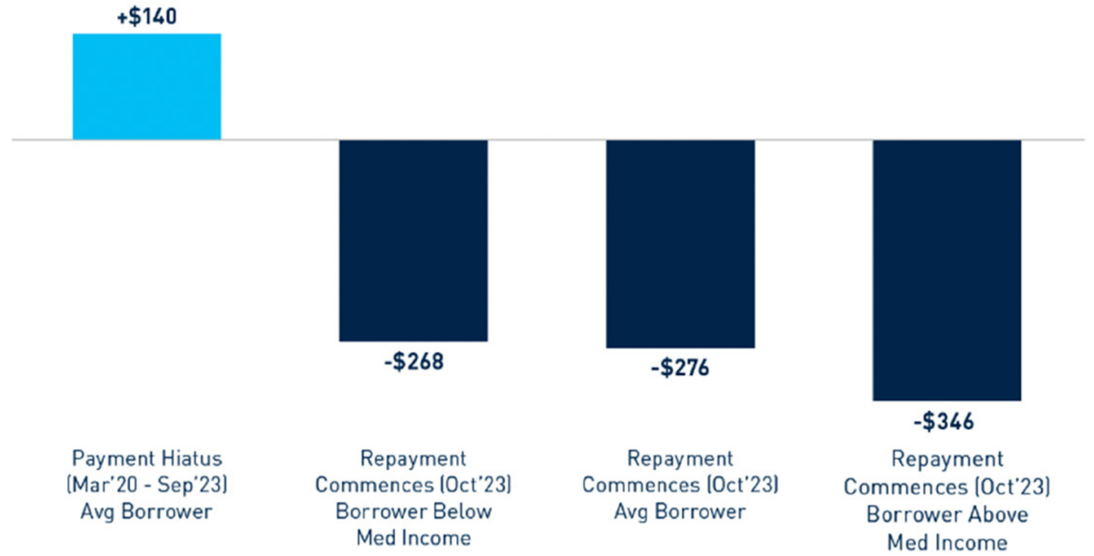
[9] Rakesh Kochhar and Stella Sechopoulos, "COVID-19 Pandemic Pinches Finances of America's Lower- and Middle-Income Families," Pew Research Center, April 20, 2022, https://www.pewresearch.org/social-trends/2022/04/20/covid-19-pandemic-pinches-finances-of-americas-lower-and-middle-income-families/.

[10] Lucia Mutikani, "U.S. consumer spending ends 2022 on weaker footing; inflation slowing," Reuters, January 27, 2023, https://www.reuters.com/markets/us/us-consumer-spending-falls-inflation-cooling-2023-01-27/.

[11] Max Zahn, "Credit card debt has reached a record high. Here's what it means for the economy," ABC News, November 8, 2023, https://abcnews.go.com/Business/credit-card-debt-reached-record-high-means-economy/story?id=104717977.

[12] PYMNTS and LendingClub, *New Reality Check: The Paycheck-to-Paycheck Report*, August 2023, https://www.pymnts.com/study/reality-check-paycheck-to-paycheck-indulgent-spending-financial-distress/.

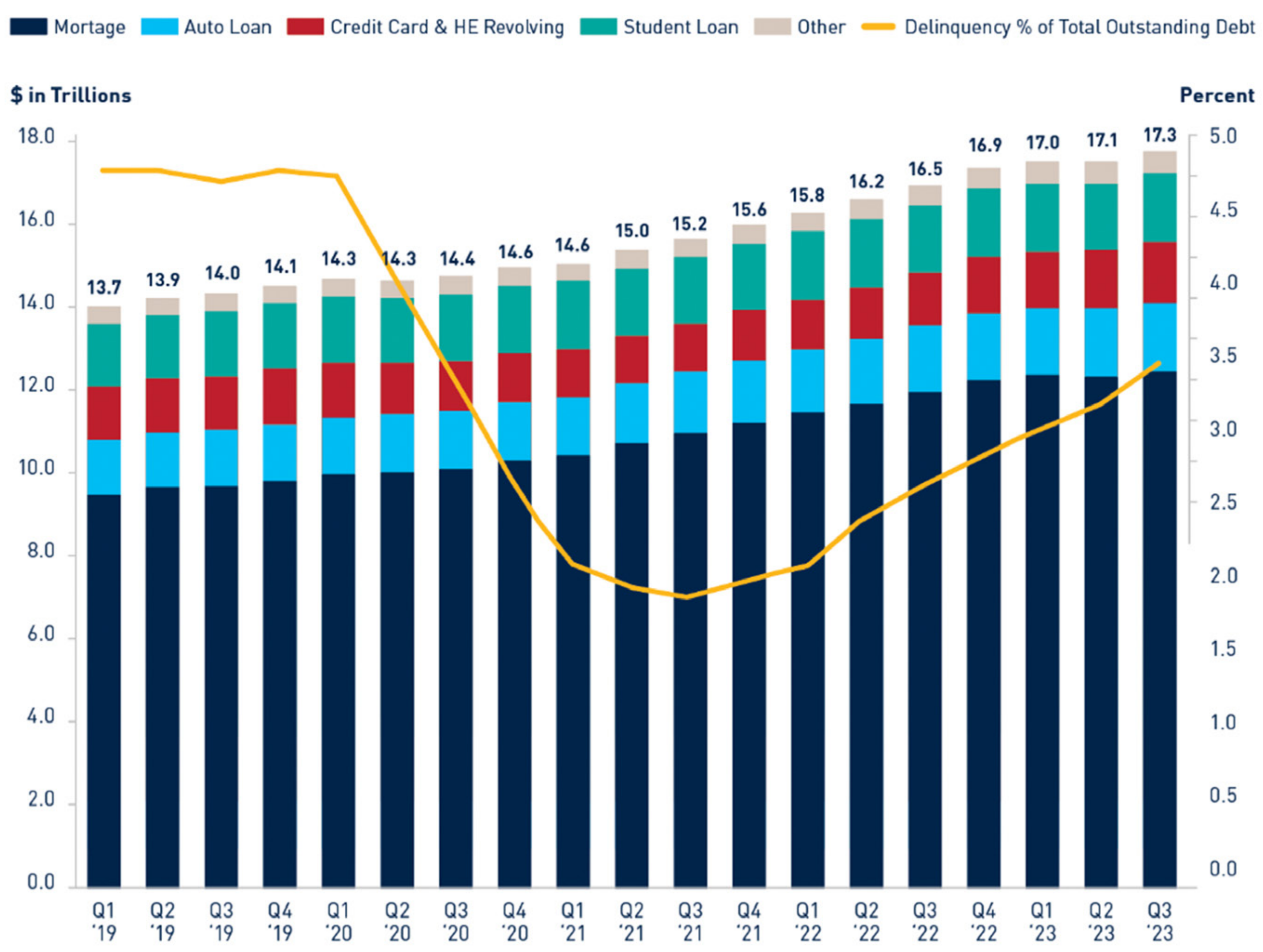
Exhibit 1: Change to Wallet—Monthly Average per Borrower*



**Payment hiatus* change to wallet considers federal borrowers only; changes to wallet after *repayment commences* consider federal and private borrowers.

Source: BRG analysis of FSA data (2023); Hanson (2023).

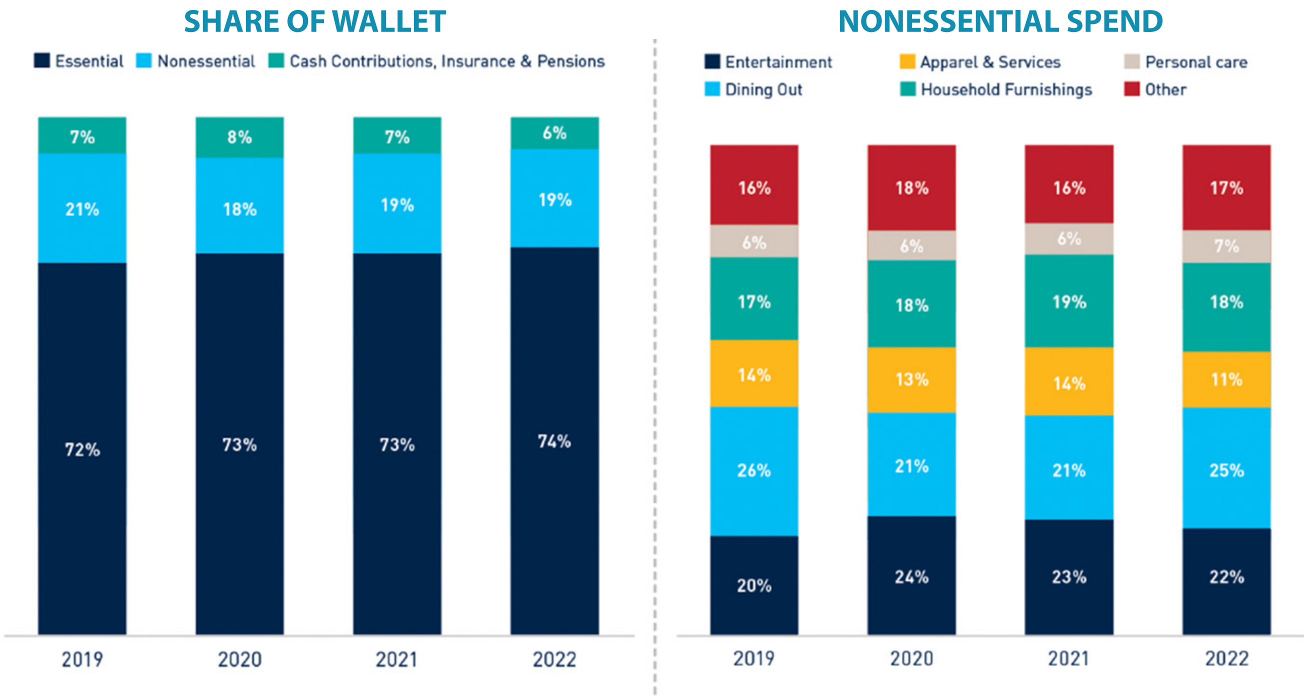
Exhibit 2: Total Debt Balance and Delinquency—Q1 2019: Q3 2023



Source: BRG analysis of Federal Reserve Bank of New York, "Quarterly Report on Household Debt and Credit."

Continued from p.37

Exhibit 3: Share of Wallet and Nonessential Spend for Consumers Below Median Income



Source: BRG analysis of US Bureau of Labor Statistics, Consumer Expenditure Surveys (2019–2022).

Borrowers Above Median Income[13]

While lower-income households benefitted from the relief of the payment hiatus, borrowers above median income had student loan payments baked into their budgets; they continued to make payments and pay off more debt throughout the hiatus to take advantage of the pause on payments and interest rates.[14]

Excess pandemic savings, as well as increased home and stock values, contributed to strong higher-income consumer spending, despite inflation, as reflected in Exhibit 4.[15] The return of repayments is less likely to impact this cohort, but other macro factors may influence these consumers. A decline in consumer sentiment in October 2023 shows this cohort cutting back, trading down, and leveraging financing options like "buy now pay later (BNPL)."[16]

Expected Impact on Retail

As budgets squeeze due to student loan repayments, consumers are likely to cut down on nonessential spending. Retailers that target lower-income consumers may feel increased pressure, and premium retailers that typically target higher-income consumers may be faced with customers trading down. The chart in Exhibit 5 depicts BRG's projected impact to consumer wallets by income group and category in 2024.

Mass merchandizers, discount retailers, and private labels may benefit as consumers trade down to cheaper alternatives.[17] Retailers that have put effort behind affordable fashion, such as mass merchandizers that have invested in apparel, may benefit as apparel is the top nonessential retail item that budget-squeezed consumers spend on.

Department stores and specialty retailers are expected to be hard hit in 2024.[18] With consumers trading down to value players and forgoing new appliances and household furnishings, department stores and specialty retailers risk a declining top line.

Home goods and sporting goods retailers are also vulnerable to this shift, showing a decline year over year in October 2023, falling 12 and 4 percent, respectively.[19]

Consumers are likely to make more use of lenient financing offered by retailers—Exhibit 6 reflects August 2023 data on the percent of consumers who used deferred payment options. While lower-income consumers are more likely to be light users of deferred payment plans, consumers above median income report being moderate and heavy users of lenient financing

[13] In this article, households with annual earnings above the national median income of $52,000 are considered "higher income."

[14] Sarah Turner, "Student loan pause has benefitted affluent borrowers the most, others may struggle when payments resume," Brookings, April 13, 2023, https://www.brookings.edu/articles/student-loan-pause-has-benefitted-affluent-borrowers-the-most-others-may-struggle-when-payments-resume/; Sandy Baum and Adam Looney, "Who owes the most in student loans: New data from the Fed," Brookings, October 9, 2020, https://www.brookings.edu/articles/who-owes-the-most-in-student-loans-new-data-from-the-fed/#:~:text=The%20highest%2Dincome%2040%20percent,10%20percent%20of%20the%20payments.

[15] Abha Bhattarai, "Americans, especially wealthy ones, are still spending big," *The Washington Post*, October 24, 2023, https://www.washingtonpost.com/business/2023/10/24/consumer-spending-wealthy-economy-gdp/.

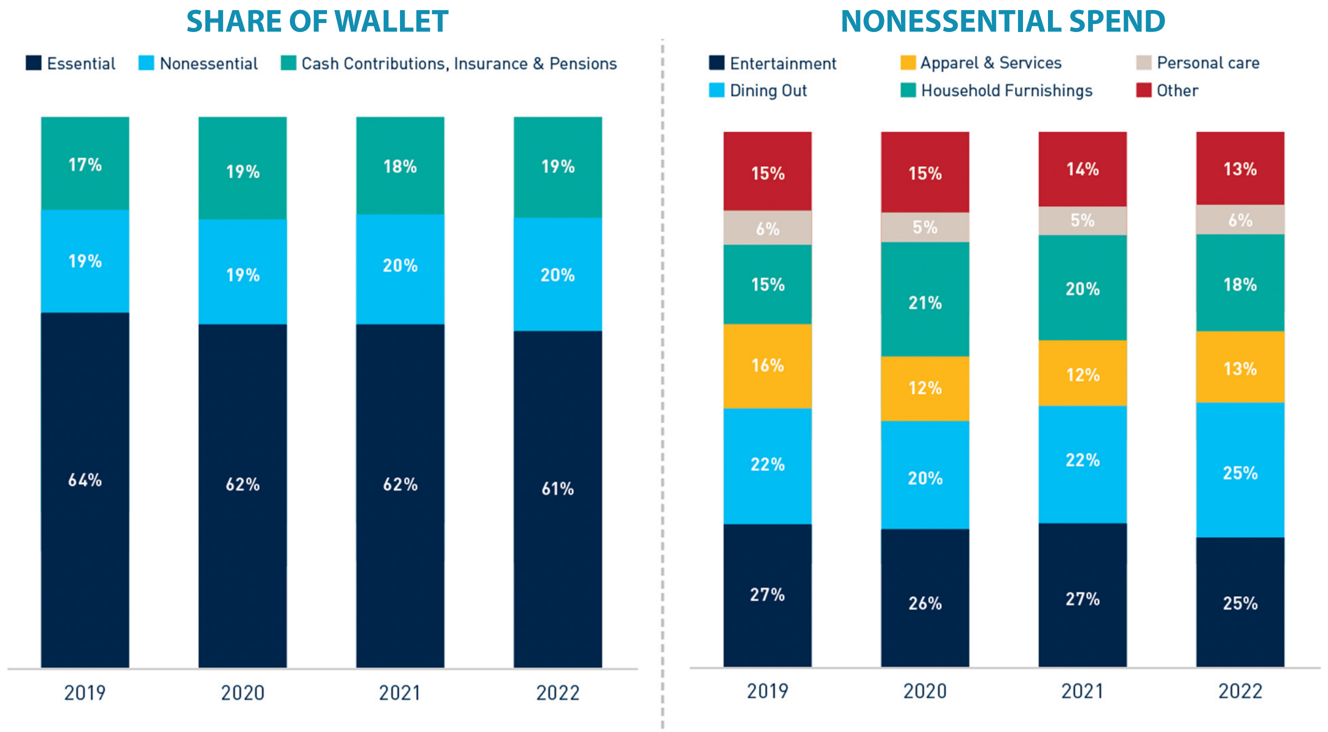
[16] PYMNTS, "Are High-Income Consumers Poised to Pull Back and Trade Down?", October 27, 2023, https://www.pymnts.com/consumer-finance/2023/are-high-income-consumers-poised-to-pull-back-and-trade-down/.

[17] Dominick Reuter, "Student-loan holders will soon have $300 less to spend each month. That could be bad news for Target and Dick's," Business Insider, July 10, 2023, https://www.businessinsider.com/student-loan-payments-will-affect-target-more-than-walmart-2023-7.

[18] Jacob Bogage and Jaclyn Peiser, "Consumers and retailers brace for student loan payments restart," *The Washington Post*, June 30, 2023, https://www.washingtonpost.com/business/2023/06/29/student-loans-economy/.

[19] Daphne Howland and Caroline Jensen, "Monthly retail sales from the US Commerce Department," Retail Dive, December 14, 2023, https://www.retaildive.com/news/department-stores-decade-of-decline/586488/.

Exhibit 4: Share of Wallet and Nonessential Spend for Consumers Above Median Income



Source: BRG analysis of US Bureau of Labor Statistics, Consumer Expenditure Surveys (2019–2022).

Exhibit 5: Retail Categories—Projected Share of Wallet

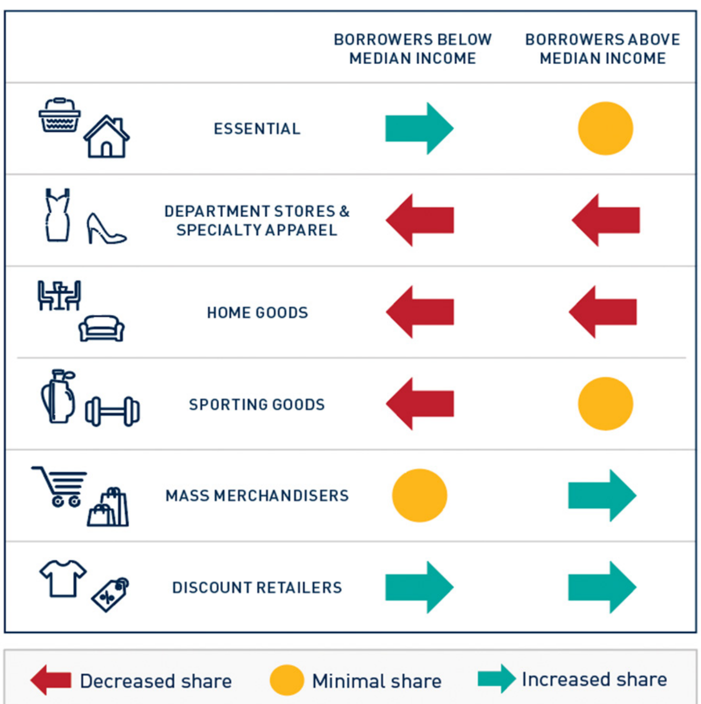
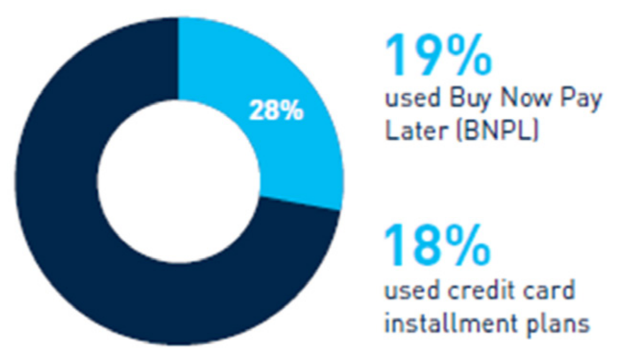


Exhibit 6: % of Consumers Using Deferred Payments in the Last 3 Months as of August 2023



Source: PYMNTS and Amazon Web Services, *Tracking the Digital Payments Takeover* (August 2023).

offerings. Consumers who used lenient financing for their purchases in prior months may struggle to make payments currently. Clothing and accessories are the most common retail items purchased with deferred payment plans.[20]

[20] PYMNTS and Amazon Web Services, *Tracking the Digital Payments Takeover*, August 2023, https://www.pymnts.com/study/tracking-digital-payments-takeover-installment-plans-bnpl/.

Questions for Retailers Navigating Uncertainty

Facing a changing consumer wallet due to student loan repayments, retailers need to address critical questions to navigate the uncertainty ahead.

1. **What is the value proposition for customers?**
   - Now more than ever retailers will need to know their customers' preferences and offer a compelling assortment that will drive conversion.
   - As consumers will have less discretionary income with student loan repayment, retailers need to demonstrate value proposition to earn every sale.

Continued from p.39

- Leveraging lifetime value (LTV) and customer-centricity to inform product strategy can help ensure retailers offer compelling products at attractive price points to their best customers.
- Retailers may also consider lenient financing offerings and promotion in their go-forward strategy.

2. **What product categories does the brand stand for?**
   - Prioritize a focused assortment: double down on what you are good at.
   - Products must resonate with the consumer.
3. **Is there a disciplined inventory strategy?**
   - More flexible open-to-buy and speed-to-market.
   - Retailers should be laser focused on buying the right depth and breadth of assortment.
   - Rationalize the assortment and cut the unproductive tail.
   - Taking appropriate markdowns will be critical to clear aging inventory and improve working capital.
4. **Is the organization nimble?**
   - Roles and responsibilities should be aligned to business drivers.
   - Implement processes to enable quick decision-making and eliminate unnecessary roadblocks.
   - Organizational results are based on clear and measurable key performance indicators.
5. **Is tackling margin erosion a priority?**
   - Retailers need to take a deep look at promotion strategy and marketing effectiveness to drive margin-accretive sales.
   - Leverage analytics to focus investments on high-margin, high-sell-through products and look to exit unprofitable categories that are not drivers for your core business.
6. **What opportunities are the organization pursuing to drive cost efficiencies?**
   - As retailers continue to face downward pressures on the top line, reducing indirect costs will be a key lever to maintain profitability.
   - Retailers will also need to scrutinize return trends to understand fully loaded costs associated with e-commerce.
   - In a weak environment of consumer demand, retailers will need to find a strategy to disincentivize returns via shipping while not alienating the consumers and ultimately hurting the top line.

These questions should serve as the groundwork for retailers that are looking to face the uncertainties of consumer spending strategically in 2024. Without the proper tools in place to weather a challenging period of volatile inflation rates, high borrowing costs, and revamped student loan payments, retailers will inevitably miss out on target customers.

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WHEN COMPANIES NEED A CHANGE AGENT

William Snyder, Carmen Barrett, and Cody Clarke
CR3 Partners

There is a difference between steady state management and change agents. A great steady state management team can execute an operating plan every day with precision. They can do the same thing over and over, never deviating from the defined process. Management disciplines such as Six Sigma are designed to support these teams by minimizing variation, thereby increasing efficiency. Building the type of team that can execute with continued precision is difficult and oftentimes these teams cannot react to deviations in the process. Deviations from a defined process can create conflict in an organization that is dedicated to staying the course. The team may resist making wholesale changes and will instead make small revisions to improve the process, though many times this turns into an exercise in micro-incrementalism. Employees in an organization that advocate change can be marginalized to reduce tension.

Every company will eventually face internal or external pressures requiring them to pivot. It is hard to imagine a company the size of Amazon would have to undergo a major change but even Jeff Bezos in 2018, during an all-hands meeting in Seattle, told his employees, "I predict one day Amazon will fail. Amazon will go bankrupt."[1] Bezos' goal is to delay the inevitable.

In cases like these, a great steady state management team needs to be augmented with a change agent. A Chief Restructuring Officer (CRO), sometimes referred to as a Chief Strategic Officer, is a change agent tasked with helping the team address deviations. The CRO is usually brought in by stakeholders in the capital stack—people who have money to lose.

Most companies are managed by a C-suite that includes a CEO, CFO, COO, CIO, and others. Each function reports to the CEO, the orchestrator of the operating plan. The owners, represented by the Board of Directors, set the strategic goals along with the C-suite. The role of the CRO is to drive change in the organization. The CRO reports to the Board of Directors along with the CEO. The CRO at times can be seen as the copilot of the organization—the CEO keeps the plane flying while the copilot figures out how to fix it. The CRO is meant to be a temporary part of the team. In a steady state, the existing management team and processes work, making the CRO an unnecessary expense.

Unfortunately, many of the companies we work with have less than three weeks' cash. Their options may be limited, but action must be taken swiftly. The sooner change can be implemented, the more runway there is to see the results. Teams, including capital sources, that are reluctant to pivot can delay the change agent's decisions until the results are untenable, usually an inability to pay bills as they come due.

Effective turnaround engagements are a defined process and an ongoing one. To be effective they must be immediately impactful.

Key Steps of the Restructuring Process

Exhibit 1 lays out key steps in order for the process of restructuring to be immediately impactful and effective.

Alignment of Goals

Alignment of goals at the start of a case is critical. There must be buy-in from the Board of Directors, capital stakeholders, and management. Turnaround plans are, by their nature, disruptive, and one party undermining the actions may cause the process to fail. Alignment should include CRO reporting structures, access to information and personnel, time frames, and a communication protocol to ensure transparency. Due to tight timelines, it is imperative that the CRO be empowered to execute the new plan.

Evaluation

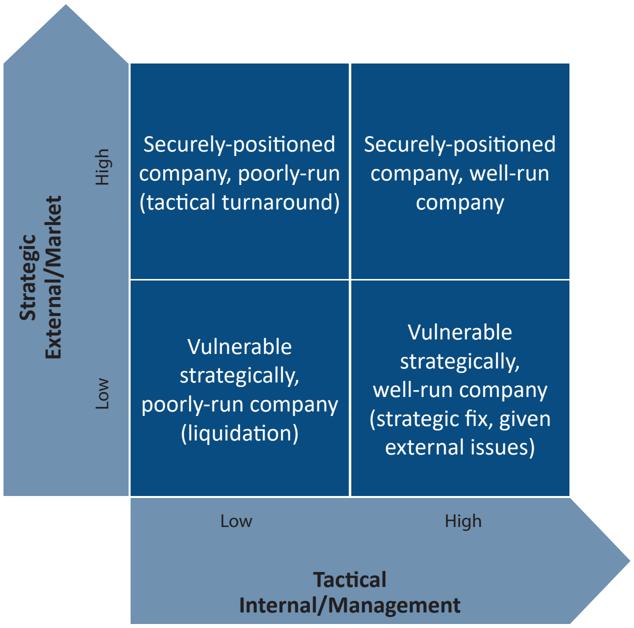
The evaluation phase often incorporates immediate cash preservation initiatives since in most cases the company has liquidity issues. One of the first priorities is determining what is moving the company in the wrong direction—either internal operations or outside influences, diagrammed in Exhibit 2 on the next page. Most of the time there is a combination of both, although usually one dominates. Internal issues are much easier to fix since management has complete control of what happens within the walls of the company. Outside issues are more difficult to assess and solve. This is the point where the CRO and management team must size up the steps necessary and determine if there are sufficient resources to deal with

[1] CNBC: https://www.cnbc.com/2018/11/15/bezos-tells-employees-one-day-amazon-will-fail-and-to-stay-hungry.html.

Exhibit 1: Steps in the Restructuring Process

Continued from p.41

Exhibit 2: Strategic vs Tactical Turnaround



the negative forces—not all companies can be restructured. At times the best solution is to sell the company's assets or liquidate them, although that is the exception.

Very few companies are "dead." Usually, there is a core business worth saving. The goal is to "find the live pony in the dead horse."

Most companies must shrink first by implementing cuts so they can return to profitability and then grow to prosperity. This process involves intense data mining to determine core products, customers, and locations. Data mining is a critical component of the evaluation phase and most companies today have a wealth of data in their ERP systems as compared to systems from decades ago. Unfortunately, while the data may exist, companies often cannot access it or get it into a form that is usable. For the CRO team, the ability to evaluate a company's records is a critical step in the process and the CRO team needs to include the skills to mine and analyze the data. Exhibit 3 provides an overview of many of the best sources of information.

The evaluation phase concludes with a report to the board and stakeholders regarding the steps and capital needed to complete the turnaround. The evaluation always contains alternatives based on capital and resources available to complete the transformation. A competent management team that can execute the plan is a major, necessary component, although contract supplemental professionals can bridge the gap until permanent management is found. If sufficient capital is available, a restructuring is usually preferable to maximize value. All too often, the capital required cannot be raised and the assets are sold to another entity that can capitalize on the "live pony."

Stabilization

In rare circumstances, the best option is a total liquidation where there is no strategic reason for the assets to go forward as a going concern. All options are weighed during restructuring, as any process that does not allow any points of failure is doomed. This is especially true when outside forces must cooperate to be successful. The plan should be documented with responsibilities, milestones, and contingencies so that the team knows who is responsible for each action and can pivot quickly if necessary.

Immediate restructuring steps are generally taken in the evaluation process to stabilize the company. For example, cutting product lines or selling excess inventory. These actions can end up strategic in nature when they were originally tactical decisions to live another day. Much like the work of an emergency room doctor performing an amputation, the patient is saved although the rest of their life is affected by the steps taken.

Execution of Improvements

Operational changes are much harder to execute than most realize. Often, processes have been in place for decades and have become part of the culture. Additionally, these processes may have seemingly worked for decades but were either impacted by a sudden change or a change so slow that management lost sight of it. Getting alignment from employees, customers, and suppliers can be difficult as these constituents may be distrustful of the change or the CRO. Most often though, a sudden pivot is necessary to preserve capital, making alignment of goals and empowerment of the CRO imperative. The objective eyes of the CRO can help make these quick decisions. A CRO should be mindful of their temporary position and work to build support for change within the organization.

Implementation of Reporting and Tracking Systems

Once the improvements are executed and operations are fixed, a robust reporting system must be implemented to track successes and to serve as an early warning system. The Board of Directors and management must identify the key issues that are fundamental to the organization and how to track them. If the processes are not tracked and employees held accountable, they tend to revert to prior practices, particularly after the CRO disengages. The company drifts back to prior practices and fails

Exhibit 3: Best Sources of Information

Employees	Internal Systems	Customers	Suppliers	Competition
•Great source for internal information. •Outspoken employees prevoiusly may have been marganilized - important to demosntrate they have a voice. •Come to find many strong employees still remaining.	•Company's raw data •Specific company detail at a granular level. Can paint a very clear picture. •More often than not data will be unorganized and reqiure filtering & organizing. •Data mining skills paramount (incl. Excel).	•Many times who is not buying is as important as who is. •Largest source of incoming cash flow. Key to maintain relationships and build new ones where opportunites arise.	•Market knowledge & competitor insights. •Major company artery: Critical to production & scheduling. •Vital to get an open line of cummunication with critical vendors ASAP.	•Provide a snapshot of market trends. •Ability to emulate a succesful competitor. •Key to understand where the Company's has competitive advantages as well as disdvantages.

again. The management team must be committed to the new way of operating.

EXIT

Turnarounds are much faster than most people realize. Most client engagements last about six months. It takes 4-6 weeks to assess the issues, 2-4 months to affect the change, and 2-4 months to ensure the change is working and the company is set up to continue the new processes. Turnarounds at larger organizations can take longer but will follow the same steps. For *Pilgrim's Pride*, the entire restructuring process was only one year, while *Furr's Cafeterias* was implemented in four weeks.

Case Examples

Pilgrim's Pride Company was a public $8B sales company that was the largest integrated poultry producer in the United States. The company filed for bankruptcy in December of 2008 and emerged from Bankruptcy one year later, paid all of its claims, and returned about $500MM of value back to the shareholders. This was a tactical restructuring. The core poultry business was very sound, it simply produced more chicken than customers demanded, resulting in a loss in the market. By eliminating one billion pounds of production and all of the related costs, the company bounced from a $350MM loss to a $650MM profit in less than a year. Over $500MM of expenses were taken out of the company when it was rightsized, and it is still prospering today.[2]

Furr's Cafeterias was a public 100-store, in-line cafeteria chain. The concept was dying along with other chains in the industry. The decision was to close 40 stores and move to an all-you-can-eat concept. This required changing the entire menu to speed-scratch recipes to get the cost down to make the business model work. The entire kitchen, serving line, and cash register had to be reconfigured. This change was implemented in four weeks. The company was sold out of bankruptcy and was in business from 2002 to until shutting down in 2020 during COVID.

Conclusion

Change is inevitable and even great management teams can fail in addressing it. The CRO is a partner to management, helping them navigate the change, and driving meaningful and lasting improvements. The sooner the change agent can join the team, the higher the chances of a successful turnaround.

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[2] Detailed case study at https://www.cr3partners.com/case-studies/pilgrims-pride.

ROLLIN' THE DICE: MAJESTIC STAR CASINO AND THE S ELECTION REVOCATION GAMBLE

Nataly Brown, Nate Meyers and Michael Barton, CIRA
RSM US LLP

Introduction

Taxpayers in bankruptcy are often confronted with a litany of legal hurdles and tax planning may take a backseat. While tax is generally not at the forefront of thought in bankruptcy proceedings, taxpayers should be aware of the critical implications of their tax entity classification. The purpose of this article is to discuss the dichotomic dilemma that arises when an S corporation or its QSub (defined below) is entering bankruptcy, but the owner(s) themselves are not.

Background

One of the greatest tax concerns of a financially distressed company undergoing a debt restructuring is generally cancellation of debt income, colloquially referred to as CODI. At a very high level, debtors generally realize and recognize income when all or a portion of their current debt is actually or deemed satisfied for an amount less than the original outstanding liability.[1]

In terms of tax entity classification, S corporations are unique and are generally chosen for their flow-through / corporate hybrid structure. As a consequence, for federal income tax purposes, CODI passes through to the shareholders who increase their basis in their stock by such amount.[2] Shareholders who have suspended losses may benefit from the basis increase which could free up suspended losses to help offset CODI.[3]

There are two major relevant exclusions to the general rule of income recognition, which are the insolvency and bankruptcy exclusions.[4] Generally speaking, the bankruptcy exclusion excludes from gross income any amount of indebtedness discharged in a Title 11[5] case.[6] The bankruptcy exclusion is only applicable if the discharge of indebtedness is granted by the court or pursuant to a plan approved by the court. In the context of a subchapter C corporation (and generally an S corporation), the bankruptcy exclusion is applied at the corporate level; such that if the corporation is the debtor in bankruptcy, CODI is excluded from taxable income. Alternatively, if the debtor entity is a qualified subchapter S subsidiary (QSub),[7] the bankruptcy exclusion only applies if the owner (i.e., the S Corporation parent) is itself a party to the Title 11 case.[8] Put differently, an S corporation owner of a QSub who is not independently insolvent or a party to a bankruptcy proceeding is generally not covered by an exclusion, and may have recognition of CODI, even if its QSub is in bankruptcy and the discharge of indebtedness is granted by the court or pursuant to a court-approved plan.

Illustrative Example

The ability to revoke an S election during bankruptcy allows a shareholder to potentially shift significant tax consequences to the debtor entity, and ultimately to the creditors. For example: a QSub in a Title 11 case has outstanding secured debt of $150x, unsecured debt of $50x, and assets with a fair market value (FMV) of $175x with a tax basis of $75x. Assume that the QSub is owned by an S corporation, which is wholly owned by a single shareholder, neither of whom are in bankruptcy nor are insolvent. Per a court sanctioned plan, the QSub assets are auctioned off for their FMV of $175x which is used to satisfy the *total* outstanding debt of $200x.

- The asset sale generates $100x of gain.
- The amount of forgiveness in excess of the auction proceeds generates CODI of $25x.

The sole shareholder will thus bear the tax liability from both the $100x gain and the $25x of CODI but will receive no proceeds from the sale.

If however, the shareholder revokes the S election, forcing the debtor to convert into a C corporation, the $100x gain would have been "blocked" and taxable at the subsidiary corporation level (reducing available proceeds for creditors). Moreover, since the C corporation subsidiary is in bankruptcy, the $25x of CODI would be excluded but would reduce corporate level tax attributes (to the extent available).

Here, the conversion would cause the unsecured creditors to receive significantly less recovery due to the C corporation tax liability and could potentially drive the estate into administrative insolvency.

[1] Section 61(a)(11).
[2] Section 1366(a); 1367(a).
[3] Section 1366(d).

[4] Section 108(a)(1), note the insolvency exclusion is beyond the scope of this article but is incredibly common and relevant in debt restructuring transactions.
[5] Note that a Chapter 7 (liquidating) or Chapter 11 (reorganizing bankruptcy) are two examples of title 11 bankruptcies.
[6] In this article two prominent U.S. Code Titles are referenced: Title 26, the "Internal Revenue Code," and Title 11, the Bankruptcy Code. Herein, all section references are to the Internal Revenue Code of 1986 (the "Code"), as amended, or to underlying regulations; and Title 11 will be used in reference to the Bankruptcy Code.
[7] Section 1361(b)(3)(B).
[8] Treas. Reg. Sec. 1.108-9(a)(2).

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Majestic Star

Traditionally, it was widely accepted that S corporation elections, similar to net operating losses (NOLs), were considered part of an S corporation's bankruptcy estate. This concept was established by the case *Trans-Line West,*[1] which laid the foundation for several related decisions.

Enter *Majestic Star,* a case involving a QSub[2] debtor subsidiary ("MSC") in a Title 11 bankruptcy case, where the S corporation owner/parent (the "Company") of the QSub was not in bankruptcy.[3] The pivotal issue was whether the Company's decision to revoke its S corporation election status, causing itself and MSC to convert to regarded C corporations for federal tax purposes, was a post-petition transfer of property of the bankruptcy estate.

As an S corporation, the Company was not subject to federal or state taxation and its income and losses would pass through to its shareholder ("Shareholder"). MSC had properly been treated as a QSub of the Company, thus it was not treated as separate from the Company for federal tax purposes. As such, MSC's income and losses would also ultimately pass through to the S corporation's Shareholder.

As of the petition date, both the Company and MSC retained their status as an S Corporation and as a QSub, respectively. The Shareholder and the Company did not file for bankruptcy nor were they debtors in any of the petitions in question. After the petition date, the Shareholder revoked the Company's S Corporation status and thus the Company converted to a regarded C Corporation. As a result of the revocation, MSC's status as a QSub was also automatically terminated (and thus converted to a regarded C Corporation) since it no longer met the requirement of being wholly owned by an S corporation.

As a result of the entity conversion, MSC owed $2.26 million in state income taxes. The trustee filed a complaint stating that the revocation caused an "unlawful post-petition transfer" of MSC's estate property. The bankruptcy court came to the same conclusion and ordered the Company and the IRS to take all measures needed to restore the original status of MSC as a QSub of the Company by restoring the Company's S Corporation status.

[1] In re Trans-Line West, Inc., 203 B.R. 653 (Bankr. E.D. Tenn. 1996).

[2] Qualified Subchapter S Subsidiary (which is treated as an entity disregarded as separate from the S Corporation for U.S. federal income tax purposes).

[3] Majestic Star Casino, LLC v. Barden Development, Inc. (In re Majestic Star Casino, LLC), 716 F.3d 736 (3d Cir. 2013).

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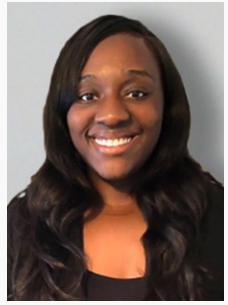

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Both the Company and the IRS[4] appealed the decision. The IRS argued that MSC's status as a QSub was not "property" of the MSC estate because MSC "never had a right to claim, continue, or revoke" it's status "either before or after it filed its bankruptcy petition," and that no "transfer" of estate property occurred when the Company revoked its S election and triggered the loss of MSC's QSub status.[5]

On appeal, the 3rd Circuit appellate court disagreed with the bankruptcy court and held that the S election was not property of the bankruptcy estate. The court reasoned, in part, that even if "QSub status were property at all, it would be property of the subsidiary's S-corp parent."[6] Thus, in effect, the 3rd Circuit afforded the Shareholder the ability to revoke the S election and significantly improve their tax position.

[4] As a result of the bankruptcy court's order, the IRS's tax claim lost being treated as an administrative expense of the bankruptcy estate, which would have allowed the government to be paid before most other creditors. Ibid., at 746.

[5] Ibid., at 745.

[6] Ibid., at 760.

Vital Pharmaceuticals

In a recent 2023 bankruptcy case, *Vital Pharmaceuticals,*[7] the S corporation debtor ("Debtor") auctioned its assets for $370 million and as such, the tax liability from the gross income would flow up to the sole shareholder ("Shareholder"). All of the proceeds from the sale were to go to secured and unsecured creditors with none remaining to cover this tax liability. To avoid the tax, the Shareholder tried to revoke Debtor's S election during bankruptcy. The court however, concluded that S election was property of the estate and thus could not be revoked by the Shareholder.

In determining that the S election status was property of the estate, the court determined that the reasoning of the 3rd Circuit in *Majestic* was deeply flawed.[8] The court's scathing rebuke of *Majestic* is predicated upon the court's view that the 3rd Circuit applied fallacious logic and poor reasoning; however, a fulsome description of the *Vital* court's opposition is beyond the scope of this article. The *Vital* court in their conclusion mention that the Shareholder reaped the advantages of the Debtor's S corporation status, thereby avoiding double taxation for 30 years. The court further concludes that since the S corporation status grants it the valuable privilege of avoiding/diverting tax liability, this status is considered an asset of the estate and is thus safeguarded by the Bankruptcy Code's automatic stay.[9]

Conclusion

The Tax Court has yet to rule on this matter, and it remains uncertain whether it ever will. In the decade following the *Majestic* ruling, shareholders have leveraged the decision to circumvent substantial tax liabilities by revoking their S corporation status, thereby shouldering the regarded C corporation with the tax burden. However, the recent *Vital* ruling may prompt other courts to reconsider their stance on the issue. The *Majestic* case was adjudicated in the 3rd Circuit, while *Vital* was decided in the 11th Circuit. If an S corporation is located within either of these jurisdictions, the corresponding ruling will likely take precedence. Shareholders in similar circumstances are advised to seek counsel from their tax advisor.

[7] In re Vital Pharm., No. 22-17842-PDR (Bankr. S.D. Fla. Oct. 6, 2023).

[8] Ibid., at 16.

[9] Ibid., at 34.

LIABILITY MANAGEMENT WHACK-A-MOLE

Josh Feltman, Justin Forlenza, Jennifer Selendy, and Samuel Kwak

Liability management exercises and consequent objections to and redrafting around them have been compared by some commentators to a game of whack-a-mole. Just as one strategy arguably permitted by contract is accepted or rejected by the courts and/or the market, another strategy creatively designed by lawyers and bankers pops up.

The Creditor Rights Coalition, a thought-leadership advocacy organization, asked its expert Contributors to weigh in on the ongoing Incora trial in the Southern District of Texas. The SDTX, which in recent years has heard the plurality of nationwide large bankruptcy cases, is the first bankruptcy court to engage in an extensive weeks-long trial (no final decision as of this writing) after ruling against the company at the summary judgment stage. Will Incora be viewed as just another bump along the road, or does it indicate a more fundamental shift in terms of law, litigation strategy, or choice of venue? How closely are financial sponsors examining what's happening in Incora? Read on.

The views expressed are those of the authors only. Learn more at www.creditorcoalition.org.

Josh Feltman (*Wachtell Lipton)*:

Pre-*Incora* we had *Serta* as a lodestar, guiding debtors' wagons southwest from Yankee concerns about good faith and the need for further factual development to Cowboy certitude as to the completeness of the very same written contracts and the meaning of "open market." Post-*Incora* we face the Scylla of "good faith" (and the need for further factual development) in New York and the Charybdis of the "Integrated Transaction Doctrine" (and the need for further factual development) in Texas. The law-school version of me could write a 50-page article on the difference between those two, but the old-man version can synopsize it in three-words: *six of one* . . . Each is susceptible to application in a wide variety of circumstances and leaves substantial room for judicial discretion.

Or at least I hope that's the case. If Judge Isgur's summary judgement opinion stands for the proposition that any amendment to a debt document followed by a transaction that would not have been permitted but for that amendment should be "integrated," then this decision is vastly more radical than anyone believes. (Other than every single law-firm currently representing someone on the losing end of a transaction that required modification of pre-existing loan documents, perhaps.)

That said, *Incora* involves two circumstances constituting metaphorical "moles" particularly susceptible to whacking, the involvement of equity sponsors in the additional capacity of creditholder participants in the debt exchange and the issuance of new debt (itself then immediately exchanged) in order to obtain the requisite vote of an existing class. Without expressing a real opinion, one might allow that it is at least plausible that a judge would find those two circumstances indicative of (1) a breach of the implied covenant of good faith (though Judge Isgur

declined to do so) *and/or* (2) transactions in respect of which the separate mechanical steps are simply too precious to credit as having independent legal significance (a notion Judge Isgur is willing to entertain).

One could also imagine a narrowly tailored decision emerging from the exhaustive trial, following which we all deem the whole case much ado about nothing, or at least that the creditor takeaway ought merely to be "don't let the sponsors get high on their own supply." A settlement could actually be the most impactful outcome from a market perspective, as we would be left with all of the Judge's very interesting questions and analysis but not very much in the way of guidance on application to particular facts.

In this light, I think the close watching may be coming more from leading creditor types than from sponsors. It is well documented that liability management transactions often do not "work," where "work" is defined as "avoid a short to medium term bankruptcy." Nonetheless, sponsors will always have an incentive to try to extend their runway—what do they have to lose given the company is footing the bill, even of the inevitable litigation? But if creditors come to believe that liability management is likely not to "work"—defined as "provide participating debtholders with a high probability of a meaningful non-ratable recovery"—then the benefits to the corporate enterprise of an earlier restructuring (less aggregate cash burn, earlier ability to reinvest in the business and/or shed burdensome contracts, quicker path to control, a cheaper, less litigious, less risky bankruptcy) may come to dominate the decision calculus. At the least we might conclude that *Incora* has already placed another stone on that side of the scales.

Justin Forlenza *(Covenant Review)*:

The term "Whack-A-Mole" is a fair way to describe what has been going on in the liability management market since its inception. For every contractual provision that lenders attempt to strike down by adding a "blocker" or another type of protective provision, it seems that two more potential moles will spring forth, either hidden in old agreements (waiting to be unearthed by crafty lawyers and financial professionals) or developed *de novo* by clever lawyers. When credit agreements now consistently run upwards of 300 pages and ever increasing in complexity, there are always more potential loopholes that borrowers or their sponsors may exploit in a liability management scenario.

Consider the Serta blocker: although *Covenant Review* has seen Serta blocker provisions increasingly included in broadly syndicated loans since 2020, their drafting leaves potential holes large enough to drive a double-length NYC bus through. Several recent uptier liability management transactions have been structured as two-step transactions: first, the majority lender group that is steering the transaction amends the credit agreement to allow for a priming debt incurrence and exchange transaction and also to strip most of the existing covenant and default protections. Step two is the "ratable offer" made to the existing minority lender group, which is often required by the Serta blocker provisions.

However, even *if* a protective provision is included, there is no guarantee that it will work to actually protect a minority lender group. Serta blockers often only vaguely require the priming debt to be offered to all lenders on the "same" terms; often backstop, commitment, and similar fees are explicitly *excluded*. As such, the majority "steering" lender group could receive significantly better economic terms than the other lenders and still comply with the Serta blocker. Further, the terms of the priming debt can sometimes be explicitly *adverse* to the existing lenders—the currency may be different, or there could be a PIK interest component included.

One complicating factor in the *Incora* transaction was the "vote rigging" element. Because it could not initially garner sufficient bondholder support, *Incora* first amended its existing indenture to permit the issuance of additional notes, which then voted to meet the two-thirds threshold for collateral releases required by the original indenture. Judges appear to view this tactic (used several times including in *Revlon*, *Bombardier*, and *iHeart*), with some distaste, which perhaps provides them with an incentive to allow litigation to proceed. And although the opinions seemed to throw cold water on good faith and fair dealing arguments, the reasoning under the "integrated transaction" or "step-transaction" doctrine (which states that when different components of a transaction are sufficiently related, the court can consider them as part of the same overall transaction) is similar. In each case, it seems that the judges are, at least implicitly, looking through the form of these transactions to analyze the overall substance. In both cases, the courts found that whether the step-transaction doctrine should be applied to collapse the various transaction steps to a single set of related transactions was a factual issue of intent, and therefore could not be dismissed before a trial.

This doctrine might be a viable alternative to the good faith and fair dealing doctrine when assessing the viability of an uptier liability management transaction. Practically speaking, everyone involved in these transactions understands that even if they are technically structured as multi-step amendments and exchange offers, they are all interrelated. The step-transaction doctrine is especially important in the vote rigging context, because in those transactions it is pretty clear that without the additional notes issuance, the issuer would not have received sufficient consents to allow for the collateral release / subordination element of the transaction.

Regardless, even if courts begin to more creatively apply transactional doctrines in these contexts, there are still many other credit agreement provisions that issuers can take advantage of in order to structure a liability management transaction. As such, the game of whack-a-mole is likely to continue indefinitely.

Jennifer Selendy and Samuel Kwak *(Selendy Gay)*:

Although the first of its kind in some respects, the ongoing drama in the *Incora* case should not have come as a surprise to anyone following the litigation of liability management transactions or, as some call it, lender-on-lender violence.

Like previous uptiering decisions denying motions to dismiss, the court's summary judgment ruling highlights a common feature of these recurring contract claims—whether the transaction constituted a breach often hinges on crucial, yet undefined, terms: "redemption" and "right of payment" in *Incora*; "open market purchase" in *Serta*; and "purchase" in *Mitel*, to name just a few. The ambiguity of such terms both opens the door to these transactions in the first place and prolongs the resolution of the inevitable disputes that ensue as we see playing out now. The company and participating lenders argue that without a specific anti-subordination sacred right, uptiering is permitted. Excluded lenders protest that credit agreements were drafted to protect against subordination and indecorous exits whether or not such agreements used the magic "s" word.

Any trial court tasked with resolving these ambiguities faces a number of complexities. While bankruptcy courts could sometimes be viewed as expedient to meet the deadlines imposed by debtors looking to a shotgun bankruptcy proceeding, it is heartening to see Judge Isgur prioritize the trial's timeline over that of the debtor's unrealistic confirmation schedule.

We are watching a real-time battle of experts. In *Incora*, each side has retained a Columbia law professor to endorse the party's desired reading of the contract in light of the purported industry standard. Dueling experts on the meaning of central and disputed contract provisions will almost always preclude summary judgment.

Contractual ambiguity also necessitates a factual inquiry into the intent of the drafting parties as well as the circumstances surrounding the execution of the transaction at issue. We have seen substantial testimony from a substantial number of participating lenders, company witnesses, financial advisors, and the equity sponsor. According to Judge Isgur, the debtor and participating lenders' intent will inform whether there was an "integrated transaction." While it is well-settled in many jurisdictions that multiple agreements executed at the same time may constitute a single transaction, this issue has not been ruled upon decisively in the context of liability management transactions. Further, because Judge Isgur allowed the tortious interference claim against the equity sponsor to proceed, the equity sponsor is not off the hook, and the nature of the trial has covered the actions of the sponsors.

Recent developments in *Incora* suggest an expeditious resolution will be difficult. In fact, the mediation that took place in the middle of the trial was not successful, and the trial has resumed. As a result, *Incora* has pushed back the plan confirmation hearing by another month, delaying the hearing that was initially scheduled for February 27 to May 16. Given how expensive each additional day in bankruptcy is, the delay caused by the protracted dispute over a liability management transaction—

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which was purportedly executed for the benefit of the debtor—undermines the prospect of *Incora*'s emergence from bankruptcy in a strong financial position.

Incora is also the first uptiering case to find the excluded lenders' contract and tort claims to be non-core claims under the bankruptcy code. While the bankruptcy court may "submit proposed findings of fact and conclusions of law to the district court," only the district court may enter a final judgment as to the claims and may review *de novo* the bankruptcy court's findings and parties' objections absent the parties' consent to entry of a final judgment by the bankruptcy court. Under federal law, there is also a chance that the district court is required to or chooses to remand the case to the state court. This means a bankruptcy court's *non-final* ruling may be subject to an early challenge. Indeed, 15 days after Judge Isgur's order, one of the excluded lenders sought clarification on whether the court's order constituted "proposed findings of fact and conclusions of law"—so that it may seek a potential "do-over" before the district court.

In this regard, *Incora* may change market participants' calculus in considering a non-pro rata liability management transaction where the expectation is that any dispute regarding the transaction will be quickly litigated in the bankruptcy court.

First, protracted litigation, combined with a potential do-over in the district or state court, takes a toll on the debtor, equity sponsor, and participating lenders' resources.

Second, it is unclear whether a bankruptcy court, especially the Bankruptcy Court for the Southern District of Texas, will continue to be viewed as a favorable venue for non-pro rata liability management transactions in light of *Incora*'s more creditor-friendly outcome (as opposed to *TPC* and *Serta*) at the summary judgment stage.

The Creditor Rights Coalition distributes curated content and original features to thousands of thought-leaders in the financial industry on a weekly basis as well as sponsors industry-leading events and conferences. Sign up to receive updates at www.creditorcoalition.org.

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CORPORATE TRANSPARENCY ACT 101: TIPS FOR BUSINESS AND RESTRUCTURING FIDUCIARIES

Sheryl P. Giugliano, Russell H. Stern, and Alexandra C. McCormack
Ruskin Moscou Faltischek, P.C.

On January 1, 2024, the Corporate Transparency Act (the "CTA") went into effect. The CTA will likely result in the filing of millions of reports disclosing beneficial ownership information with the United States Department of Treasury's Financial Crimes Enforcement Network (FinCEN).

Congress enacted the CTA as part of the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021. The stated goals of the CTA are to investigate and otherwise deter illicit activity, including money laundering, terrorist financing, fraud, corruption and tax fraud schemes, of which in the past, individual owners' identities have been obfuscated by complex corporate structures. The CTA will allow the federal government to gain a greater understanding about the individuals that own, operate, and otherwise control certain entities operating or qualified to do business in the United States.

The CTA impacts professionals in the business community generally, and more specifically the bankruptcy and restructuring community. This article provides bankruptcy and restructuring professionals with certain "need to know" information, as well as practical tips for navigating CTA filings.

Before proceeding to file a CTA report with FinCEN, company management (and potentially bankruptcy trustees, receivers and recently retained chief restricting officers (CRO)) should be able to answer the following questions about the relevant entity:

- Which entities are required to file beneficial ownership reports?
- When must the initial report be filed with FinCEN?
- Who are the Beneficial Owners (as is hereinafter defined)?
- What information is required to be reported by a Reporting Company (as is hereinafter defined) on behalf of each Beneficial Owner?
- Who is considered a Company Applicant (as is hereinafter defined) and is it required that their information be disclosed in every filing?
- What are the consequences if reports are not timely filed or not filed at all?

Answering these questions will require a level of familiarity with the organization and potentially additional due diligence to understand who owns or controls the company that is required to report. In a restructuring or bankruptcy context, these answers may be especially difficult to obtain due to internal barriers, resistance, or a failure to maintain accurate or complete books and records. Note that the analysis under the CTA requires peeling back the corporate onion layers to reveal the individuals (humans) that own or control the organization; if there are multiple entities or trusts layered within a certain organization, the report filed with FinCEN should identify only those individuals that qualify as beneficial owners.

Reporting Companies and Filing Exemptions

To begin, a "Reporting Company" is defined as (a) any domestic entity that was created by the filing of a document or instrument with a Secretary of State or similar office, or (b) a foreign entity if a similar document or instrument was filed with a Secretary of State or other similar office to register to do business in the United States and unless otherwise exempt by one of the twenty-three (23) specific exemptions set forth in the CTA, that entity is required to file a CTA report with FinCEN.

Examples of exemptions include but are not limited to: large-operating companies; tax-exempt entities; subsidiaries of exempt entities; and companies otherwise subject to government reporting and oversight (such as banks, insurance companies, and certain investment vehicles), among others.

Bankruptcy and restructuring professionals are best served by carefully examining the exemptions available and ensuring strict compliance if they will be relied upon for declining to participate in this reporting process.

Beneficial Ownership

This area may be of the most importance to court appointed trustees (chapter 7 or chapter 11) and estate-retained (pre- or post-confirmation) officers. "Beneficial Owners" are defined as those individuals who have "Substantial Control" over a Reporting Company or own at least twenty-five percent (25%) of the ownership interest in a Reporting Company, whether directly or indirectly. "Substantial Control" is a fact-specific analysis and varies depending on the company structure. Examples of substantial control include, but are not limited to:

- Individuals within the organization who direct or otherwise influence "important decisions" whether because of their role, by agreement, a special arrangement or otherwise;
- Senior officers or C-suite executives serving the Reporting Company (e.g., general counsel, chief financial officer); and
- Those individuals with authority over the appointment or removal of any senior officer of a Reporting Company or a majority of the board of directors (or similar body) of a Reporting Company.

"Substantial Control" may include a Chief Restructuring Officer

Continued from p.51

(CRO) retained by a company pre- or post-petition in a chapter 11 case, pre-petition court-appointed receivers, post-petition chapter 7 or chapter 11 trustees, and other estate fiduciaries given the ability to oversee, administer, collect, or otherwise dispose of or control all or substantially all of the estate's assets; provided, however, that each have broad powers and an ability to make key decisions on behalf of the Reporting Company. Certain exemptions may apply.

It is the responsibility of the Reporting Company's management to see that CTA reports are timely filed.

As of the date of this article, in one case, *In re YLG Partners*,[1] the applicability of the CTA to panel trustees has been challenged. The U.S. Department of Treasury's request for an extension of time to respond was granted, and interested parties anxiously await a decision from the bankruptcy court. It seems likely that we will see similar challenges in bankruptcy cases throughout the country.

Timeline for Filing CTA Reports with FinCEN (and Company Applicants)

Reporting Companies formed on or after January 1, 2024, have ninety (90) days from the date of formation or organization to file their initial report with FinCEN, which must include:

> (i) entity-specific information about the Reporting Company, including: (a) the name of company; (b) the business address of the company; (c) EIN/TIN; (d) country of organization/formation; and (e) the state of formation/organization or if foreign, state of qualification to conduct business;
>
> (ii) personal information for each Beneficial Owner, including: (a) full legal name; (b) current residential address; (c) date of birth; (d) unexpired identification number, which may include either a valid U.S. driver's license or passport. Each Beneficial Owner must also submit a photo of their form of identification. A Company may have an unlimited number of Beneficial Owners; and
>
> (iii) personal information about the person or persons who filed or directed the filing of the documents that created the domestic company or registered foreign company to conduct business in the United States (a "Company Applicant"), including: (a) full legal name; (b) current business address; (c) date of birth; (d) unexpired identification number, which may include either a valid U.S. driver's license or passport. Each Company Applicant must also submit a photo of their chosen form of identification. A company may have up to two (2) Company Applicants. Following the filing of the initial report, FinCEN does not require that updates be made to then accurate Company Applicant information.

Reporting Companies formed before January 1, 2024 have until January 1, 2025 to file their initial report and are exempt from providing the information set forth in (iii) above regarding Company Applicants. Updated reports must be timely filed with FinCEN within thirty (30) days of the change in circumstance that triggered the updated reporting requirement. Notable changes include, but are not limited to, changes in control or ownership, change in address and/or expiration of a license or other identifying document.

By way of example, it seems that the appointment or retention of a CRO to a company that qualifies as a Reporting Company would constitute a change in the Beneficial Owners requiring an updated filing with FinCEN. This prediction assumes that the CRO exercises substantial control over the Reporitng Company from the date of his or her appointment and, therefore, qualifies as a Beneficial Owner. This analysis should apply to other Reporting Company fiduciaries, arguably whether they are in bankruptcy or not.

Another example which would likely require an updated reporting requirement is a creditor whose claim is evidenced by a document permitting an exchange of equity for debt, if the debt of that creditor is later converted to equity in the Reporting Company and the equity is in excess of the (25%) or more threshold.

Penalties for Failure to File

The CTA imposes civil and criminal penalties on those entities and their principals who do not comply. Companies that file incomplete or incorrect information may be subject to daily fines of $591.00 per day. In the case of a willful failure to file, provide complete or updated information, or fraudulent conveyance of false information, Reporting Companies may be subject to a penalty of up to $10,000.00 per infraction and two-year imprisonment.

It is not yet known whether penalties for failure to comply with the CTA will be treated as priority claims under 11 U.S.C. § 507(a)(8), or mere general unsecured claims.

Recent Challenges to the CTA

As noted above, in at least one known bankruptcy case, a chapter 7 trustee challenged the applicability of the CTA to panel trustees.[2] In *YLG Partners*, the trustee filed a motion to determine that the CTA does not apply to bankruptcy trustees. In February 2024, the Bankruptcy Court entered an order *sua sponte* directing the United States Department of Treasury to file a response within fourteen (14) days. The Department of Treasury moved for an extension of time to respond, and the deadline was extended through May 10, 2024.

The CTA faced an additional challenge in Alabama by way of a lawsuit alleging that the enactment of the law exceeded the Constitutional limits on Congress' power.[3] Judge Liles C. Burke of the U.S. District Court for the Northern District of Alabama ruled in *National Small Business United v. Yellen* on March 1, 2024, that the CTA is unconstitutional. Application of Judge Burke's ruling is believed to apply only to the plaintiffs in the case, and not at large to all potential Reporting Companies nationwide.

Additional challenges should be expected and watched carefully.

[1] *See* In re YLG Partners, Inc., 23-10709 (BAK) (U.S.B.C. M.D.N.C., Greensboro Div.) (chapter 7 trustee filed motion to determine that chapter 7 trustee has no duty to report debtor's beneficial ownership information to the U.S. Department of the Treasury).

[2] *See* In re YLG Partners, Inc., 23-10709 (BAK) (U.S.B.C. M.D.N.C., Greensboro Div.).

[3] National Small Business United et al v. Yellen et al, No. 5:2022-cv-01448.

Conclusion

Each Reporting Company's situation will prove unique and will require a fact-specific analysis to determine when reports must be filed (if ever), what information should be included (if any), whether any updates should be made to FinCEN, and which individuals are responsible for the foregoing. Understanding the impact of the CTA and ensuring compliance is a potentially added responsibility for CROs, trustees, and company leadership of financially distressed entities during the course of a bankruptcy case and after—making timely filings (and updates) even more crucial. Practitioners should continue to familiarize themselves with the CTA requirements and any changes in the compliance landscape.

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BANKRUPTCY COURT PAVES THE WAY FOR EXCLUDED BONDHOLDERS TO SEEK RECOVERIES FROM PRE-PETITION LIABILITY MANAGEMENT TRANSACTION

Leah Eisenberg
Mayer Brown LLP

Introduction

In a recent decision in the Chapter 11 proceedings of Wesco Aircraft Holdings, Inc., operating as "Incora" ("Incora" or the "Debtors"),[1] Judge Isgur tackled the limits of a pre-petition liability management transaction that, among other things (i) favored a certain group of bondholders (the "Participating Holders") while excluding other holders[2] (the "Excluded Holders"), (ii) subordinated the Excluded Holders' claims, and (iii) released the Excluded Holders' liens that secured such claims (the "Transaction"). By denying summary judgment on a majority of these claims, Judge Isgur paved the way for the Excluded Holders to proceed to trial against the Debtors, the Participating Holders, the Debtors' private equity sponsor and the indenture trustee (the "Trustee") that was party to the Transaction.

Background

Incora was the product of a nearly $2 billion 2019 leveraged buyout by its equity sponsor. In 2022, to address liquidity issues, the Debtors and the Participating Holders entered into the Transaction pursuant to which the Participating Holders provided the Debtors with new financing that involved, among other things (i) amending the applicable indentures by majority vote to permit the issuance of additional notes to the Participating Holders, (ii) offering such additional notes on a non pro rata basis only to the Participating Holders, (iii) exchanging the Participating Holders' notes for such additional notes that were secured and had a higher priority liens, and (iv) releasing the liens securing the notes of the Excluded Holders. Thereafter the Excluded Holders challenged the Transaction in New York state court, asserting claims against Incora, the Participating Holders, the Trustee and Incora's equity sponsor, for among other things, (i) breach of the indenture agreements, (ii) breach of the implied covenant of good faith and fair dealing, and (iii) tortious interference.

On June 1, 2023, Incora filed for bankruptcy in the Bankruptcy Court for the Southern District of Texas and simultaneously commenced an adversary proceeding against the Excluded Holders seeking to ratify the Transaction. The Excluded Holders filed a counter-complaint. On January 14, 2024, and January 23, 2024, Judge Isgur issued opinions on the parties' motions for summary judgment.

[1] *See* In re Wesco Aircraft Holdings, Inc., et al. v. SSD Investments Ltd., No. 23-90611, 2024 WL 156211 (Bankr. S.D. Tex. Jan. 14, 2024); and In re Wesco Aircraft Holdings, Inc., et al. v. SSD Investments Ltd., No. 23-90611, 2024 WL 255855 (Bankr. S.D. Tex. Jan. 23, 2024).

[2] The Excluded Holders included Langur Maize, a party to this litigation.

The Opinion

A. Threshold Rulings

Addressing the issue of whether the court had subject matter jurisdiction over certain claims against non-debtors, Judge Isgur concluded the contractual indemnification obligations under the governing indentures implicating Incora were sufficient to give rise to "related to" jurisdiction with respect to the claims asserted against the Trustee and the Participating Holders. With respect to jurisdiction over the standing claims of the Excluded Holders, the court concluded (i) the standing claims were core and (ii) the contract and tort claims were non-core as they were state law-based, suggesting that other "excluded" investors could litigate similar liability management claims outside of a bankruptcy court.

Turning to whether certain claims asserted by the Excluded Holders against non-debtor parties were property of the bankruptcy estate, the court ruled that they were not, which claims included declaratory relief of liability regarding standing, breach of contract, breach of the implied covenant of good faith and fair dealing, tortious interference with contract, and conversion. The breach of contract claims included breaches of indenture provisions, including provisions governing redemption, non-impairment, and direction, each discussed below.[3]

B. Breach of Contract Claims

Judge Isgur denied summary judgment for most of the breach of contract claims asserted by the Excluded Holders against the Debtors and the Participating Holders, finding there existed genuine issues of disputed facts regarding (i) whether all the agreements involved in the Transaction were interrelated such that it would be deemed an integrated transaction (as opposed to each agreement being viewed as independent, resulting in independent multiple transactions) and (ii) the indenture provisions themselves, which the court found to be ambiguous, including those on redemption, non-impairment and directions.[4]

[3] The court concluded the claims for equitable lien and equitable subordination were disguised fraudulent conveyance claims that were property of the Incora estate and were thus dismissed.

[4] Judge Isgur granted summary judgment and dismissed the Excluded Holders' claims for (i) breach of the implied covenant of good faith and fair dealing as being duplicative of the breach of contract claims, (ii) conversion, (iii) breach of contract against the Trustee due to the indentures' indemnification provisions and (iv) unjust enrichment claims as the court viewed the indentures are valid contracts.

Notably, Judge Isgur's opinion is a departure from a decision by Judge Jones, also of the Bankruptcy Court of the Southern District of Texas, in the Chapter 11 case of *Serta Simmons Bedding, LLC* ("*Serta*"),[5] who ruled that a pre-petition "uptier" exchange transaction, comprised of the issuance of priming super priority debt through amendments in exchange for existing first and second lien debt to a group of majority lenders at a discounted value, did not violate the existing credit agreement. The *Serta* transaction had the result of subordinating and devaluing the existing debt of non-participating lenders, who later argued (unsuccessfully) that (i) this priming transaction violated the applicable *pro rata* sharing provision under the credit agreement and (ii) the debtor and the participating lenders violated the implied covenant of good faith and fair dealing. In ratifying the transaction, Judge Jones also noted that the participating lenders did not breach the implied covenant of good faith and fair dealing by their participation and extolled the inherent fairness of an "open market" process of soliciting interest from existing lenders.

With respect to the indentures' redemption provisions, the Excluded Holders argued (i) such provisions required a *pro rata* redemption or purchase of the notes if less than all the notes were to be redeemed and (ii) by selecting the Participating Holders' notes for exchange, instead of a *pro rata* apportionment amongst all the noteholders, the Participating Holders were placed in a better position upon a default. Judge Isgur concluded there was a genuine dispute as to whether the Transaction was a redemption (requiring the Trustee to select notes for redemption or purchase on a *pro rata* basis) or an exchange pursuant to an open market or privately negotiated transaction, as argued by the Debtors and the Participating Holders.

The Excluded Holders also argued the indentures' non-impairment provisions (also known as "sacred rights"), which required the consent of each affected holder if any supplement or waiver adversely affected such holder, were violated when the priority of payment provisions were changed without their consent. Judge Isgur concluded "the right of payment" was ambiguous, questioning whether such right applied to changes in rankings or of lien stripping. Finally, the Excluded Holders also argued the Participating Holders' direction to the Trustee to retire only their notes for purchase in the exchange was an improper direction. Citing disputed facts as to the Trustee's action in retiring the notes (or not refusing to retire the notes), which turns on whether the Participating Holders' actions were allowed under the indentures, Judge Isgur denied summary judgment. Judge Isgur's preliminary analysis on such point turned on the word "may" as to whether the Trustee was obligated to use its reasonable discretion to refuse to retire the notes as unlawful and in violation of the indentures.

C. Langur Maize's Standing

The Debtors and others alleged, among other things, that Langur Maize did not have proper standing to sue non-debtor entities under Article III of the Constitution, which requires a showing that Langur Maize suffered an injury-in-fact. Pursuant to N.Y. G.O.L. § 13-107, a transferor's bond-related claims against an obligor,

indenture trustee, depositary or guarantor is automatically assigned without the need for a formal assignment of claims.[6] The court found that while Section 13-107 applied to Langur Maize's claims against the Debtors, the Trustee and all applicable guarantors, thereby providing for appropriate Article III standing, Section 13-107 did not apply to parties not expressly mentioned in the statute (which included the Participating Holders) and as such, Langer Maize was required to establish that it (i) had been assigned its claims by an entity with standing or (ii) personally suffered an injury-in-fact.

With respect to standing through assignment, Langur Maize argued it had the requisite standing as The Depository Trust Company ("DTC"), as record holder of the applicable notes, provided Langur Maize authorization to bring its claims in New York state court and the bankruptcy court. The court concluded DTC, as the record holder, did not have a claim assignable for standing purposes because as the record holder, DTC had no actual interest in the underlying notes beyond just holding them in the form of a global security; rather, the beneficial owners of the applicable notes were the holders and thus the real parties in interest.[7]

Thus, for Langur Maize to have standing, it was required to show it suffered an injury-in-fact.[8] The court concluded there existed a genuine issue of material fact as to whether Langur Maize suffered an injury-in-fact for claims not assigned other than by operation of Section 13-107 to have proper standing to bring its claims against entities other than the Debtors, the Trustee and guarantors such that such issue was to proceed at trial. On the

[5] *See* In re Serta Simmons Bedding, LLC, No. 23-90020,2023 WL 3855820 (Bankr. S.D. Tex. June 6, 2023).

[6] Pursuant to N.Y. G.O.L. § 13-107, a transferee (i) is not required to demonstrate its own injury to bring a claim for damages and (ii) is expressly permitted to sue for breaches of duties that occur prior to the purchase of the bond, regardless of the bondholder's knowledge of these breaches.

[7] The court also rejected Langur Maize's argument that DTC had standing pursuant to N.Y. U.C.C. § 3-301 (which has typically been applied in the context of nonpayment actions, such as foreclosures) which allows the record owner of a note to sue for payment under a debt. The court concluded Section 3-301 did not apply to a suit for a breach of an indenture agreement and related tort claims because DTC did not experience the alleged harms itself, and thus, could not assign these claims to an entity that did not suffer an injury.

[8] The court concluded Langur Maize properly received authorization to bring its suit in New York state court (and the bankruptcy court court) through a two-step authorization process: (i) DTC, acting through its nominee, Cede & Co., authorized the custodian for the notes to take any and all actions and exercise any and all rights and remedies that Cede & Co., as the holder of the notes, was entitled to take, and (ii) the custodian then authorized Langur Maize, as beneficial owner of the notes, to take any and all action.

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issue of Langur Maize's discounted purchase of the notes, the court concluded such fact was relevant only to the question of whether Langur Maize suffered an injury sufficient for standing purposes and as such, did not decide what effect the discounted price may have had on any damages award.

Conclusion and Take-Aways

The outcome of the continued litigation involving the Transaction will likely implicate Incora's Chapter 11 case and restructuring, as the Debtors' plan confirmation process continues to be pushed out pending the outcome of the litigation. From a broader perspective, this decision is important for majority lenders, minority lenders, indenture trustees and borrowers/issuers as it may serve as a roadmap for minority positions to challenge pre-petition debt restructurings that subordinate or otherwise impair their debt. Indeed, despite the *Serta* decision, both borrowers/issuers and majority lenders considering non-pro rata liability management transactions as in *Incora* should be mindful of the risk that claims brought by excluded/minority lenders may go to trial in both state and bankruptcy courts.

As a result of this decision, indenture trustees should be mindful that, notwithstanding they generally may rely on indenture indemnity provisions to protect themselves from liability, their participation in any such transaction will be subject to scrutiny and their actions may not be absolved solely as having acted at the direction of the requisite number of noteholders.

Finally, holders who are transferees of previously assigned/purchased notes should also be aware that they will be required to satisfy Article III standing in any litigation against parties not expressly set forth in Section 13-107.

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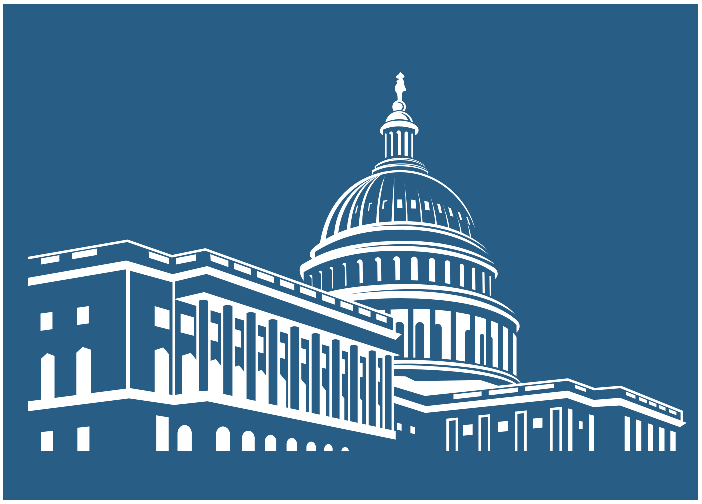

VALUING C CORPS AND PASS-THROUGH ENTITIES UNDER THE TCJA

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Overview

On December 22, 2017, President Donald J. Trump signed into law the Tax Cuts and Jobs Act of 2017 (the TCJA).[1] The TCJA was the most comprehensive tax reform package since the Tax Reform Act of 1986. The TCJA contained sweeping changes to corporate and individual tax rates, deduction limitations, foreign income taxation, and the tax treatment of pass-through entities (PTEs) such as S corporations and limited liability companies.

In this article, we will discuss the valuation-related characteristics of the TCJA and provide a series of conceptual and quantitative solutions that address these characteristics. These solutions address the tax law changes as well as the changing nature of the absolute and relative values of C corporations (C corps) and pass-through entities (PTEs). We will focus the discussion on tax attributes as they relate to businesses operating in the U.S. The foreign tax characteristics of the TCJA are complicated and deserving of another article devoted solely to these issues.

In this article, we will not address valuation issues such as control, marketability, liquidity, or standard or premise of value. We will use general terminology such as enterprise value, debt, equity, and cash flow without specific definition. This is not to suggest that these issues are not important; however, the variability of these issues in conjunction with the new tax law creates a nearly infinite variety of situations that would require individualized analyses. Consequently, the objective of this article is to provide a conceptual framework for the conduct of valuations in this changing tax environment.

[1] The TCJA was originally introduced to Congress as the Tax Cuts and Jobs Act of 2017.

Legislation Timeline

The legislation timeline of the TCJA is an important consideration when conducting engagements with valuation dates prior to 2018. The seeds of the TCJA were sown during the 2016 presidential campaign of Donald J. Trump. As a candidate, Mr. Trump promised to lower corporate tax rates, reduce taxes on the repatriation of foreign earnings, and make American companies more profitable and competitive. Mr. Trump was elected president on November 8, 2016. The other important dates in this timeline are as follows:

- Sept. 29, 2017—The U.S. Senate (“the Senate”) released the fiscal 2018 budget allowing for tax cuts.
- Oct. 26, 2017—U.S. House of Representatives (“the House”) passed the Senate budget, which opened the door for budget reconciliation to be used for passage of an omnibus tax reform bill with a simple majority vote.
- Nov. 2, 2017—House Republicans introduced the bill for tax reform, the Tax Cuts and Jobs Act of 2017. This document provided substantial detail about where the House was heading on tax reform.
- Nov. 9, 2017—Senate released its version of a tax reform bill. There were differences in the House and Senate versions, but the general direction of Congress regarding tax reform could be ascertained at this point.
- Dec. 4, 2017—House and Senate versions of the tax bill were submitted to a conference committee for resolution.
- Dec. 20, 2017—The conference committee provided its version of the TCJA to the House and Senate, which approved the amendments and sent the bill to the President for signing.
- Dec. 22, 2017—President Trump signed the TCJA into law.

Once the TCJA came out of the conference committee on December 20, 2017, the President’s signature was simply a formality. Consequently, when conducting engagements with valuation dates on or after December 20, 2017, the valuation-related tax attributes of the TCJA may be considered, absent a compelling reason not to do so.

When conducting engagements with valuation dates occurring earlier in the Legislation Timeline, a probability weighted analysis of the provisions of the TCJA and previous tax law may be appropriate. Components of the TCJA and the level of probability for any given date are a matter of professional judgement after taking into consideration the Legislation Timeline listed above.

Business Tax Changes

The primary valuation-related tax changes in the TCJA that affected businesses at the entity level are as follows:

- Permanent reduction in the federal corporate income tax rate from a top marginal rate of 35% to a flat rate of 21%.
- Permanent limitation on the deductibility of business interest expense.
- Temporary “bonus” (accelerated) depreciation.

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Corporate Tax Rate

Table 1 provides an example of the combined effective federal and state corporate tax rates applicable to C corps under the previous tax law and the TCJA.

As demonstrated on Line 1 of Table 1, the TCJA reduces the federal corporate tax rate from a top marginal rate of 35% to a flat rate of 21%. The assumed average state corporate tax rate of 6.3% on Line 2 is held constant but is tax affected using a 35% federal tax rate for 2017[2] and a 21% federal tax rate for 2018.[3] As demonstrated on Line 4, the effective state corporate tax rate on Line 4 increases from 4.1% to 5.0% due to the lower federal corporate tax rate in 2018. Adding the tax rates from Line 1 and Line 4 results in the combined effective federal and state corporate tax rate of 39.1% under 2017 tax law and 26.0% under the TCJA.

The reduced corporate tax rate has the potential to materially change the way companies operate and perform financially beginning in 2018. In addition, as of 2018, it was more difficult to estimate the effective tax rates of publicly traded or privately held companies based on historical tax rates. Of particular concern was the estimation of 2018 tax rates for companies that operate internationally. Changes in international tax recognition, foreign tax credits, the global intangible low-taxed income (GILTI) tax, repatriation transition taxes, and the change from a worldwide tax system to a territorial tax system impacted the taxes paid by companies that operate internationally.

Business Interest Expense

Under the terms of the TCJA, the ability of businesses to deduct business interest expense[4] is limited to 30% of adjusted taxable income (ATI). During 2018 through 2021, the TCJA generally defined ATI as earnings before interest, taxes, depreciation, and amortization (EBITDA). After 2021, the TCJA generally defined ATI as earnings before interest and taxes (EBIT). This expense limitation applied to businesses that reported average annual revenues in excess of $25 million during the three-year period prior to the tax year at issue.

There are exceptions for companies that use floor plan financing, such as automobile dealerships. In addition, there are specific provisions for PTEs that should be considered when analyzing this limitation. Disallowed interest expense in any given year may be carried forward to offset taxable income in future years.

This provision of the TCJA has the potential to impact the after-tax cost of debt capital used to calculate the weighted average cost of capital (WACC), as applied in the discounted cash flow (DCF) method, for companies impacted by the business interest expense limitation.

"Bonus" (Accelerated) Depreciation

Under the terms of the TCJA, companies were allowed to deduct up to 100% of their expenditures on qualified property[5] until 2022. After 2022, this 100% figure declines by 20 percentage points per year until 2027, when the percentage becomes zero.

Bonus depreciation has the potential to alter the timing of a company's projected cash flows for the 10 years subsequent to 2017, or more. A discussion of this provision of the new law is beyond the scope of this article; however, Joseph Thompson and David Neuzil have authored an article titled "Valuing Bonus Depreciation under the New Tax Law."[6] We use the value conclusions for bonus depreciation contained in that article in our demonstration exhibits.

Weighted Average Cost of Capital (WACC)

Table 2 provides a WACC analysis based on the tax rates reflected in the TCJA. We will be using the WACCs provided in Table 2 in subsequent sections of this article.

Table 2

	Weighted Average Cost of Capital	2017 Tax Law	2018 Tax Law
(1)	Equity Rate	14.2%	14.2%
(2)	Debt Rate	5.0%	5.0%
(3)	Tax Deduction @ 39.1% & 26%	-2.0%	-1.3%
(4)	Tax Affected Debt Rate	3.0%	3.7%
(5)	Capital Structure - Debt	45.1%	40.4%
(6)	Capital Structure - Equity	54.9%	59.6%
(7)	WACC	9.16%	9.96%
(8)	Long-term Growth	0.0%	0.0%
(9)	WACC Capitalization Factor	9.16%	9.96%

As demonstrated in Line 9 of Table 2, the WACC increases from 9.16% in 2017 to 9.96% in 2018. The reasons for this are twofold: (1) lower combined effective federal and state tax rate on Line 3 is used to tax affect the debt rate on Line 2, and (2) equity capital

[2] References to 2017 tax law are based on the assumption that the tax law in effect prior to the enactment of the TCJA is the relevant tax law. References to 2018 tax law assume the TCJA is the relevant tax law.

[3] Under the TCJA, state and local taxes remain deductible for corporations. The same is not true for individuals, who are now limited in their ability to take such deductions on their personal income tax returns.

[4] The interpretation of what qualifies as "business interest expense" is complicated. Issues such as "earnings stripping," PTE deductions, and floor plan financing can impact how the business interest expense limitation is calculated. We recommend readers becoming familiar with the language of the TCJA prior to making adjustments for the business interest expense limitation.

[5] In general, the TCJA defines qualified property as tangible property subject to depreciation under the modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less.

[6] Joseph Thompson and David Neuzil, "Valuing Bonus Depreciation Under the New Tax Law," *Business Valuation Review*, Volume 37, Issue 1, Spring 2018, 15-19.

Table 1

	Corporate Tax Rates	2017 Tax Law		2018 Tax Law	
(1)	Federal Corporate Tax Rate		35.0%		21.0%
(2)	Average State Corporate Tax Rate	6.3%		6.3%	
(3)	Federal Tax Deduction @ 35% & 21%	2.2%		1.3%	
(4)	Effective State Corporate Tax Rate	4.1%	4.1%	5.0%	5.0%
(5)	Combined Effective Corporate Tax Rate		39.1%		26.0%

on Line 6 has become a larger component of the overall capital structure.

The change in capital structure is attributable to the increase in equity value associated with the decline in the corporate tax rate. An iterative capital structure analysis results in a heavier weighting on equity capital, which tends to increase the overall WACC. In Table 2, the iterative capital structure is based on the values of debt, equity, and enterprise value reflected in the single period capitalization (SPC) method presented in a subsequent section of this article.

The calculations presented in Table 2 are intended to demonstrate a concept rather than actual analysis. The equity rate of return, debt rate, and iterative capital structures could be materially different in 2018, as opposed to 2017. In addition, the business interest expense limitation may impact the tax-affected interest rates used in the WACC. For ease of explanation, we assume the capital structures of the subject company and guideline companies are consistent with the iterative capital structure.

C Corporation Valuation Example

Our analysis of a C corp value using the valuation-related characteristics of the TCJA is based on the following attributes:

- Use of a single period capitalization (SPC) method.
- Valuation date of December 31, 2017.
- Combined effective federal and state corporate tax rates provided in Table 1.
- Capital expenditures are equal to depreciation.
- Incremental working capital is zero in perpetuity.
- SPC method does not reflect bonus depreciation calculations.
- Business interest expense limitation is not applicable.
- WACC is adjusted for the impact of the new tax rate on the after-tax cost of debt capital and the changing nature of the iterative capital structure.

Single Period Capitalization Method

Table 3 illustrates our SPC method analysis using the tax rates from Table 1.

As demonstrated on Lines 1 through 3 of Table 3, debt-free net income (DFNI) is calculated by tax affecting EBIT by a 39.1% rate under the 2017 tax law and by a 26% rate under the 2018 tax law. Since capital expenditures and depreciation are equal and we have assumed that incremental working capital is zero, the DFNI is equal to debt-free cash flow (DFCF). We then capitalized DFCF using a WACC of 9.16% (2017 tax law) and 9.96% (2018 tax law). The resulting enterprise and equity values are illustrated on Lines 9 and 11, respectively.

Market Approach

The market approach is generally comprised of the guideline public company (GPC) method and the merger & acquisition (M&A) method. We discuss the impact of the TCJA on each of these valuation methods below.

GPC Method

Under the Efficient Market Hypothesis,[7] the prices of publicly traded equity securities incorporate information available in the marketplace. As discussed in the Legislation Timeline section of this article, the pendency of tax reform began in earnest on November 8, 2016 (when President Trump was elected) and concluded on December 22, 2017 (when the TCJA was signed into law). Analysts will have to determine when, and to what extent, the expectation of tax reform became incorporated in the pricing of publicly traded equity securities. Certainly, by December 22, 2017, all speculation had ended regarding the components of the TCJA and the certainty of passage. Consequently, it is reasonable to assume that the prices of publicly traded equity securities have reflected the characteristics of the TCJA since December 22, 2017.

If the valuation date for the subject company occurs on or after December 22, 2017, and the GPCs used in the analysis are substantially similar to the subject company, tax-related financial adjustments to the GPCs and/or subject company may not be necessary. However, if the GPCs and subject company are not substantially similar, tax characteristics such as bonus depreciation, interest expense limitations, and taxation of foreign earnings may impact the financial comparability of the

[7] The Efficient Market Hypothesis is a market theory that evolved from a 1960s dissertation by Eugene F. Fama, Ph.D. Professor Fama is a Nobel Prize Laureate in Economic Sciences and finance professor at the University of Chicago, Booth School of Business. The Efficient Market Hypothesis is a foundational component of modern business valuation theory.

Table 3

	2018 Projected Income Statements	2017 Tax Law	2018 Tax Law	
(1)	Earnings Before Interest & Taxes	$ 200,000	$ 200,000	
(2)	Corporate Taxes @ 39.1% & 26%	(78,200)	(52,000)	
(3)	Debt Free Net Income	$ 121,800	$ 148,000	
	Valuation Analysis			
(4)	Debt Free Net Income	$ 121,800	$ 148,000	
(5)	Depreciation Expense	100,000	100,000	
(6)	Capital Expenditures	(100,000)	(100,000)	
(7)	Debt Free Cash Flows	121,800	148,000	
(8)	WACC Capitalization Factor	9.16%	9.96%	
(9)	Enterprise Value	1,329,084	1,485,915	Value
(10)	Debt	(600,000)	(600,000)	Increase
(11)	Equity Value	$ 729,084	$ 885,915	21.5%

GPCs and the subject company. When this is the case, financial performance adjustments may be necessary.

A comprehensive discussion of this issue is beyond the scope of this article; however, we look forward to the research and modeling that the academic and valuation communities will present on this issue. For the purpose of this article, we assume the GPCs are identical to the subject company and no financial adjustments are necessary. Given the valuation date used in our example is December 31, 2017, we assume the GPC method provides an indication of value that reflects the relevant characteristics of the TCJA. Consequently, we assume the indications of value provided by the GPC method and SPC method are identical.

M&A Method

If both the valuation date for the subject company and the guideline M&A transactions used in the analysis occur on or after December 22, 2017, tax-related financial adjustments to the target companies and/or subject company may not be necessary, assuming the M&A target companies are identical to the subject company. However, similar to the GPC method, financial adjustments may be necessary if the tax attributes of the TCJA affect the target companies and the subject company in a dissimilar manner. For the purposes of this article, we assume the M&A target company was acquired in 2016 and is a C corp that is identical to the subject company. The following Table 4 and Table 5 illustrate a valuation issue that may arise when a 2016 corporate transaction is used to value a subject company as of a 2018 valuation date.

Table 4

2016 Transaction	Target Company
(1) 2016 Enterprise Value	$ 1,329,084
(2) 2016 EBITDA	300,000
(3) 2016 EBITDA Multiple	4.43

Based on the information provided in Table 4, the 2016 EBITDA multiple is 4.43. As demonstrated in Table 5, the application of this multiple to the 2018 EBITDA of the subject company will result in the exact same enterprise value as the 2016 transaction.

Table 5

Subject Company	2018 Valuation
(1) 2018 EBITDA	300,000
(2) 2016 EBITDA Multiple	4.43
(3) 2016-Based Enterprise Value	$ 1,329,084

The conclusion of value in Table 5 may be incorrect because the earnings multiple derived from a 2016 corporate transaction would not reflect the tax attributes of the TCJA, including the reduction of the corporate tax rate from 35% to 21% and changes in the cost of capital.

For the purposes of this article, we will assume the tax related valuation differences in enterprise value between a 2016 corporate transaction and a 2018 valuation date are twofold: (1) increase in the WACC from 9.16% to 9.96% and (2) reduction in the federal corporate tax rate from 35.0% to 21.0%.

These two factors have disparate impacts on the enterprise value of the subject company for a 2018 valuation date, when compared to a 2016 corporate transaction. The higher WACC results in a lower enterprise value and the lower corporate tax rate increases the after-tax earnings and resulting enterprise value. To correct these issues, the first step is to calculate the WACCs of the subject company as of the 2016 transaction date and the 2018 valuation date. The second step is to identify the corporate tax rates applicable to 2016 and 2018. Once these numbers are determined, the following formula can be used to adjust the enterprise value of the subject company when a 2016 corporate transaction is used to estimate enterprise value in 2018.

Enterprise Value Adjustment Multiple (EVAM)

$$\frac{(1 - \text{2018 Tax Rate})}{(1 - \text{2016 Tax Rate})} \times \frac{\text{2016 WACC}}{\text{2018 WACC}} = 1.1180$$

Where:

2018 Tax Rate	=	26.0%
2016 Tax Rate	=	39.1%
2016 WACC	=	9.16%
2018 WACC	=	9.96%

Table 6 demonstrates the application of the enterprise value adjustment multiple (EVAM). The EVAM may be used to adjust the enterprise value (or enterprise value multiple) of the subject company when using an M&A multiple derived from a corporate transaction that does not reflect the tax attributes of the TCJA.

Table 6

Enterprise Value Adjustment Multiple	2018 Valuation
(1) 2018 EBITDA	$ 300,000
(2) 2016 EBITDA Multiple	4.43
(3) 2016-Based Enterprise Value	1,329,084
(4) Enterprise Value Adjustment Multiple	1.1180
(5) 2018 TCJA-Adjusted Enterprise Value	1,485,915
(6) Debt	(600,000)
(7) 2018 TCJA-Adjusted Equity Value	$ 885,915

As demonstrated in Table 6, we multiply the 2018 EBITDA of the subject company by the 2016 EBITDA multiple to conclude a 2016-based enterprise value of $1,329,084. The EVAM of 1.1180 is then applied to the 2016-based enterprise value to calculate the 2018 TCJA-adjusted enterprise value of $1,485,915 on Line 5. If the objective is to value equity, the debt may be subtracted from this amount to calculate the 2018 TCJA-adjusted equity value of $885,915.

There are a few caveats regarding the use of the EVAM in the M&A method. The EVAM only corrects for the change in the WACC and corporate tax rates attributable to the TCJA. There are other issues that may impact the purchase price and structuring of corporate transactions that may be as important, or more important, than the WACC or corporate tax rates attributable to the TCJA (including, for example, the availability of bonus depreciation under the TCJA).

In addition, the condition of the capital markets and various micro- and macro-economic conditions may have a substantial impact on the value of a target company involved in a 2016 transaction as compared to a 2018 valuation of a company. In addition, changes in the assumed or iterative capital structures used in the WACC calculations can have a material impact on the enterprise value of the subject company, as well as the EVAM.

Having said this, the reduction of the corporate tax rate provided in the TCJA will impact the WACC, cash flows, and enterprise values of many companies. Therefore, it is important to consider these corporate tax changes when conducting an M&A method that uses pre-TCJA corporate transactions to value a subject company with a valuation date that occurs during the Legislation Timeline or after the TCJA became law.

Individual Tax Changes

Individual taxation is important to PTE business valuation because owners of PTEs are taxed at individual tax rates based on their pro-rata share of the earnings of the PTE. The primary valuation-related tax changes in the TCJA that affect individuals are as follows:

- Temporary implementation of a graduated individual income tax structure, with a top marginal tax rate of 37.0% (down from 39.6%).
- Temporary limit of $10,000 (in the aggregate) for certain itemized deductions, including state and local taxes (SALT).
- Temporary 20% deduction of Qualified Business Income (QBI) of PTEs.

New Graduated Individual Tax Rate Structure

The TCJA temporarily replaced the existing federal individual income tax rate structure with a new structure for tax years beginning in 2018 and ending in 2025. For example, during the eight years beginning in 2018 there were seven marginal tax brackets for single individuals, starting at 10.0% for taxable incomes below $9,525 and going up to 37.0% for taxable incomes in excess of $500,000. This provision is temporary and sunsets at the end of 2025. Consequently, in 2026 the tax brackets and rates revert back to their pre-TCJA (i.e., 2017) levels. For the purposes of this article, we will be using the 37.0% top marginal tax rate in our analysis.

State and Local Income Taxes (SALT)

Under the old tax law, state and local taxes (SALT) were deductible for federal tax purposes on individual tax returns. This deduction effectively reduced state income tax rates for individuals in states that tax income. Under the TCJA, individuals are limited to $10,000 in itemized deductions for items such as SALT. This deduction limitation, which began in 2018 and will terminate at the end of 2025, effectively increased the state income tax rates on individuals in states that tax income. In addition, since the TCJA maintains the existing top federal tax rate of 20% on dividends and capital gains, the SALT deduction limitation effectively increases the combined federal and state income tax rates on dividends and capital gains in states that tax this form of income.

The earnings of PTEs are subject to state income taxes on the individual tax returns of their owners. Although the top federal income tax rate for individuals is somewhat lower under the TCJA, the SALT deduction limitation served to offset this tax benefit, particularly in high-tax state jurisdictions. Consequently, the combined federal and state income tax rates on PTE earnings are somewhat similar to what they were under the old tax law for high income individuals.

Qualified Business Income Deduction

Under the TCJA, individuals may deduct up to 20% of their pro rata share of the qualified business income (QBI) of certain PTEs for tax years beginning in 2018 and terminating at the end of 2025. The TCJA essentially defines QBI as the taxable income of a PTE business. In order to qualify for the 20% deduction, income

Table 7

	2018 Tax Law			
Dividend / Capital Gains Tax Rates	Temporary Period 2018-2025		Permanent Period 2026 and Beyond	
(1) Federal Dividend/Capital Gains Tax Rate		20.0%		20.0%
(2) Average State Individual Tax Rate	5.5%		5.5%	
(3) Federal Tax Deduction @ 0% & 39.6%	0.0%		2.2%	
(4) Effective State Individual Tax Rate	5.5%	5.5%	3.3%	3.3%
(5) Net Investment Income Tax (NIIT)		3.8%		3.8%
(6) Combined Effective Dividend/Capital Gains Tax Rate		29.3%		27.1%

Table 8

	2018 Tax Law			
Individual Income Tax Rates	Temporary Period 2018 - 2025		Permanent Period 2026 and Beyond	
(1) Federal Individual Tax Rate		37.0%		39.6%
(2) Average State Individual Tax Rate	5.5%		5.5%	
(3) Federal Tax Deduction @ 0% & 39.6%	0.0%		2.2%	
(4) Effective State Individual Tax Rate	5.5%	5.5%	3.3%	3.3%
(5) Net Investment Income Tax (NIIT)		3.8%		3.8%
(6) Effective Tax Rates - PTE Service Business		46.3%		46.7%
(7) 20% Qualified Business Income Deduction		9.3%		0.0%
(8) Effective Tax Rate - PTE Non-Service Businesses		37.0%		46.7%

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must be derived from business operations located in the United States.

In general, individuals that fully qualify for this deduction are all PTE business owners except owners of certain service businesses. The TCJA generally defines service businesses as a business in which the principal assets of the firm are the reputation or skill of the firm's employees and/or owners. The TCJA specifically excluded engineering and architecture firms from the definition of service-based businesses.

For all PTEs, the TCJA limits the 20% QBI deduction to the greater of: (1) 50 percent of W-2 wages paid to employees, or (2) the sum of 25% of W-2 wages paid plus 2.5% of the unadjusted basis of qualified property employed in the business. In addition to these limitations, the TCJA phased in the disallowance of the QBI deduction for service-based PTEs when the owner's taxable income exceeded $157,500 for individuals or $315,000 for joint returns.

Tables 7 and 8 on the previous page provide a summary example of the individual tax rates used in this article.

In the following section of this article, we will address how the changes in individual tax rates listed above affect the relative values of C corps and PTEs.

Van Vleet Model

The Van Vleet Model is fundamentally based on a formula referred to as the S Corporation Equity Adjustment Multiple (SEAM). The SEAM is used to adjust the equity value of a PTE when such value has been estimated using C corp data.

The Van Vleet Model accounts for the tax treatment differences of C corps, PTEs, and their respective shareholders and is the most widely used PTE model in the U.S. A comprehensive discussion of the Van Vleet Model is beyond the scope of this article; however, Table 9 provides a conceptual demonstration of the model and how the SEAM would be calculated under the previous tax law. Table 9 was prepared using the following assumptions:

- Entity-level combined effective corporate tax rate = 39.1%
- Entity-level state income tax rate on PTEs = 1.0%
- Dividend/distribution ratio = 75%
- Shareholder-level dividend/capital gains tax rate = 27.1%
- Shareholder-level combined effective individual income tax rate = 46.7%

As demonstrated in Table 9, the earnings of the C corp and PTE are taxed at the entity-level on Line 2 and at the shareholder-level on Lines 5, 6, and 9. Line 13 provides the total economic benefit derived by the shareholders of C corps and PTEs after recognition of both entity-level and shareholder-level taxation. The two measurements of economic benefit on Line 13 are then compared to each other in order to determine the relative economic benefit difference of being a C corp shareholder as compared to a PTE shareholder. On Line 14 of Table 9, this relative economic benefit difference is converted to a percentage difference of 18.86%. By adding 1.0 to this number, the SEAM

Table 9

		2017 Tax Law	
	All PTE Businesses	C Corp.	PTE
(1)	Earnings Before Taxes	$100,000	$100,000
(2)	Entity Taxes @ 39.1% & 1%	(39,100)	(1,000)
(3)	Net Income	60,900	99,000
	Dividends / Distributions		
(4)	Dividends / Distributions @ 75%	45,675	74,250
(5)	Dividend Taxes @ 27.1%	(12,378)	NM
(6)	Individual Taxes @ 46.7%	NM	(46,233)
(7)	Net Dividend / Distribution Benefit	33,297	28,017
	Capital Appreciation		
(8)	Capital Appreciation	15,225	24,750
(9)	Capital Gains Taxes @ 27.1%	(4,126)	NM
(10)	Net Capital Appreciation Benefit	11,099	24,750
	Net Economic Benefit		
(11)	Net Dividend / Distribution Benefit	33,297	28,017
(12)	Net Capital Appreciation Benefit	11,099	24,750
(13)	Total Economic Benefit	$ 44,396	$ 52,767
(14)	PTE Business vs C Corp Benefit		18.86%
(15)	S Corporation Equity Adjustment Multiple (SEAM)		1.1886

is quantified at 1.1886. This SEAM may then be used to adjust the C corp equivalent value of equity of a PTE to a PTE equity value when the tax rates used in Table 9 are appropriate for the analysis.

Table 10 provides the SEAMs for non-service and service businesses for the temporary and permanent periods included in the TCJA.

The tax rates used in Table 10 are obtained from Tables 7 and 8. The SEAMs that result from these calculations are attributable to non-service and service PTEs for the temporary period (2018 through 2025) and the permanent period (2026 and beyond).

After the SEAMs are calculated in this manner, the next step is to weigh the applicable SEAMs by the proportional contribution that the temporary and permanent periods make to the overall conclusion of enterprise value. The weighted SEAM is then applied to the C corp equivalent equity value to conclude a PTE equity value.

Table 11 demonstrates a method that may be used to calculate the contributory weights of the temporary and permanent periods to the overall enterprise value.

As demonstrated in Table 11, the projected cash flows for the 2018 through 2025 temporary period are $148,000 per year as derived from the SPC method demonstrated in Table 3 (on page 59). These eight years of projected cash flows are discounted at the WACC of 9.96% and then summed to a total value of $790,715 as provided on Line 9. The total enterprise value of the subject company is $1,485,915, per Line 9 of Table 3.

In order to calculate the contributory value of the permanent period cash flows to the enterprise value, we subtract the value of the temporary period cash flows on Line 10 from the enterprise value on Line 12. Based on our analysis, the contributory values of the temporary and permanent periods to the enterprise value are 53.2% and 46.8%, respectively.

Table 10

		2018 Tax Law		
		Temporary SEAM		Permanent SEAM
	SEAM Components	Non-Service PTE	Service PTE	All PTEs
(1)	Combined Effective Corporate Tax Rates	26.00%	26.00%	26.00%
(2)	Combined Effective Individual Tax Rates	37.00%	46.30%	46.70%
(3)	Pass-through Entity State Tax Rate	1.00%	1.00%	1.00%
(4)	Combined Effective Capital Gains Tax Rates	29.30%	29.30%	27.10%
(5)	Combined Effective Dividend Tax Rates	29.30%	29.30%	27.10%
(6)	Assumed C Corp Dividend Payout Ratio	75.00%	75.00%	75.00%
(7)	PTE vs C Corp Benefit	19.21%	1.62%	-2.19%
(8)	SEAM	1.1921	1.0162	0.9781

$$\text{SEAM} = 1 + \frac{(t_c + t_{cg} - t_s - t_i + t_s t_i - t_c t_{cg} + D_p t_d - D_p t_{cg} - D_p t_c t_d + D_p t_c t_{cg})}{(1 - t_c - t_{cg} + t_c t_{cg} - D_p t_d + D_p t_{cg} + D_p t_c t_d - D_p t_c t_{cg})}$$

SEAM Components

t_c = Combined Effective Corporate Tax Rate

t_i = Combined Effective Individual Tax Rate

t_s = Pass-through Entity State Tax Rate

t_{cg} = Combined Effective Capital Gains Tax Rates

t_d = Combined Effective Dividend Tax Rates

D_p = Assumed C Corp Dividend Payout Ratio

Table 11

	Temporary Period Cash Flows	Projected Cash Flow	Present Value Factors @ 9.96%	Present Values
(1)	2018 Present Value of Cash Flow	$ 148,000	0.9094	$134,594
(2)	2019 Present Value of Cash Flow	148,000	0.8270	122,403
(3)	2020 Present Value of Cash Flow	148,000	0.7521	111,315
(4)	2021 Present Value of Cash Flow	148,000	0.6840	101,232
(5)	2022 Present Value of Cash Flow	148,000	0.6220	92,063
(6)	2023 Present Value of Cash Flow	148,000	0.5657	83,724
(7)	2024 Present Value of Cash Flow	148,000	0.5145	76,140
(8)	2025 Present Value of Cash Flow	$ 148,000	0.4679	69,243
(9)	Value of Temporary Period Cash Flows			$790,715
(10)	Temporary Period Cash Flows	$ 790,715	53.2%	
(11)	Permanent Period Cash Flows	695,201	46.8%	
(12)	Enterprise Value	$1,485,915	100.0%	

	Non-Service Business	SEAM	Weights	Weighted SEAM
(13)	Temporary Non-Service SEAM	1.1921	53.2%	0.6344
(14)	Permanent SEAM	0.9781	46.8%	0.4576
(15)	Weighted Non-Service SEAM			1.0920

	Service Business	SEAM	Weights	Weighted SEAM
(16)	Temporary Service SEAM	1.0162	53.2%	0.5407
(17)	Permanent SEAM	0.9781	46.8%	0.4576
(18)	Weighted Service SEAM			0.9984

After calculating the temporary and permanent weights described above, the next step is to multiply the temporary and permanent SEAMs by these temporary and permanent contributory weights in order to quantify weighted SEAMs for non-service and service businesses. These calculations are presented in Table 11 on Lines 13 through 15 for non-service businesses and Lines 16 through 18 for service businesses. The resulting weighted SEAMs are applied to the C corp equivalent equity value to quantify the PTE equity value for non-service and service businesses.

Table 12 on page 64 provides a summary of our valuation analysis of C corps and PTEs under the 2017 tax law and 2018 tax law.

As demonstrated on Line 1 of Table 12, the 2018 enterprise value provided by the SPC method is $1,485,915. This value needs to be adjusted for the value of bonus depreciation available under the TCJA. This adjustment is necessary because no specific adjustments for bonus depreciation were included in the projected cash flows used in the SPC method.

In our view, it is preferable to quantify the value of bonus depreciation separately, as embedding it within the projected cash flows may require extending projections 10, 15, or more years, and may distort projected fixed asset turnover ratios that are often used to determine the reasonableness of projected capital expenditures and depreciation expense. By isolating the cash flow benefit of bonus depreciation, we avoid this complexity.

As demonstrated on Line 4 of Table 12, the 2018 enterprise value under the GPC method is $1,504,915. For simplifying purposes, we have set the 2018 adjusted enterprise value provided by the GPC method equal to that provided by the SPC method. As discussed in a previous section of this article, it is our assumption that the GPC method conducted for a 2018 valuation date would provide an indication of value that is consistent with the characteristics of the TCJA, including the bonus depreciation calculation.

As demonstrated on Line 9 of Table 12, the enterprise value provided by the M&A method is $1,485,915. This value needs to be adjusted for bonus depreciation. This adjustment is necessary because the 2016 multiples used in this method do not reflect the incremental value attributable to bonus depreciation available under the TCJA. Consequently, we have added the value of bonus depreciation to the enterprise value provided by the M&A method. If the multiples used in this method were derived from 2018 corporate transactions, the adjustment for bonus depreciation may not be necessary.

On Line 10 of Table 12, we average the enterprise values provided by each of the valuation methods to conclude an average adjusted enterprise value of $1,504,915. We then subtract debt from this enterprise value to quantify an equity value of $904,915. This indication of value is on a C corp equivalent basis. If the objective of the analysis is to value PTE equity, the weighted SEAM must be applied to the C corp equity value to quantify a PTE equity value. This calculation is conducted on Line 13. The resulting conclusions of PTE equity values for the non-service and service businesses are $988,182 and $903,440, respectively. For comparison purposes, we have also included the C Corp and PTE equity values under 2017 tax laws.

Under the prior tax law, PTEs enjoyed a meaningful tax advantage over C corps (Table 9 demonstrates an 18.86% economic benefit

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Table 12

		2017 C Corp	2018 Tax Law: PTE Non-Service Business	2018 Tax Law: PTE Service Business	2018 Tax Law: 2018 C Corp
	Single Period Capitalization Method				
(1)	Enterprise Value	$ 1,329,084	$ 1,485,915	$ 1,485,915	$ 1,485,915
(2)	Bonus Depreciation	NM	19,000	19,000	19,000
(3)	Adjusted Enterprise Value	1,329,084	1,504,915	1,504,915	1,504,915
	Guideline Public Company Method				
(4)	Enterprise Value	1,329,084	1,504,915	1,504,915	1,504,915
(5)	Bonus Depreciation	NM	NM	NM	NM
(6)	Adjusted Enterprise Value	1,329,084	1,504,915	1,504,915	1,504,915
	Merger & Acquisition Method				
(7)	Enterprise Value	1,329,084	1,485,915	1,485,915	1,485,915
(8)	Bonus Depreciation	NM	19,000	19,000	19,000
(9)	Adjusted Enterprise Value	1,329,084	1,504,915	1,504,915	1,504,915
(10)	Average Adjusted Enterprise Value	1,329,084	1,504,915	1,504,915	1,504,915
(11)	Debt	(600,000)	(600,000)	(600,000)	(600,000)
(12)	Equity Value (C Corp Basis)	729,084	904,915	904,915	$ 904,915
(13)	Weighted SEAM	1.1886	1.0920	0.9984	
(14)	Equity Value (PTE Basis)	$ 866,554	$ 988,182	$ 903,440	
(15)	Increase in PTE Equity Value over 2017 Valuation		14.0%	4.3%	
(16)	Increase in C Corp Equity Value over 2017 Valuation				24.1%

advantage for PTEs under the prior tax law). Under the TCJA, the values of PTEs and C corps will tend to increase, but C corps increase in value more than PTEs, narrowing the equity value gap that existed under prior tax law.

As demonstrated on Lines 15 and 16 of Table 12, the 2018 C corp equity value increased by 24.1% as a result of the TCJA, whereas the 2018 equity values of non-service and service PTEs increased by only 14.0% and 4.3%, respectively. This convergence of equity values is particularly true for service PTEs, which in the example shown in Table 12 are now valued essentially the same as C corp equity value (the weighted SEAM is 0.9984).

The temporary 20% QBI deduction allows non-service PTEs to maintain some of the PTE equity value advantage afforded under the prior tax law, but only about half of it (in the Table 12 example, the weighted SEAM for non-service PTEs is 1.0920 under the TCJA, down from 1.1886 under the prior tax law). As the remaining portion of the temporary period declines, the value of this economic benefit will also decline, eventually leaving non-service PTEs in much the same position as service PTEs.

Since the SEAMs are weighted based on the contributory value of the temporary and permanent periods, the weighted SEAMs will decline as the remaining period of the temporary period declines. After the expiration of the temporary period at the end of 2025, the SEAMs for both non-service and service businesses will be identical. At that point, it is possible that PTE equity values may be less than C corp equivalent values.

Summary and Conclusion

As a result of the TCJA, there are now three distinct types of business entities from a tax perspective: (1) C corps, (2) PTE service businesses, and (3) PTE non-service businesses. The TCJA presents new challenges for valuing each type of business. Many of the tax law changes can be specifically addressed in the subject company's financial adjustments or projections (regardless of entity type). However, we recommend that analysts separately quantify the value of bonus depreciation and add this amount to the concluded equity values in a manner consistent with the guidance discussed in this article (generally) and the Thompson/Neuzil article (specifically).

It appears that the values of most businesses have increased as a result of the beneficial tax attributes of the TCJA. C corps have experienced a greater percentage increase in value compared to PTEs. In fact, most of the value benefit of being a PTE has largely disappeared for service business. The tax-related value benefit of being a PTE is still material for non-service businesses, but this benefit will decline as the remaining portion of the temporary period (and thus the QBI deduction) diminishes as 2026 approaches.

If Congress decides to extend the sunset provision or make the QBI deduction permanent, non-service PTEs will continue to enjoy a level of economic benefit that is superior to C corps. However, there is little evidence at this point in time that Congress will take this action.

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1st PLACE: Shuo (Steven) Wang – *BDO USA*

Steven Wang is a Director in BDO's Turnaround & Restructuring Services with over 10 years' experience in advisory services to clients across a wide range of industries. He transitioned to the turnaround and restructuring industry after several years in financial audit in both the U.S. and Australia, including healthcare, wealth management, manufacturing, and agriculture. Steven is well versed in both U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), as well as in valuation based on his work with top domestic and international asset managers. He holds a Bachelor of Commerce (First Class Honors), University of Melbourne; State of Chamber of Commerce Exhibition for Econometrics Top of the Class Award.

2nd PLACE: Andrew Kim – *M3 Partners*

Andrew Kim is a Senior Associate at M3 Partners, based in New York, where he focuses on financial and operational restructuring for distressed businesses and lenders. Andrew specializes in bankruptcy preparation, building financial models, investigation support, and cost reduction initiatives for a wide variety of industries. Prior to joining M3, he spent three years with Alvarez & Marsal's restructuring investment banking team and worked at FanDuel as an acquisition strategy and planning manager. Andrew received his BS in International Politics from Georgetown University's School of Foreign Service.

3rd PLACE: Jack Donohue – *DSI Consulting*

Jack Donohue is a Director at Development Specialists, Inc. and is based in their Chicago office. He specializes in complex Debtor engagements advising the executives, boards of directors, and key stakeholders of financially distressed companies. Jack has assisted clients with forbearance negotiations, out-of-court restructuring, and Chapter 11 processes, including 363 sales and the building of plans of reorganization. He has led cash management and liquidity forecasting and developed business plan projections for middle-market companies across a variety of industries. Jack received his BSBA in Finance from the University of Arizona, and he is a Certified Public Accountant (CPA)

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AIRA GRANT NEWTON EDUCATIONAL ENDOWMENT FUND 2024 SCHOLARSHIP AWARDED TO DELANIE TU'UMALO

Delanie Tu'umalo is a third-year Accounting major and Communication studies minor at Pepperdine University who excels at Tableau and reports her favorite accounting topic is capitalized interest. She was selected by the accounting faculty for excellence in academic achievement, leadership, and exemplary community involvement. She is from the state of Hawaii and is exploring full-time opportunities in Oahu.

Outside of the busy coursework and campus life, she is a talented pianist and choir accompanist. She is very involved in church activities and serves as the Social Media Manager for a youth program. In her free time, she enjoys going to the beach and spending time with family—she says her family is her motivation and she strives to make them proud.

In an email to AIRA, she expressed "sincere gratitude for being selected as the recipient of the accounting scholarship awarded by the Association of Insolvency and Restructuring Advisors at this year's Accounting Honors Banquet. It was such a pleasure meeting and conversing with Mr. Tom Jeremiassen and I truly appreciated his passion for supporting Pepperdine's accounting program and students. This scholarship is a tremendous help in furthering my academic goals. I am incredibly grateful for your investment in my future."

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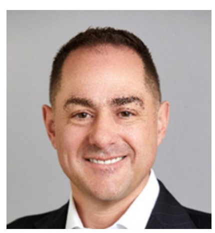

LOS ANGELES, April 8, 2024 /PRNewswire/ -- Introducing Resolution Financial Advisors LLC (Resolution), poised to redefine industry standards with its launch on April 8, 2024. Created by longtime employees of Sherwood Partners, Inc., Resolution is a partnership formed to create a new premier service. Founded by **David M. Johnson, CFA, CIRA**; Molly Froschauer, Esq.; Jeffrey Klausner, CPA; and Ryan Small, each partner brings years of professional leadership and knowledge in distressed advisory. Serving as Managing Director, Mr. Johnson has over 25 years' experience in financial advisory, insolvency, and restructuring roles, having begun his career at Alvarez & Marsal. Ms. Froschauer is a bankruptcy attorney with over ten years' experience in bankruptcy and ABC processes. Mr. Klausner is a corporate financial advisor who has served as CFO of both public and private companies. Lastly, Mr. Small's professional skills span corporate restructuring, foreclosures, receiverships, ABCs and IP monetization.

Resolution specializes in a variety of financial and legal tools including Assignments for the Benefit of Creditors, foreclosures, receiverships, and federal bankruptcy proceedings. More than mere advisory, Resolution also acts as a fiduciary agent, taking over the responsibilities of the Board and providing a measure of protection for officers and directors. Resolution provides a turnkey process for stakeholders, handling the monetization of assets (including Intellectual Property) in order to provide maximum recovery. See https://resolutionfa.com/.

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