AIRA JOURNAL

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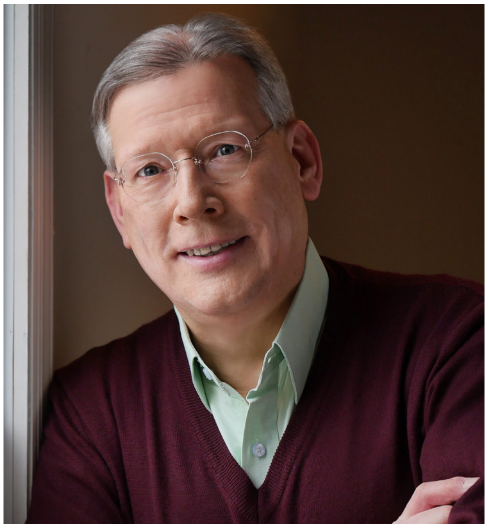

JAMES M. LUKENDA, CIRA
AIRA EXECUTIVE DIRECTOR
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FROM THE DESK OF THE EXECUTIVE DIRECTOR

As we turn past 2025 and look to 2026, I want to thank the AIRA staff, the membership, and all who participated in the Association's programs for a successful year. Participation in the CIRA certification program continues to be strong with many firms encouraging their professionals to add to their personal skill sets through certification. CDBV certification, while not as common, continues to draw in those professionals looking to add to their valuation credentials with AIRA's certification focused on the unique issues of distressed business valuation.

I also wish to take this opportunity to welcome the following industry leaders to the AIRA board:

Matthew Fleming, CIRA
Deloitte Financial Advisory Services LLP

Michael Fleming, CIRA
Stout

Abhimanyu Gupta, CIRA
Huron Consulting Group

James Katchadurian
CR3 Partners, LLC

Timothy Mohan, Esq.
Foley & Lardner LLP

Briana A. Richards, CIRA
EY Parthenon

James Schwarz, CIRA, CDBV
BDO Consulting

Teri Stratton
Hilco Global

Kyle Sturgeon, CIRA
Meru, LLC

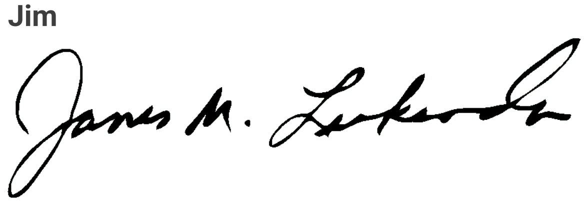
These seasoned professionals will serve as AIRA's director class through 2029.

At the AIRA annual meeting and conference last June, the AIRA Board awarded its 2025 Emmanual M. Katten Award to Keith J. Shapiro, long-time counsel to AIRA and a renowned contributor to the restructuring and turnaround profession. In accepting the Manny Katten award, Keith spoke about his career, the opportunities it has afforded him, and the relationship of restructuring to the pursuit of his many interests. For those of you who are starting out in your career or did not have the opportunity to hear Keith in June I cede the remainder of my column to publishing Keith's acceptance speech.

As always, interesting and timely articles relevant to our work follow. Please read, enjoy, and learn.

With best wishes for the New Year,

Jim



2025 MANNY KATTEN AWARD WINNER KEITH J. SHAPIRO'S ACCEPTANCE SPEECH

Keith J. Shapiro

"Good afternoon. I am so humbled and grateful to receive the prestigious Manny Katten Award. I had the privilege to work on cases with Manny as a young lawyer and knowing him and having seen him in action as both a practitioner and leader makes receiving this award even more special. Thank you also to AIRA Executive Director Jim Lukenda and to my old friend Steve Darr for the very kind introduction.

And thanks so much to AIRA founder Grant Newton, a truly kind and brilliant man, who got me started in AIRA as a Board member and then as its lawyer over 30 years ago. I was asked to share my journey with you, as well as something important that I've learned along the way. I've learned so much over the years, and continue to learn every day, but the thing I've learned that has enriched my life the most is that our identities need not be limited to the title on our business cards and that those of us who practice in the restructuring arena are uniquely qualified to excel at many things far beyond the restructuring world. We shouldn't sell ourselves short when constructing our path through our professional lives.

Steve highlighted the unconventional path I've taken through my various careers, doing seemingly disparate things in each chapter.

My journey started in a working-class Chicago home with parents who didn't have the opportunity to go to college. I studied finance at the University of Illinois and discovered bankruptcy law at Emory Law School, leading to a judicial clerkship and then job offers to practice bankruptcy law. Within a year of law school graduation, the company my dad worked for filed for Chapter 11 relief and he was out of work for about two years. From this I gained a massive chip on my shoulder and a deep appreciation of the financial stability and security that a steady paycheck provides. My career in law certainly provided that security.

I don't want to understate how much I loved my legal career. I started at the bottom and eventually worked on many of the biggest cases in the country and was honored to lead the American Bankruptcy Institute. I started Greenberg Traurig's twelfth office, in Chicago, in 1999 and had the privilege to serve as co-head and Chairman of that office. That decision was life changing for me, as the firm's unique entrepreneurial and collaborative culture empowered me to test and develop my business skills. They enabled me to risk failure on big dreams and mentored me and allowed me to play a central role in building a multi-billion-dollar global business. I gained enormous self-confidence and experience in the process.

Meanwhile, behind the scenes, since college I had developed an insatiable appetite for investing in businesses. From my early 30's I invested virtually every dollar I made into private deals. I became what I call "a professional passive investor," a capital source participating in hundreds of deals while I practiced law. Private equity, real estate, private credit and financial institutions, you name it. On my regular flights to Delaware and New York, my briefcase was always filled with private placement memos and deal updates alongside my legal pleadings. My investment strategy was the product of the endless permutations of what I saw businesses do wrong during my day job, trying to use my restructuring experience to identify and avoid potential future pitfalls in non-distressed deals. Although—and perhaps because—not every deal turned out as envisioned, it turned out to be a very lucrative endeavor. I started thinking about spending all of my time on the deal side of my life, but was terrified at the thought of walking away from the safety of a steady paycheck, the love and pride I felt for my law firm, and the respect and recognition I had earned as a well-known bankruptcy lawyer.

A little over a decade ago, in a spontaneous burst of courage, after my best year ever as a lawyer, I just did it. I wish I could tell you what I was thinking that day, or that I had some fancy plan, but it's mostly a blur. I know I was fatigued and no longer got an adrenaline rush when I landed a big new matter or won a big decision. I felt a deep sense of satisfaction in what I had accomplished as a lawyer and law firm leader, like a chapter that had been completed; and I knew that I craved having a lot more time to meet with entrepreneurs and to play a more active role in my investments. I was lucky to have the unqualified support of Marci, my incredible wife, who has always believed in me and encouraged me to trust my instincts.

Today, two of my three sons now work me to death and run circles around me as my partners in Karlov Street Capital, investing our capital and that of our many investors in real estate and private equity opportunities through dozens of special purpose investment funds. We've deployed hundreds of millions of dollars. It turns out that my passion for private investments had laid the foundation for a second career that would provide me with deep satisfaction. By putting my safe and secure identity at risk, the adrenaline was back and I still wake up excited to this day. The identity reflected on my old business cards had become outdated.

So, about career number 3…In about 2005 I developed a fascination with restaurants after working on some high-profile restaurant meltdowns. I had observed that most restaurants failed due to a laundry list of reasons that could to a great extent be identified on the day they signed their leases and construction contracts. And I loved the joy and energy that fills the room when a restaurant is hitting on all cylinders. I started passively putting money into restaurant deals that met my criteria, always expecting to lose my money, and regularly modifying my model as I gained experience. It was my version of Vegas gambling, which incidentally is something in which I do not partake. My gambling need is more than satisfied by my day job.

Ultimately it proved to be no different than my private equity and real estate strategy, using my restructuring experience to identify risk factors in the balance sheet, lease and vendor agreements, corporate governance and strategy, that people who repetitively watch companies fail are uniquely able to spot. A warning: Please do not hear these comments and think I'm suggesting that you should invest in a restaurant! It is insanely risky and not for the faint of heart.

Shortly after I pulled back from law practice and before I started my investment firm, having enjoyed my restaurant investments and thinking a slow paced life was ahead of me, I teamed up with a very earnest and highly pedigreed husband and wife chef team who sought a mentor and the capital to simultaneously start two adjacent restaurants, Smyth and The Loyalist. I did not realize that I was entering a world far removed from my passive restaurant investor hobby and that I would now endure sleepless nights and the kind of drama that we see on the many restaurant-focused TV shows these days.

And little did I know that this crazy, risky hobby would turn into career three, allowing me the surreal privilege and honor to walk the red carpet as one of only 14 Michelin 3-star restaurants in America, for Smyth to be listed by the Robb Report as one of the 20 greatest restaurants of the 21st Century and to be listed in 2025 as the #4 restaurant among North America's 50 Best. After 20 years in the restaurant space, I now get to spend time mentoring and supporting people who are true creative geniuses. Definitely not something anyone ever expected from a guy who has blown up several microwaves in his lifetime. As an offshoot of my restaurant life, I even had the chance to finance, seed, and serve as a Board member of a startup that originated in one of my restaurant investments and became a leading restaurant reservation system that was ultimately acquired by American Express.

These are fun stories, but the point here is that I might never have experienced these uniquely gratifying and unexpected moments in my life had I continued to identify solely as a bankruptcy lawyer. Because of my fear of failure and desire for safety and security, I may have sold myself short and missed the chance to push the boundaries of who I am and what I'm capable of doing; and to experience the high and lows of some incredible adventures.

I don't want to close without highlighting perhaps the best extension of the special skills that restructuring professionals share. And this one does NOT require giving up your day job! The skills we share have allowed an incredible number of restructuring professionals to hold incredible philanthropic leadership roles that have helped so many who are in need. If you have not deployed your talents in what for me has been a fourth career, I encourage you to do so. You have a portfolio of talents that can make a huge difference. I can tell you that this part of my professional life, to which I devote part of every day, has been the greatest source of joy and satisfaction of everything I've done.

What has become clear to me is that restructuring professionals are not just lawyers and financial advisors – we're problem solvers, strategists, and builders. And these skills transcend any one job title. The ability to identify risks, to solve seemingly unsolvable problems in the face of hundreds or thousands of antagonistic counter-parties, and to stay calm and act decisively under incalculable pressure, is a skill set that allows us to successfully take our talents in so many directions.

A single job title does not do us justice. A job title can be just a chapter in a much richer story. When we stop defining ourselves by what we do and start exploring who we are, we can unlock opportunities and life experiences we never realized were possible. It's a lesson that took me decades to learn, and I hope sharing a bit of my journey helps some of you shortcut that path.

Thanks to AIRA again for this kind recognition. I wish you many years of continued success.

[This speech has been adapted and updated for publication.]

Keith Shapiro is the CEO and founder of Karlov Street Capital. He co-founded the Chicago office of Greenberg Traurig, served as Vice President of the firm, Chairman of Strategic Recruiting and a member of its Executive Committee for many years. He is a member of the American College of Bankruptcy. Keith currently serves on the Executive and Board of Governors of the Jewish Agency for Israel and on the Board of the Jewish Federation of Metropolitan Chicago, where he chaired the nearly $100 million 2024 Annual Campaign. His past Board service includes the American Bankruptcy Institute, Turnaround Management Association, INSOL, Tock, and the Jewish Theological Seminary, among others. He has proudly served as a Board member and then Special Counsel to AIRA for more than 30 years.

We hope you like the new look of the AIRA Journal.

Please send your comments, suggestions, and ideas for articles to AIRA Journal Managing Editor, Alexandra Mahnken at: amahnken@aira.org.

PRESIDENT'S LETTER

Eric Danner, CIRA
CohnReznick Advisory LLC

Happy Holidays to All!

'Tis the season for a variety of recurring December events: anxious clients facing year-end deadlines of various kinds…professional services firm partners chasing after end-of-year collections…all of us trying to fathom where the last calendar year went!

In all seriousness, I trust that this note finds you and yours in good spirits and in good health. The prospect of spending holiday season time with family and friends is one that I eagerly anticipate each year, and I hope that you are doing the same. I know for some of us 2025 was a highly successful year, while for others this year was full of unanticipated challenges. Either way, it is a time to take the measure of the year and give thanks wherever appropriate.

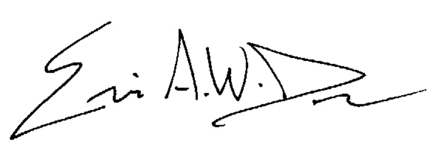
I will start - by giving thanks to all of you who attended the AIRA's 41st Annual Bankruptcy & Restructuring Conference in Newport Beach, California this past June. It was a very successful affair, strongly attended and with the highest quality programming to match. The organizers, both industry professionals and administrative support staff, worked long days and nights to put it all together – to great effect. It was a gamble to bring the conference back to Newport Beach so soon after we held it there in 2023 - but our confidence was justified!

It is hard to believe that the next annual conference is just around the corner in June 2026 – this time in Nashville, Tennessee. This is another venue that does not disappoint, and I certainly hope to see as many of you there as can make the trip.

As for 2026…it will no doubt be a continuation of 2025's interesting voyage and it certainly seems that the stress and uncertainty that drives our industry is not diminishing. May 2026 be a successful year for all of you – with each of you defining it in your own way.

Until we next meet, you have my very best,

Eric Danner



TWO SIDES TO EVERY STORY: THE HOLISTIC VIEW OF ABCS

OVER 80% OF VC-BACKED STARTUPS FAIL; that's a feature, not a bug. But what is a board to do when this happens? How can its members honor their fiduciary duty to creditors, employees, and shareholders? In our experience, federal bankruptcy is usually not a cost-effective or value-maximizing solution for many IP-focused startup companies. Knowing the options that exist will ensure that investors can make the best use of their remaining cards.

> *Life is not always a matter of holding good cards, but sometimes, playing a poor hand well.*
>
> **Jack London**

By now, readers of the AIRA Journal know that, increasingly, companies are turning to Assignments for the Benefit of Creditors ("ABCs") as an effective, streamlined alternative to federal bankruptcy. Especially in the lower middle-market space and even in large, complex, and/or publicly traded situations, ABCs provide a nimble, cost-effective path toward maximizing value and preserving continuity:

- **Speed and Cost Efficiency:** Unlike Chapter 11 bankruptcies, ABCs can be executed within weeks, not months, avoiding the bureaucratic overhead and professional fees associated with court supervision. The accelerated timeline often means quicker recoveries for creditors and less depletion of estate value. And although the assignee will perform its duties over months (or longer), board members can generally resign immediately.
- **Control and Discretion:** The debtor ("assignor") retains the right to select the assignee, typically a seasoned fiduciary with sector-specific expertise. This contrasts with a bankruptcy trustee, who may lack operational context or the ability to monetize esoteric assets. Additionally, many ABCs proceed under the radar, avoiding the public stigma of bankruptcy for all stakeholders.
- **Maximizing Recoveries:** ABCs allow for swift marketing of assets (sometimes as a going concern) maintaining customer relationships, employees, and operational value that could be lost in drawn-out bankruptcy proceedings.

Critics (usually those who have never served as assignees) will point out that an ABC does not provide some of the comforts of federal bankruptcy such as the automatic stay and the ability to sell assets free and clear of liens. Experienced assignees know that these are obstacles in theory, but rarely in practice. When this "bankruptcy for the businessman" is operated by a

business-savvy assignee, much can be accomplished. As assignees, we have even beaten back involuntary bankruptcy efforts (another theoretical “obstacle” that we have seen fewer than five times in nearly 20 years of practice).

BUYING VIA ABCS

Usually, it is to the boards of directors of assignors and their legal advisors that we direct this message. But there are two sides to every story: for every sale there must be a buyer. Matt has acquired and sold various distressed assets through both section 363 bankruptcy processes and ABC processes. He has evaluated and completed distressed business acquisitions in manufacturing, software, consumer tech hardware, business services, healthcare, and media. In Matt’s experience, the ABC is a much faster and cost-effective process which serves the distressed company’s stakeholders well: it may give a business a second chance at thriving with a clean balance sheet, prevent job loss, provide vendors with a continuing customer, and full or partial recovery for senior lenders.

Note that these are always asset sales, and it is sometimes the case that the going concern is broken beyond repair. Employees may have been terminated, facilities vacated, and key vendor relationships burned. These can still be opportunities for investment firms with portfolio companies in a related space to acquire IP and other assets at great bargains and integrate them into existing operations. Matt explains, “Because we have operating businesses, we can absorb these ABC assets and revitalize them in a de-leveraged situation. ABCs pose unique challenges but offer very attractive risk/reward profiles. Since ABCs are less understood than healthy M&A and require the buyer to have more operating and restructuring capabilities, there tend to be fewer parties bidding on the assets, giving the buyer an opportunity to acquire the assets at a significant discount.” This works best when operations can be maintained ahead of a pre-packaged ABC, or in an operating ABC. Example: David was once called on to effectuate an ABC by a board that suddenly found their company out of cash due to fraud. A transaction had been pending with a Fortune 500 acquiror for $50 million but blew up when the company ceased operations. However, the assignee was able to resuscitate the sale of the technology (only) at a large discount, delivering a windfall to the buyer yet enabling the secured creditors to be paid in full.

As much as we love ABCs for their flexibility and scalability, they are not always the right tool. For example, there is no such thing as an involuntary ABC, so frustrated secured lenders may need to exercise their rights under Article 9 of the Uniform Commercial Code (i.e., foreclose) to force asset liquidation. In our experience, because commercial banks are loath to foreclose and own the assets, a combination of carrots and sticks often must be employed to persuade the company to monetize assets voluntarily. Still, a foreclosure sale can be an effective tool to force a public sale of collateral, establish asset value, and extinguish junior lienholders. We have performed this service for non-bank venture lenders to great effect. Of course, while this may solve (in whole or in part) the lender's problem, it does not provide a wind-down solution for the borrower, its unsecured creditors, and its board who must now attend to an asset-less shell.

Experienced assignees may be reluctant to take an assignment in certain circumstances where risks are not well-defined and could implicate the assignee: environmental liability, trust fund tax deficiencies, certain litigation, etc. These risks may be mitigated by effectuating the ABC in a jurisdiction with court supervision, such as Delaware. Alternatively, these situations may be better addressed in federal bankruptcy court.

Other key considerations (beyond the scope of this article) are:

- Choice of ABC jurisdiction
- Secured creditor consent to an ABC
- Computation of critical fiduciary obligations
- Pre-wind down contingency planning ahead of an expected funding or sale
- Preservation of NOLs (yes, it is possible!).

Maximizing recovery depends on each of these subtleties being addressed appropriately by an experienced advisor and the details of each are almost certain to surprise even the most seasoned investors and boards.

ABOUT THE AUTHORS

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David Johnson, CFA, CIRA is the Managing Principal of Resolution Financial Advisors LLC, a Los Angeles-based advisor specializing exclusively in end-of-life advisory for boards, executives, lenders, and investors navigating the complexities of distressed companies seeking wind down, insolvency, or value recovery processes.

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ABC SUPPLEMENTAL

MECHANICS OF AN ABC

General Assignments for the Benefit of Creditors ("ABCs") date back to English common law, and in some US states pre-date the Bankruptcy Code (1979) and even the Bankruptcy Act (1898). Today, some states (CA, DE, NY, NJ, FL) have statutes governing ABCs; in other jurisdictions ABCs can be effectuated under common law.

A debtor may consider an ABC when:

- It has debts that it cannot pay
- It has assets of uncertain value
- Its board wishes to delegate its fiduciary duties and resign
- A fiduciary is needed to liquidate assets, deal with creditors, and perform administrative wind-down functions
- A federal bankruptcy is not desired due to cost, time, publicity and loss of control.

To enter into an ABC, the debtor will sign a contract with a disinterested third party who will serve as an "assignee" (trustee). Once effectuated, 100% of debtor assets are transferred to the assignee who then possesses a statutory lien on the assets (this lien does not trump existing, perfected liens which remain in place). In some states, a petition will be filed with a court, and some public reporting will be required. In others, there is no judicial process and no public filing. Therefore, the chosen state of jurisdiction is a material consideration.

The assignee will have proposed a fee and an overall ABC budget which is generally funded to the assignee at the time of the ABC. Only these approved budget amounts may be disbursed by the assignee at this time. The "ABC date" is analogous to a bankruptcy petition date with respect to the treatment of creditors: no creditor may be paid until such time as a claims process has been run, allowed claims determined, and the assignee has determined the priority and computed the amounts (if any) to be disbursed to creditors. Exception: a perfected secured creditor can be paid sooner if the assignee determines there are funds to do so.

In the meantime, the assignee will be moving quickly to monetize assets. Machinery &

equipment, inventory, and A/R collection are usually straightforward, but patents and other intellectual property can require an extended sale process. In addition, the assignee will want to avoid incurring "administrative" expenses such as rent or large cloud storage costs. This generally means vacating leased facilities very quickly, including remediation of hazardous materials to avoid additional landlord claims. The ABC budget should anticipate and provide for a transition period for these kinds of items.

FLAVORS OF ABCS

It can be helpful to think about ABCs applied in the following ways, depending on the debtor's situation.

HARD SHUTDOWN

In cases where there is little or no prospect of maintaining a going concern due to a lack of operating capital, a hard shutdown may be the only option.

- All employees are terminated with final pay
- Facilities are abandoned, sometimes necessitating negotiations with landlords if personal property (such as equipment or inventory) must be recovered
- Vendor payments cease. This may have adverse consequences for data stored in the cloud, work in process, and value recovery generally.

Even in such cases, the debtor will need to fund an ABC budget that covers a fee for the assignee (generally a one-time flat fee) plus out-of-pocket costs for such assignee tasks as running the creditor claims process, preparation of final income tax returns, closure of a 401(k) plan, records storage, and other administrative items generally considered important to boards of directors.

This does not mean that the assignee will not attempt to monetize assets, but it often means that the resources to do so are limited. For example, we like to have the ABC estate retain one or more of the debtor's employees to assist with the monetization of assets (especially intellectual property), if we have the budget to do so.

OPERATING ABC

If a company has revenue, it may be possible to continue operations even after an ABC has been effectuated, as long as:

- A skeleton crew of employees remain and can be paid from collections
- Critical overhead can be funded (expenses such as advertising/marketing usually cease). And remember: antecedent debt (i.e., old A/P) is NOT paid post-ABC, analogous to a bankruptcy post-filing period.

This has worked well for us in cases where the assignor had inventory on hand and existing purchase orders: cash could be generated simply by filling orders until inventory ran out. Two paths to value are thus created for the creditors: revenue in the ordinary course, and the chance to sell a going concern. While any sale would still be an asset sale, it is likely that more value can be obtained from a buyer who does not need to put Humpty Dumpty back together again. In such cases, an energetic assignee is needed to keep the operations going under less-than-ideal circumstances.

PRE-PACKAGED ABC

Sometimes there is no liquidity to fund an ABC budget. Sometimes the debtor does not want to disrupt operations or notify employees of a change until a transition plan has been determined. In these cases, we delay the onset of the ABC. The prospective assignee can be engaged for a small retainer, but not as assignee (yet). Rather, the assignee acts as a sales agent or dealmaker to structure a transaction under the assumption that there will be an ABC. It should be said that a robust marketing process is still required to ensure that any sale can be shown to be at arm's-length.

Once a transaction has been negotiated and the parties are ready to close, a two-step process ensues: (1) On closing day, the debtor enters into the ABC and the assignee takes title to all assets, then (2) the assignee sells some or all of the assets to the third-party buyer under the pre-negotiated sales agreement. These steps usually occur on the same day, so that the assets pass through the hands of the assignee but briefly.

A portion of the sales proceeds will fund the ABC budget; the balance is available for creditors. Buyers love this because there is no discontinuity of the operations (although employees will be terminated and then re-hired by the buyer); and the buyer does not need to assume any unwanted liabilities (i.e., avoids successor liability).

With the most time-sensitive task complete, the assignee can now focus on the administrative wind down of the assignor without time pressure.


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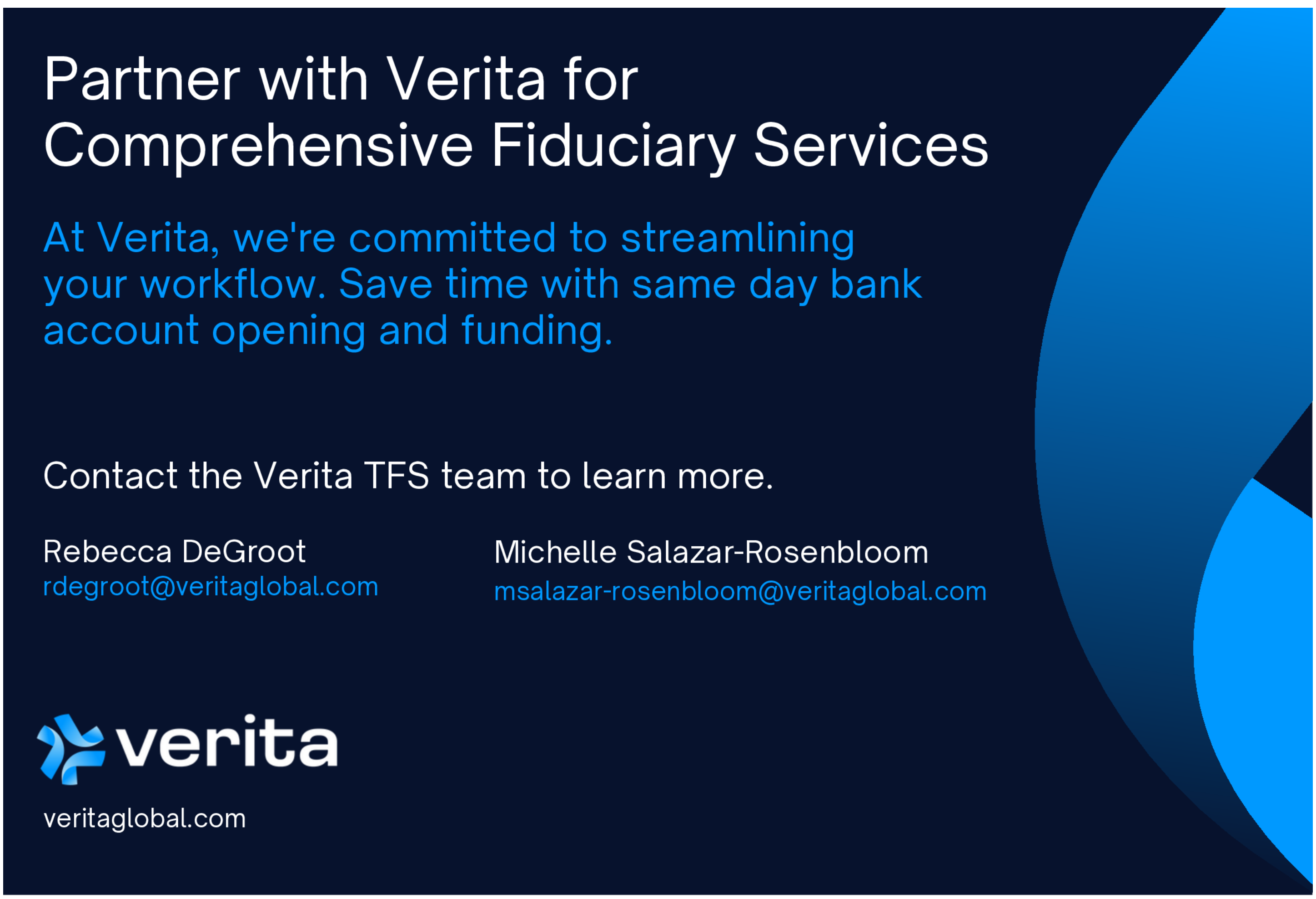
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THE HUMAN ANTIDOTE TO AI HYPE: EXPERTISE AS THE ANCHOR OF REAL VALUE

YOU WOULD NOT HAND OVER YOUR PORTFOLIO TO A STRANGER WHO SPEAKS CONFIDENTLY BUT HAS NEVER MANAGED A DOLLAR. So why are companies outsourcing their forecasting and strategic decision-making to large language models (LLMs) — tools that sound smart but lack context and true understanding? Some possible answers point to the stress, the nuance, the need for speed, and the fact that there might be 200 different models for a specific problem to solve. The challenge arises when these circumstances push people to trust AI blindly for the answer. A surgeon with more than 1,000 surgeries knows exactly which tool to pick for a surgery, based on their vast experience. Due to the physical nature of their work and industry regulations, they cannot outsource this highly cognitive task to AI. But statistical and machine learning experts live in the digital world and are more easily subsumed by novice AI models, even when cases where AI usage went wrong abound. For instance, Zillow's "home buying debacle" shows the limitations and real-world consequences of using AI to value real estate.[1]

A Goldman Sachs report warning about the potential for AI to disrupt labor markets illustrates the expected uneven impact across different functions, with about a quarter of jobs affected overall in the US and Europe.[2] A disproportionate number of those impacted will be white-collar and administrative roles. On the other hand, manual and non-routine roles are predicted to face the least amount of AI disruption.

This predicted disruption contextualizes many companies' eagerness to jump into these new technologies out of impulse and without a clear business purpose. The headline of a recent article by Gartner reads, "Gartner Predicts Over 40% of Agentic AI Projects Will Be Canceled by End of 2027."[3]

The business press has covered the struggles companies face in deriving value from AI. An article from S&P Global states that 42% of respondents abandon their AI initiatives before they reach

1 https://edition.cnn.com/2021/11/09/tech/zillow-ibuying-home-zestimate.
2 https://www.gspublishing.com/content/research/en/reports/2023/03/27/d64e052b-0f6e-45d7-967b-d7be35fabd16.html.
3 https://www.gartner.com/en/newsroom/press-releases/2025-06-25-gartner-predicts-over-40-percent-of-agentic-ai-projects-will-be-canceled-by-end-of-2027.

> *Most agentic AI projects right now are early-stage experiments or proof of concepts that are mostly driven by hype and are often misapplied. This can blind organizations to the real cost and complexity of deploying AI agents at scale, stalling projects from moving into production. They need to cut through the hype to make careful, strategic decisions about where and how they apply this emerging technology.*
>
> **Anushree Verma,**
> **Senior Director Analyst, Gartner**

production (up from 17% the previous year).[4] Surveys such as this suggest that AI is not moving the needle on business performance in a way that matches the hype.

This is not an anti-AI stance; it is a warning against the blind application of AI to problems it is not built to solve — like statistical forecasting, judgment-based trade-offs, or risk modeling.

A surgeon would not use a shovel to perform surgery, but that is exactly what is happening in business: LLMs are being thrown at modeling problems without proper expert oversight simply because they are new, available, and are promoted by effective marketing campaigns.

This is not innovation. It is costing companies time, trust, and a strategic edge.

Why is this happening? It is simple. Budgets are tighter. Timelines are faster. Expectations are higher. AI is seen as the savior, and technical nuance is often ignored in favor of "good enough." But here is the problem: when you are betting millions, "good enough" does not cut it. The most successful firms in history did not get there by taking shortcuts. They minimized risks, played a long game, and listened to experts to develop repeatable outcomes.

Forecasting, statistics, and judgment? Those are not tasks to be thrown into the stochastic blender of a language model trained to autocomplete. They are problem-solving tasks that need to be context-aware. Let's reframe the problem by discussing where AI truly adds value — and where human common sense must remain non-negotiable. If your AI strategy does not start with judgment, it ends in delusion.

4 https://www.spglobal.com/market-intelligence/en/news-insights/research/ai-experiences-rapid-adoption-but-with-mixed-outcomes-highlights-from-vote-ai-machine-learning.

WHEN IT COMES TO FORECASTING, AI ASSISTS—HUMANS LEAD

The potential to develop better forecasts with AI exists, but only if humans are at the forefront. Combining the expertise of highly skilled and trained practitioners with the leverage of AI-enhancement offers a substantial comparative advantage to surpass the short-term vision of the AI-led, easy-way-out alternative.

A strong forecasting team is small, with one senior subject matter expert (SME) at fractional time working with one or two junior analysts. The SME should lead the higher-level strategic decisions, while junior analysts manage AI tool deployment, support methodological discussions, and build their skills as Machine Learning (ML) practitioners.

Low cognitive tasks will be upended by a new AI start-up every six months. Beware of claims that AI is a button to press to fix the business problem (automate out of existence), which will become cheaper and faster every year. Lesson: do not play this game, stay creative!

We argue for three key players in successful forecasting implementations.

- **The industry expert** focuses on extracting value from forecasting within the business. For example, they should know how forecasts relate to inventory decisions and opportunity costs from lost sales. After all, every future decision in a business relates to a forecast.
- **The forecasting expert** translates the latest scientific discoveries into practice. As problem solvers with deep knowledge of research and past forecasting model failures, they know when AI should be applied and when it should not. They link the business' needs with careful statistical modeling. Pairing an industry expert (or client) with the forecasting expert to codevelop solutions is the best formula for success.
- **Junior resource(s)** perform the bulk of the work, learning and developing as they collaborate alongside senior experts. They actively use AI to enhance or replace low cognitive tasks while taking on higher cognitive tasks as they develop into strategic resources for the firm.

Teams configured in this way can develop an effective approach to capturing patterns in the underlying data and predicting future outcomes. In the last 20 years, the goal was to maximize the accuracy of predictions of future responses. However, a shift in recent years has AI/ML models overfitting on the past,

> *We are certainly at the beginning of an AI automation revolution that will assume many work tasks and eventually redefine organizations. This will be gradual but ultimately transformational. Right now, leaders should focus on solving specific business problems using machine learning and generative AI for the three Cs of content, coding, and conversation. Some labor can be saved, but new skills will also be needed. For most companies, being a fast follower is enough, and executives should require evidence of proven benefits elsewhere before they invest.*
>
> **Rob Hornby, Co-CEO, AlixPartners**

resulting in high-profile accuracy failures that lack explainability, a non-starter in high-value forecasting challenges (see the previously referenced example of Zillow attempting to forecast home pricing, where the issue stemmed from a lack of established causality between the inputs and outcomes – in other words, the patterns of the past were not repeatable).

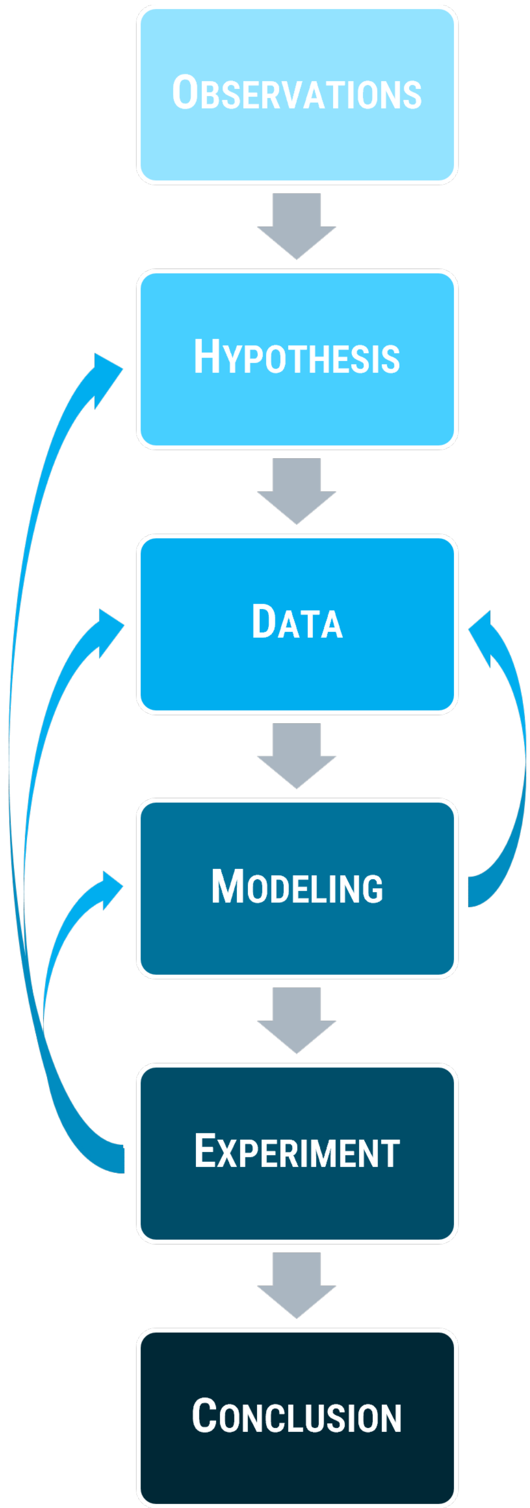
Our approach combines our industry knowledge with our forecasting expertise to identify future patterns that are the most repeatable. We also attempt to identify patterns that are not repeatable or those that may be disrupted by changes in the macroeconomic environment, such as tariffs or COVID. By not overfitting on the past, we are more likely to see a return on investments in the future. In essence, our approach aligns with the Scientific Method. Testing and validation are critical. We test a hypothesis (data pattern) before we suggest our clients invest in it (see diagram for reference).

Here is how we put these practices into action:

In a recent engagement, we helped our client automate part of their financial monthly close using AI, delivering results in just five weeks. Our seasoned industry experts, forecasting specialists, and the client's team worked together to build a solution that improved strategic decision-making across 200+ revenue streams. The AI-driven forecasting tool helped identify seasonal revenue increases and important trends to improve strategic decision-making, influencing $300 million of revenue. Issues with problematic revenue streams were flagged, equipping the CFO to act proactively and enhance future revenue estimates. The CFO praised the team for solving a strategic and analytically challenging issue they had struggled with for five years.

COMMON SENSE: THE UNBEATABLE ADVANTAGE

AI is an amazing tool, with a myriad of virtues. It also has some substantial shortcomings, which call for caution in its use and adoption. One of these shortcomings lies at the heart of our firm's core values: AI lacks common sense. It is not context



aware without expert prompting; it struggles with the nuances of real-world problems; it does not grasp abstract concepts, but instead repeats learned patterns that can be implemented by anyone for cents on the dollar. Thus, the credibility of experts and establishing client trust are critical for the adoption of AI in forecasting. Accountability is a key part of the equation; ChatGPT cannot be blamed for a forecast gone wrong, but humans can.

We are at a pivotal moment with the potential of AI to reshape business outcomes and the economy in general, and it is up to us to make the right decisions. Pace is important, timing is paramount, and a careful pondering of risks and benefits is called for.

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62%
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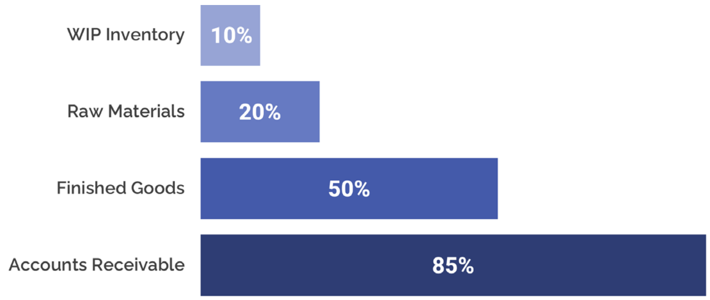
FREEING CASH FROM THE BORROWING BASE

MANAGING WORKING CAPITAL COLLATERAL FOR ASSET BASED REVOLVERS

Asset Based Revolving loans (ABL revolvers) are commonly used by companies to finance working capital needs. These revolving loans are secured against current assets such as accounts receivable, inventory, and occasionally machinery and equipment. The collateral value of a company's working capital assets is certified through a borrowing base certificate, at predetermined intervals (e.g., weekly or monthly), which is an official document that outlines the maximum loan amount a lender is willing to provide to a company based on that collateral.

COLLATERAL VALUE OF WORKING CAPITAL ASSETS

The collateral value of a company's working capital assets is determined by the liquidity of the assets; the value is based on how quickly the asset can be converted into cash. The higher the liquidity, the higher an advance rate a lender is willing to offer. The advance rate is the percentage of the underlying collateral asset value that a lender will loan against. Accounts receivable are often the most liquid of these assets and as a result typically carry the highest advance rates. Inventory also plays a role in collateral values. Inventory that is finished and immediately shippable tends to carry the highest inventory-related advance rate, as it is the most liquid. The advance rate decreases for work-in-progress inventory (WIP) and raw materials, as they will take longer to be converted into finished goods and, ultimately, cash.



The conversion of accounts receivable, finished goods, WIP inventory, and raw materials to cash is crucial to a company's longevity. Mismanagement of current assets can lead to cash shortages, even in otherwise profitable companies. When a company faces financial distress, they will often ask the lender to increase the advance rates on its revolver. Lenders typically reject such requests, further exacerbating the liquidity shortfall. In fact, in a default situation, lenders typically reduce advance rates, take reserves, and/or impose additional blocks against the borrowing base to protect their position. In such cases, the borrower must find alternative ways to create liquidity as the lender will not intervene to rescue the distressed company.

EFFECTIVE MANAGEMENT OF WORKING CAPITAL ASSETS

The following steps are essential for effectively managing working capital collateral for revolvers.

STEP 1: AUDIT THE BORROWING BASE

The first step in managing working capital is ensuring the accuracy of the borrowing base. Our firm has often found millions of dollars in discrepancies due to issues like incorrectly aged accounts receivable, improperly valued inventory, untimely inventory additions, lack of understanding or planning for inventory valuation changes, or incorrect offsets. These errors can significantly diminish the value of the borrowing base.

Let's consider a fictitious seafood processor as an example. According to GAAP, inventory is to be carried on the books of the borrower at a lower cost or market value. This is also the case with lenders. In a declining market, the value of inventory can decrease, causing the borrower to mark inventory to a lower value, reducing availability of borrowing against that inventory. This may cause the borrower to be out of compliance or in an overadvance situation with the lender. In this case, the lender will ask the borrower to come back into compliance, which may require selling inventory at depressed values, funding an infusion of cash, or pledging additional assets to the borrowing base. Performing a "mini audit" before the lender conducts its review can help identify and correct these discrepancies, building credibility with the lender and helping to avoid the need for a more intrusive field audit.

STEP 2: ADDRESS INELIGIBLE ASSETS

The borrower must address ineligible assets, which are assets excluded from the borrowing base and not eligible for advances. Common examples include aged receivables (often over 90 days past due), receivables concentrated with a single customer, and outdated or obsolete inventory. In situations where liquidity is limited, it is essential to focus on managing cash flow rather than the income statement. If the company is already in default, a plan should be developed that frees up cash by addressing these ineligible assets.

As an example, collecting overdue accounts receivable or selling ineligible inventory can quickly generate cash. In some cases, a candid conversation with a customer regarding overdue payments may improve cash flow. Holding onto slow-moving or obsolete inventory to avoid a write-off only worsens the situation. If facing default, it is best to find a way to sell inventory to generate cash. Although packaging and supplies are typically excluded from the borrowing base, companies can collaborate with vendors to warehouse these items and provide them on a just-in-time basis, freeing up valuable working capital.

STEP 3: FOCUS ON INVENTORY MANAGEMENT

Inventory management often presents the largest opportunities for cash gains and improvement, primarily because their advance rates are much lower than those of accounts receivable. It is common for lenders to offer advance rates of around 50% on finished goods inventory, meaning the borrower needs to produce the other 50% in cash when it is needed. Additionally, it is common for borrowers to impose a sub-limit on inventory to induce the borrower to manage inventory and not carry too much. For example, on a $100 million revolving ABL, there may be a $50 million sub-limit of availability on finished goods inventory. If the borrower has $120 million of finished goods inventory, an advance rate on finished goods inventory of 50%, and the borrower is subject to a $50 million sub-limit, there is $20 million of finished goods inventory that the borrower cannot borrow on. Remember that this inventory is carried at the lower of cost or market value. In this example it may make sense for the borrower to sell the excess $20 million of finished goods inventory - even at cost or at a loss - to generate liquidity for the business. This may lead to losses that will be reflected in the income statement. However, in tight liquidity situations cash is more valuable than maintaining a profit margin.

For manufacturers, the potential for gains is even greater, as advance rates on WIP inventory and raw materials are usually much lower than on finished goods. Advance rates might be as low as 20% for raw materials, 10% for WIP, and then rise to 50% for finished goods. Once the finished goods are sold and converted to accounts receivable, the advance rate can jump to 85%.

The progression from raw materials, to WIP, to finished goods, to accounts receivable can result in a dramatic increase in liquidity and borrowing capacity. For example, look at a standard bill of materials and assume a product sells for $100.

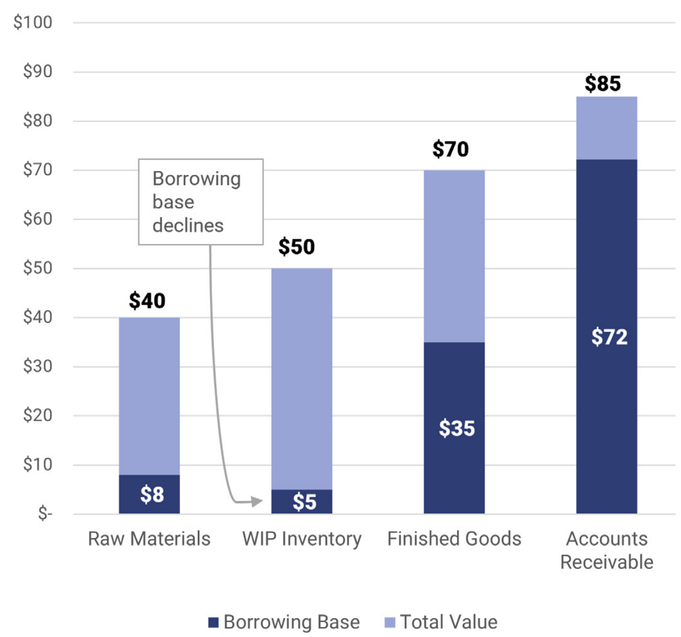
For this example, the following assumptions apply:

- Raw materials are 40% of the sales price
- WIP is 50% of the sales price
- Finished goods are 70% of the sales price
- AR (i.e., net sales after returns, discounts, and allowances) is 85% of the gross sales

Lenders are willing to advance:

- 20% on raw materials
- 10% on WIP
- 50% on finished goods
- 85% on accounts receivable

Based on the above, the chart below illustrates how the borrowing base changes at each stage of the production and sales cycle:



As the product moves through production and into sales, its costs and value increase.

- **Raw Materials**: We begin with $40 of raw materials (40% of the $100 sales price). Applying a 20% advance rate, the borrowing base is $8.
- **WIP:** At this stage, $10 of costs are added and raw materials become WIP worth $50. With a lower (10%) advance rate, the borrowing base falls to $5.
- **Finished Goods:** $20 of costs are added to transform the WIP into finished goods, now valued at $70. With a 50% advance rate the borrowing base is $35.

In this example, the gross sale of $100 is reduced by returns, discounts, and allowances to $85 in accounts receivable. With an 85% advance rate, the borrowing base jumps to $72.25.

Now, suppose a company holds $1 million in inventory composed of:

- 20% raw materials
- 40% WIP
- 40% finished goods

Based on the following, and the above-mentioned advance rates, inventory can be converted into $280,000 cash.

Inventory Type	Inventory Breakdown *(b)*	Inventory Value *(a * b)*	Advance Rate *(c)*	Cash Converted *(a * b * c)*
	Total Inventory *(a)*	$1,000,000		
Raw Materials	20%	$200,000	20%	$40,000
WIP	40%	$400,000	10%	$40,000
Finished Goods	40%	$400,000	50%	200,000
			Total Cash	**$280,000**

With more cash on hand, more materials may be purchased, and inventory increases to $1.1 million with the following composition:

- 35% raw materials
- 25% WIP
- 40% finished goods

Inventory Type	Inventory Breakdown *(b)*	Inventory Value *(a * b)*	Advance Rate *(c)*	Cash Converted *(a * b * c)*
	Total Inventory *(a)*	$1,100,000		
Raw Materials	35%	$385,000	20%	$77,000
WIP	25%	$275,000	10%	$27,500
Finished Goods	40%	$440,000	50%	$220,000
			Total Cash	**$324,500**

The increase in total inventory allows conversion of assets into $324,500 cash.

Increasing inventory value has a substantial impact on the total cash a lender would be willing to lend. This impact is further magnified when factoring in inventory turnover. If inventory turns six times per year, the original scenario will generate $1.68 million in annual cash flow, while the revised inventory would generate $1.77 million in annual cash flow. This demonstrates how both the composition and turns of inventory are critical drivers of liquidity and working capital efficiency.

The charts on the next page illustrates the impact higher inventory turns have on potential cash conversion.

Inventory Type	Inventory Breakdown *(b)*	Inventory Value *(a * b)*	Advance Rate *(c)*	Cash Converted *(a * b * c)*
Total Inventory *(a)*		$6,000,000		
Raw Materials	20%	$1,200,000	20%	$240,000
WIP	40%	$2,400,000	10%	$240,000
Finished Goods	40%	$2,400,000	50%	$1,200,000
			Total Cash	**$1,680,000**

Inventory Type	Inventory Breakdown *(b)*	Inventory Value *(a * b)*	Advance Rate *(c)*	Cash Converted *(a * b * c)*
Total Inventory *(a)*		$6,000,000		
Raw Materials	35%	$2,100,000	20%	$420,000
WIP	25%	$1,500,000	10%	$150,000
Finished Goods	40%	$2,400,000	50%	$1,200,000
			Total Cash	**$1,770,000**

Understanding this progression is critical for managing working capital and optimizing borrowing capacity in a manufacturing or distribution business.

In some cases, shifting resources to the manufacturing process can improve liquidity. For instance, CR3 Partners recently worked with a client who had millions of dollars in WIP, which was preventing them from making payroll. We created the battle cry “ship your WIP” and started planning all company strategies around shifting resources to convert WIP to cash. By accelerating production, we turned the WIP into finished goods, which significantly improved liquidity. Similarly, analyzing what inventory can be shipped and sold, regardless of whether there are active orders for it, can generate cash.

The cycle time from raw materials to WIP to finished goods needs careful management, especially considering recent supply chain disruptions. During the COVID pandemic, companies faced difficulty in securing the materials needed to fulfill orders. When supply chain issues eased, inventories swelled, putting additional pressure on traditional working capital lines.

Today, many companies are finding that their existing working capital lines are insufficient to meet the growing demands of the post-pandemic supply chain. Revolvers are designed to support short-term financing needs and quickly-turning assets. However, lenders are often reluctant to use these lines to fund long-term working capital needs, leaving companies with the challenge of finding additional, more permanent sources of funding.

CONCLUSION

Effectively managing working capital and collateral in revolving asset-based loans is essential for maintaining liquidity, especially during financial distress. By conducting regular audits, addressing ineligible assets, and optimizing inventory cycles, companies can enhance their cash flow and avoid running into severe liquidity shortages. In times of default or financial difficulty, it is critical for businesses to proactively manage their assets and take responsibility for their own financial health, as lenders will not provide a safety net.

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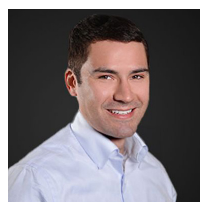
William Snyder is a Senior Managing Director and Partner based in Dallas. With executive and entrepreneurial experience spanning close to 40 years, William has restructured, managed, and guided a multitude of companies in a wide variety of industries. William is a broadly experienced restructuring professional who has participated in the restructuring of hundreds of companies and has acted as a fiduciary in many cases. He brings a meaningful style of results-driven leadership to complex crisis situations. He is a speaker and presenter on a wide range of turnaround topics.



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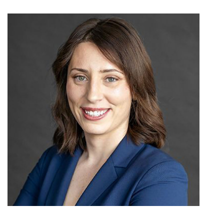

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Clara Goetsch is a Senior Associate based in Dallas. Clara is an experienced financial professional with a strong background in the manufacturing and professional services industries. She has served in both advisory and interim leadership roles, supporting companies through complex financial transformations and critical phases of their growth or restructuring. Clara has successfully led organizations through Chapter 11 bankruptcy emergence, implemented cost savings and performance improvement initiatives, and developed comprehensive cash flow and projection models. She has also played a key role in private equity transactions by performing detailed working capital and EBITDA adjustments to support acquisitions.

AN EYE ON SUBCHAPTER V: RECENT CASES AND DECISIONS

INTRODUCTION

Subchapter V of the Bankruptcy Code, created by the Small Business Reorganization Act of 2019 and effective on February 19, 2020, is now a little over five years old. It offers significant benefits for small and mid-size businesses seeking to reorganize, including unique features that are not available in traditional Chapter 11 cases, such as (i) providing the debtor with the exclusive right to file a reorganization plan (even if it is removed as debtor-in-possession), (ii) allowing the debtor to retain its ownership interests without satisfying the Bankruptcy Code's absolute priority rule and (iii) removing the requirement for an impaired, accepting class of creditors for purposes of plan confirmation.

Another advantage of Subchapter V is that such cases tend to be shorter, more efficient, and cost-effective as Subchapter V eliminates (i) the filing of a disclosure statement, (ii) the appointment of a creditors' committee, (iii) the payment U.S. Trustee fees, (iv) the filing of post-confirmation reports (in some cases), (v) the ability to appoint a chapter 11 trustee or examiner, and (vi) the payment of allowed administrative claims at plan confirmation, as such claims can be paid over time. While a Subchapter V trustee is automatically appointed in a Subchapter V case, the additional administrative costs tend to be modest as the trustee generally has a distinct role limited to facilitating the debtor's reorganization and monitoring the debtor's confirmation and consummation of a plan.

Since Subchapter V's enactment, bankruptcy courts are continuing to flesh out specific issues that are unique to Subchapter V, even some that are still of first impression, including eligibility, committee appointment, professional compensation, and debt discharge. Recent cases on these topics are discussed below.

SUBCHAPTER V ELIGIBILITY

To qualify for Subchapter V, the debtor must, among other things, (i) be engaged in commercial or business activities, (ii) not have publicly traded equity, and (iii) have aggregate non-contingent liquidated secured and unsecured debts as of the date of petition of no more than the statutorily defined limit (currently $3,424,000), which amount excludes debts owed to affiliates and insiders.

As a matter of first impression, to address an objection by the United States Trustee that argued the combined debt in the debtors' cases exceeded the statutory debt limit, the debtors in In re Hub City Home Health, Inc., sought a ruling on whether, as a matter of law, priority unsecured wage claims are included in the category of unsecured debts used to calculate the debt limit for eligibility as small business debtors under Subchapter V. 667 B.R. 822 (S.D. Tex. 2025). The Bankruptcy Court recently ruled (i) the priority wage claims, even though they were paid post-petition and were not listed in the debtors' original schedules, did not affect whether they are counted as part of the debt limit and (ii) "unsecured debts" includes priority wage claims for purposes of Subchapter V eligibility.

Also as a matter of first impression, a Bankruptcy Court recently ruled that a not-for-profit company can be "engaged in commercial or business activities" as required to qualify under Subchapter V of the Bankruptcy Code. In re Ellingsworth Residential Community Association, Inc., 125 F.4th 1365 (11th Cir. 2025), the Bankruptcy Court found that, despite being a not-for-profit corporation, the debtor engaged in "business activities" and was thus eligible to be a Subchapter V debtor.

PROFESSIONAL COMPENSATION

Another issue recently ruled upon was the payment of the debtor's professional compensation for work performed after the debtor was removed as debtor-in-possession and where the Subchapter V trustee's powers were expanded. A creditor in In re Athena Medical Group, 2025 WL 2125130 (Bankr. D. Az. 2025) objected to the payment of such compensation, arguing that counsel for a dispossessed Subchapter V debtor was not entitled to an award of attorney fees from the estate. As a matter of first impression, the Bankruptcy Court held that a Subchapter V debtor who lost debtor-in-possession status could not seek compensation for its counsel from estate funds.

THE APPOINTMENT OF A CREDITORS' COMMITTEE

As explained above, among the benefits of a Subchapter V case is that it affords a more streamlined and affordable reorganization process, which is achieved, in part, by the elimination of a significant estate party-interest in traditional Chapter 11 cases: a creditors' committee. This issue arose recently in In re Cinemex Holdings USA, 2025 WL 2489585 (Bankr S.D. Fla. 2025), where a creditor filed a motion seeking the appointment of a committee in the debtors' Subchapter V cases, which motion was opposed by the Debtors. Finding there was little case law on what a court should consider in determining whether there was "cause" to warrant the appointment of a committee in such circumstances, the Bankruptcy Court sought guidance from the Bankruptcy Code's provisions relating to (i) the expansion of a Subchapter V trustee's duties and (ii) the extreme circumstances of removal of a Subchapter V debtor-in-possession. After relying on Sections 1102(a)(3) and 1181(b) of the Bankruptcy Code, applying a non-exclusive list of factors and balancing the potential cost of a committee against the need to protect the interests of creditors, the Bankruptcy Court held that the creditor failed to establish cause to appoint a committee.

PLAN INJUNCTION

The ongoing issues relating to approval of non-debtor third-party releases in light of Harrington v. Purdue Pharma L.P., 603 U.S. 204 (2024) ("Purdue") is not unique to traditional Chapter 11 cases. In the context of an order overruling an objection to a Subchapter V debtor's plan, the Bankruptcy Court in In re Engineering Recruiting Experts, LLC, Case No.: 3:24-bk-03292-BAJ recently overruled an objection and approved a Subchapter V plan enjoining lawsuits against the non-debtor owner for the five-year life of the plan. The Bankruptcy Court differentiated a non-consensual third-party permanent release (as presented in Purdue) from a temporary injunction that would dissolve on discharge, dismissal, or plan default, which was presented in Engineering Recruiting Experts. The Bankruptcy Court relied upon other courts that also found similar temporary injunctions to be necessary to facilitate the plan's successful implementation, including In re Hal Luftig Co., 667 B.R. 638 (Bankr. S.D.N.Y. Feb. 24, 2025) and

In re Miracle Restaurant Group LLC, 24-11158, 2025 Bankr Lexis 1188 (Bankr. E.D. La. May 13, 2025).

DEBT DISCHARGE

Finally, another issue that has recently been addressed by bankruptcy courts is the applicability of non-dischargeability provisions under Section 523(a) to debts of a corporate debtor (including limited liability companies) in Subchapter V cases.

If a debtor's bankruptcy plan is confirmed as a consensual plan under Section 1191(a), the dischargeability of its debts is governed by Section 1141(d). Avion Funding, L.L.C. v. GFS Indus., L.L.C. (In the Matter of GFS Indus., L.L.C.), 99 F.4th 223, 227 (5th Cir. 2024). Thus, a corporate debtor that confirms a consensual reorganization plan under Section 1191(a) may discharge almost all its debts, irrespective of the non-dischargeability provisions under Section 523(a). However, if a plan is confirmed on a non-consensual basis, the dischargeability of a debtor's debts (upon completion of the applicable payment plan) is governed by Section 1192, which expressly incorporates Section 523(a), which itself carves out for individual debtors specified non-dischargeable debts.

Acknowledging the question "is a close call," the Eleventh Circuit recently articulated the dispute: "how to best interpret the interplay between § 1192(2) and § 523(a)—does § 1192's discharge provision, which references § 523(a), apply to individual and corporate debtors?" In re 2 Monkey Trading, LLC, 142 F.4th 1323, 1329 (11th Cir. 2025). The Fourth, Fifth and Eleventh Circuits have each concluded in the affirmative -- based on the plain language of Section 1192, both individual and corporate debtors cannot discharge any debts of the kind listed in Section 523(a). Id.; See In re GFS Indus., L.L.C., 99 F.4th 223, 232 (5th Cir. 2024); In re Cleary Packaging, LLC, 36 F.4th 509, 517-518 (4th Cir. 2022).

Presently, there are no decisions at either the trial or appellate level on this issue in either the Second or Third Circuit, where a material number of corporate debtors are filed.

CONCLUSION

As Subchapter V provides a more streamlined and cost-effective path for eligible small and mid-sized businesses to reorganize as compared to traditional Chapter 11 bankruptcy, courts will continue to address legal and factual issues that arise and case law, some unique to Subchapter V, will continue to develop.

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Leah's practice encompasses corporate reorganization, bankruptcy and corporate trust default matters, and bankruptcy litigation. She represents debtors, creditors, indenture trustees, creditors' committees, secured creditors, lenders, and bidders. Leah's pro bono clients included a synagogue in a proceeding in the Beth Din (Jewish Court), Holocaust survivors who were successful recipients of French reparations, and a not-for-profit Holocaust education organization. Prior to joining Pashman Stein, Leah worked at Mayer Brown LLP and Foley & Lardner LLP. Earlier in her career, Leah served as a first law clerk to the Honorable Robert E. Gerber, U.S. Bankruptcy Judge for the Southern District of New York.

US TARIFFS SPUR CHAPTER 11 FILINGS

WHILE THE IMPOSITION OF NEW TRADE POLICIES AND THE RECALIBRATION OF SPECIFIC TARIFFS IS BY NO MEANS A NEW PHENOMENON, the sheer scale, scope, and unpredictability of recent US trade policy have created an extremely challenging environment for US businesses that rely on imported supplies to sell their products to US consumers. This is particularly true for companies that have been (or may now be) grappling with low margins and liquidity issues or companies that are vulnerable to sudden decreases in demand or competition from suppliers unaffected by import tariffs. While it is too early to assess the long-term consequences of the Trump Administration's trade policies, the short-term effects are visible in a handful of distressed companies, some of which have resorted to US bankruptcy courts for protection. The key question is: Are these cases a harbinger of what we might see over the next 12 to 24 months, or are they exceptions to the rule as companies adapt to the new US trade policies – and the retaliatory responses that we will inevitably see from other countries?

DEFINING TARIFFS

Tariffs are intended to protect domestic industries from foreign competition and to remedy perceived trade imbalances, but higher tariffs often come with the immediate (and unintended) consequence of exacerbating financial stress for companies. Tariffs are taxes imposed on imported goods, and for many companies, particularly in manufacturing, retail, agriculture, and logistics, tariffs increase the cost of imported components or finished goods. These higher costs must either be absorbed by businesses or passed on to consumers. In many cases, companies operate on thin margins and lack the pricing power to shift these costs, resulting in squeezed profits, reduced liquidity, and poor long-term cash flow sustainability. Businesses that cannot pass these costs onto consumers may experience margin compression, leading to cash flow issues, which may trigger covenant breaches on loans or impair a company's ability to service its debts.

A CONSTANTLY SHIFTING LANDSCAPE

As a result of the constantly shifting trade landscape, businesses across the globe are forced to operate in a state of uncertainty as to what impact tariffs will have on daily operations and ultimately, their bottom line. Modern supply networks are globalized and optimized for efficiency purposes and cost savings, and while there may be incentives to manufacture and buy locally, many companies are looking to the global markets to fulfill their business needs. When tariffs are introduced or increased, companies are forced to reconfigure these supply networks, which could mean sourcing materials from more expensive or less reliable suppliers, or moving production altogether. These shifts are costly, time-consuming, and fraught with risk. In addition, retaliatory tariffs from other

countries can further hinder exports, cutting off key revenue streams.

TRADE RELATIONSHIP MANAGEMENT

As of June 2025, the top five largest trading partners with the US for imports were Mexico, Canada, China, Ireland, and Vietnam, and for exports were Canada, Mexico, China, the United Kingdom, and the Netherlands.[1] Since the announcement of new tariffs on February 1, 2025, firm trade deals have been announced with Vietnam (blanket 20% tariff on Vietnamese imports and no reciprocal tariffs on United States exports),[2] the United Kingdom (certain aspects of that trade deal, namely tariffs on steel, aluminum, and derivative products remain unsettled)[3] and the European Union (even though a significant first step, the July 27, 2025 political agreement struck between President Trump and European Commission President Ursula von der Leyen is, in fact, a nonbinding agreement to further negotiate tariffs between the United States and the 27 nation bloc).[4]

More recently, President Trump announced steeper tariffs on more than 60 countries that went into effect on August 7, 2025, with tariffs ranging as high as 50% for some countries. For example, Canada, one of the US's largest trading partners for both imports and exports, saw tariffs on most of its exports to the US increase to 35% from 25%, and tariffs on exports from Brazil to the US increased to 50%.[5] President Trump has also threatened to impose tariffs on companies such as Apple and Mattel that manufacture products outside of the US on their imports into the US of at least 25%.[6]

THE CONSEQUENCES OF LOW DIVERSIFICATION

For those businesses lacking a sufficient financial cushion or the ability to avoid tariff-induced disruptions by pivoting away from supply markets that are subject to import duties, the result has sometimes been Chapter 11 or similar insolvency proceedings in other jurisdictions. In particular, retailers that rely on imported goods, manufacturers sourcing parts from overseas, and logistics companies hit by rerouted supply chains have all reported increasing financial

1 *Top Trading Partners – April 2025*, United States Census Bureau, https://www.census.gov/foreign-trade/statistics/highlights/topyr.html#exports (data reflects trade data based on goods only).

2 *Trump Announces Trade Deal with Vietnam*, BBC News, July 2, 2025, https://www.bbc.co.uk/news/articles/c4gd66q0q7go.

3 *A Timeline of Trump's Tariffs Actions So Far*, PBS News, May 26, 2025, https://www.pbs.org/newshour/economy/a-timeline-of-trumps-tariff-actions-so-far. *See also Trump Announces His First Trade Deal with the UK. Here's What's In It.*, Yahoo.com, May 8, 2025, https://finance.yahoo.com/news/trump-announces-his-first-trade-deal-with-the-uk-heres-whats-in-it-120417143.html.

4 *EU-US Trade Deal Explained*, European Commission, July 28, 2025, https://ec.europa.eu/commission/presscorner/detail/en/qanda_25_1930.

5 *Trump Administration Updates: White House Announces Sweeping New Tariffs for Much of the World*, The New York Times (Updated Aug. 4, 2025), https://www.nytimes.com/live/2025/07/31/us/trump-news.

6 *Trump is Threatening to Impose Tariffs on Two American Companies*, CNN, June 3, 2025, https://www.cnn.com/2025/06/02/business/trump-tariffs-apple-iphone-mattel-barbie.

strain. This can be seen in statements made in several recent bankruptcy filings:

Claire's, an American go-to establishment for ear piercing, colorful and trendy jewelry and merchandise targeted towards girls, tweens and teens.

> *The Company relies heavily on foreign suppliers. Indeed, between November 2024 and April 2025, the Company purchased approximately 70% of its inventory from suppliers located outside of the US, including, among others, 56% from mainland China, 8% from Vietnam, and 3% from Thailand. As a result, the Company has been significantly impacted by the implementation of sweeping tariffs on imported goods in April 2025, which led to higher projected costs and uncertainty in inventory pricing. The Company could not raise prices to fully offset the effects of tariffs on the Company's cost of goods sold.*[7]

At Home Group Inc., an American big-box retail chain of home furnishing stores.

> *Beyond macroeconomic challenges, retail industry headwinds, and internal pressures, the Company has faced significant challenges in addressing tariffs given its reliance on goods sourced from China. Despite the Company's experience with navigating tariff changes in recent years, the current tariff policy dynamic introduced a new level of volatility during the early stages of the new senior management team's implementation of its refined business strategy. The introduction of broad-based tariffs caused significant unpredictability and disruption to the retail industry and put retailers—especially At Home—in a difficult position.*[8]

Forever 21, a multinational fashion retailer.

> *The debtors' business has been negatively impacted by the "de minimis exemption" which exempts goods valued under $800 from import duties and tariffs. Consequently, retailers that must pay duties and tariffs to purchase product for their US stores and warehouses have been undercut. Despite widespread calls from US companies and industry groups for the US government to create a level playing field for US retailers by closing the exemption, US laws and policies have not solved the problem.*[9]

Sunnova, an American solar energy company.

> *Over the last couple of years, a combination of industry-specific pressures and macroeconomic headwinds resulted in reduced investment in, and diminished profitability for, residential solar. These forces include economic volatility, above-target inflation, prolonged high interest rates, and more recently, tariffs and uncertainty over federal incentives for solar power generation.*[10]

Hudson Bay Company, a Canadian department store retailer.

> *Recent and continuing uncertainty in financial markets, together with trade tensions with the US and the threat of tariffs, have created even more*

7 Declaration of Chris Cramer, Chief Executive Officer, Chief Operating Officer, and Chief Financial Officer of Claire's Holdings LLC and Certain of its Affiliates, In Support of the Debtors' Chapter 11 Petitions and First Day Pleadings, *In re Claire's Holdings LLC, et al.*, No. 25-11454, ECF No. 27 (Bankr. D. Del. Aug. 6, 2025).

8 Declaration of Jeremy Aguilar, Chief Financial Officer of At Home Group Inc. and Certain of its Affiliates, In Support of the Debtors' Chapter 11 Petitions and First Day Pleadings, *In re At Home Group, Inc., et al.*, No. 25-11120, ECF No. 4 (Bankr. D. Del. June 16, 2025).

9 Declaration of Stephen Coulombe in Support of Chapter 11 Petitions and First Day Pleadings, *In re F21 OPCO, LLC, et al.*, No. 25-10469, ECF No. 2 (Bankr. D. Del. Mar. 16, 2025).

10 Declaration of Paul Mathews, President and Chief Executive Officer of Sunnova Energy International Inc., in Support of Debtors' Chapter 11 Petitions, *In re Sunnova Energy International, Inc., et al.*, No. 25-90160, ECF No. 17 (Bankr. S.D. Tex. June 9, 2025).

challenging conditions for refinancing and business operations.[11]

Uncertainty around tariffs will remain pervasive for the foreseeable future, and Chapter 11 is a meaningful (even if only) option for many businesses. Filing for Chapter 11 affords these companies the immediate protection of the worldwide automatic stay while also providing a forum for robust dealmaking. Debtors, lenders, creditors, contract counterparties, and other interested parties can leverage the tools available in Chapter 11 to secure much-needed emergency financing, renegotiate contract terms, engage in marketing processes for the potential sale of the distressed company, right-size operations and workforce, pay off debts, and at the end of the process, hopefully emerge as stronger, more resilient companies.

PREPARING FOR THE FUTURE

Looking ahead, businesses must consider the full spectrum of consequences associated with tariffs. While global trade negotiations are ongoing and the hope is for a win-win solution, the endpoint is unpredictable, and the interim period may bring unintended side effects. As companies continue to navigate this evolving terrain, tariff risk mitigation is essential, and the implementation of supportive fiscal policies may help stave off bankruptcy. However, for those companies without the requisite means to avoid bankruptcy filing, Chapter 11 provides a useful forum to bring all the key players to the table and iron out a comprehensive solution.

11 *In Re Hudson's Bay Company*, 2025 ONSC 1530, CV-25-00738613-00CL (Mar. 10, 2025).

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Rich is one of the preeminent cross-border bankruptcy and restructuring lawyers in the US and is the recognized leader in cross-border and sovereign restructurings involving companies and countries in Latin America and other emerging markets. He has advised clients involved in some of the most noteworthy restructurings in and outside of the US over the last two decades. Rich is regularly recognized as a leading lawyer by Chambers Global, Chambers USA, Chambers Latin America, Latinvex, Latin Lawyer, Financial Times, Global M&A Network, The Legal 500 Latin America, The Legal 500 U.S., IFLR1000, and Lawdragon. Rich has served on Cleary's Executive Committee numerous times. He is based in the firm's New York office.

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PRIVATE CREDIT'S ABILITY TO WITHSTAND ECONOMIC PRESSURES

The private credit market has withstood significant economic pressures, including a sharp increase in interest rates, without experiencing a widespread wave of defaults. The market's resilience can be attributed to various factors, including the ability of lenders to restructure loans and the capacity of borrowers to absorb higher interest costs. An examination of the current market conditions and trends reveals that private credit defaults remain modestly above historical levels, but are not yet at crisis levels, suggesting a more stable outlook for investors.

THE PRIVATE CREDIT INDUSTRY ONCE AGAIN HAS BEEN UNDER SCRUTINY.

With the incredible growth of the asset class in recent years, questions have arisen as to whether private credit poses a potential systemic risk to the financial system, since the market has not yet been tested by a significantly prolonged period of stress. While the brief but sharp market upheaval in early 2020 during the pandemic did serve as a meaningful test, it was short-lived compared with the type of sustained stress that some observers remain concerned about.

Our experience indicates that private credit funds have and continue to face testing through a range of market conditions and, to date, have generally demonstrated resilience.

ASSESSING THE MIDDLE MARKET'S RESILIENCE

Beginning in March 2022, the Federal Reserve embarked on an aggressive tightening cycle, raising the Fed Funds target rate by 525 basis points in just 16 months. The three-month Secured Overnight Financing Rate (SOFR), the most common base rate benchmark for middle-market loans, saw a similar increase (see chart on next page).

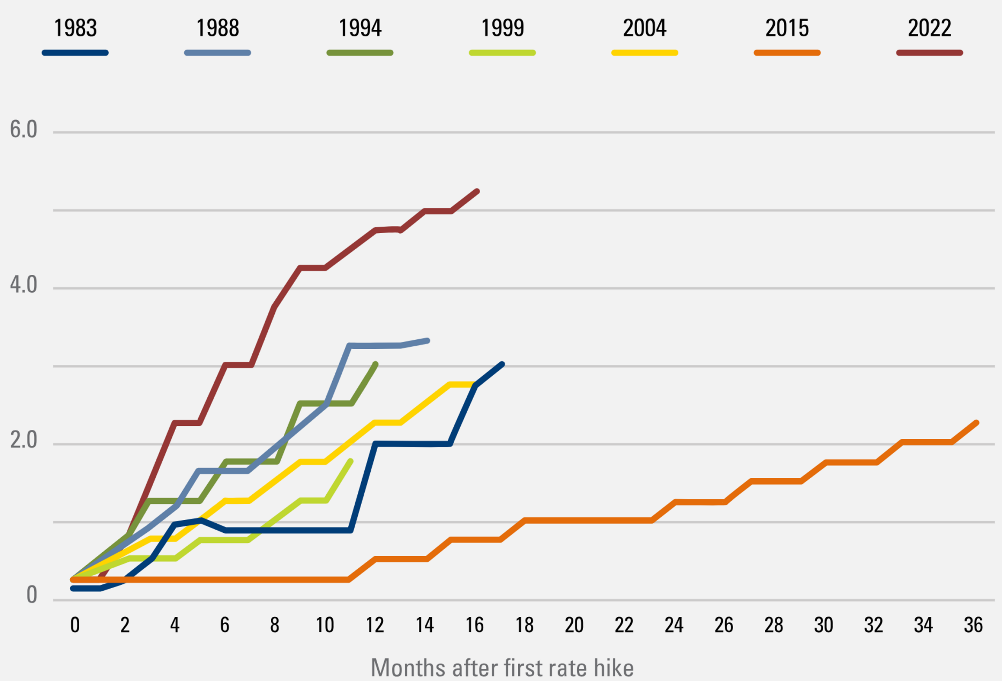
Meanwhile, in 2021 through the middle of 2022, the private equity and private credit community engaged in record deal activity which was characterized by high purchase price multiples and record leverage levels to finance such deals. The deals were generally underwritten assuming a 1% "floor" SOFR rate, which was generally expected to remain at that level or slightly above throughout the life of the loans.

Consequently, after the Fed increased rates over 500 basis points and SOFR followed accordingly, borrower interest costs expanded, leading to tightened coverage ratios and reduced liquidity. Interest costs increased by more than 50% across the board for floating rate borrowers, and interest coverage ratios declined to ~1x, where cash flow was covering interest payments. Moreover, the Fed's ongoing policy stance of "higher for longer" given stubbornly high inflation with steady macroeconomic growth emerged as the primary monetary policy stance. Financial market observers warned of the prospect of a wave of defaults as leveraged borrowers reckoned with higher base rates on older vintage floating rate loans and an inability to refinance loans given high leverage ratios and an uncertain outlook, with the economy showing signs of slowing, notably through the summer of 2025.

In response to the slowing economy, recession risk, and a material rise in default rates, the Fed lowered the Fed Funds Rate by 100 basis points between September and December 2024, providing some relief to borrowers with high amounts of floating rate debt. However, this rate cut was only one factor that contributed to improved conditions for overleveraged borrowers. The tightening of credit spreads also played a significant role, as many borrowers were able to refinance their debt at lower rates, which in turn helped to stabilize coverage levels. Despite these developments, the Fed's subsequent pause in rate reductions and the introduction of new trade tariffs led to ongoing uncertainty. Many outsiders continued to believe that a large wave of defaults and credit losses were still imminent, which, combined with concerns about the macroeconomic outlook, potentially affected the recovery prospects for higher-levered private credit borrowers.

The Most Aggressive Tightening Cycle in Decades

Changes in the Fed Funds target rate in past tightening cycles (in percentage points)



Source: U.S. Federal Reserve

DEFAULT RATES AND LENDER PROTECTIONS

So far, default activity in private credit markets has remained relatively contained. The KBRA DLD Direct Lending Index showed a trailing 12-month default rate of 1.8% as of September 11, 2025,[1] mirroring the 1.8% rate reported at the end of 2024, which remains materially below thresholds that would generally raise systemic concerns. Moreover, KBRA's latest forecast suggests a potential uptick in defaults, with the lower middle market default rate expected to reach 3% by year-end 2025, driven by a growing pipeline of stressed borrowers. This forecast is notable, as it reverses the previous trend and exceeds the projected overall US direct lending default rate.

By contrast, high-yield public markets typically exhibit higher default expectations. While Moody's cites default rates of 3 to 4% (and credit losses at around 3.2%),[2] actual observed defaults in high-yield indices are closer to 2.5%, averaging around 1.7%, and suggesting that current spreads embed a healthy buffer of 0.9% to 1.5% above loss expectations.

However, recent broader data tells a more mixed story. S&P reports a trailing 12-month high-yield

1 KBRA DLD Default Research, "Default Weekly 9/12/2025: Increase Ahead for LMM Default Rate, Six Added to Default Radar," September 12, 2025.
2 Moody's Asset Management Research Team, "US Credit Review & Outlook: Corporate Credit Risk Looking for a Catalyst to Break Out," Moody's Analytics, August 7, 2025.

default rate above 4% through September 2025, near long-term averages (~4.5%), and forecasts the rate falling to 4.25% by June 2026.[3] UBS forecasts 2025 defaults of ~4.8% (USD HY) and ~3.3% (EUR HY), although those fall to about 1.2% when excluding a few distressed outliers.[4] Deutsche Bank also suggests that defaults may fall to ~4.4% by the end of 2025, before climbing to 4.8% to 5.5% in 2026.[5]

It is also important to distinguish between reported defaults – typically outright missed payments – and broader adjusted measures of default risk that more closely reflect the realities of private markets. Because private loans are often held by a small group of lenders (sometimes just one), lenders and sponsors are frequently able to restructure or amend terms via various liability management exercises (LMEs) before a missed payment occurs. LMEs often include the following or a combination of the following:

- debt-for-equity exchanges
- covenant waivers
- maturity extensions
- amendments
- equity infusions
- PIK toggles.

While these actions help preserve value and buy time for borrowers, they are effectively signs of stress and a more complete measure of risk to capture. It is also relevant to point out that these LMEs are a way for lenders to extract additional economics and protections to partially offset the incremental risk borne when there are quasi-default events.

According to the Pitchbook LCD Distressed Weekly report, as of August 31, 2025,[6] the trailing 12-month default rate for conventional payment defaults in the US leveraged loan market stood at 1.36%, with 15 issuers defaulting across 1,244 facilities. The combined rate, including distressed LMEs, is significantly higher at 4.37% as tracked by issuer count. For context, this combined rate is below the recent high of 4.70% reported in December 2024, suggesting a potential stabilization in distressed activity.

Another important distinction is in lender protections. Private credit loans often carry tighter financial covenants, including maintenance provisions that can trigger earlier lender engagement when performance weakens. High yield bonds, by contrast, are generally covenant-lite, offering fewer ongoing protections. These structural differences, combined with the prevalence of proactive restructurings in private markets, help explain why default patterns can diverge between the two. While no market is immune to stress, the combination of modest defaults, meaningful covenant protections, and lenders' ability to act early suggests that private credit remains well positioned to navigate the environment.

VALUATION IMPLICATIONS FOR PRIVATE CREDIT INVESTORS

Valuation is another focus area for private credit investors. Valuation Research Corporation (VRC) has previously highlighted the differences between public and private credit markets, including reporting standards and market volatility.[7] Recent public credit market volatility related to tariff issues highlights the importance of a more measured approach to valuing buy-and-hold securities.

In early April, when the broadly syndicated loan market was trading down sharply on tariff headlines, VRC did widen credit spreads in its proprietary Middle Market matrix for first lien, second lien, and uni-tranche loans by 25 basis points from March 2025 levels. Generally, given the excess dry powder in the private markets relative to new LBO/M&A-led issuance demand, competition kept new issuance terms, albeit at lower volumes, relatively tight versus Q1 standards and relative to bank secondary trading indications. However, as the tariff concerns eased and public and private markets rebounded, we tightened them back to pre-March levels,[8] even as we applied a more granular credit-by-credit analysis of the tariff impact on individual borrowers. We continue working with clients to apply a detailed analysis of the tariff impacts to their portfolios, in accordance with their established and documented valuation policies.

This approach, which involves applying a uniform spread adjustment in response to breaking news and then conducting a detailed assessment of the impact on individual credits, is well-established. It is similar

3 S&P Global Ratings, "Default, Transition, and Recovery: Distressed Exchanges Lead August 2025 Defaults," September 11, 2025.
4 UBS Asset Management 2025 Fixed Income Default Study, January 17, 2025.
5 Deutsche Bank's 27th Annual Default Study, June 2025, as reported in Bloomberg Law June 9, 2025.
6 PitchBook LCD Global Distressed Credit Weekly Wrap Report, September 5, 2025.

7 https://www.valuationresearch.com/insights/private-debt-market-valuations/.
8 https://www.valuationresearch.com/insights/2q-2025-update-middle-market-credit-spreads-required-returns/.

to the strategy employed by private credit market participants during the pandemic in early 2020, when the global economy was significantly disrupted.

CONCLUSION

Private equity and private credit markets, given their close and interdependent relationship, have generally worked constructively through periods of stress to minimize losses across both sides. In many cases, this collaboration has resulted in defaults being avoided, or at least deferred, through proactive measures.

The private credit market has thus far demonstrated resilience through rising interest rates, refinancing pressures, pandemics, trade disruptions, and other episodic volatility, supported by covenant structures and disciplined valuation practices. At the same time, the market's continued growth and evolving dynamics mean that risks for borrowers, funds, and investors remain, underscoring the importance of careful monitoring and measured analysis as the sector adapts to future conditions.

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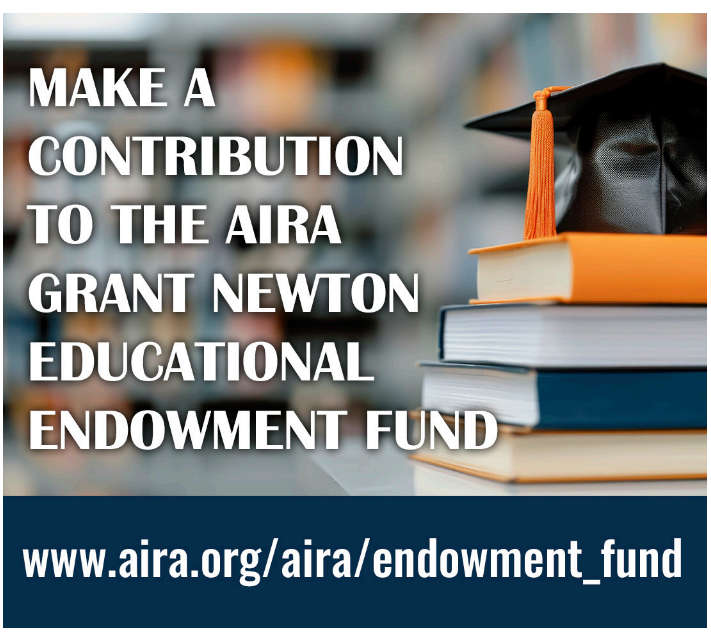


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NORMALIZATION IN BUSINESS VALUATIONS

BUSINESS VALUATION IS A FORWARD-LOOKING exercise based on expected income that is to be received after the contemplated valuation date.[1] A hypothetical investor will not pay for yesterday's dollar, so the relevance of business valuation is found in its ability to aid in understanding the outcomes from anticipated future economic benefits, such as the value of forecasted future cash flows. Historical cash flows are relevant to the extent they aid in the prediction of future cash flows. The hypothetical investor is likely to examine past cash flows in conjunction with forward-looking projections of cash flows to better understand the nature of those future cash flows.[2] These forecasted cash flows and their associated risks are the basis for determining a subject company's value.[3]

The process of developing a business valuation likely requires tradeoffs.[4] One of those tradeoffs includes the application of the analyst's judgment in weighing the reliability versus the relevance of available information.[5] This tradeoff is not binary; it reflects continuums of relevance and continuums of reliability. For example, because the estimate value is a forward-looking exercise, future cash flows have greater relevance. However, since future cash flows are difficult to forecast, they are typically less reliable than historical cash flows. In contrast, historical cash flows often offer as a reliable estimate of future economic benefit but may be less relevant to an estimation of value. How can an analyst bridge the relevance/reliability gap in financial information necessary to value an asset? Normalization is one such process.

WHAT IS NORMALIZATION?

Normalization, in the context of business analysis, is typically a set of techniques or processes undertaken to improve the consistency and reliability of the data underpinning an analysis.[6] Normalizing adjustments are typically a process used to conform data to industry standards and remove nonrecurring items.[7] Such techniques are frequently used to evaluate the operational or financial performance of a company or division, the effectiveness of business procedures, and the management of data. When applied across these various functions, normalization allows for a more robust understanding of the underlying data and sharpens the conclusions derived from that data. Normalization allows the analyst to focus on features that are essential to the end goal and removes extraneous variables or "noise."[8]

Normalization in the context of performing a valuation takes on a narrower meaning.[9] To someone outside of the valuation industry, normalization may mean adjusting reported financial statements to remove items that are considered non-repeatable or "outliers," or to adjust for irregularities. Further, normalization adjustments may be considered as a tool to better control variations in life-cycle peaks or troughs. The activity of normalization in valuation can be a deeper process that uncovers and determines the core future cash flows of the subject of the valuation, the risks associated with those cash flows, and the potential for those cash flows to grow (or recede) in the future.

WHY DO WE NORMALIZE?

Normalization primarily involves forming a bridge between historical cash flows experienced by a subject company and the future cash flows forecasted to be realized by that company.[10] Normalization frequently occurs when:

- creating a reasonable basis for analysis

1 Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 45 (6th ed. 2025).
2 Ibid., 45-48.
3 James R. Hitchner, Financial Valuation Applications and Models, 229-230 (5th ed. 2025).
4 Jack F. Williams, Teaching Bankruptcy Valuations to Law Students and Other Unnatural Acts, 39 Emory Bankr. Dev. J. 51, 51 (2023).
5 Ibid, 77.

6 https://estuary.dev/blog/data-normalization/, https://www.modernanalyst.com/Resources/Articles/tabid/115/ID/5999/An-Introduction-to-Business-Process-Normalization.aspx.
7 Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies 45 (6th ed. 2025).
8 James R. Hitchner, Financial Valuation Applications and Models, 181 (5th ed. 2025).
9 Ibid., 185-189.
10 This normalization is important across all forms of valuation approaches, including; (a) the Income Approach ("Income Approach") that estimates value based upon the future cash flows which an asset can reasonably expect to generate, (b) the Market Approach ("Market Approach") that estimates value on a relative or comparative basis, and (c) the Asset Approach ("Asset Approach") that adjusts the assets and liabilities of a subject company's balance sheet to their fair market value.

- developing a reasonable and stable estimate of the subject company's future cash flows, and
- providing reliable comparability across a relative valuation.

> *With the enormously expanded amount of data available, analysts must go beyond simply measuring the economic income of a given enterprise. Analysts also must attempt to determine what factors give rise to the ability (or inability) of the enterprise to generate required returns for the foreseeable future; that is, they must make in-depth enterprise risk assessments. Consequently, a well-reasoned valuation analysis includes certain critical elements:*
>
> - An estimation of the amount of future economic benefits (normalization and projection of future cash flows)
> - An assessment of the probability or risk that the projected / forecasted future economic benefits will be realized and will be sustainable over the long run.[11]
>
> **James Hitchner**

Therefore, a valuation analyst must go beyond what is presented in financial statements and determine if those metrics present an informed picture of the company's future expectations. Ideally, the analyst should strive to ascertain the economic underpinnings of the subject company, not just its current accounting reality.[12] This usefulness of normalization applies beyond the aforementioned normalization adjustments to reported results.[13] The key to a reasonable and reliable valuation estimate is to base the analysis on cash flows which are anticipated to represent a sustainable and repeatable future reality.

An example here is helpful. A valuation practitioner is asked to value a company in a cyclical industry, such as heavy manufacturing, where the subject company, a construction equipment manufacturer, is at the peak of its economic cycle. A valuation based on reported historical earnings, at that single point in time, may be inflated because it fails to consider future changes in the economy, company responses, future investments, and other factors. As a cyclical company, the subject company's cash flows are likely to fluctuate over its cyclical period, with peak earnings being higher than the average earnings during the economic cycle.[14] The same can be said for companies that are in commodity industries, in high-growth mode, or in a decline.[15]

Normalization can go beyond subject company's cash flows estimates, and an analyst can also consider whether adjustments to such variables as economic growth rates and risk variables are necessary. The normalization of these types of valuation inputs, specifically including the Weighted Average Cost of Capital ("WACC") and growth rate variables, is currently a controversial topic among valuation practitioners. For example, normalization of inputs to WACC were (and continue to be) particularly prevalent because of the "Great Recession," and later the economic disruption caused by the COVID pandemic, as the risk-free rate in the US was essentially zero. Many practitioners took the view that interest rates after the COVID pandemic fell outside of what should be considered normal, pre-COVID experience, and things would return to "normal" after some time; therefore, a normalization adjustment was necessary. Similar concerns can also arise when the economy deviates from other concepts of "normal" when analyzing periods of high or low inflation.[16]

Normalization can also be useful when performing valuations using a relative value approach like the Market Approach to ensure there is comparability in earnings metrics across guideline company arrays.[17]

11 James R. Hitchner, Financial Valuation Applications and Models, 181 (5th ed. 2025).
12 Aswath Damodaran, Musings on Markets: Earnings and Cash Flows: A Primer on Free Cash Flow, Oct. 25, 2022 (https://aswathdamodaran.blogspot.com/2022/10/earnings-and-cash-flows-primer-on-free.html).
13 Jack F. Williams, Teaching Bankruptcy Valuations to Law Students and Other Unnatural Acts, 39 Emory Bankr. Dev. J. 51, 89-95 (2023).
14 See, e.g., In re Chemtura Corp., 439 B.R. 561, 581-83 (Bankr. S.D.N.Y. 2010).
15 Aswath Damodaran, Musings on Markets: Dealing with Aging: Updating the Intel, Walgreens and Starbucks Stories!, Sep. 9, 2024 (https://aswathdamodaran.blogspot.com/2024/09/dealing-with-aging-daignosing-intel.html); Aswath Damodaran, Musings on Markets: Myth 5.5: The Terminal Value at my DCF!, Nov. 30, 2016 (https://aswathdamodaran.blogspot.com/2016/11/myth-55-terminal-value-ate-my-dcf.html). Aswath Damodaran, Musings on Markets: Commodity companies and commodity dependent markets, Aug. 30, 2009 (https://aswathdamodaran.substack.com/p/commodity-companies-and-commodity-09-08-30) .
16 These adjustments and the potential concerns with making them are detailed later in this article.
17 Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 285-289 and 297-305 (6th ed. 2025).

The variables used in defining the multiple should be estimated uniformly across assets in the "comparable firm" list. If earnings-based multiples are used, the accounting rules to measure earnings should be applied consistently across assets. The same rule applies with book value-based multiples.[18]

Under the Market Approach, if a practitioner has normalized the earnings of the subject company, it follows that the practitioner should consider whether that similar normalizing adjustments should be applied to the guideline companies before deriving valuation multiples.[19] As with all normalization adjustments, the practitioner should look to the facts and circumstances of each of the guideline comparable companies, at the time of the valuation, to understand if adjustments are necessary. In contrast to simply accepting a guideline company's reported financial metrics, normalizing and conforming metrics across the guideline array is more likely to protect the derived valuation estimate from distortions related to accounting methodologies or events that may not occur in the future.

As observed by Mr. Hitchner, failure to normalize earnings may instead result in valuation estimates that are over- or under-stated.[20]

HOW DO WE NORMALIZE?

As described briefly above, normalization primarily involves forming a bridge between a subject company's historical cash flows and forecasted future cash flows (or economic benefits), and the risks that surround their potential realization by that company.

NORMALIZATION OF CASH FLOWS

To understand a subject company's potential future earning power based on historical results, a normalization of historical results may be necessary for both an Income Approach and a Market Approach valuation. Examples of historical financial results that may require adjustment include:

Income Statement Adjustments

- **One-time or non-recurring income and expense:** Eliminating gains or losses from unusual or infrequent events that are not expected to occur in the future including adjusting for litigation expenses or a windfall profit from an unusual investment (e.g., an investment in artificial intelligence software).
- **Discretionary expenses:** Removing expenses that are not reasonably necessary to the business' core operations, for example, non-essential corporate aircraft or expenses incurred for a CEO's birthday celebration.
- **Rent or lease expenses:** Adjusting rent to fair market value, if appropriate, or including adjustments if, for example, a company leased equipment at higher rates during a period of equipment scarcity or was able to lock rent rates for office space significantly below market rates.
- **Related party transactions:** Eliminating income or expenses from agreements with related parties, for example, adjusting for tax-efficient transfer pricing or accounting for special purpose entities used to generate current earnings.

Balance Sheet Adjustments

- **Non-operating assets and liabilities:** Removing assets or liabilities that do not relate specifically to the generation of the core business's cash flows. For example, adjustments include pension benefit obligation or accounting for a large non-essential artwork collection.
- **Net working capital:** Adjusting for proper levels of working capital in the event the company is not at optimal levels. Normalizing for such things as excess cash on the balance sheet or non-collectible accounts receivable.
- **Excess or shortfall of investment in operating assets:** Adjusting for the overinvestment or underinvestment in the operating assets. Performing an analysis of the subject company's fixed asset base to determine if proper investment has been made to ensure the company's future operations.[21]

When implementing the Market Approach or the capitalized earnings method under the Income Approach, on historical Earnings Before Interest, Taxes, Depreciation, and Amortization ("EBITDA"), the reported results may not accurately measure the future cash flows of the subject company.[22] Therefore, normalization adjustments, as supported by the facts, are made to reflect future expectations of

18 Relative Valuation, Asset-Based Valuation and Private Company Valuation, Aswath Damodaran, updated January 2024 (https://pages.stern.nyu.edu/~adamodar/pdfiles/eqnotes/valpacket2spr24.pdf).

19 Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 285-289 (6th ed. 2025).

20 James R. Hitchner, Financial Valuation Applications and Models, 1315-1316 (5th ed. 2025); Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies 48-49 (6th ed. 2025).

21 Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 109-111 (6th ed. 2025). See generally, James R. Hitchner, Financial Valuation Applications and Models (5th ed. 2025).

22 Jack F. Williams, Teaching Bankruptcy Valuations to Law Students and Other Unnatural Acts, 39 Emory Bankr. Dev. J. 51, 121 (2023).

the subject company. Some examples of normalizing adjustments to EBITDA that are often encountered include:

- Significant litigation settlements received or paid
- Sales of land non-core to operations
- Currency translation gains and losses
- Asset impairments
- Increase in non-core mark-to-market assets (Bitcoin, NFTs)
- Revenue disguised as amortization costs

Normalization adjustments can also affect inputs to the discounted cash flow method ("DCF Method"), as implemented under the Income Approach, particularly the estimate of a subject company's terminal value.[23] Without normalization, the terminal value may be subject to distortion caused by unrealistic assumptions carried over from the forecast period and not reflect a steady-state sustainable business in perpetuity.[24] Examples of these types of normalizing adjustments affecting terminal value include:

- **Margins:** Depending on the line-item estimate of economic benefits used (e.g., EBITDA, EBIT, etc.), the appropriate margin can be adjusted to a mid-cycle estimate based on a historical average, projected average, or a blend of both to avoid peak or trough assumptions, affecting the perpetuity portion of the DCF Method estimate.
- **Capital expenditures ("CapEx"):** Adjustments to reflect a steady and sustainable level of maintenance CapEx and long-term growth levels consistent with the business plan, historical investment position, and peer investment practices.
- **Working capital:** adjustments to reflect a stabilized and sustainable level appropriate for the perpetuity period.
- **Taxes:** adjustments made to reflect the steady state of the subject company and future profitable expectations.

These adjustments help ensure that the terminal period cash flows reflect the operative reality of the subject company's future state.[25] Care must be taken to understand how the subject company's future is projected and expected to unfold. At the point of terminal estimation, the evaluator must determine if the company is: (1) still in rapid growth mode, requiring assumptions to support that growth; (2) positioned for a mature period of stable earnings, and can be sustained on maintenance level capital investment; (3) on the downturn and requiring a wind-down analysis; or (4) in a position somewhere between these categories. In the end, adjustments should be tailored to reflect the subject company's realistic long-term operative reality.

Think back to the above discussion of a cyclical manufacturer of heavy machinery. Assume the company has a 10-year lifecycle, from peak to trough of its economic cycles or business cycles. To reflect future cash flows an analyst should review

23 The DCF Method often yields a value that is heavily comprised of a subject company's terminal value, which can be a majority of the DCF Method estimated value. Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 1001 (6th ed. 2025); James R. Hitchner, Financial Valuation Applications and Models, 249 (5th ed. 2025).

24 Jack F. Williams, Teaching Bankruptcy Valuations to Law Students and Other Unnatural Acts, 39 Emory Bankr. Dev. J. 51, 91-96 (2023). James R. Hitchner, Financial Valuation Applications and Models, 249-255 (5th ed. 2025).

25 Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 272-281 (6th ed. 2025).

the information at hand to determine how best to estimate what the normal level ("mid-cycle") of steady-state cash flows is appropriate to represent the terminal period's contribution to the valuation estimate.[26]

There are many techniques an analyst can use to estimate this mid-cycle level of revenue.[27] These techniques include the use of historical and projected data, assuming they are representative of the subject company's full life cycle. Assume an analyst has five years of historical information and has been provided with five year future projections. The analyst may determine it appropriate to average revenue across the full 10 year period in developing a mid-cycle estimate. The analyst could also determine that the midpoint metric may be more reliable, or that certain historical and projected years should be removed from consideration. These methods can be equally valid when developing a mid-cycle estimate of margins, investment (capital expenditures), and other terminal value assumptions.

Another factor the analyst should take into account is the nature of the terminal value.[28] Does it extend into the future with no endpoint (mathematically, a perpetuity)? If not infinite, practically speaking, it still represents a really long time. Thus, it is essential to understand the components being incorporated into terminal period cash flows, for example:

- Was an investment undertaken during the analyzed timeframe?
- Is likely such an investment will be required again in the future, especially considering that forever is a very long time?

NORMALIZATION OF RISK AND GROWTH

Determining a normalized level of cash flows also requires an assessment of the measures of risk and growth that underly those cash flows. Under the Income Approach, risk is typically measured with a discount rate based on the WACC of the subject company.[29] This WACC is the weighted average cost, at market value, of all the financing sources of the company, primarily equity and debt.[30]

The cost of equity portion of the WACC is frequently based on some form of the Capital Asset Pricing model (CAPM).[31] Two key CAPM inputs include the equity risk premium (ERP) and the risk-free interest rate. Because both inputs are affected by current economic conditions when observed, some valuation practitioners advocate for smoothing of these inputs when performing a valuation. For example, Kroll (Duff and Phelps) regularly provides an estimate of a normalized equity risk premium and an associated, or paired, normalized risk-free rate.[32] Should a valuation practitioner decide to adopt these normalized estimates, care must be taken to match the normalized equity risk premium with the corresponding normalized risk-free rate.

In essence, a normalized ERP and risk-free rate attempt to smooth volatility or adjust for what a practitioner determines is a non-normal or outlier environment. Thus, one may conclude that to provide a reasonable value estimate of a subject company, a valuation practitioner would need to consider the use of normalized estimates of these inputs. As Professor Aswath Damodaran hypothesizes, "[i]nterest rate on a guaranteed investment = Expected inflation + Expected real growth rate," such expectations can be measured at the time of the valuation date.[33]

Normalization within macro inputs like the ERP and the risk-free rate may be met with skepticism for three main reasons:

- The need to determine the time frame for measuring what is normal
- Macro inputs tend to be measures of what can be realized in the current market and not necessarily in the future
- These inputs cannot be verified or replicated independently.

What is the Time Frame for Measuring What is Normal?

A determination of what is normal, in terms of macro inputs, is very much in the "eye of the beholder." What may be normal to one analyst may be a subset of what is normal to the next analyst. For example, if one considers 20-year risk-free rates over certain periods, they could come to different conclusions. For

26 See generally, Aswath Damodaran, Ups and Downs: Valuing Cyclical and Commodity Companies, Stern School of Business, New York University, Sep. 2009.
27 See generally, Ibid.
28 James R. Hitchner, Financial Valuation Applications and Models, 229 (5th ed. 2025).
29 Ibid., 292.
30 Shannon P. Pratt and ASA Educational Foundation, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 166 (6th ed. 2025).
31 Jack F. Williams, Teaching Bankruptcy Valuations to Law Students and Other Unnatural Acts, 39 Emory Bankr. Dev. J. 51, 62-64 (2023).
32 https://www.kroll.com/en/reports/cost-of-capital/recommended-us-equity-risk-premium-and-corresponding-risk-free-rates.
33 Aswath Damodaran, Musings on Markets: Dealing with Low Interest rates: Investing and Corporate Finance Lessons, Apr. 3, 2015 (https://aswathdamodaran.blogspot.com/2015/04/dealing-with-low-interest-rates.html).

example, the following chart shows the average 20-year rates over various periods.[34]

Defining the time frame of "normal" can have a significant effect on the estimate of the risk-free rate. Assuming a valuation date of December 31, 2024, the subject company's cost of equity can vary by 0.5% to 2% simply based on the determination of the "normal period," potentially leading to an outsized effect on the estimate of value.[35] Such judgment calls are ripe for manipulation, and the selected period should be supported by an assessment by the valuation practitioner.

20-year Treasury Securities Average Daily Yield

Period	Average Period Yield	12/31/2024 Yield	Difference
1/1/1994 - 12/31/2024	4.35%	4.86%	-0.51%
1/1/2004 - 12/31/2024	3.46%	4.86%	-1.40%
1/1/2014 - 12/31/2024	2.84%	4.86%	-2.02%
1/1/2020 - 12/31/2024	3.08%	4.86%	-1.78%

Today's Information is Reality

An analyst's valuation estimate should be grounded in reality, and when observed, these types of inputs are based on the same snapshot in time that the subject company was experiencing, or what a theoretical buyer could realize on other investment opportunities. The use of a normalized risk-free rate ignores the fact that the rate as of the valuation date is what an investor can earn if they choose not to invest in risky assets.[36]

A second consideration is that the estimates used must be aligned. Mixing normalized ERP with the current period-based risk-free rate and/or growth rate estimate (or any non-aligned combination) will lead to a mismatch of the outlooks, and an unreliable valuation estimate. If these variables are not estimated on the same basis, it will be difficult for the valuation practitioner to support the premise that the derived WACC, and thus the valuation estimate, reflects the subject company's then–operative reality.

Finally, the long-term growth rate may also be estimated on a normalized basis. Typically, the long-term growth rate, used in the calculation of a terminal value capitalization rate, is often informed by an estimate of inflation.[37] Therefore, if a valuation date is in the midst of an elevated or depressed period of inflation, it may result in the selection of a higher or lower estimate of a long-term growth rate than what would be considered "normal." This may, in turn, lead to significant value differences relative to what a "normalized" long-term growth rate would indicate. If the valuation practitioner ultimately determines a different level of inflation than currently being expected is appropriate, they will find that such a corresponding investment instrument to recognize this level of return, "…only exists in your estimation."[38] This deviation from reality may cause the associated valuation estimate to be questioned unless the valuation practitioner can fully support the adjustment based on the facts and circumstances.

CONCLUSION

When appropriate, normalization can be an essential tool in deriving a reliable valuation estimate based on the forecasted future of the subject company. Accordingly, the process used to normalize historical cash flows and other valuation inputs should be subject-specific and based on associated facts and circumstances. As always, a valuation practitioner should take care to ensure that any normalizing adjustments applied are made to reflect the operative reality of the company as of the valuation date.

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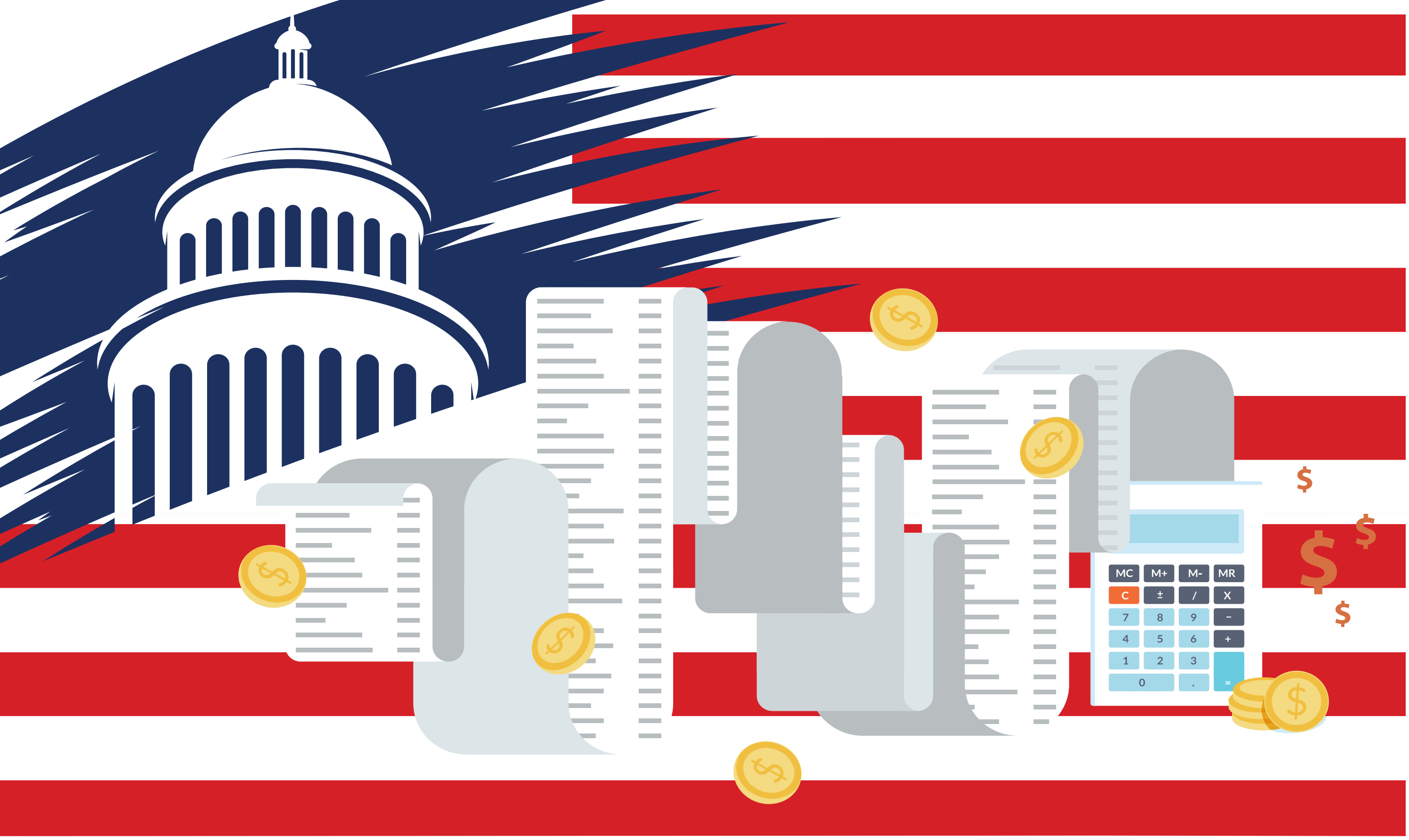
34 Data obtained from https://fred.stlouisfed.org/series/DGS20.
35 The same analysis can be performed for any of the macro variables; the selection of a time period necessarily influences the estimate. One should also take care in normalizing one variable and not others because of a relationship between these variables that must be considered when determining the proper estimate.
36 Jack F. Williams, Teaching Bankruptcy Valuations to Law Students and Other Unnatural Acts, 39 Emory Bankr. Dev. J. 51, 99 (2023).
37 Ibid., 94-95.
38 Aswath Damodaran, Musings on Markets: Dealing with Low Interest rates: Investing and Corporate Finance Lessons, Apr. 3, 2015 (https://aswathdamodaran.blogspot.com/2015/04/dealing-with-low-interest-rates.html).



THE ONE BIG BEAUTIFUL BILL PLANNING OPPORTUNITIES FOR DISTRESSED C CORPORATIONS

Tax changes contained in the One Big Beautiful Bill Act present planning opportunities for many distressed corporations.

INTRODUCTION

President Trump signed the One Big Beautiful Bill Act (OBBBA) into law on July 4, 2025.[1] Unlike the Tax Cuts and Jobs Act[2] (TCJA), the OBBBA does not introduce sweeping changes to the Internal Revenue Code (IRC). The TCJA generally expired in 2025, and many of the "paybacks"[3] in the TCJA took place in the later effective years of the TCJA. The OBBBA addresses some of these TCJA "payback" provisions and makes other TCJA provisions permanent.

In the wake of this evolving tax legislation, distressed corporations (i.e., those grappling with financial losses and negative cash flows) find themselves at a crossroads. The OBBBA addresses several punitive provisions of previous tax law that disproportionately impacted struggling businesses. By making targeted adjustments and permanent reforms, the OBBBA offers tangible relief and renewed planning opportunities, particularly for loss corporations that were previously burdened by tax liabilities. This article explores the specific ways in which these legislative changes directly benefit distressed companies.

BACKGROUND

Three key provisions in the TCJA caused unexpected tax increases for many C corporations starting in 2022. These rules hit struggling companies especially

1 Public Law No: 116-21.
2 Signed into law on September 22, 2017, as Public Law No: 115-97.
3 Taxpayer unfavorable provisions that required repayment or adjustment.

hard. The TCJA phase-outs caused many businesses with losses to pay taxes in 2022, despite having negative cash flows. A by-product of the OBBBA is to alleviate these issues.

The three favorable OBBBA provisions discussed in this article are:

- **Innovation and research and experimental:** Allows for the immediate expensing of domestic research costs, while providing an ability to accelerate remaining unamortized amounts of previously capitalized research costs incurred in 2022 through 2024. This provision is permanent.
- **Business interest:** Restores TCJA's original, more favorable EBITDA-type calculation of the business interest deduction limit for tax years beginning in 2025. The provision is permanent and provides specific rules for how the business interest expense limitation interacts with other tax provisions that capitalize interest.
- **Capital expenditures and investments:** Reinstates 100% expensing of qualified assets in the year they were put into service (i.e., bonus depreciation) for property acquired beginning January 20, 2025. The provision is permanent. Another provision expands the scope of qualified assets to cover manufacturing buildings, but only for buildings placed in service before January 1, 2031.

CAPITALIZATION OF RESEARCH AND EXPERIMENTAL EXPENDITURES

Historically, section 174 provided taxpayers the option to immediately deduct research & experimental (R&E) expenditures under section 174(a) or elect under section 174(b) to capitalize them over a period of at least 60 months.[4]

For taxable years ending on or after December 31, 2000, software development costs could be (i) deducted currently under rules similar to section 174(a); (ii) capitalized and amortized over 60 months from the date of completion of the project; or (iii) capitalized and amortized over 36 months from the date the software is placed in service.[5]

TCJA PROVISIONS

The TCJA amended section 174(a) to eliminate the ability to currently deduct R&E expenditures in tax years beginning after December 31, 2021.[6] As such, domestic R&E expenditures were amortized over five years and 15 years for expenditures incurred outside of the United States, both with a midyear convention.

When considering the timing implication of this provision, taxpayers with R&E expenditures were disproportionately affected in the 2022 tax year, as only 10% of the R&E expenditures could be deducted than during the initial 2022 tax year:

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

These TCJA provisions relating to section 174 were very unpopular, and it was anticipated that the capitalization requirement would be legislatively "fixed." For example, the Build Back Better Act[7] as passed by the House of Representatives in November 2021, contained language to extend the immediate deductibility of R&E expenditures through the end of 2025. However, the bill was ultimately not enacted into law.

OBBBA PROVISIONS[8]

The OBBBA returns the option for full expensing of domestic R&E expenditures (research costs) for tax years beginning after December 31, 2024. Taxpayers may also choose to capitalize and amortize those expenditures over a period of at least 60 months. Foreign research costs remain subject to capitalization and amortization over a 15-year period. Importantly, software development expenditures continue to be treated as research costs under the provision.

This return to full expensing comes with options. While the provision is generally not retroactive, taxpayers can elect to accelerate any domestic research costs that were capitalized but still are unamortized. Taxpayers who make this election would accelerate those costs with their first tax return beginning after December 31, 2024. Any amount accelerated can be spread over one or two tax years.

Eligible small business taxpayers can elect to make the law retroactive to tax years beginning after December 31, 2021 (instead of December 31, 2024).

4 Beginning with the month in which the taxpayer first realizes benefits from such expenditures.
5 Notice 2000-50.
6 Including software development costs.

7 H.R.5376 - Build Back Better Act, 117th Congress (2021-2022).
8 Adapted from "The OBBBA Restores Favorable Tax Treatment of Domestic R&E Expenses," Jul. 30, 2025, https://rsmus.com/insights/services/business-tax/obbba-tax-research-development.html.

This election generally requires an eligible small business taxpayer to amend its 2022, 2023, and 2024 returns[9] and would subject the taxpayer to the fully restored section 280C, which would require taxpayers to haircut their R&E credits on the amended tax returns.

Eligible small business taxpayers also may elect to treat the retroactivity election as a change in method of accounting. Guidance from the Internal Revenue Service is likely necessary for taxpayers to make such elections.

The rules also allow other taxpayers to deduct unamortized amounts either in the first taxable year beginning after December 31, 2024, or ratably over a period of two taxable years starting with the first taxable year beginning after December 31, 2024.

Small businesses: Definitions, clarifications and requirements

An eligible small business taxpayer is any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) that meets the gross receipts test of section 448(c) for the for the taxpayer's first taxable year beginning after December 31, 2024 (generally the 2025 taxable year for calendar-year taxpayers).

The gross receipts test is computed by determining the average annual gross receipts over the preceding three taxable years; if the average annual amount is $31 million or less (as adjusted, where applicable), the taxpayer may be an eligible taxpayer. In applying this test, aggregation rules determine which related entities' gross receipts are included, and separate rules apply to determine whether the taxpayer is a tax shelter for purposes of eligibility.

For eligible small business taxpayers, the OBBBA provides an optional "retroactivity election" that allows the taxpayer to apply the R&E expenditure regime under section 174A (and the related coordination under section 280C, as amended) to domestic R&E amounts paid or incurred in taxable years beginning after December 31, 2021 (generally 2022–2024), rather than only applying section 174A prospectively for taxable years beginning after December 31, 2024. This retroactivity election is not an election to change the taxpayer's overall accounting method from accrual to cash (or vice versa); it is an election to apply section 174A treatment to domestic R&E expenditures for the affected pre-2025 years, consistent with IRS procedural guidance.[10]

Per the OBBBA, an eligible small business taxpayer must make this retroactivity election in the manner prescribed by Treasury/IRS no later than July 4, 2026 (July 6, 2026 applying section 7503 because July 4, 2026 falls on a Saturday), and generally must file amended returns (or, if applicable, an administrative adjustment request) for each taxable year affected by the election, subject to the normal statute of limitations on refund claims. The OBBBA also permits the taxpayer to implement the retroactivity election as a change in method of accounting for the first taxable year affected by the election, and IRS guidance provides procedures for that approach.

What favorable tax treatment of R&E expenses means for businesses

The return to full expensing could result in a significant cash tax benefit, especially for companies that invest heavily in innovation. But the OBBBA introduces options (particularly around retroactivity and acceleration) that require thoughtful consideration and modeling.

SMALL BUSINESSES

For eligible small businesses, the decision to amend prior returns could unlock refunds but may also trigger administrative complexity. Each option has potential benefits and drawbacks.

For example, required capitalization caused many to pay more in income taxes during the 2022–2024 taxable years. Amending returns may provide welcome cash refunds (especially for distressed companies) but may also require pass-through entity owners to amend their individual returns. This could also require cash distribution analyses for entities. Owners could receive a refund of prior cash tax distributions, and entities will need to determine how they treat those refunds in any future distribution analysis.

In addition, amending returns also requires retroactivity for the coordinating research cost disallowance provision. Many taxpayers did not elect a reduced credit amount in 2022–2024 taxable years due to the ambiguity of how the disallowance applied when capitalizing research costs. Helpfully, an amending small business can elect or revoke

9 As described above, taxpayers were most affected by these provisions in the 2022 tax year.

10 See for example, Rev. Proc. 2025-28 (Aug. 28, 2025), including discussion of OBBBA §70302(f)(1) (small business retroactivity election), eligibility by reference to §448(c).

an election on the amended returns if they are filed during the one-year period beginning on July 4, 2025.

LARGER BUSINESSES

A larger business that deducts current domestic R&E expenditures may reduce taxable income in 2025, but it could also affect other provisions, such as the section 163(j) business interest expense limitation. More specifically, because amortized research costs are added back in the adjusted taxable income (ATI) calculation, but fully expensed costs are not, the choice could influence interest deductibility and overall tax posture.

STATE TAX CONFORMITY

Not all states automatically conform to federal tax changes. Businesses operating in multiple jurisdictions must assess how state-level treatment of research costs may differ from federal rules.

STEPS BUSINESSES SHOULD TAKE NOW

***Model the tax impact of expensing vs. amortization*:** Run multiyear tax projections to compare the effects of full expensing versus continued amortization. Consider how each option interacts with other tax attributes, such as net operating losses and interest limitations. This modeling will help identify how the tax ramifications align with broader business objectives.

***Evaluate the retroactivity election*:** Eligible small businesses should assess whether amending 2022–2024 returns is worth the administrative effort and other consequences. While retroactivity may unlock refunds, it could also require pass-through entities to coordinate with owners on individual return amendments and cash distribution policies.

Prepare for elections and compliance: Whether electing retroactivity or acceleration, businesses must ensure proper documentation and compliance. The IRS is expected to issue guidance on how to make these elections, particularly for taxpayers who have already filed returns for tax years beginning after December 31, 2024, and ending before July 4, 2025.

***Assess state conformity*:** Identify which states conform to the Internal Revenue Code on a rolling basis and which use fixed-date conformity. This will help determine where additional adjustments or disclosures may be required.

LONG-TERM CONSIDERATIONS

***Reassess R&E investment strategy*:** With domestic research costs now fully deductible, businesses may find it more financially attractive to increase investment in innovation or onshore more R&E activities. This could include expanding internal R&E teams, accelerating product development, bringing outsourced research back in-house, or performing R&E in the United States instead of abroad.

***Review accounting method elections*:** Taxpayers may elect to capitalize and amortize domestic research costs over 60 months or use the optional 10-year write-off under section 59(e). These options may be preferable for businesses seeking to smooth taxable income or align deductions with revenue recognition or allow for less interest disallowance.

***Monitor IRS guidance*:** Watch for IRS guidance on the mechanics of elections, treatment of short years, and coordination with other tax provisions.

***Integrate tax planning into business strategy*:** The return to full expensing is not just a tax issue—it's a business opportunity. Companies should integrate tax planning into budgeting, forecasting, and strategic decision-making. This includes evaluating how tax savings from R&E expensing can be reinvested and how they affect valuation in capital raises or acquisitions.

SECTION 163(J) RESTRICTIONS

TCJA PROVISIONS

The TCJA attempted to address the issue of excessive corporate debt by modifying section 163(j). These changes brought section 163(j) more in line with OECD guidance and expanded the application of the limitation to all interest expense, not simply related party interest. Under the TCJA, interest expense deductions are generally limited to the sum of business interest plus 30% of adjusted taxable income (ATI).[11] Any interest disallowed under this section is allowed to be carried forward indefinitely until it can be deducted.[12]

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

11 Floor financing interest is also included in the formula for auto dealerships. IRC § 163(j)(1).

12 IRC § 163(j)(2). Note that in the event of a section 382 ownership change, 163(j) are subject to section 382 limitation, per IRC § 382(d)(3).

increasing $1 million per year, with a $31 million limitation for the 2025 tax year.

Section 2306 of the CARES Act[13] added section 163(j)(10) to increase the ATI limitation from 30% to 50% for taxable years beginning in 2019 and 2020, unless a taxpayer elects out of the change.

For the 2021 tax year, the ATI limitation thus decreased back to the 30% statutory amount. For tax years before 2022, ATI was computed before interest deductions, NOLs and non-business income (essentially EBIDTA). For the 2022 tax year, ATI is computed before interest deductions, NOLs, non-business income, depreciation, amortization and depletion (essentially EBIT).[14]

For example, assume taxable income is $100, interest incurred is $60 and depreciation is $50 both in 2021 and 2022. ATI for 2021 would thus be $100 plus $60 of interest incurred and $50 of depreciation = $210. 30% of $210 would be $63. As such, all interest incurred would be deductible. In 2022, ATI would thus be $100 + $60 = $160. 30% of $120 would be $48. As such, $12 of interest would not be deductible in 2022, and would be carried forward to subsequent years.[15] See schedule below:

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

As more fully articulated in a prior AIRA Journal article, "New Tax Law May Limit Interest Deductions for Distressed Businesses,"[16] distressed businesses experienced disproportionately higher taxes with correspondingly lower cash flows as a result of the section 163(j) adjusted taxable income limitation. The reversion to the 30% limitation, the decrease from EBITDA to EBIT and increasing interest rates resulted in an especially difficult burden for distressed C corporations.

13 Coronavirus Aid, Relief, and Economic Security Act, Public Law 116-136, 134 Stat. 281.
14 IRC § 163(j)(8)(A).
15 IRC § 382(d)(3) provides that section 163(j) carryforwards are treated as pre-change losses for purposes of section 382.
16 New Tax Law May Limit Interest Deductions for Distressed Businesses, Loretta Cross and Jaime Peebles. AIRA Journal Vol. 31 No. 4-2018.

OBBBA PROVISIONS[17]

The OBBBA reinstates a favorable business interest expense limitation. For many companies, the restored ability to add back depreciation, depletion, and amortization (DDA) to the adjusted taxable income (ATI) calculation reopens a crucial deduction that had been significantly curtailed in recent years, particularly as interest rates rose and capital costs increased. This shift could materially improve after-tax cash flow for many companies.

Businesses are advised to model multiyear impacts considering economic changes, refinancing schedules, the ability to electively capitalize research costs, and the delayed effective date of the elective capitalization rules, which begin one year after the computation based on EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) returns.

How the OBBBA changes the business interest expense limitation

The OBBBA's core change to the business interest expense deduction limitation is the reintroduction of the DDA addback to ATI. This adjustment reverses the post-2021 tightening of the interest limitation, which had excluded those non-cash expenses and, as a result, reduced the amount of deductible interest for many businesses.

The restored EBITDA-based approach is particularly beneficial for companies with significant capital investment or amortizable intangibles, as such deductions increase the overall 30% limitation calculation.

The legislation also includes several other technical refinements. It excludes from the ATI calculation certain international tax items, such as:

- Subpart F income
- Net CFC tested income (formerly GILTI, or global intangible low-taxed income)
- The section 78 gross-up
- The portion of the deductions allowed under sections 245A(a)

This provision may impact companies that have made a controlled foreign corporation (CFC) group election to increase their ATI basis under section 163(j).

Importantly, the OBBBA also modifies the treatment of electively capitalized interest. Starting in tax years

17 Adapted from "OBBBA Restores Higher Business Interest Expense Limit: How Businesses Can Benefit," Jul. 14, 2025, https://rsmus.com/insights/services/business-tax/obbba-tax-business-interest-expense.html.

after December 31, 2025, any business interest expense that is electively capitalized to property will retain its character as interest and remain subject to the section 163(j) limitation. This effectively removes a planning tool that some businesses had used to manage taxable income and interest deduction timing.

What the changes to the business interest expense deduction limitation mean for businesses

For many companies, the return to an EBITDA-based limitation will generally increase the amount of deductible interest expense—particularly those with large depreciation or amortization deductions. This is especially relevant for capital-intensive industries and businesses that have recently undergone acquisitions, where goodwill amortization can significantly affect ATI.

However, the loss of elective capitalization as a planning tool may reduce flexibility. Businesses that previously capitalized interest to personal property—especially those without significant capital assets—may find themselves with fewer options to optimize their business interest deduction.

It is also worth noting that the restored DDA addback aligns with the permanent reinstatement of 100% bonus depreciation under the OBBBA (discussed below). Its permanence ensures that businesses will continue to generate substantial depreciation deductions—further enhancing the benefit of the EBITDA-based limitation.

BONUS DEPRECIATION

TCJA PROVISIONS

The TCJA allowed 100% bonus depreciation for qualifying business property acquired and placed in service after September 27, 2017, and before January 1, 2023. During the "phase out" period, bonus deprecation was phased out 20% per year, as follows:

2023	80%
2024	60%
2024	40%
2026	20%
2027 and later	0%

OBBBA PROVISIONS

The OBBBA restores 100% bonus depreciation for property placed in service after January 19, 2025. The OBBBA makes 100% bonus depreciation permanent. The determination of the acquisition date can be complex, and the acquisition date may depend on specific contract language when examining property that is constructed or ordered with a long lead time.

As such, under the TCJA, an asset placed in service on December 31, 2024, would have been eligible for 60% bonus depreciation, while an asset placed in service between January 1, 2025 and January 19, 2025 would only have been eligible for 40% bonus depreciation. However, under the OBBBA, an asset placed in service on January 20, 2025 (or later) would be eligible for 100% bonus depreciation.

A taxpayer may elect out of the additional first year depreciation for the taxable year the property is placed in service. If the election is made, it applies to all qualified property that is in the same class of property and placed in service by the taxpayer in the same taxable year. The election must be made by filing a statement with Form 4562, "Depreciation and Amortization," by the due date, including extensions, of the Federal tax return for the taxable year in which the qualified property is placed in service by the taxpayer. The election out of bonus depreciation is generally irrevocable.

Moreover, a taxpayer can not only elect out of bonus deprecation into MACRS[18] but can also elect on the Form 4562 to utilize the Alternative Deprecation System (ADS)[19]. The ADS generally provides for slower depreciation than MACRS. For most personal property, the ADS election is made for an entire class of property (e.g., all 5-year property placed in service that year). However, for residential rental property and nonresidential real property, the election can be made on a property-by-property basis. The ADS election is irrevocable once made for a property or asset class.

SPECIAL CONSIDERATIONS FOR DISTRESSED COMPANIES

CANCELLATION OF DEBT INCOME GENERALLY

During the COVID pandemic, the Federal Reserve dramatically reduced the federal funds rate[20] and thus greatly decreased the cost of acquiring debt. As a result, companies were able to incur debt at record low interest rates. Many companies and business

18 MACRS is the acronym for the "modified accelerated cost recovery system," per section 168.
19 Note that certain property, such as tangible property used primarily outside of the United States, must use the ADS per section 168(g).
20 The Federal Funds rate went to nearly 0%. For example, the rate was 0.05% in April of 2020. See, https://fred.stlouisfed.org/series/FEDFUNDS.

owners took advantage of these very low interest rates and incurred large amounts of debt. However, many of these loans are now becoming due under typical 5- to 7- year terms. Most companies will not be able to refinance their debt at the same interest rates or perhaps even refinance for the same principal amount.

For distressed companies, lenders may have no recourse except to forgive all or part of the debt, and/or receive equity in partial or whole consideration for the debt.

In general terms, to the extent the debtor's adjusted issue price (AIP) in the debt exceeds the fair market value of the consideration (or issue price in a new debt instrument) received in exchange for debt, such excess results in cancellation of debt income (CODI).

CODI is taxable to the extent a corporation was solvent immediately before the exchange.[21] If a taxpayer is insolvent immediately before a CODI event, they may exclude the COD income, however only to the extent of such insolvency.[22] To the extent a corporation is insolvent immediately before the CODI event, a corporation must reduce its tax attributes, such as net operating losses (NOLs), by the amount of excluded CODI.[23]

APPLICATION OF THE OBBBA TO CODI EXCHANGES

If a corporation is solvent (note that insolvency is assessed at the entity level for C corporations), it may benefit from accelerating unamortized section 174 expenses into 2025 or into both 2025 and 2026.[24] Additionally, electing bonus depreciation in 2025 can further increase deductions for that year. As a result of these strategies, the corporation may generate larger net operating loss (NOL) carryforwards. These NOL carryforwards can then be used to offset or eliminate tax liabilities that arise from a CODI event. In this way, careful tax planning allows solvent corporations to manage the impact of CODI and minimize their federal tax burden (subject to certain limitations).

21 IRC section 61(a)(11).
22 IRC sections 108(a)(1)(B) and (a)(3).
23 The order of attribute reduction is described in section IRC 108(b)(2). While CODI is excluded from taxable income to the extent of insolvency, the loss of tax attributes can result in greater tax liabilities in years after the CODI event as such tax attributes would not be available to offset future taxable income/federal income tax. As such, the taxpayer is provided a "fresh start" to extinguish debt without current federal income tax. However, federal income tax may thus be higher in later years due to the loss of such tax attributes.
24 Qualified small business should also consider whether amending 2022-2024 returns might be a more beneficial alternative based on their specific facts.

When a corporation is insolvent, applying the various options available under the OBBBA becomes increasingly complex. Companies that do not expect to have taxable income typically avoid accelerating deductions, such as bonus depreciation or immediate R&E expense deductions. However, interactions with attribute reduction rules can lead to unexpected outcomes. For instance, when a company reduces the tax basis in assets such as accounts receivable or inventory, it may inadvertently generate taxable income in the same year the debt is discharged, or in the following year. This possibility means that, in some cases, increasing deductions in 2025 could be advantageous. As a result, corporations must perform careful tax planning to determine the optimal strategy for applying the OBBBA provisions and general tax principles.[25]

APPLICATION OF THE OBBBA TO M&A TRANSACTIONS

When a corporation plans to be sold through a stock transaction, sellers usually aim to minimize tax liability in the final seller's tax return. Typically, when a corporation leaves or joins a federal consolidated group, it must file a short period return up to the sale date. Sellers seek to reduce federal income tax to as close to zero as possible without generating an NOL.[26]

Buyers also benefit when deferred tax deductions remain available post-close. If the seller does not fully depreciate or amortize assets before the sale, the buyer can, in certain circumstances, inherit a higher tax basis in those assets. This allows the buyer to claim larger depreciation or amortization deductions after the acquisition. These deductions are generally more valuable than NOL carryforwards, which are often subject to section 382 limitations[27] and a general 80% taxable income limitation for NOLs generated after 2017. Given the options available under the OBBBA, both parties should model various scenarios with the goal of minimizing current federal income tax, without creating a large NOL.

25 While beyond the scope of this article, partnerships may also have CODI concerns and thus may want to similarly consider acceleration of deductions.
26 Note that the final seller's short-period return will generally include transaction expenses (to the extent deductible under general tax rules) such a change of control bonuses, stock option expenses, investment banker and other professional fees.
27 Under complex rules, section 382 imposes a limitation on the use of NOLs to the extent there has been a greater than 50% change in ownership (by value) over a prescribed rolling testing period (which is generally 3 years – or shorter if there has been a prior ownership change in the prior 3 years or if the corporation was not a "loss corporation" as defined in section 382(k)(1). See https://rsmus.com/insights/services/business-tax/a-primer-of-section-382-built-in-gains-and-losses.html.

SUMMARY

For many corporations, the amortization of R&E expenditures over five years, the 30% of EBIT deduction for business interest, as well as the phase out of bonus deprecation collectively resulted in large increases to taxable income during the 2022 - 2024 tax years.[28] Distressed companies found themselves struggling to service debt payments as a result of the increased tax liabilities. As such, the OBBBA changes to R&E deductions, interest deductions, and the availability of full bonus depreciation should offer much needed financial flexibility for distressed companies. For qualified small businesses, a retroactive election to amend 2022 through 2024 tax returns to immediately expense R&E expenses for those years may result in welcome tax refunds.

For distressed companies anticipating COD income, debt-equity exchanges, and/or other M&A activity, careful application of the OBBBA rules may result in much more favorable outcomes than were available during the 2022-2024 TCJA wind down period. However, understanding the potential tax consequences of the various options available under the OBBBA requires careful navigation of these new federal tax rules by skilled tax professionals.

28 In some cases, converting a current year loss into positive taxable income after these large adjustments.

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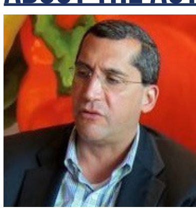

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