AIRA | Association of Insolvency & Restructuring Advisors

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Long-Term Acute Care Hospitals Brace for More Restructurings as New Rules Phase-in

Steven Fleming, CIRA, CDBV, and David Tyburski

What's Inside:

34TH Annual Bankruptcy & Restructuring Conference Recap & Sponsors on p.10

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AGENDA

3:00 – 3:30pm Registration

3:30 – 3:35pm Welcome and Opening Remarks

3:35 – 4:25pm Keynote Presentation:
Kevin Cofsky, Perella Weinberg Partners

4:25 – 4:35pm Break

4:35 – 5:30pm M&A Panel

Moderator:
Dennis Ulak, Huron

Panelists:
Austin Elam, Haynes and Boone, LLP
Marcel Hewamudalige, Evercore

5:30 – 5:40pm Break

5:40 – 6:35pm Restructuring Panel

Moderator:
Larry Manning, FTI Consulting, Inc.

Panelists:
Eli Columbus, Haynes and Boone, LLP
Honorable Marvin Isgur, U.S. Bankruptcy Court, Southern District of Texas
Brett Lowrey, Houlihan Lokey
Becky Roof, CIRA, AlixPartners, LLP

6:35 – 7:45pm Networking Reception

Up to 3 CPE available - more information and registration at www.aira.org

IN THIS EDITION

FROM THE ASSOCIATION

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From the **Executive Director's Desk**

THOMAS MORROW, CIRA
AIRA

Hello AIRA Members:

As this issue goes to press our outgoing President, Joel Waite, has reached the end of his term. I want to thank Joel for his enthusiastic leadership. I am equally looking forward to working with our new President, Kevin Clancy.

I was reviewing files from Grant and came across an article he had written about the CIRA program. It remains a compelling basis for pursuing the CIRA designation. By the way, we just issued the 1800th certificate!

CIRAs: Well Equipped for Economic Crisis

By Grant Newton, CIRA (2009)

Current economic conditions have created great demand for services of financial experts trained in the area of insolvency and restructuring. Rendering financial advisory services in the business turnaround, restructuring and bankruptcy practice areas requires both specialized knowledge and relevant experience.

In 1992, the Association of Insolvency and Restructuring Advisors (AIRA) sought to meet the need for a standard of recognized expertise in this field by establishing the Certified Insolvency and Restructuring Advisor (CIRA) program. The CIRA designation is awarded to financial advisors who have demonstrated a high level of competency through completion of a thorough course of study, rigorous examination and 4,000 hours of relevant experience.

The CIRA Program is comprised of three parts:

- *Part One: "Managing Turnaround and Bankruptcy Cases," covers an introduction to bankruptcy and the process of business turnaround, including financial statement analysis of troubled companies, pre-bankruptcy planning, dealing with creditors and their committees, and special investigations for preferences and fraudulent transfers.*
- *Part Two: "Plan Development," deals with the development of Chapter 11 plans, determination of going-concern and liquidation values, financing turnarounds, plan negotiation, establishment of classes of creditors and shareholders, plan confirmation, and tax issues and impacts.*
- *Part Three: "Accounting, Financial Reporting and Taxes," includes accounting for the operations of the Chapter 11 debtor during bankruptcy, adoption of fresh start accounting, and reporting on emergence from Chapter 11. Also included in part three is a discussion of retention and fees of financial advisors, litigation services guidelines, and tax considerations.*

Over 3,500 people have taken one or more parts of the CIRA exam. AIRA has issued a total of 1,170 CIRA certificates; another 480 individuals have passed all three parts of the exam and are in the process of completing certification requirements. Financial advisory firms with the largest number of CIRAs and candidates who have completed all three parts include FTI Consulting Inc. (83), Alvarez & Marsal LLC (60), AlixPartners, LLP (57), KPMG LLP (34), and Deloitte (30).

A recent recipient of the CIRA certificate stated, "It's worth mentioning what a challenging and positive experience the CIRA program has been for me. I have 'collected' a handful of certifications and found the CIRA — with the exception of the CPA — to be the most difficult. Furthermore, the information and body of knowledge of the CIRA course has proven absolutely relevant to my practice."

AIRA's First Endowment Fund Scholarship

AIRA's Board of Directors established the AIRA Grant Newton Educational Endowment fund to recognize Grant's work to establish AIRA and promote education in this field. Early in 2018, the Board elected to create a scholarship of $2,500 to be awarded annually to an undergraduate accounting student, at Pepperdine University where Grant is Professor Emeritus. The chairman of Seaver College's Business Division, Professor Dean Baim, and the accounting faculty will help select a recipient to receive each scholarship.

At Pepperdine's accounting banquet on March 27, AIRA board member Tom Jeremiassen and Grant Newton awarded AIRA's first scholarship to Matthew Lund, a junior accounting major interested in forensic accounting. Thanking AIRA for the scholarship, Matthew stated "…it's not about the money, it's about the motivation the scholarship instilled in me to keep pursuing my dreams." He says he wants to pay it forward, "…in hopes of inspiring and motivating someone else." Congratulations, Matthew, and best wishes for your future!

A Letter from **AIRA's President**

JOEL WAITE
Young Conaway Stargatt & Taylor LLP

Greetings to all AIRA members and friends:

I enjoyed seeing many of you at the AIRA's 34th Annual Bankruptcy and Restructuring Conference, held at the Loews Vanderbilt Hotel in Nashville from June 13-16. It was the first time we have held our annual conference in Nashville, and based upon the comments we received, Nashville and the conference were a big hit. The conference included a large variety of interesting and timely topics with distinguished and talented groups of panelists, including eight bankruptcy judges. In addition to the panel discussions, the conference also featured three very interesting and prominent keynote speakers. Our preconference lunchtime speaker on Wednesday, June 13th was Keith Hegger, Chief Financial Officer for the Nashville Predators Professional Ice Hockey Team, who talked about some the unique challenges of handling the finances for a professional sports team. On Thursday morning, June 14th, the day started with a keynote address by James W. Bradford, Dean Emeritus of Vanderbilt University's Owen Graduate School of Management, who talked about leadership. And at the Friday luncheon, we were very fortunate to have as our keynote speaker, The Honorable Alberto R. Gonzales, former Attorney General of the United States (2005-2007) and current Dean and Doyle Rogers Distinguished Professor of Law at Belmont University College of Law, who talked about a variety of topics including his time serving as counsel to President George W. Bush, his tenure as U.S. Attorney General and various current topics in the news.

In addition to the educational component of the conference, there were many opportunities to network with fellow restructuring professionals, and have fun experiencing some of what makes Nashville such a great place to visit. Optional excursions on Thursday afternoon included clay shooting, a Nashville food and walking tour, Segway tour of Nashville and a tour of The Hermitage (historical home of President Andrew Jackson). On Friday night, we had a large group go to the famous Wildhorse Saloon for dinner, live music and a little line dancing.

At the awards dinner on Thursday evening, Bob Bingham (Zolfo Cooper) was presented with the Manny Katten Award in recognition of his many years of contribution to the AIRA and our profession. Congratulations, Bob!

I want to thank our three conference Co-chairs – Lawrence R. Ahern III (Brown & Ahern), Robert H. Barnett (Conway MacKenzie) and Jennifer Meyerowitz (GCG); our Judicial Co-chairs Judge Randal S. Mashburn (Bankr. M.D. TN) and Judge Shelley D. Rucker (Bankr. E.D. TN); the entire planning committee and the AIRA staff for all of their hard work and support in planning this year's conference and making it a great success.

The end of the Annual Conference also marked the end of my term as AIRA's President. At the conclusion of the Annual Conference, Kevin Clancey (CohnResnick) became the new AIRA President. I've known Kevin for a long time and am confident he will do a fantastic job as AIRA's President. It was a pleasure to serve as AIRA's President over the past year. I enjoyed having the opportunity to work more closely with AIRA's Board of Directors, executive director Tom Morrow, and our hard-working and talented AIRA staff. I look forward to working with and supporting Kevin in his new role.

I hope everyone has a great summer and I look forward to seeing you soon at a future AIRA event.

Joel A. Waite

Long-Term Acute Care Hospitals Brace for More Restructurings as New Rules Phase-in

STEVEN FLEMING, CIRA, CDBV, and DAVID TYBURSKI
PwC

For years, Long-Term Acute Care Hospitals (LTACHs) have been at the center of a transformation of how healthcare providers care for patients and are reimbursed for services. Now, as new patient care models continue to take hold and regulatory changes are implemented, LTACH operators are bracing for a sector restructuring that may reshape the landscape of post-acute care.

Background

One of the key goals of the Affordable Care Act was to encourage the development of new patient care models that would redistribute risk, reduce cost and enhance quality across the $3.5 trillion healthcare industry in the US.[1,2] Since the ACA was signed into law in 2010 and major provisions phased in through 2014, these new patient care models have driven significant changes to the ways healthcare services are delivered, contracted, reimbursed and coordinated at each stage of the patient care continuum.

A key mechanism to accomplish these changes has been the shift from the predominantly fee-for-service framework to design and implementation of value-based care models. Traditional fee-for-service models are driven by the number and type of procedures performed, whereas value-based care systems incorporate measures of quality of care provided. This change is incentivizing the use of bundled payments, accountable care organizations and utilization of management strategies to transition to comprehensive patient treatments and outcome-based payment arrangements. As a result, providers are reevaluating where, how and by whom clinical services are delivered. This is most evident in the post-acute and long-term acute care sectors.

Post-Acute Care

The post-acute care (PAC) sector includes the following categories, in order of increasing acuity (or intensity) of care provided: home health services, skilled nursing facilities, inpatient rehabilitation facilities and long-term acute care hospitals. In 2016, Medicare's payments for fee-for-service PAC expenditures in these four categories totaled $60.3 billion (Exhibit 1).[3] In general, PAC primarily includes recovery and rehabilitation treatments to patients discharged from short-term acute care hospitals. LTACHs are a category of their own within the sector, in that although they treat patients discharged from short-term acute care hospitals, they themselves also provide acute care treatment.

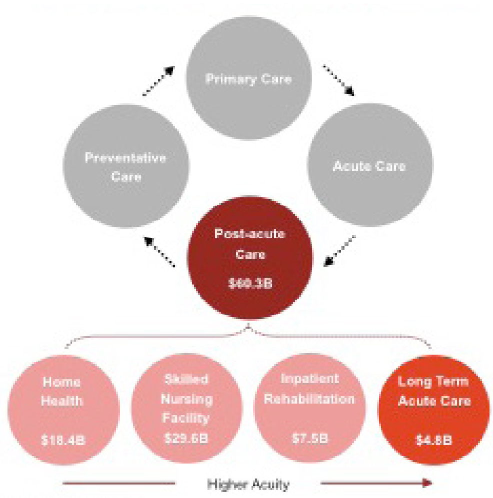
To capitalize on incentives in new payment models, acute care hospitals (ACHs) are seeking better integration with downstream PAC providers to improve coordination across the continuum. Integration has helped providers achieve higher payments through reimbursement bonuses and lower readmissions penalties.

1 Centers for Medicare & Medicaid Services (CMS), *National Health Expenditures 2016 Highlights*, https://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/highlights.pdf (accessed February 12, 2018).

2 Although complete reports on 2017 data for National Health Expenditures (NHE) have not been released as of the date of this publication, projected data for 2017-2026 are available at https://www.cms.gov/research-statistics-data-and-systems/statistics-trends-and-reports/nationalhealthexpenddata/nhe-fact-sheet.html (accessed April 30, 2018).

3 Medicare Payment Advisory Commission (MedPAC), *A Data Book: Health Care Spending and the Medicare Program (June 2017)*, Chart 8-2, http://www.medpac.gov/docs/default-source/data-book/jun17_databookentirereport_sec.pdf?sfvrsn=0 (accessed February 12, 2018).

Exhibit 1: Patient Care Continuum and Medicare's Fee-for-Service PAC Expenditures



Long-Term Acute Care Hospitals

LTACHs treat high acuity patients for relatively extended periods of time. Patient length of stay in LTACHs typically averages greater than 25 days, and many LTACH patients have chronic illnesses that often include pulmonary and respiratory failures requiring mechanical ventilation administered by skilled nursing and clinical staff.[4]

LTACH facilities fall into one of two models: a stand-alone model where patient admissions are sourced from a range of local acute care facilities, or a hospital-in-hospital (HIH) model where the LTACH is co-located within an acute care hospital that is usually the largest source of patient referrals.

More than 40% of the LTACH sector is highly concentrated within two corporates: Kindred Healthcare, Inc. and Select Medical Holdings Corporation own 19% and 24% of the facilities, respectively. Of the remaining 57%, it is estimated that only 12 operators own more than five facilities (Exhibit 2).[5,6,7] The total number of LTACHs remained relatively constant over the years 2009-2016, due in part to a

Exhibit 2: LTACH Facilities as a Percentage of Total

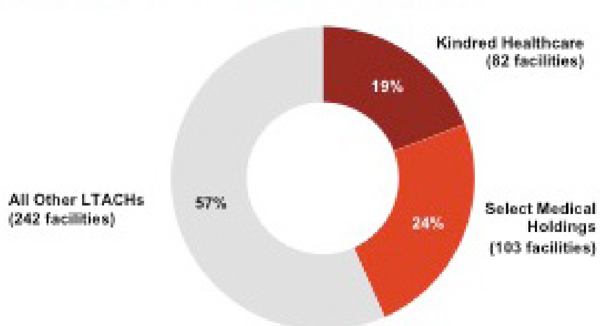
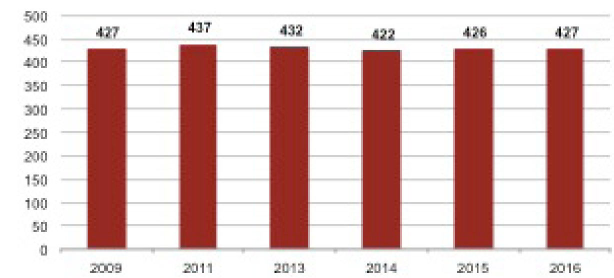


Exhibit 3: Total LTACH Facilities



moratorium on new licenses that ended September 2017 (Exhibit 3).[8]

Regulatory Changes Impacting LTACHs

Specific legislative changes aimed at LTACHs are driving fundamental shifts in reimbursements for LTACH Medicare and Medicaid patients. To qualify for the LTACH Prospective Payment System (PPS) reimbursement rate, an LTACH patient must have spent either (1) three days in an ICU immediately before being admitted to the LTACH, or (2) 96 hours on a ventilator in an LTACH immediately preceded by a short-term acute care stay.[9]

Patients who do not meet the PPS criteria are reimbursed at a lower site-neutral rate. Initially, the site-neutral rate was to be phased-in over a two-year period, but Congress extended the timeline by two years. Now the 100% site-neutral rate will take effect for discharges in cost report years ending after Oct. 1, 2019. During the transition, non-qualifying patients are reimbursed at a blended rate equal to 50% of the site-neutral rate and 50% of the PPS rate. The transition to 100% site-neutral reimbursements will be fully phased-in from October 2019 (for the earliest impacted) through September 2020[10] (Exhibit 4 on next page).

LTACH operators are now navigating the final year of the blended reimbursement for non-qualifying patients. Once the transition to the 100% site-neutral rate is completed in 2019 and 2020, margins will experience additional downward pressure.

Margins in the sector have already declined in recent years from the statutory impacts of budget neutrality and sequestration, which, in part, caused margins to drop from 7.6% in 2012 to 4.6% in 2015 (Exhibit 5 on next page).[11]

In addition to the more stringent patient criteria, several other rule changes are adding challenges and layers of complexity, as shown in Exhibit 6 on p. 21.

Industry Distress and Response

Distress in the sector has already resulted in a number of bankruptcy filings. On June 23, 2017, Acadiana

4 MedPAC, *Data Book*, Charts 8-16 and 8-17.

5 MedPAC, *Data Book*, Chart 8-1.

6 Kindred Healthcare, Inc., *Form 10-K 2016*. Retrieved from SEC EDGAR website, http://www.sec.gov/edgar.shtml

7 Select Medical Holdings Corp., *Form 10-K 2016*. Retrieved from SEC EDGAR website, http://www.sec.gov/edgar.shtml

8 MedPAC, *Data Book*, Chart 8-2.

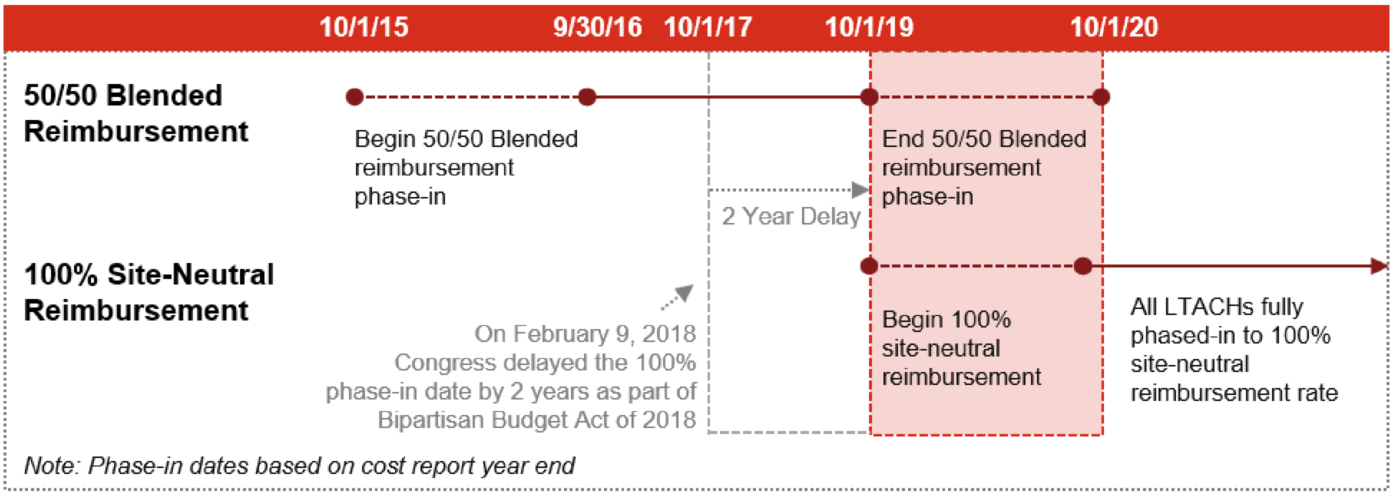
9 Med PAC, *Report to the Congress: Medicare Payment Policy* (March 2018), 304, http://medpac.gov/docs/default-source/reports/mar18_medpac_entirereport_sec.pdf?sfvrsn=0

10 Social Security Act (42 U.S.C. 1395ww(m)(6)(B)(i), as amended by H.R. 1892 ("Bipartisan Budget Act of 2018").

11 MedPAC, *Data Book*, Chart 8-19.

Continued from p.7

Exhibit 4: Transition to 100% Site-Neutral Reimbursement



Management Group (AMG), the Louisiana-based operator of 14 PAC facilities, and 10 of its operating LTACHs filed for Chapter 11 bankruptcy protection.[12] AMG management cited "the effects of the new, more stringent long-term acute care hospital patient criteria, and a severe rate reduction for non-qualifying patients" as key factors that precipitated the Chapter 11 filing.[13] Since filing, AMG has ceased operations at four of its LTACH facilities and is attempting to reorganize around the remaining LTACHs and affiliated PAC facilities.[14]

To avoid similar in-court restructurings, ACHs and LTACHs are pursuing a number of strategies, including:

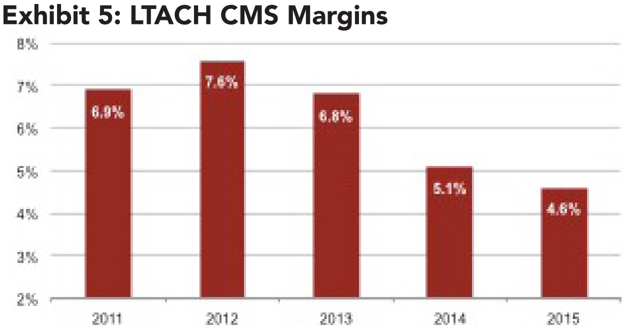
- Realignment—Large hospital networks are realigning their acute care operations with LTACHs through joint ventures or strategic partnerships to better coordinate care across the continuum in an effort to capture payment incentives and minimize penalties.
- Acquisitions—Acute hospitals are acquiring post-acute care facilities, including LTACHs, to build out their treatment capabilities at each phase of the patient care continuum.
- Divestitures—Some participants are pursuing strategic exits of facilities or markets that do not align with the provider's existing care continuum or new patient criteria. Ultimately, some facilities, particularly in rural markets with suboptimal demographics and limited referral sources, will not likely be viable in the new regulatory environment.

As regulatory forces continue to reshape and transform the sector, the resulting disruption will create opportunities for companies that recognize and address gaps in their business models. Some companies are better positioned to navigate these organizational and operational changes. Larger LTACH operators can leverage size and scale advantages that provide access to:

- Investment capital that can facilitate organizational restructurings
- Information systems that analyze and model complex data sets
- Strategic partners to pursue joint ventures or combinations
- Management teams that have the depth and experience to address these challenges

Smaller LTACH operators, i.e., four or fewer facilities, which account for 35% of the market, may not have the same level of internal resources or access to outside investment capital as they navigate these headwinds. As a result, disruption may be concentrated in this segment of the market.

Exhibit 5: LTACH CMS Margins



The material in this article is presented for general information purposes only and should not be used as a substitute for consultation with professional advisors.

12 *In Re: Acadiana Management Group, L.L.C., et al.*, Case No. 17-50799, U.S. Bankruptcy Court, Western District of Louisiana, Lafayette Division.
13 *Ibid.*, Declaration in Support of First Day Motions, filed June 23, 2017, Doc. No. 12.
14 *Ibid.*, Chapter 11 Plan of Reorganization for Acadiana Management Group, LLC, et al., filed November 17, 2017, Doc. No. 477.

Exhibit 6: Additional Rule Changes

Rule / Regulation*	Description
Patient Criteria & Site-Neutral Reimbursement Rate	<u>Patient Criteria:</u> • 3 days of ICU immediately prior to being admitted to an LTACH, or • 96 hours on a ventilator in an LTACH and STACH stay immediately prior to being admitted to an LTACH <u>Site-Neutral Reimbursement Rate:</u> • 2 year phase-in of site-neutral rate • During phase-in site-neutral cases are reimbursed at 50/50 blend of site-neutral and IPPS rate
25% Rule	• Payment adjustments to penalize LTACHs that admit > 25% of patients from a single ACH • Full implementation delayed; Most HIHs and satellites will be paid standard LTACH rates for eligible patients as long as the share of Medicare admissions from the host hospital does not exceed 50%
Moratorium	• Prohibits, with certain exceptions, new LTACHs or new satellites of existing LTACHs • Also prohibits an increase in the number of an LTACH certified beds (effective 4/1/14 to 9/30/17)
50% Compliance Test	• For cost reporting periods starting on or after October 1, 2019, an LTACH must have no more than 50 percent of its cases paid at the site-neutral rate to receive the LTACH payment rate for eligible cases

*Source: CMS, Federal Register 42 CFR § 412.522

ABOUT THE AUTHORS

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Steve is a Principal in the New York office of PwC's Business Recovery Services practice (BRS). He has 20+ years of business advisory experience with PwC, during which he has played leading roles in the firm's London, New York and Dubai offices, giving him a unique global perspective on transaction advisory. Steve has provided financial advisory services to many local and international clients, spanning the whole deal spectrum from devising acquisition/disposal strategies to performing valuations and due diligence, business reviews, and negotiating with potential investors. He has extensive experience assisting distressed companies, has served as Chief Restructuring Officer ("CRO") in Chapter 11 cases, and is qualified as an expert witness with respect to Valuation, DIP financing, §363 transactions and other bankruptcy related matters.

David Tyburski

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David is a Director in the New York office of PwC's Business Recovery Services practice (BRS) where he specializes in developing and executing turnaround plans for underperforming and distressed companies. He advises a variety of stakeholders including companies, lenders and other creditor constituencies through both formal insolvency proceedings as well as out of court restructurings. David's deal experience covers a broad range of industries where he takes a hands-on approach to business plan development, working capital management and balance sheet restructurings with a keen focus on delivering successful outcomes for his clients. His experience also includes complex cross border restructurings and distressed M&A transactions across North and South America, Europe and Asia.

EMMANUEL M. KATTEN AWARD

Congratulations to Robert S. Bingham!

Zolfo Cooper's Senior Director Robert Bingham, CIRA, was awarded AIRA's 2018 "Manny Katten" Award, honoring his "outstanding leadership, dedication and service to the bankruptcy, restructuring and turnaround field." The June 14 awards ceremony took place at AIRA's Annual Bankruptcy Conference and was also attended by Zolfo Cooper Senior Managing Director Scott Winn and Director Denise Lorenzo, CIRA.

Bob's involvement with the AIRA spans more than 15 years. His firm, Zolfo Cooper, has shown tremendous support for the CIRA program, sponsoring the CIRA Medals for candidates with the highest composite exam scores each year. In 2003, Bob even earned the Gold Medal himself in recognition for that year's highest score. He also taught CIRA certification classes for many years, with former AIRA executive director Grant Newton, and served on AIRA's board of directors for 12 years. As a member and director, Bob has made significant contributions to the direction of AIRA and was always willing to put in significant time and resources on Association projects. AIRA misses Bob's presence on the board, but we wish him and his wife the very best in their retirement in Colorado.

AC18 ZOLFO COOPER AWARDS

Medals for the Zolfo Cooper Awards and Certificates of Distinguished Performance were conferred upon candidates who earned the top composite scores for all three parts of the CIRA exam completed by end of the previous year.

GOLD MEDAL: Bruce Buchanan, CIRA

Bruce was just named Head of Restructuring and Special Situations at Oppenheimer & Co.Prior to Oppenheimer & Co., he was leading PwC's Debt Capital Advisory practice. Bruce and holds an M.B.A. in Finance from New York University and the FINRA Series 24 (Principal) securities license.

SILVER MEDAL: Daniel Demko

Daniel was unable to attend the Awards Banquet – but he had good reason: he was getting married! Daniel is a Manager in Ernst & Young's Chicago office.

BRONZE MEDAL: Colm Hannon

Colm is a Managing Director in EY's Restructuring Advisory practice, based in the Chicago office.He received a BA degree from Trinity College in Dublin, Ireland, his home town. He moved to Chicago from Dublin almost five years ago.

Certificates of Distinguished Performance

James Depfer III, CIRA

James received his CIRA certificate at the banquet as well as the Certificate of Distinguished Performance. He is a Manager with Deloitte Transactions and Business Analytics in Arlington, VA. He received a B.S. in Finance and Economics from the University of Delaware as well as M.S. in Finance.

Amer Rehman, CIRA

Amer has two decades of corporate finance and strategy experience advising and investing in distressed companies. He began his career in investment banking at Credit Suisse and most recently was a Director in PwC's restructuring practice. He received a BA, with distinction, from Yale University.

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Zolfo Cooper is the world's preeminent financial advisory and interim management firm, dedicated to providing restructuring leadership to companies and their stakeholders. For over 30 years, Zolfo Cooper professionals have helped clients resolve their most complex, high-stakes business problems. Whether stepping in as interim management, advising a company's lenders, leading a restructuring or identifying risks arising from disputes, Zolfo Cooper delivers results—from maximizing value to enhancing a company's long-term competitive advantage. With offices and affiliations in the world's leading financial centers, Zolfo Cooper assists clients spanning the middle-market to the largest and most complex cross-border situations.

Conway MacKenzie is a global management consulting and financial advisory firm with expertise in financial and operational restructurings, valuation and opinion services, transaction services, investment banking, case management, and litigation support services. Serving clients in both the private and public sectors, our Firm focuses on delivering value in a changing landscape. Linking business plans to operating performance, financial results, and investor expectations, we help ensure today's performance correlates to tomorrow's returns. The Firm has over 100 professionals with a nationalfootprint of 11 offices across the United States.

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

The Deal ranks Duane Morris as among the most active bankruptcy practices in the United States. No firm handled more cases with $25M+ in liabilities in the first half of 2017 than Duane Morris. Not every financially troubled company needs bankruptcy protection. Not every insolvent business needs to shut its doors. At Duane Morris, we work with each client to determine the best strategy for deriving maximum value from a troubled company for the benefit of the debtor and its creditor constituencies.

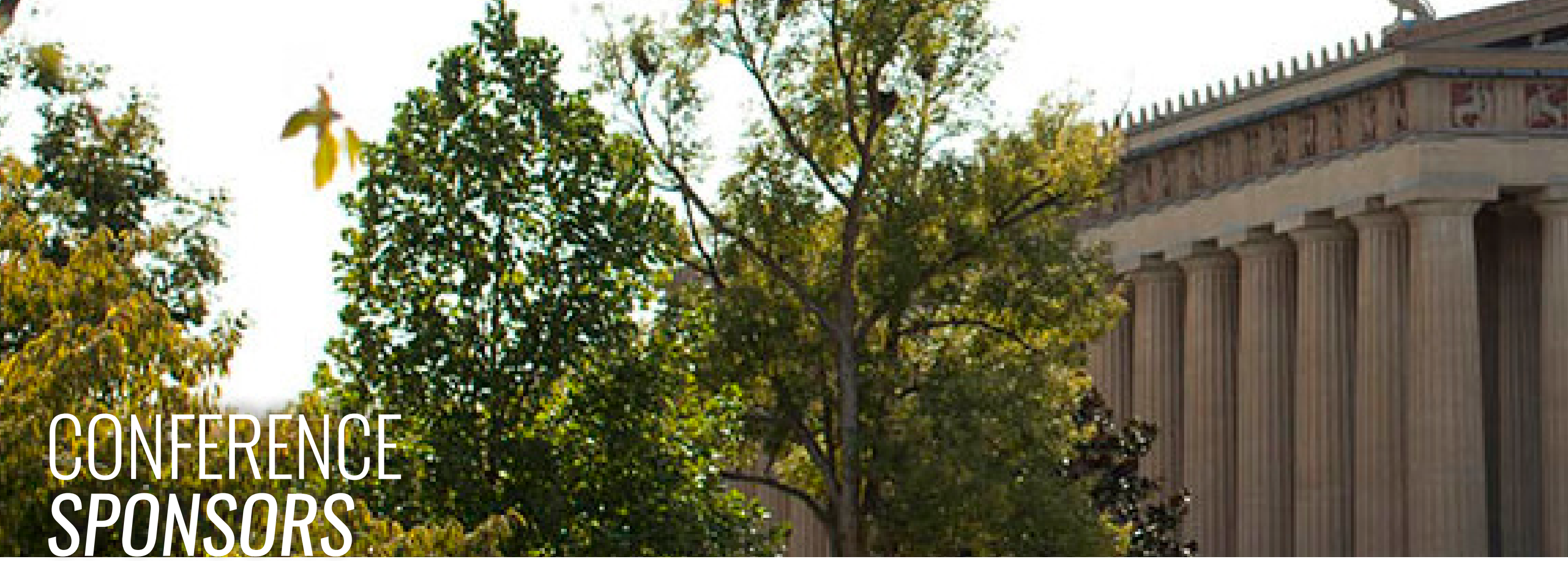
FTI Consulting, Inc, Inc. is a global business advisory firm dedicated to helping organizations protect and enhance enterprise value in an increasingly complex legal, regulatory and economic environment. The Corporate Finance/Restructuring practice at FTI Consulting, Inc. has 700+ professionals situated around the world, who focus on strategic, operational, financial and capital needs of businesses. As the #1 provider of crisis management services, our experts address the full spectrum of financial and transactional challenges faced by companies, boards, private equity sponsors, creditors and other stakeholders, whenever and wherever. Results oriented: Our success depends upon achieving optimal outcomes for our clients.

GCG provides a fully integrated, multidisciplinary approach when addressing all aspects of a bankruptcy administration.With best-in-class technology, industry experts, and cost-effective programs, we take a swift and proactive approach to address any hurdles that might arise. GCG's considerable experience managing the administration of bankruptcy cases in all chapters, out-of-court exchange offers, solicitations, and rights offerings, makes us an ideal partner for any administration. In acknowledgement ofour experience and qualifications, M&A Advisor awarded GCG the Restructuring Deal of the Year for the chapter 11 reorganization of Samson Resources and the Information Management Product of the Year for 2017.

Protiviti is a global consulting firm that helps companies solve problems in finance, operations, risk, technology, and governance. Our Restructuring &Litigation Services Practice specializes in providing restructuring, insolvency and crisis management services, litigation consulting, and forensic accounting. Our professionals have extensive experience and knowledge in developing and implementing successful plans of reorganization, vendor and stakeholder negotiations, liquidating estate assets, and providing a full range of valuation services and expert testimony. We represent debtors, committees of unsecured creditors, secured lenders, fiduciaries and other interested parties. Protiviti, which employs 3,300 professionals in more than 70 offices in over 20 countries, is a wholly owned subsidiary of Robert Half International Inc.

PwC's crisis and restructuring professionals advise on solutions for a range of needs. We work with companies to evaluate strategic and financial alternatives and assist with corporate reorganizations, evaluating liquidity positions and advising on operating efficiency and margin enhancement. We help organizations execute the quick, decisive action necessary to pivot them towards a stronger future.

The Bankruptcy and Corporate Restructuring Section of Young Conaway Stargatt & Taylor, LLP brings a depth of legal knowledge, technological skill, and creativity to complex and fast-paced reorganizations, restructurings, liquidations, and distressed acquisitions and sales. Our 35 bankruptcy attorneys have been able to achieve optimal results in a wide array of industries. Publications such as U.S. News and World Report and Chambers USA continue to rank Young Conaway as one of the nation's preeminent insolvency practices. Young Conaway's bankruptcy and corporate restructuring attorneys represent clients' interests in Delaware, the Southern District of New York, as well as other bankruptcy courts throughout the United States.



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ArentFox LLP, founded in 1942, is internationally recognized in core practice areas where business and government intersect. As a result of guiding principles centered on first-rate legal work and exceptional service, the firm has earned its reputation for providing clients with the counsel they need to meet critical challenges in their "world." Complex problems require interdisciplinary solutions and should be approached with a practical perspective and managed with maximum efficiency. With offices in Los Angeles, New York, San Francisco, and Washington, DC, Arent Fox provides strategic legal counsel to clients that range from Fortune 500 corporations and start-ups, to trade associations and foreign governments.

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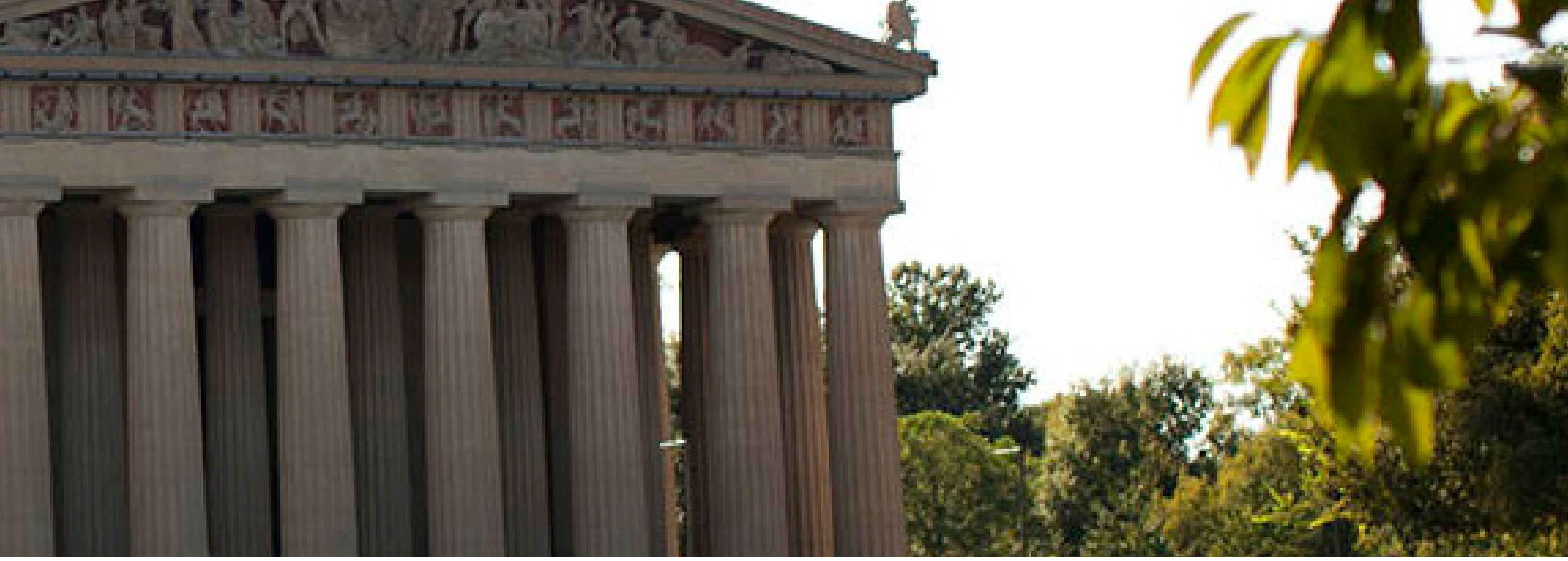

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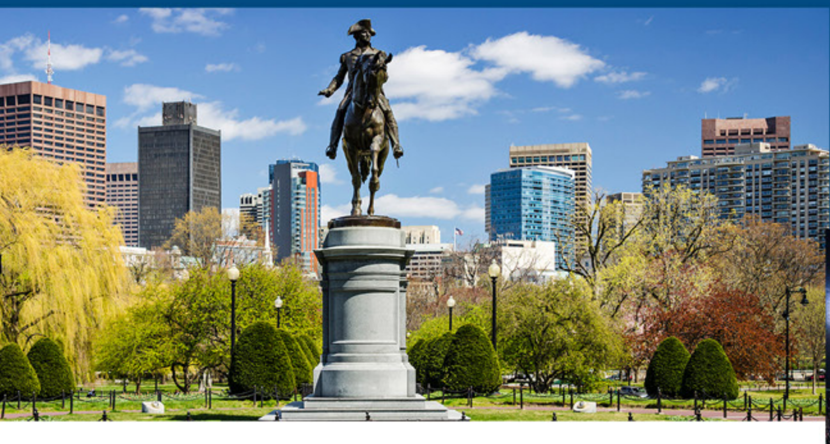

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Recent Developments in the War on Cryptocurrency Fraud[1]

KEVIN B. DUFF, *Rachlis Duff Adler Peel & Kaplan, LLC*
S. GREGORY HAYS, CIRA, *Hays Financial Consulting LLC*

Fanaticism over cryptocurrencies may have reached a crescendo in January 2018 as Bitcoin's price spiked to nearly $20,000 per bitcoin. While Bitcoin's current price is now less than half what it was only a few months ago, interest in the esoteric currency has not faded. In fact, some reports have suggested an appetite in the marketplace for Bitcoin to replace gold as an investors' choice.[2]

However, while some see cryptocurrencies as a burgeoning area for investment and financial utility,[3] many virtual currencies remain stippled by fraud. In a recent decision involving alleged cryptocurrency fraud, the court observed that "[t]he rise in users and value of virtual currencies has been accompanied by increased fraud and criminal activity."[4] One estimate pegged the *daily* loss from cryptocurrency fraud at $9 million.[5] A recent study by Satis Group suggested most digital coin offerings are scams,[6] finding that as many as 81% of recent ICOs were scams.[7] But the news may be even worse for investors: following an analysis of the ICO industry, Satis Group reported only 3.7% of ICOs over $50 million were considered to be either successful or promising.[8]

Regulatory Enforcement Is Rising

Although the regulatory regime for cryptocurrencies remains nascent[9] and uniformity is lacking as to the nature of cryptocurrencies for regulatory purposes,[10] regulators have become increasingly active in enforcement actions. Last fall, the Securities and Exchange Commission (SEC) created a Cyber Unit to target cyber-related misconduct and fraud.[11] The SEC also issued trading suspensions on the common stock of a handful of issuers (including First Bitcoin Capital Corp., CIAO Group, Strategic Global, and Sunshine Capital) who publicized their investments in ICOs or actions they had undertaken with respect to cryptocurrencies.[12]

In January 2018, the respective enforcement directors of the SEC and the Commodity Futures Trading Commission (CFTC) issued a joint statement about their enforcement efforts in cryptocurrency markets:

> When market participants engage in fraud under the guise of offering digital instruments – whether characterized as virtual currencies, coins, tokens, or the like – the SEC and the CFTC will look beyond form, examine the substance of the activity and prosecute violations of the federal securities and commodities laws. The Divisions of Enforcement for the SEC and CFTC will continue to address violations and bring actions to stop and prevent fraud in the offer and sale of digital instruments.[13]

Shortly thereafter, the Chairmen of the SEC and CFTC co-authored an op-ed, published in *The Wall Street Journal*, which made clear that both regulators are "looking at cryptocurrencies."[14]

In February 2018, in a move seen as a harbinger of future enforcement efforts, the SEC issued subpoenas to about 80 cryptocurrency companies.[15] Eaglesham and Vigna reported "[t]he sweeping probe significantly ratchets up the regulatory pressure on the multibillion-dollar U.S. market for raising funds in cryptocurrencies."[16] This activity is being coordinated with the SEC Enforcement Division's Cyber Unit, created in 2017, and the investigation is expected to continue throughout 2018.[17,18] Recent reports that the SEC is working on dozens of crypto cases continue to confirm that, as many industry pundits have predicted, 2018 will be a busy year for enforcement actions.[19]

The following are among enforcement actions seen thus far in 2018.

SEC v. AriseBank

In January 2018, the SEC filed an enforcement action against AriseBank and its principals, Jared Rice and Stanley Ford, alleging that AriseBank undertook a fraudulent and unregistered ICO that claimed to have raised $600 million from investors in just two months.[20] AriseBank purportedly sought to become the world's first 'decentralized' bank, from which its customers could receive traditional banking products and services in connection with more than 700 cryptocurrencies. AriseBank planned to raise $1 billion in capital through sales of its AriseCoin.[21] The SEC called it, "an outright scam."[22]

The court appointed Mark Rasmussen as the federal equity receiver, representing the first time SEC has requested appointment of receiver in an ICO case. After appointment, the receiver announced recovery of virtual currencies held by AriseBank, including Bitcoin, Litecoin, Bitshares, Dogecoin and BitUSD, as well as a plan to hold those cryptocurrencies within the receivership estate pending a recommendation to the court as part of the receiver's liquidation plan.[23]

CFTC v. My Big Coin Pay

Also in January 2018, the CFTC brought an action for fraud and misappropriation of $6 million related to a solicitation for a cryptocurrency known as "My Big Coin."[24] The action named as defendants Randall Crater, Mark Gillespie, and My Big Coin Pay, Inc.[25] The CFTC's Director of Enforcement, James McDonald, stated this action shows:CFTC is actively policing the virtual currency markets and will vigorously enforce the anti-fraud provisions of the Commodity Exchange Act. In addition to harming customers, fraud in connection with virtual currencies inhibits potentially market-enhancing developments in this area. We caution potential virtual currency customers, once again, that they should engage in appropriate diligence before purchasing virtual currencies.[26]

SEC v. Sharma

In April 2018, the SEC filed an action alleging co-founders of Centra Tech perpetrated a fraudulent ICO that raised over $32 million from investors in its "CTR Tokens," on the premise that Centra planned to create a cryptocurrency debit card that would have relationships with major credit card issuers.[27] Centra's ICO was backed by several celebrity endorsers including boxer Floyd Mayweather and DJ Khaled.[28] Centra's "white paper" also included fictitious executives with impressive biographies.[29] On April 20, 2018, it was reported that another co-founder of Centra, Ray Trapani, has been charged with securities fraud, wire fraud, and conspiracy.[30] The SEC's amended complaint describes Trapani as a mastermind of Centra's fraudulent ICO.[31] On May 14, 2018, a federal grand jury returned indictments for Trapani and co-founders Sohrab Sharma, and Robert Farkas.[32]

SEC v. Longfin

In April 2018, in *SEC v. Longfin Corp.*, the SEC successfully obtained a court order freezing $27 million in trading proceeds from allegedly illegal distributions and sale of restricted company shares.[33] Shortly after it became registered on NASDAQ, Longfin announced its acquisition of a cryptocurrency business after which its stock price soared and its market cap surpassed $3 billion.[34] Some have observed that the SEC's action in *Longfin* is indicative of "the SEC's heightened and aggressive focus in this area."[35] Most recently, however, the court lifted the temporary restraining order against the company and its principal, but the case remains pending.[36]

CFTC v. Kantor

On April 16, 2018, the CFTC filed an action in the U.S. District Court for the Eastern District of New York charging Defendants Blake Harrison Kantor (aka Bill Gordon), Nathan Mullins, Blue Bit Banc (UK-based), Blue Bit Analytics, Ltd. (Turks and Caicos-based), Mercury Cove, Inc., and G. Thomas Client Services with running a fraudulent binary options scheme involving a cryptocurrency, "ATM Coin."[37] The Complaint alleges that over a four-year period, the Defendants defrauded over 700 investors into purchasing illegal off-exchange binary options. It also alleges they attempted to conceal their scheme by inviting customers to transfer account balances into ATM Coin,[38] and misled customers into believing their digital coin holdings had substantial value.[39] The U.S. Attorney has filed a parallel criminal action (*United States v. Kantor*, Case No. 18 CR

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177 (E.D.N.Y.)) charging Kantor with fraudulent conduct, including the conduct that is the subject of the CFTC's action.[40]

The CFTC's Director of Enforcement, James McDonald, described the *Kantor* action as an indication that "the CFTC is continuing its efforts to root out fraud in our markets," including fraudulent schemes stretched across multiple markets and including virtual currencies.[41]

FTC v. Dluca

In an enforcement action of its own, the Federal Trade Commission recently took action to shut down and freeze the assets of My7Network and Bitcoin Funding Team, along with their individual defendants, as promoters of referral investment schemes in Florida.[42] The defendants, including Thomas Dluca, Louis Gatto, and Eric Pinkston, allegedly promoted deceptive chain referral schemes involving cryptocurrencies.[43] These schemes falsely promised that participants could earn large returns by paying cryptocurrency such as bitcoin or Litecoin to enroll in the schemes.[44] By its structure, the defendants' fraud took the form of a classic pyramid scheme. Tom Pahl, Acting Director of the FTC's Bureau of Consumer Protection, stated, "[t]his case shows that scammers always find new ways to market old schemes, which is why the FTC will remain vigilant regardless of the platform – or currency used. … The schemes the defendants promoted were designed to enrich those at the top at the expense of everyone else."[45]

SEC's Section 21(a) Report on The DAO

In July 2017, the SEC issued guidance on its view of ICOs as securities in a Section 21(a) Report of Investigation regarding the digital token sale by The DAO (an acronym for Decentralized Autonomous Organization).[46] In short the Report makes clear the SEC views ICOs as securities offerings, irrespective of whether the issuer's stock is promoted as a digital token.[47] SEC Chairman Jay Clayton has repeatedly stated that "merely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security."[48]

CFTC v. McDonnell

A recent ruling in *CFTC v. McDonnell* has buttressed the CFTC's efforts to bring enforcement actions relating to cryptocurrencies.[49] Hon. Jack Weinstein of the U.S. District Court for the Eastern District of New York found that the "CFTC has standing to exercise its enforcement power over fraud related to virtual currencies sold in interstate commerce."[50] In reaching this conclusion – consistent with the CFTC's administrative order from the administrative proceeding, *In the Matter of: Coinflip, Inc.*, CFTC Docket No. 15-29 ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.") – the *McDonnell* court found that "[a] 'commodity' encompasses virtual currency both in economic function and in the language of the statute."[51] The court also found that the "CFTC's broad authority extends to fraud or manipulation in derivatives markets and underlying spot markets."[52]

SEC v. Zaslavskiy

Relatedly, in *SEC v. Zaslavskiy*, an action initiated in 2017 by the SEC and also pending in the Eastern District of New York, Hon. Raymond J. Dearie is (at the time this article went to press) considering whether an allegedly fraudulent ICO involving "REcoin" – touted by defendant Maksim Zaslavskiy as "The First Ever Cryptocurrency Backed by Real Estate" – is a security subject to SEC regulation.[53]

Consumer Financial Protection Bureau – Consumer Advisories

Although not presently active in the area of enforcement, the Consumer Financial Protection Bureau long ago weighed in on the risks to consumers about Bitcoin. In 2014, CFPB Director Richard Cordray warned consumers to be cautious in relation to virtual currencies: "Virtual currencies are not backed by any government or central bank, and at this point consumers are stepping into the Wild West when they engage the market."[54]

Chief among potential issues with virtual currencies, the CFPB identified, "unclear costs, volatile exchange rates, the threat of hacking and scams, and that companies may not offer help or refunds for lost or stolen funds."[55] More information is available to consumers in the CFPB's August 2014 Consumer Advisory, "Risks to consumers posed by virtual currencies."[56] The CFPB allows "consumers who encounter a problem with virtual currency products and services – including exchange services or online digital wallets – [to] submit a complaint with the CFPB."[57]

Internal Revenue Service – Investigations and Tax Matters

The IRS is actively investigating and pursuing possible income taxes and penalties against certain cryptocurrency investors.[58] Gains in cryptocurrencies are taxable events and the IRS has indicated that very few investors have reported any Bitcoin profits. The IRS has subpoenaed trading accounts from one exchange and is pursuing capital gains taxes. As Baldwin summarizes in a recent Forbes article, "The IRS wants a share of the billions made last year. This is going to get ugly."[59]

Furthermore, the Tax Cuts and Jobs Act eliminated an exemption for like-kind exchanges, meaning all crypto transactions are now a taxable event and investors could have thousands more transactions to report. It is notable that a 2017 IRS report indicated only 802 customers of Coinbase (an exchange) reported Bitcoin-related activity in 2015; and in February 2018, Credit Karma found only 100 reports of cryptocurrency transactions in a sample of 250,000 returns.[60] While some investors may believe they can remain "anonymous" and have no need to report such transactions, the IRS is likely to pursue taxes and assess penalties that can range from 20% to 50% of any income generated from cryptocurrency transactions. Last year, the IRS subpoenaed records for transactions from 2013 to 2015 for 14,000 customers with more than $20,000 in virtual currencies.[61] At today's prices, this suggests the IRS is pursuing investors who have only about 2.5 Bitcoins.

San Francisco tax attorney Robert W. Wood recently suggested that Bitcoin owners who want to clear up past transgressions should report foreign Bitcoin accounts, using the IRS's amnesty program for foreign bank accounts. Wood asserts, "With extensive data swapping deals between the IRS, foreign governments and foreign banks, almost no offshore account is secret anymore."[62] There are signs the IRS is likely to take more aggressive action in 2018 on taxable income associated with cryptocurrencies. Investors who used Bitcoins to invest in ICOs might be in for a rude awakening if their transaction is taxed at the Bitcoin price as of the time of the exchange. If this occurs, investors may be taxed at the conversion price, and even if the ICO tanks may still owe capital gains taxes on the price of Bitcoin at conversion. In this scenario, capital losses may only be carried forward but the investor may owe taxes now.

On February 8, 2018, the IRS announced formation of a new task force of international crime investigators; in addition, the IRS is also deploying new software to identify crypto tax cheats. Given so much extra attention from the IRS, investors may realize they need to properly report dealings in virtual currencies.[63] With all crypto transactions stored on digital ledgers, the transaction data exists – the IRS just needs to determine which taxpayer owns the digital keys.

International Regulation and Enforcement Actions

It is noteworthy that other countries are also wrestling with cryptocurrencies and how to regulate them.[64] The Managing Director of the International Monetary Fund, Christine Lagarde, has stated that international regulation of cryptocurrencies is "inevitable."[65] Below are a few examples of international developments in this area.

Canada

Like its neighbor to the South, Canadian authorities are stepping up their actions against virtual currency fraud.[66] During recent parliamentary hearings, the Canadian government has been "looking at updating its laws around cryptocurrencies, money laundering, and terrorist financing."[67] But cryptocurrency fraud is having an effect even at the local level. For example, in Vancouver, British Columbia, from 2016 to 2017 there was "a 350% increase in filings related to cryptocurrency "and as of January 2018 the responsible agency projects "a potential for 800 cases by the end of year — a 300% increase over 2017."[68] While enforcement against fraud may be increasing, regulation may not be keeping pace. Some concern has been expressed, however, that over-regulating virtual currencies may stifle innovation.[69]

China

According to a February 2018 article by Andrew Nelson:

> China has been taking ever-increasing actions to clamp down on all things cryptocurrency. Starting off by banning ICOs, China ordered a bank account freeze associated with exchanges, kicked out bitcoin miners, and instituted a nationwide ban on internet and mobile access to all things related to cryptocurrency trading. The People's Republic of China appears to be the most stringent cryptocurrency regulator of the major economies regarding cryptocurrencies. This is an odd about-face given that, in 2017, Chinese bitcoin miners made up over 50 percent of the worldwide mining population and that cryptocurrency adoption in China increased at a rate higher than any other country.[70]

Recently, China's Central Bank signaled that China may follow global cryptocurrency regulations. It offered support for a global regulatory framework, suggesting that a lack of a coordinated international regulatory environment "leads to a regulatory vacuum."[71] Chinese authorities also recently shut down a crypto-based Ponzi scheme valued around $13 million from 13,000 investors.[72]

India

With regard to the crypto landscape in India, Nelson states:

> India, once viewed as a burgeoning, friendly environment for cryptocurrencies, has been clamping down on cryptocurrencies in 2018. India's tough stance stems from similar concerns that other, more stringent regulatory regimes have cited: money laundering, illegal activity proliferation, sponsorship of terrorism, tax evasion, etc. While the cash-reliant country is facing stern regulations, participants of the local cryptocurrency industry do not believe India can "ban" cryptocurrencies through regulations in the same way China has.[73]

Russia

Russia has in the past been critical of cryptocurrencies, but more recently announced plans to launch its own "CryptoRuble" in an effort to dodge economic sanctions from the West.[74] Unsurprisingly, this plan is not without its detractors.[75]

Small Countries with Noteworthy Developments

Located at the crossroads of Eastern Europe and Western Asia, Georgia has positioned itself as the world's second most prolific miner of cryptocurrencies behind China.[76]

Vietnamese Prime Minister Nguyen Xuan Phuc recently issued a directive calling for his country's government and financial bodies to strengthen "management of activities related to Bitcoin and other cryptocurrencies." This action followed allegations that Vietnam-based Modern Tech

Continued from p.25

defrauded 32,000 investors in a scam estimated to be the equivalent of USD $658 million in an ICO involving sales of Ifan and Pincoin, two ECR-20 tokens.[77]

The smallest EU member is making big waves with this news: "[t]wo of the world's largest cryptocurrency exchanges plan to make the tiny European nation of Malta a central hub of their operations, and analysts say others are sure to follow."[78]

Conclusion

Recent enforcement actions reflect increasingly active regulatory scrutiny surrounding cryptocurrencies. Such scrutiny should reduce fraud, result in greater market confidence, and lend legitimacy to cryptocurrency transactions. There is a long road ahead to achieve those important goals and along the way, there will continue to be fraud and enforcement actions striving to reveal fraud and punish wrongdoers. But the extraordinary market capitalization of cryptocurrencies, even considering the downturn of the past few months, signals that cryptocurrencies are here to stay.

This article has been prepared for informational purposes. It highlights and illustrates certain legal information, but the information is not intended as and should not be construed to be legal, investment, or tax advice. Your receipt or transmission of the information herein does not create an attorney-client or other professional relationship and cannot substitute for obtaining legal advice from an attorney licensed in your state or from another professional. You should not act on this information without seeking professional counsel. Although the authors and this publication intend to provide up-to-date legal information, the information contained in this article may not reflect the most current legal developments.

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New Tax Law May Limit Interest Deductions for Distressed Businesses

On December 22, 2017, President Trump signed into law H.R. 1, referred to as The Tax Cuts and Jobs Act ("TCJA" or "the Act") effecting the most significant U.S. tax changes in more than 30 years.[1] Due to provisions in the new Act, highly leveraged companies with over $25 million in revenue and poor profit margins need to be aware they may not be able to deduct the full amount of their interest expense in 2018 and subsequent years. This has potentially significant impacts of concern to many business entities and their advisors, as well as parties in interest to potential restructurings and distressed transactions.

Under Section 13301 of the Tax Cuts and Jobs Act, the interest expense deductions of any business will be subject to a "Ceiling Test," unless the business falls under the "Exemption for Certain Small Businesses." The **Ceiling Test** limits the interest expense deduction of nonexempt businesses to the sum of the following items: 1) business interest income, 2) 30% of adjusted taxable income, which approximates earnings before interest, taxes, depreciation, and amortization (EBITDA), and 3) floor plan financing interest. For any taxable year beginning after December 31, 2021, adjusted taxable income will include any allowable deduction for depreciation, depletion, and amortization. Thus, in four years, adjusted taxable income will essentially be equal to earnings before interest and taxes (EBIT), making a business's adjusted taxable income relatively higher for 2021 and later years.

This new limitation, determined by the Ceiling Test, replaces Section 163(j) of the Tax Code prior to the 2018 changes. Section 163(j) similarly provided a limitation on interest expense deductions, but it mostly applied to interest paid on loans to relatives or controlled entities (more than 50%). Therefore, the impact of the old limitation was relatively insignificant and unsubstantial when compared with the new limitation's impact on distressed businesses.

The Ceiling Test does not, however, apply to all companies. The **Exemption for Certain Small Businesses** provides that any business that qualifies under the "Gross Receipts Test" of Section 448(c) is exempt from the Ceiling Test. A business meets the requirements of the **Gross Receipts Test** (which is amended by Section 13101 of The Tax Cuts and Jobs Act) if the company's average annual gross receipts during the last three taxable-year periods does not exceed $25 million. If the business has not existed for three or more years, the interest expense deduction would simply be the average annual gross receipts over the year(s) the business has existed. Thus, any business that does not earn more than $25 million (on average) can deduct all of its interest expense each year.

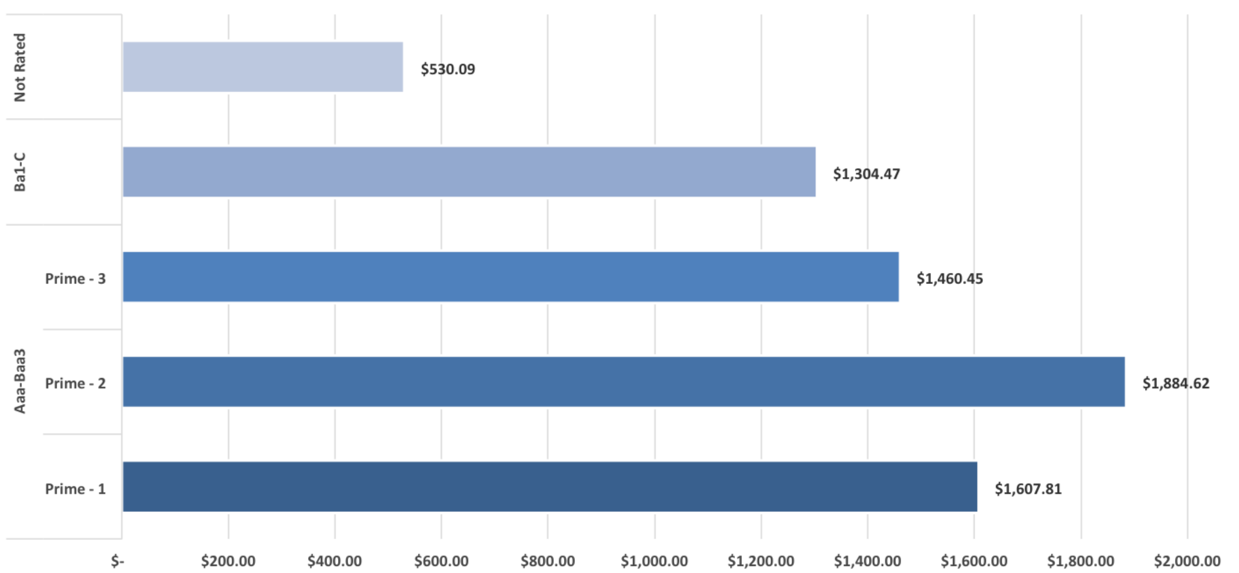
Nevertheless, the Exemption for Certain Small Businesses only applies to just that – certain small businesses – leaving those highly leveraged companies with over $25 million in revenue subject to the new Ceiling Test and unable to include full interest expenses on their tax returns. This is significant because before the Act, very few distressed companies paid income taxes. As the new tax provisions are implemented, it is important to examine potential tax impacts for certain distressed companies, particularly those with:

- Small or negative EBITDA
- High leverage or interest rates
- Limited resources to meet debt service obligations and tax payments

As companies start to experience distress, they often borrow more and at higher interest rates. These are the very companies that will see their interest expense climb above 30% of EBITDA. Such companies often end up asking lenders for relief and need lower tax burdens during turnaround and recovery, so they can continue providing

1 The bill as passed has become Public Law No: 115-97. While the final version of the legislation is titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," this article refers to the new law by its former and commonly used name, "The Tax Cuts and Jobs Act," or "the Act." Provisions within the Act serve to amend the Internal Revenue Code; for applicable references, the first section number listed is the section of the Act followed by the IRC section it is amending.

Exhibit 1: U.S. Corporate Bonds by Rating (Moody's) as of December 20, 2017 (in $billions)



Source: Bloomberg Finance, L.P. (2017). U.S. corporate bonds outstanding as of December 20, 2017.

jobs and supporting the U.S. economy. But instead, the Tax Cuts and Jobs Act's changes to the corporate tax code could boost defaults and cause more struggling companies to end up in bankruptcy.

It is expected that over 25% of junk bond issuers will pay more in taxes under the new Act.[2] Junk bonds are rated BB or lower by Standard & Poor's and BBa or lower by Moody's. Exhibit 1 shows the total amount of U.S. bonds outstanding when Congress passed the Act, December 20, 2017.[3] According to Moody's ratings, over $1.3 trillion are considered junk bonds. This suggests that issuers of more than $325 billion ($1.3 trillion X 0.25) in junk bonds may experience higher taxes and increased cash constraints starting in 2018.

Junk bonds have the highest interest rates because the issuers are the riskiest borrowers; therefore, the combined effects of the new Act and other factors may help create the "perfect storm" of demands on troubled companies. Lower EBITDA, higher interest expense and increased taxes will put these entities at even more at risk of having to file for bankruptcy.

In fact, reduced interest deductions may lead to paying higher taxes even at the new lower 21% rate. Exhibit 2 (on next page) illustrates the tax effect before and after the 2018 changes under two scenarios: where a company is at break-even EBITDA and where it has minimally positive EBITDA.

This simplified analysis shows that in this instance, the company will pay more in taxes under the new Act in 2018 under either scenario. To a distressed company with low profit margins, paying increased income taxes *or any income taxes* may cause an immense burden. Thus, due to higher taxes under the new Act, highly leveraged companies with poor profit margins will be under more pressure to find solutions, and will need to focus even more on generating and preserving cash if they are going to recover. Quite often such businesses do not have the ability to deleverage; however, they may be able to address the issue through the following approaches.

Effectively manage net operating losses—Many distressed companies have already generated net operating losses (NOLs) that may be able to offset increased taxes. It is unfortunate that NOLs may have to be used to shield taxes created by the Act's tax code changes; however, disallowed interest deductions can be carried forward to future years when the company's interest expense is below the ceiling.

The Tax Cuts and Jobs Act also provides major changes to utilization of NOLs: 1) effectively limits the amount of NOLs businesses can deduct to 80% of the business's taxable income (gross income minus allowable deductions other than the NOL deduction), 2) removes the ability of businesses to carry back NOLs to prior years, and 3) allows businesses to carry forward NOLs into perpetuity instead of limiting carryforward to 20 years.[4]

2 Jonathan Schwarzberg, "Lower-Rated Firms at Risk from U.S. Tax Changes," Reuters, December 15, 2017, https://www.reuters.com/article/us-levfirms-tax/lower-rated-firms-at-risk-from-us-tax-changes-idUSKBN1E92HR.

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4 Pursuant to section 172(e)(2) of the Act, the amended carryback and carryforward rules apply to any NOL arising in a tax year ending after Dec. 31, 2017. Based on section 172(e)(1) of the amended statute, the 80% limitation rule applies to losses arising in tax years that begin after Dec. 31, 2017. This timing difference is the subject of some debate, as there are inconsistencies among House and Senate bill dates and the enacted effective dates.

Continued from p.29

Exhibit 2: Before and After TCJA—Tax Effects at Break-even and Minimally Positive EBITDA

Under 2017 Tax Law (in millions)	Break-even	Minimal EBITDA
EBITDA	$3.50	$4.00
Interest Expense	$2.40	$2.40
Depreciation	$1.10	$1.10
Income Before Taxes	$-	$0.50
Taxes at 35%	$-	$0.18

Under 2018 Tax Law		
EBITDA	$3.50	$4.00
Interest Deduction Cap Percentage	30%	30%
Interest Deduction Ceiling	$1.05	$1.20
EBITDA	$3.50	$4.00
Deductible Interest Expense	$1.05	$1.20
Depreciation	$1.10	$1.10
Income Before Taxes	$1.35	$1.70
Taxes at 21%	$0.28	$0.34
Interest Expense Carry forward	$1.35	$1.20
Additional Tax Paid	**$0.28**	**$0.17**

Consider selling assets to reduce debt—A complete review should be made of all assets, including subsidiaries, business units and intangibles. Assets that are not core to the business could be sold or otherwise monetized to reduce debt levels, which in turn will reduce the amount of interest expense. This needs to be carefully evaluated, as selling a profitable subsidiary may allow for the pay down of the debt but can also reduce EBITDA. These are tough strategic and financial decisions that may require the help of outside advisors.

Convert some debt to equity—Look at the capital structure of the organization and determine if there is a tranche of debt that might be open to converting to equity. This will both strengthen the company's balance sheet and reduce interest expense. With a stronger balance sheet, it may also be possible for the company to refinance the remaining debt at lower interest rates.

Improve operations by increasing EBITDA—Most businesses quickly implement cost cutting and operational improvement when they start to see a decline. But it is worthwhile to take another look, get a second opinion from an outsider, and look "under every rock." If a business can improve cash from operations, it will see higher EBITDA, which will allow for a higher deductibility cap.

Although each case is unique, all distressed situations have many moving parts and finding and addressing problem areas require aggressive action and thoughtful consideration. The tax code changes wrought by Congress in the Tax Cuts and Jobs Act have created additional hurdles that troubled companies will have to anticipate and address.

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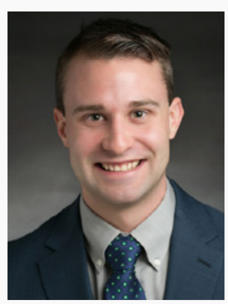

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How to Talk to a Lender in Difficult Times

MARGARET CECONI
Stout

Prompt communication with creditors and external assistance will help a distressed company survive.

When a business encounters a financial or operational downturn, its world can become turbulent. Many things are outside its control during a financial crisis, but management does have control over communication with the stakeholders who are important to the entity's survival. Stakeholders include employees, owners, and vendors, but one of the most critical stakeholders is the senior creditor – bank or lender. Because of their rights in the loan documents that allow them to quickly protect themselves, lenders can significantly impact plans for survival.

Many business owners and managers do not think to communicate with their bank or lender on a regular basis, but when the company gets into trouble, this needs to change. The fact is, the business will want help from the lender and getting help will require sharing information and explaining why it is in the lender's best interest to be supportive through a troubled situation. Therefore, it is necessary to understand the situation through the eyes of the lender.

It can never be assumed that because a bank has been with a business for five, ten or even 20 years that it will continue to support the business indefinitely, especially without a clear understanding of the current situation and how the company is going to navigate difficult times. Many business owners and managers assume their bank is their business partner, when in fact, the bank is a service provider/creditor that is highly regulated by the government. Banks are required to make sound loans that provide a good return on assets, are repaid in a timely manner, and have low risk of default. This is legislated through federal and state lending laws and reviewed by regulators on a regular basis. Because of this, banks do not have the latitude to just let poor performance slide without action on their part.

Typically, once a company is in default on its loan – whether because of past-due interest, payment defaults or failure to comply with financial ratios as part of the loan structure – the loan may be put on a watch list and the lender will monitor it more closely. Once a bank has designated a loan as a problem, the loan takes on a new set of regulatory and policy requirements. Some banks transfer problem loans to specialized departments, sometimes called "Special Assets" or the "Workout Group," for handling. Workout bankers are charged not only with collecting loans but also with reducing the bank's overall risk exposure to a financially challenged company. Anticipating what the workout bankers will analyze, and knowing what issues influence their decisions, is essential for the company and its professionals to address potential issues before they become operating emergencies.

If a loan is transferred to the workout department, owners/management and their advisors as appropriate should meet with the workout officer assigned to the account as soon possible. It will be necessary to create a detailed business plan and projections of how the management team will stop the bleeding and turn the company around, and present this at a meeting with the lender. It is critical

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that those responsible for representing the business at such a meeting be prepared to answer questions about details of the financial situation, and be able to support forecasted sales and expenses with tangible information and detailed assumptions. If the banker is concerned and is not satisfied with the facts provided, they may fill the void with what they imagine the case to be; with their own interpretations and projections which are likely to be worse than the reality.

Building Trust

A company in trouble should reach out to its bank as quickly as possible once an issue is discovered. Analysis of the issue is critical, but if time is needed, prompt notice of the problem with a request for time to review is better than silence. Banks hate to be surprised! Therefore, the earlier the communication, the better. Furthermore, in times of financial distress, being anything less than truthful with a bank can be fatal to the company. Being transparent about all news as it happens, both the good and the bad, allows for open and candid discussions that will help build trust with the bank. Establishing trust will build and/or strengthen a long-term relationship.

Conversely, the risk in not disclosing issues early is that it may be detrimental to credibility with the lenders. When the bad news comes out later rather than sooner, the banker is likely to suspect deliberate concealment, in which case owners/management are perceived as either dishonest or incompetent – or both. The heart of the relationship must be communication that builds trust.

Clear and accurate communication during any crisis is key to successful navigation through troubled waters. Communication to the lender should be early, with detailed facts given as promptly as possible and analysis thereafter as quickly as can be done with accuracy. In these circumstances, an impartial advisor can make a key difference in a business' survival by adding credibility through both better solutions and increased stakeholder confidence in execution.

Third Party Assistance

Financial advisors have long complained that banks always wait too long to involve them in the process of helping troubled borrowers. Borrowers are typically short on two key resources: time and working capital. The earlier advisors enter the picture, the more time they have to address these shortages and help develop a restructuring plan. This assistance from a third party advisor benefits banks in both the short and long term. Advisors can stop the business owner from repeating the mistakes or bad habits that are a root cause of the crisis. The third-party financial analysis not only gives the bank a better look at the business, it also results in numerous recommendations that can help turn the company around.

Turnaround advisors should be retained early on, even if company executives also have actual turnaround experience. Outside advisors bring a new set of eyes and are trained in managing and advising in troubled situations. Fresh and impartial analysis plays an essential role in solving intractable problems. An independent advisor also greatly increases the credibility of a plan and the lender's confidence in its execution and ultimate success. While a business owner may resist help, deeming it an unnecessary expense or a threat to corporate ego, a senior turnaround advisor can provide seasoned insights, outside perspective, and specialized knowledge that can increase the support of customers, vendors and, of course, the lender. Furthermore, turnaround advisors have much more experience in the successful execution of plans once they are formulated.

The bank will view the hiring of a turnaround or other restructuring professional as a positive in a distressed situation, as such advisors can bring a new set of eyes and are trained in managing and providing guidance in troubled situations.

Presenting Detailed Information and Plans to the Lender

At a minimum, the company should prepare a presentation for the bank that details the current situation. This would include how the business got there and how it will be turned around to get the bank paid. The information provided by the borrower allows the banker to better understand specific issues and how they are being or will be addressed. Typically, a banker will take this presentation to the loan committee to demonstrate to their superiors that the company is proactively addressing the issues. The opportunity here is for the company to control the narrative being provided to decision makers at the bank, instead of relying solely on the bank officer to create or convey the story. The restructuring plan must be validated and supported by the bank – without the bank's support, a company has very few options available to it in a distressed situation.

The presentation should not be simply emailed to the banker: a face-to-face meeting should be arranged to walk them through the plan and the banker should be encouraged to ask questions. This one-on-one meeting is critical for the lender to see that serious effort is being made to find a solution for all stakeholders, and that the bank's right to be repaid is kept in the forefront. After a plan has been accepted by the bank, continued communication is also critical. In distressed situations, calls or meetings should be held monthly to keep the bank informed of progress or any setbacks from the plan.

It is important for a company or borrower to understand that banks cannot and will not play the role of an equity provider. That is not the risk they agreed to when they made the loan. Foreclosure is also not generally a first choice, as this typically increases their loss and creates potential legal risks for the bank. The bank will expect the borrower to bring a solution that shows how the loan will be repaid. If this is not done, the bank might require the debtor to go out and raise equity in order to pay down the loan; or, to sell parts of the business, regardless of the loss, in order to raise cash. Thus, it is critical to develop and present a realistic plan to repay the bank.

It is also crucial that a company be proactive in addressing signs of underperformance or distress. Failing to do so risks a suboptimal solution imposed by the lender. Lenders must have complete confidence in the management team and its ability to navigate the turnaround plan and effectively operate the business going forward. Borrowers in many troubled loan situations have lost credibility by failing to adequately address the issues or meet deadlines promised to the bank.

What to Present to the Lender

In general, a company's presentation should include an executive summary/overview detailing the cause of the downturn in performance, a consideration of strategic alternatives, and a detailed turnaround plan supported by the following:

Operational and financial overview – Provide operational and financial details of the company, identifying all its challenges, whether financial, operational, or managerial. Borrowers are often surprised at how little understanding their lender has of the business, even though the bank has been its lender for years. When a company is in distress, the bank takes a fresh look at the business, with much closer scrutiny. There might also be a new banker from workout assigned to the account, and that person will not know the business as well as the former loan officer.

Market update – It is important to educate the banker about the current state of the industry and how the company is expected to perform within the marketplace and against its competitors.

Current financial performance – Focus on performance by month and year to date compared with the budget and prior-year period. Provide detailed pro forma financial projections by month and quarter for the next 12-24 months, including: balance sheet, income statement, covenant calculations and compliance, or suggested covenants; availability under the working capital revolver; and a plan to service the bank debt. Projections should address both a best-case scenario and a downside scenario and be supported by key assumptions that are achievable. This is not the time to be overly optimistic. Be realistic.

Cost-cutting initiatives – Include details of cost-cutting initiatives, such as head-count reductions, location closings, reduced inventory purchases, and salary reductions.

13-week cash flow projection – This is a tool for controlling cash, but it can also be used as a storytelling device for the bank. The bank will recognize the positive effects of cost-reduction efforts along with increased accounts receivable collections and ability to fund current operations.

Collateral – Provide an aging summary and updates on accounts receivable collections, past-due balances, inventory levels, and purchases. Discuss any impacts on availability under the revolver related to collateral levels and expected performance.

Capital expenditures – Describe the dollar amount of expenditures needed to maintain existing equipment versus the amount needed to increase or maintain sales levels.

Accounts payable – Identify critical vendors, the company's ability to pay vendors on time, past-due issues or concerns, or whether the company has been put on COD with any of its vendors.

Preferred plan – Provide details on the preferred restructuring plan, with measurable milestones along with a list of all current restructuring opportunities. Detail these options, which might include refinancing bank debt, selling a division, selling the company, raising equity, or some combination thereof. Provide a timeline over which these opportunities will occur as well as a list of potential hurdles to achieving them.

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First Circuit Rejects Seventh Circuit's Approach to Rejection of Trademark Licenses: Licensees Retain No Post-Rejection Trademark Rights

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In one of the first decisions issued this year by the United States Court of Appeals for the First Circuit, the court addressed an issue of first impression. In its January 12th decision in *Mission Products Holdings, Inc. v. Tempnology, LLC, n/k/a Old Cold LLC*, 879 F.3d 389 (1st Cir. 2018), the First Circuit held that the omission of trademarks from the definition of "intellectual property" in Section 101(35A) of the Bankruptcy Code, as incorporated by Section 365(n), leaves a trademark licensee with nothing more than a claim for damages upon the rejection of its license under Section 365(a). In so holding, the First Circuit joined the majority of bankruptcy courts which have addressed the issue and rejected the view adopted by the United States Court of Appeals for the Seventh Circuit.

Background on Section 365 and Trademarks

Subject to court approval, Section 365(a) of the Bankruptcy Code permits a debtor-in-possession to reject an executory contract. However, in the event of rejection, Section 365(n) affords special protection to licensees of "intellectual property," as that term is defined by Section 101(35A). Specifically, licensees of "intellectual property" may generally elect to treat a rejected license as not "terminated" and may retain their rights under the rejected license.

Section 365(n) was enacted in response to the Fourth Circuit's widely-criticized 1985 decision in *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043 (4th Cir. 1985), which held that that rejection of an intellectual property license under Section 365(a) terminated all of the licensee's rights under the license agreement and provided only for a money damages claim. In conjunction with enacting Section 365(n), Congress also amended the definition of intellectual property set forth in Section 101(35A) to include: trade secrets, patents and patent applications, plant varieties, copyrights and mask work protected under chapter 9 of title 17. It does *not* include trademarks. The legislative history indicates that trademarks were intentionally omitted, and congressional action "postponed," in order to allow for further study that was deemed necessary.

A majority of bankruptcy courts have inferred that the omission of trademarks from the definition of intellectual property in Section 101(35A) suggests that Congress intended not to extend the protections afforded by Section 365(n) to trademarks, thereby codifying *Lubrizol* with respect to trademarks.

In *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*, 686 F.3d 372 (7th Cir. 2012), the Seventh Circuit, however, took a different approach from the majority. In *Sunbeam*, the court reasoned that the omission of trademarks from the definition set forth Section 101(35A) "means that Section 365(n) does not affect trademarks one way or the other" and, rather than vaporizing a licensee's rights upon rejection, it is more appropriate to apply Section 365(g), which classifies rejection as a breach, excusing the estate's continued performance but leaving the licensee's trademark rights in place.

History of In *re Tempnology* Case

Tempnology was an athletic textiles company that developed a chemical-free cooling fabric used to produce "Coolcore" performance apparel and accessories. In 2012, Tempnology entered into a marketing and distribution agreement with the appellant, Mission Product Holdings, Inc., which granted Mission exclusive distribution rights with respect to certain of Tempnology's products, a non-exclusive license to Tempnology's intellectual property (expressly excluding trademarks), and a non-exclusive license to use the Coolcore trademark and logo for the limited purpose of performing Mission's obligations under the agreement.

Immediately after commencing its chapter 11 bankruptcy in 2015, the debtor filed a motion seeking to reject certain executory contracts under Section 365(a), including the agreement with Mission. Mission objected and expressly reserved its rights under Section 365(n), which lead to a fight over the scope of Mission's rights protected by Section 365(n). The debtor argued that Mission's election under Section 365(n) was limited to its non-exclusive intellectual property license (which it conceded was protected), whereas Mission asserted that its distribution and trademark rights were also protected.

The Bankruptcy Court for the District of New Hampshire held that neither Mission's exclusive distribution rights, nor its rights to use the debtor's trademark and logo, fell within the scope of rights Mission could elect to retain under Section 365(n). The bankruptcy court reasoned that the exclusive distribution rights amounted to nothing more than the right to sell and distribute certain of the debtor's products, which did not rise to the level of a license in intellectual property that could survive rejection. With respect to Mission's trademark rights, the bankruptcy court followed the majority of courts that have held by negative inference that the omission of "trademarks" from the definition of "intellectual property" set forth in Section 101(35A) renders trademark rights outside the protections afforded by Section 365(n), and, therefore, held that Mission did not retain its trademark rights post-rejection.

On appeal, the Bankruptcy Appellate Panel (the "BAP") affirmed the bankruptcy court's ruling with respect to the exclusive distribution rights, but rejected its analysis and application of *Lubrizol* to Mission's trademark rights the BAP elected instead to follow the Seventh Circuit's approach in *Sunbeam*, finding that the bankruptcy court had erred in ruling that Mission's trademark rights had terminated upon rejection. The BAP determined that Mission's post-rejection rights were governed by the terms of the agreement and applicable non-bankruptcy law.

First Circuit Rejection of *Sunbeam*

The First Circuit affirmed the bankruptcy court's ruling with respect to Mission's exclusive distribution rights, agreeing that "[a]n exclusive right to sell a product is not equivalent to an exclusive right to exploit the product's underlying intellectual property."

However, the First Circuit rejected the approach taken by both the BAP and the Seventh Circuit in Sunbeam, instead favoring a "categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise." Accordingly, the First Circuit affirmed the bankruptcy court's ruling that all of Mission's rights to the debtor's trademarks were terminated upon rejection.

In its analysis of Section 365(n)'s application to trademarks, the First Circuit examined the legislative history and concluded that, in omitting trademarks from Section 101(35A), Congress did not intend for bankruptcy courts to take an equitable approach in determining the effect of rejection on a trademark license. The court identified seven sections of the Bankruptcy Code where Congress had expressly "grant[ed] bankruptcy courts the ability to 'equitably' craft exceptions to the Code's rules," and noted that such an express grant of authority was absent from Section 365(n).

The First Circuit also criticized the Seventh Circuit's approach in *Sunbeam* as founded on an erroneous premise that a debtor-licensor could be freed from continuing performance obligations under a trademark license, while at the same time allowing a licensee to retain its right to use the trademark. The court reasoned that a trademark licensor is required to continuously "monitor and exercise control over the quality of the goods sold to the public under cover of the trademark" to prevent public deception and protect against competition. Noting that a licensor's failure to do so could jeopardize both the trademark's validity and value, the First Circuit reasoned that the *Sunbeam* approach would force a debtor to either accept such risks or continue to perform executory obligations that it had rejected, which runs counter to the policy underlying Section 365(a). The court determined that in most instances the "residual enforcement burden" on the debtor would be greater than the burden on a licensee of having its trademark rights converted to a prepetition damages claim.

The First Circuit concluded that the best approach was a categorical one and that the protections of Section 365(n) should not be extended to trademark licenses "unless and until Congress should decide otherwise."

The First Circuit's *Tempnology* decision omits any reference to the Bankruptcy Court for the District of New Jersey's decision in *In re Crumbs Bake Shop, Inc.*, in which that court held that "Congress intended the bankruptcy courts to exercise their equitable powers to decide, on a case by case basis, whether trademark licensees may retain the rights listed under Section 365(n)." 522 B.R. 766, 772 (Bankr. D.N.J. 2014). However, the First Circuit seemed to expressly reject that approach in its rejection of the dissent's equitable approach.

The Dissent

Judge Juan R. Torruella dissented in part, disagreeing with the majority's bright-line rule that rejection of a trademark license under Section 365(a) eliminates the licensee's right to use the trademark post-rejection in contravention of congressional intent. The dissent acknowledged the majority's concerns with respect to the potential "residual enforcement burden" on a debtor-trademark owner "to monitor and exercise control over the quality of the goods sold to the public" post-rejection, but noted that licensees also have quality control obligations that may be enforced. The dissent suggested that Mission's post-rejection rights should be governed by the terms of the agreement and applicable non-bankruptcy law "to determine the appropriate equitable remedy of the functional breach of contract."

On April 2, 2018, Supreme Court Justice Breyer granted Mission's request to extend the deadline to file a petition for a writ of certiorari until June 11, 2018.

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Food for Thought: What's Behind Grocery Store Bankruptcy?

DEIRDRE MCGUINNESS
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Before meal kits, grocery delivery services, self-checkouts (or any checkout lines at all), shoppers would go to a store, present a shopping list to a clerk, and wait for the clerk to gather all of their items. This was time-consuming, expensive, and didn't allow people to select their own food. In 1916, Clarence Saunders developed a concept that revolutionized the grocery industry: shoppers should serve themselves—walk the aisles, fill baskets with food of their choice, and pay for it at a cash register. Saunders' went on to open his first store, Piggly Wiggly, in Memphis, Tennessee. Since then, we've seen countless national chains stake their claim across the country. But this once innovative idea could soon be upended due to margin compression, deflation, and changing consumer preferences.

The way consumers purchase goods and services is changing at incredible speed and many retailers including those in the grocery sector have been slow to respond. Retailers have to understand how to become relevant to a new kind of consumer. The rise of online grocery shopping and meal delivery services is ushering in a new era for food retailers—leaving conventional grocers struggling to stay afloat in an already low-margin industry Supermarkets must transform the way they do business to keep pace with shifting consumer behaviors and compete with nontraditional retailers in a rapidly evolving industry.

Supermarkets feel mounting pressure to cut prices due to deflation. Grocery prices have been falling—most notably beef, dairy, and eggs—due to a shift in supply and demand. Total grocery purchases declined in 2016 YOY for the first time since 1967. Deflation is leading to a price war between grocery stores. With so much competition—especially from discount rivals—supermarkets are lowering prices and dipping into their margins to stay competitive, which could prove problematic in the long run.

The industry is also being disrupted by the pressure to compete with e-commerce giant, Amazon, as well as new entrants to the market, and discount grocers with big plans for growth.

Last summer, Amazon purchased Whole Foods for close to $14 billion—the largest ever merger and acquisition for a U.S. grocer. This is particularly significant because Amazon can now use the 400+ Whole Foods' stores to fill-on demand orders for their online grocery delivery service, Amazon Fresh. While this service only reaches a small segment of the market right now, the Amazon-Whole Foods merger is proving to be a symbolic threat that's creating an extremely competitive environment among top retailers. Walmart is already rivaling Amazon by recently launching an online grocery delivery service in 100 cites.

As some grocery retailers like General Atlantic & Pacific Tea (A&P) have filed for bankruptcy and closed their doors, a slew of discount grocers and even 99-cent stores are rapidly expanding and driving an intensely competitive landscape. Aldi, a German discount grocery chain known for its no-frill stores and private label products, is investing $3.4 billion to expand their U.S. store operations to 2,500 by 2022. The chain is remodeling their stores, with more space for natural and organic products to attract wealthier shoppers. They're also ramping up delivery options by partnering with Instacart. These moves are projected to create 25,000 U.S. jobs and make Aldi the third-largest grocery chain operator in the country behind Walmart and Kroger. Lidl, another low-cost newcomer, opened its first store in South Carolina in 2017 and plans to open 100 stores in 2018. While we haven't seen drastic industry-wide changes as yet, these efforts are already starting to disrupt the grocery business by driving smaller, regional chain stores into bankruptcy. In February, Tops Markets, a long-standing supermarket chain with close to 200 stores in New York, Pennsylvania, and Vermont filed for Chapter 11 bankruptcy. Southeastern Grocers, the parent company of BI-LO, Fresco y Más, Harveys Supermarket, and Winn-Dixie grocery stores, announced a refinancing agreement in March and filed for bankruptcy protection in April to restructure its debt. They have 700 stores, and plan to close 94. Unlike supercenters such as Kroger and Walmart, small regional chains simply don't have the resources to compete in this changing landscape. Many are burdened down by debt, or are located in close proximity to strong regional chains that have invested in innovation and added more premium in-store offerings. The supermarkets that survive and thrive over the next decade will have to find ways to shave operating costs — primarily through the use of smart technology that strengthens inventory management and find ways to improve customer loyalty — and funnel those savings into ongoing price cuts.

Another growing threat to supermarkets is the $2.2 billion meal kit market. From Blue Apron to HelloFresh, shoppers are choosing convenience over the typical grocery store experience. These services are successful because many people want to avoid stepping foot in a supermarket – most patrons do not enjoy scouring the produce section for good apples or waiting in slow checkout lines. Meal kit delivery taps into consumers' desire for healthy meals with minimal preparation time. Ingredients are delivered right to the door—perfectly portioned and ready to cook. While these services represent a fraction of the $1.5 trillion food industry, it's expected to grow 25 to 30 percent in the next 5 years, according to food industry consulting firm Pentallect Inc. Kroger and Publix Super Markets have begun offering their own meal kits in stores and it's likely that others will also follow.

Millennials' preferences are largely influencing the overall industry as well. They prefer prepared meals like meal kits or grab-and-go options and appreciate an "experience" when grocery shopping. They seek out healthy, private label products with low price points, which may be why stores like Trader Joe's and Aldi are more attractive to this clientele. Gallup research shows that millennials are more likely to purchase generic and store-brand goods than are older generations. According to Gallup, grocery stores can expect continued revenue declines until they cater to millennials needs for faster, more efficient ways of shopping.

How smart shopping is impacting supermarkets

Home based assistants like Amazon's Alexa, Google Home, Sonos, and other smart devices are having a profound impact on grocery retail. According to a report from Juniper Research, 55% of U.S. households will own a smart device by 2022. This technology shift means over time, more shoppers will start moving the mundane task of shopping for regularly replenished goods such as beverages, paper products, and other household basics online. As this trend continues, supermarkets will stock less non-perishable items and thus free up shelf space for more fresh and prepared foods, meal kits, and other non-traditional offerings. Some supermarkets have already introduced in-store bars and dining areas. Pittsburg-based Giant Eagle Inc.'s upscale Market District stores host events like food and wine Fridays. Shoppers pay $5 for a glass of wine and can shop at stations throughout the store for wine samples and appetizers while listening to a band. Reports indicate that the stores are crowded and people are having fun while they grocery shop. Another concept gaining some traction is wellness activities in stores.

Currently, brick-and-mortar grocery stores still control a large share of the food purchasing space, and customers do spend more money in stores, compared to delivery or meal kit services. But as behaviors change, and more Americans shop for their food online, traditional stores that don't adapt to these new trends to stay relevant will suffer. They must invest in new technology to enhance their digital experiences, expand delivery options, and create meal-kit offerings in their stores to stay competitive, and meet their

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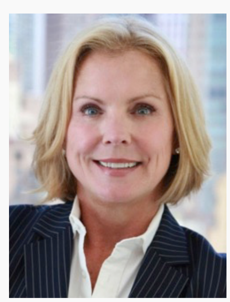

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