AIRA Journal

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WHAT'S INSIDE

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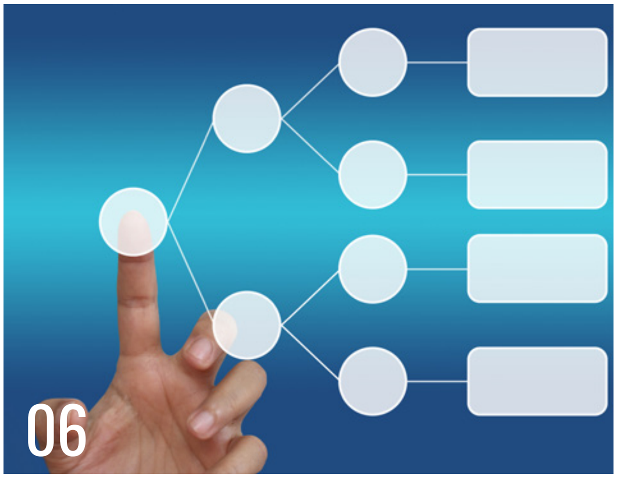

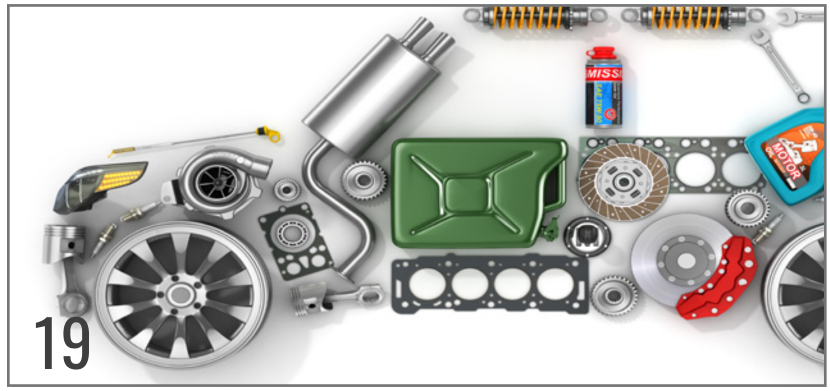

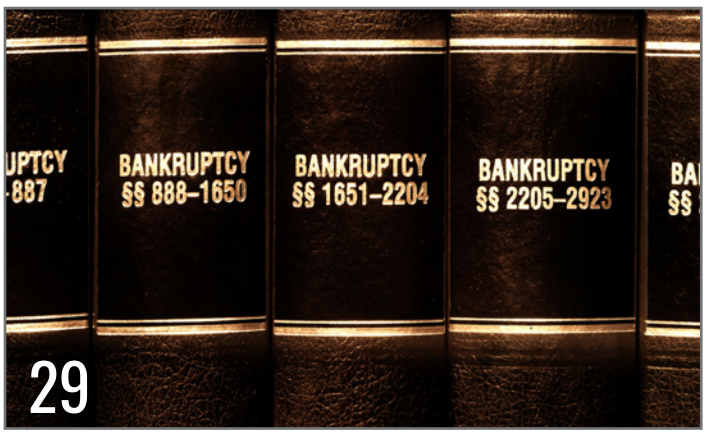

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From the Executive Director's Desk

THOMAS MORROW, CIRA
AIRA

The Power of Education

Our mission at AIRA is education. We offer the very best education for financial advisors in the restructuring industry. Our programming is split between a variety of conferences and our certification programs.

We have just completed the 8th Annual Dallas Energy Summit and are approaching the 18th Annual Advanced Restructuring & POR Conference in New York. AIRA's President, Brian Ryniker, in his letter on the adjacent page, talks about his passion for the New York POR as well as the kick-off to planning for our Annual Conference in Chicago next year.

In addition to these three programs AIRA will also co-host two other programs in early 2020: a lunch program with two panel presentations in January with the New York Institute of Credit, and VALCON at the end of February with ABI, in Las Vegas.

In addition to these fine conferences, AIRA offers the two premier certifications for financial advisors, Certified Restructuring and Insolvency Advisor and the Certification in Distressed Business Valuation. Each program consists of a multi-day class followed by a three-hour rigorous exam. In 2019 we offered the CIRA training program in New York, at AIRA's annual conference and on-line; the CDBV is offered exclusively online. We are currently setting up the dates for 2020 offerings – please check our website soon for posting of these new dates. There is still time to take two CIRA courses in 2019 as CIRA 2 online begins November 5th, and CIRA 3 online begins December 3 – register online or contact Terry Jones, Director of CIRA & CDBV. By the end of the year we expect almost 400 students will have taken the CIRA classes.

If you have been thinking about the certification programs, let me offer this encouragement. Most of the large and medium sized firms in the industry use the CIRA program as "basic training" for their new staff. You should seriously consider the CIRA program in order to level the playing field with the other firms in the industry. An additional encouragement is that this training will help you become more knowledgeable in your field, offer better services to your clients, and ultimately help you get promoted faster.

The CDBV is becoming more and more important to experts testifying in bankruptcy cases and we are seeing a renewed interest in this program. It is likely that in the next bankruptcy case in which you testify, the other side will have an expert with a CDBV credential.

Education is the reason we exist. Please join us at our conferences and certification programs.

A Letter from AIRA's President

BRIAN RYNIKER, CIRA
Ryniker Consultants, LLC

As we enter fall and the weather is changing, the AIRA is actively planning our upcoming conferences. Recently we have started planning our 36th Annual Bankruptcy & Restructuring Conference to be held in Chicago, June 2020; are actively working through ideas for VALCON, taking place in Las Vegas, February 2020; and are putting the finishing touches on this year's 18th Annual Advanced Restructuring & POR Conference ("NY POR", scheduled for December 18, 2019 at The Union League Club, New York, NY).

At this year's NY POR conference, we will present Chief Judge Kathryn C. Ferguson with the AIRA's 2019 Judicial Service Award in recognition of her many contributions to the bar and restructuring practice. Further, we have a great day of topics discussed by a group of well-respected panelists. This years' conference will include our annual Year-In-Review panel which provides Judge and Attorney perspective on certain significant decisions this past year, as well as discussions on Net-Short Debt Strategies, Litigation Funding, Healthcare Bankruptcies and Regulatory Considerations, and Mass Torts in Bankruptcy.

For their dedication to putting together this year's POR conference, I would like to thank Co-Chair Michael Lastowski (Duane Morris LLP) and our very hard working and talented planning committee: David Bart (RSM US LLP), Stephen B. Darr (Huron), Steven Fleming (PwC), Sheryl Giugliano (Diamond McCarthy LLP), Russell Perry (Ankura), Boris Steffen (GlassRatner), and Michael Sullivan (Deloitte). Finally, I would like to thank all our sponsors: AlixPartners, Ankura, Arnold & Porter, Capital Hill Ventures, CohnReznick, Duane Morris, Deloitte, Epiq, Goodwin, RSM and Young Conaway Stargatt & Taylor.

As a reminder, the NY POR conference will have a delayed start time of 10:30 am, to assist practitioners in attending the full conference. Please join us at this conference – you can register now at www.aira.org.

An Invitation from AIRA Journal

AIRA members and others are invited to submit articles, proposed topics and content-related questions to the AIRA Journal Editorial Board: Michael Lastowski mlastowski@duanemorris.com, David Bart David.Bart@rsmus.com and Boris Steffen bsteffen@glassratner.com. Articles are currently being accepted for upcoming quarterly issues; see AIRA Journal information and Authoring Guidelines at www.aira.org.

To inquire about placing an ad in AIRA Journal contact Michael Stull mstull@aira.org

USING A DECISION TREE TO VALUE CAUSES OF ACTION

MICHAEL VITTI
Duff & Phelps

Introduction

One of the most difficult types of assets or liabilities to value in a contested situation may be litigation-related claims. The key underlying valuation drivers (e.g., probability of a liability determination and amount of damages) are often subject to a wide range of views. Compounding the problem, there often are few, if any, "comps" that can be reliably used to benchmark the valuation. Not surprisingly, one side will frequently argue the litigation-related claim is worth a lot, whereas the other side will counter that it is worth a little or nothing.

Use of a decision tree can add transparency to the process. A decision tree forces a practitioner to identify key decision points in the underlying analysis and assign probabilities to potential outcomes. While one may disagree with the assigned probabilities (e.g., argue they are "garbage in/garbage out"), the underlying analysis is more transparent than a high-level assessment that does not show the underlying assumptions.

This article demonstrates the use of a decision tree for a stylized example related to a potential fraudulent conveyance claim. It also addresses prejudgment interest and the discount rate that is required to convert the nominal value of a litigation claim to present value.[1]

1 Material in this article is adapted from the panel presentation *"Valuing Causes of Action for Purposes of Third Party Releases,"* VALCON 2019, February 28, 2019, Las Vegas NV.

Hypothetical Fraudulent Transfer Claim Example

We will assume the following:

- Company A sells assets to its sister, Company B (they are both owned by the same entity), on December 31, 2015, for $1 billion. Neither company had publicly-traded equity or debt, which means we can't rely on market prices for the relevant securities. This assumption adds volatility to the valuation and solvency-related determinations.
- Company A files for bankruptcy on December 31, 2018 in a state with a 4-year lookback period. A fraudulent transfer claim is not time-barred in this situation.
- Company A's creditors contend the related party transaction resulted in asset stripping when Company A was insolvent. They want to claw back the proceeds via a fraudulent transfer lawsuit.
- The sponsor of the disputed transaction counters that Company A received reasonably equivalent value and was solvent when the transaction closed. The sponsor asserts that a fraudulent transfer lawsuit would be unsuccessful.
- Notwithstanding the sponsor's assertion, it agrees to contribute a large sum of money as part of the restructuring in exchange for receiving a release from the fraudulent transfer claim.

- The key question that needs to be answered: Is the sponsor's contribution reasonable consideration for release of the fraudulent transfer claim?

What Does the Decision Tree Look Like?

A decision tree identifies various possibilities for each key decision and assigns a probability to each possibility. For this example, there are five key decisions that must be assessed:

1. **Was there actual intent?**

   There are two types of fraudulent transfers, which are often referred to as (a) actual intent and (b) constructive. Actual intent generally refers to situations where *it was known* at the time that the debtor's creditors were hindered or defrauded. Constructive generally refers to situations where *it should have been known* at the time that the debtor's creditors were hindered or defrauded. The distinction primarily matters because there are various safe harbors that can protect defendants under the constructive prong that are not available under the actual intent prong.

   The next three key decisions are only applicable when the transaction is not a fraudulent transfer under the actual intent prong.

2. **Was it a settlement payment?**

   An otherwise constructive fraudulent transfer is immune from prosecution if the structure of the transaction fits within the settlement payment safe harbor. The primary use of this safe harbor is in situations where a transfer was made by or to (or for the benefit of) a financial institution. Not surprisingly, defendants typically argue the settlement payment safe harbor applies whereas plaintiffs typically take the opposite view.

   The Supreme Court recently addressed this issue in *Merit* (2018).[2] The Supreme Court, in a unanimous decision, focused on the overarching transaction (i.e., buyer to seller) and not the component parts (i.e., buyer to buyer's bank to seller's bank to seller). On the surface, this decision indicates the settlement payment safe harbor cannot be used by defendants just because a financial institution served as an intermediary in the transaction.

   However, a broad settlement payment defense may live to fight another day. The Supreme Court in footnotes 2 and 5 to its opinion in *Merit* suggests that future defendants may explore arguments that were not made by the defendants in *Merit*. More specifically, future defendants may be able to successfully argue they are a "financial institution" because they were a "customer" of a qualified "financial institution."

3. **Was there reasonably equivalent value?**

   The reasonably equivalent value safe harbor allows the recipient to keep the benefits of the transfer if the debtor got something in value that was close enough to the value that it gave up. A simple cash dividend is an example where the debtor did not get reasonably equivalent value because it gave up something (cash used to pay the dividend) for nothing. Other transactions, such as the sale in this example, are more subjective as it depends on an assessment of the transaction. The line in the sand that must be crossed to determine the consideration was not reasonably equivalent can be subjective.

4. **Was the debtor solvent?**

   There are three tests to assess whether a debtor was solvent at the time of the disputed transfer. The so-called Balance Sheet Test typically compares the debtor's enterprise value with the face value of its funded net debt and fair value of its unliquidated/contingent liabilities. The Adequate Capital Test typically assesses a debtor's liquidity and ability to service its debt obligations. The Ability to Pay Debts, by name, sounds like the Adequate Capital Test but in practice is typically a harder-to-fail test. Because a plaintiff only must establish that the debtor failed one of these three tests, most of the focus is on the Balance Sheet and Adequate Capital Tests.[3]

5. **How much is recovered?**

   In some fraudulent transfer cases, the amount that is recovered is straightforward. For example, a fraudulent transfer lawsuit that tries to claw back a $10 million cash dividend will recover $10 million if the lawsuit is successful. In other fraudulent transfer cases, the amount that is recovered is more subjective. This stylized example can have a wide range of possible recovery amounts because it depends on the value of assets that were sold.

Exhibit 1 on p.8 depicts these five key decision points within a decision tree framework. There are effectively two paths (in black) that lead to the fraudulent transfer claim having value. There are also three paths (in red) that lead to the fraudulent transfer claim having no value. For the fraudulent transfer claim to have value, either (a) it must meet the actual intent threshold or (b) it must get past the settlement payment, reasonably equivalent value, and solvency safe harbors

To demonstrate how the decision tree can be filled in,

2 *Merit Management Group v FTI Consulting*, 138 S. Ct. 883, 200 L. Ed. 2d 183, 583 U.S. (2018).

3 A broad discussion related to the solvency tests is beyond the scope of this article. For this author's view on the topic, see Michael Vitti, "Grounding Retrospective Solvency Analyses in Contemporaneous Information (3 of 3)," *Business Valuation Review* 33, no 3 (2014): 50-80.

Continued from p.7

we will make some assumptions. For purposes of this discussion, we will assume the following for the "Low Case," which is shown in Exhibit 2:

- There is a 40% probability that the actual intent hurdle will be met;
- For the scenarios where the actual intent hurdle is not met there is a:
  - 90% probability the settlement payment safe harbor will not apply,
  - 40% probability the reasonably equivalent value safe harbor will not apply,
  - 65% probability the debtor will be deemed insolvent; and
- Damages range from $1.4 to $1.6 billion. Damages will likely be (substantially) higher than the $1.0 billion transaction price because Company A was (a) stripped of assets for unfair consideration under the actual intent prong, and/or (b) did not receive reasonably equivalent value under the constructive prong in scenarios where damages are applicable.[4,5]

Exhibit 3 provides some context for framing the reasonably equivalent vale safe harbor. Valuing the transferred assets at $1.1 billion results in Company A receiving 91 cents on the dollar, which may be close enough to be reasonably equivalent. Valuing the transferred assets at $1.4 billion (71 cents on the dollar) to $1.6 billion (63 cents on the dollar) may not be close enough to be reasonably equivalent.

The following changes are made for a "High Case" example, shown in Exhibit 4 on p.10:

- The probability that the actual intent hurdle will be met increases from 40% to 50%;
- For the scenarios where the actual intent hurdle is not met:
  - the probability that the settlement payment safe harbor will not apply increases from 90% to 100%,
  - the probability that the reasonably equivalent value safe harbor will not apply increases from 40% to 50%,
  - the probability that the debtor will be deemed insolvent increases from 65% to 75%; and
- Each damage estimate increases by $100 million.

As shown in Exhibits 2 and 4, a series of small changes (10% points change in each liability-related assumption, $100 million change in damages) in the same direction combines to result in a large (>35%) change in output.[6]

4 There may be a possibility that the transferred assets are worth around $1 billion (or even less than $1 billion). However, those possibilities are likely not relevant for damages purposes because liability will not likely be established if the value of transferred assets is that low.

5 The same range for damages is used for the actual intent and constructive prong analyses. However, it is possible for recovery under the actual intent prong to be lower (e.g., $1.1 billion) than under the constructive prong because the transfer may have been for reasonably equivalent value yet still be a recoverable fraudulent transfer.

6 The $1.1 billion High Case is $289 million higher than the $811 million Low Case ($289 million / $811 million = 35.6%).

Exhibit 1: Decision Tree Framework for Example

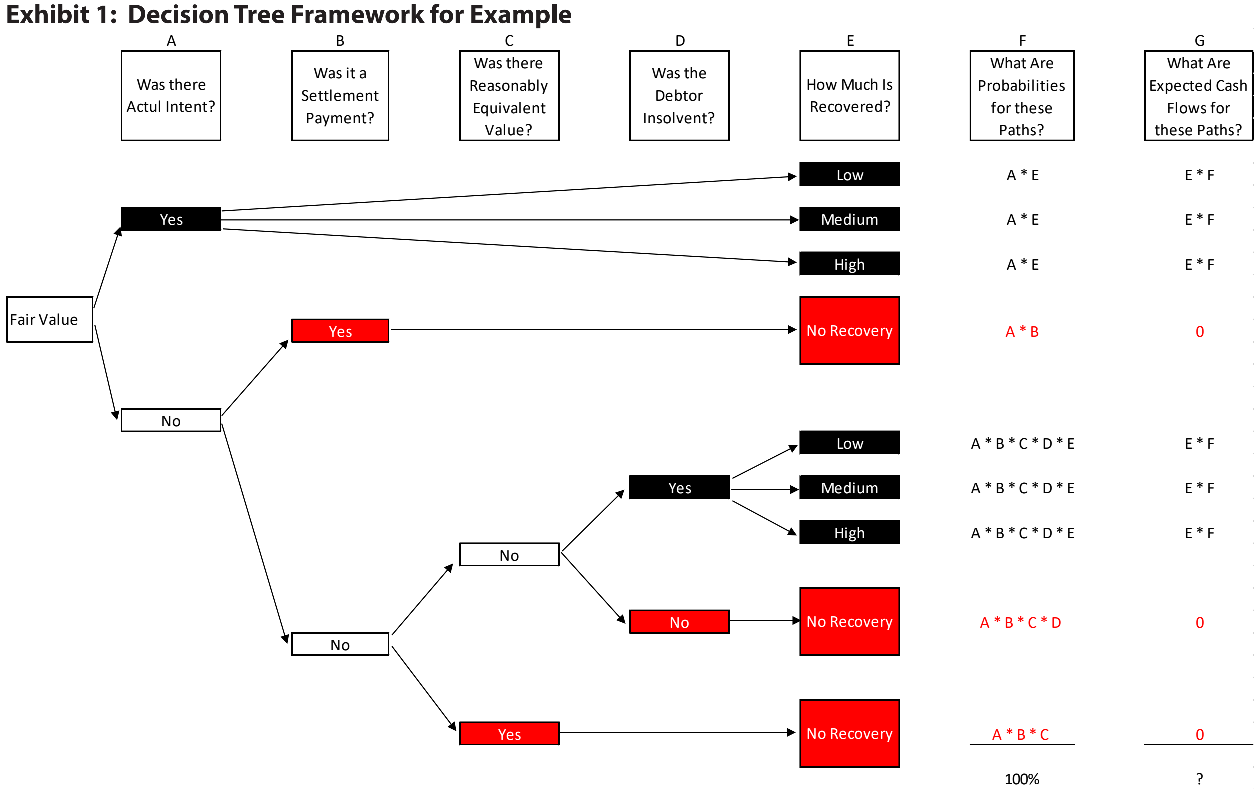
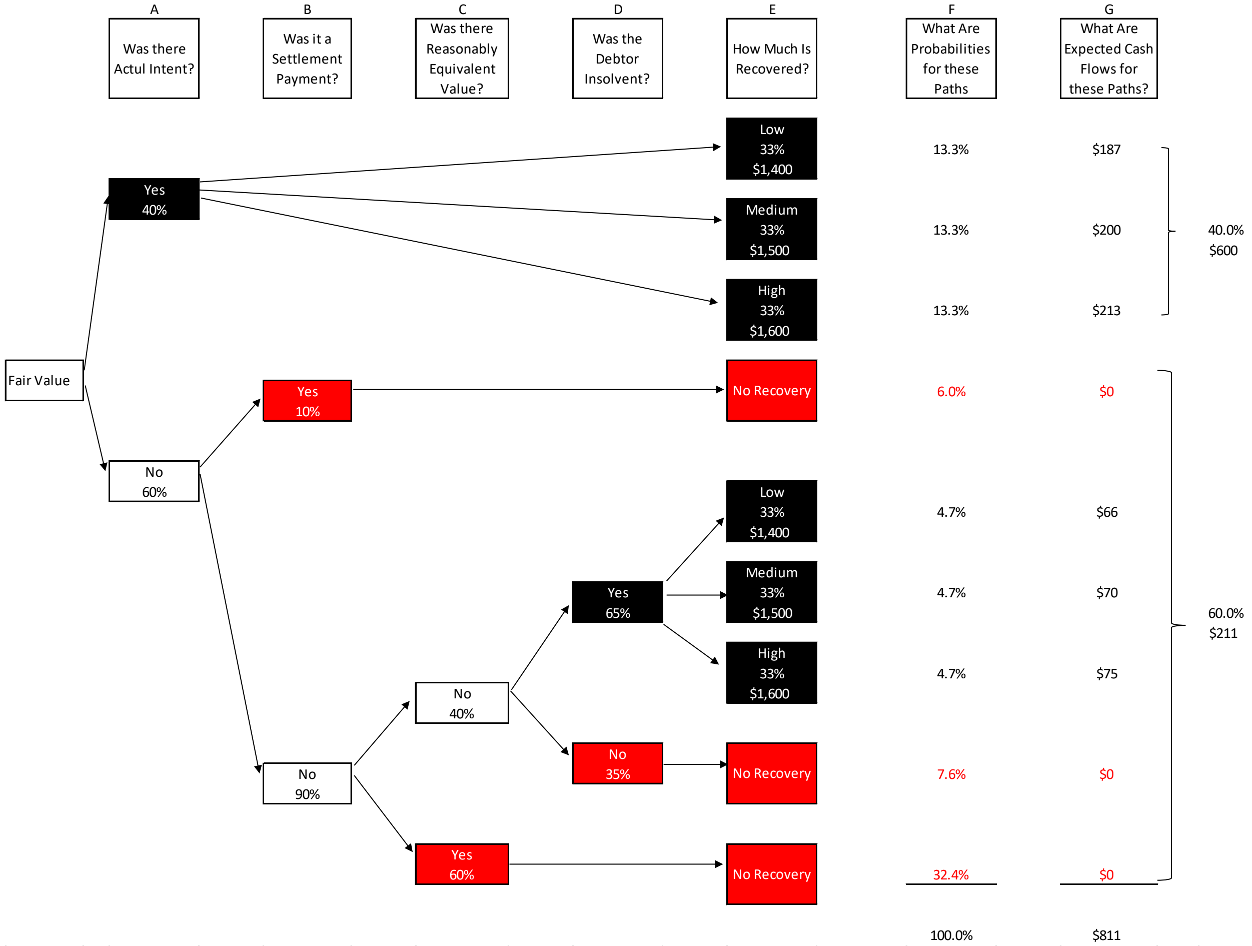


Exhibit 2: Low Case (in $millions)



Litigation Cost Considerations

Litigation costs must be added to the equation. The preceding discussion focused on the expected revenue that will be achieved if the litigation claim is pursued to a final judgment. This revenue must be reduced by expected expenses that are incurred while pursuing the litigation claim.

Litigation counsel may be paid via a percentage of the proceeds that are ultimately collected on the claim. These costs only require an assumption regarding the percentage that they are paid. Other costs (and litigation counsel's costs if they are not on a contingency basis) will be incurred regardless of the ultimate verdict. These costs will require additional assumptions.

It is noteworthy that there is a meaningful probability that the litigation claim will have a negative value (i.e., costs will be incurred but no revenue is obtained). As shown in the decision trees for this stylized example, there is a 46% probability of a negative value under the "Low case" value and a 31% probability of a negative value under the "High case" value if the claim is pursued through final judgment. The meaningful probability that a litigation claim will have negative value, combined with the potential that the defendant can incur a very large expense, helps explain why most lawsuits settle.

Exhibit 3: Get vs. Give

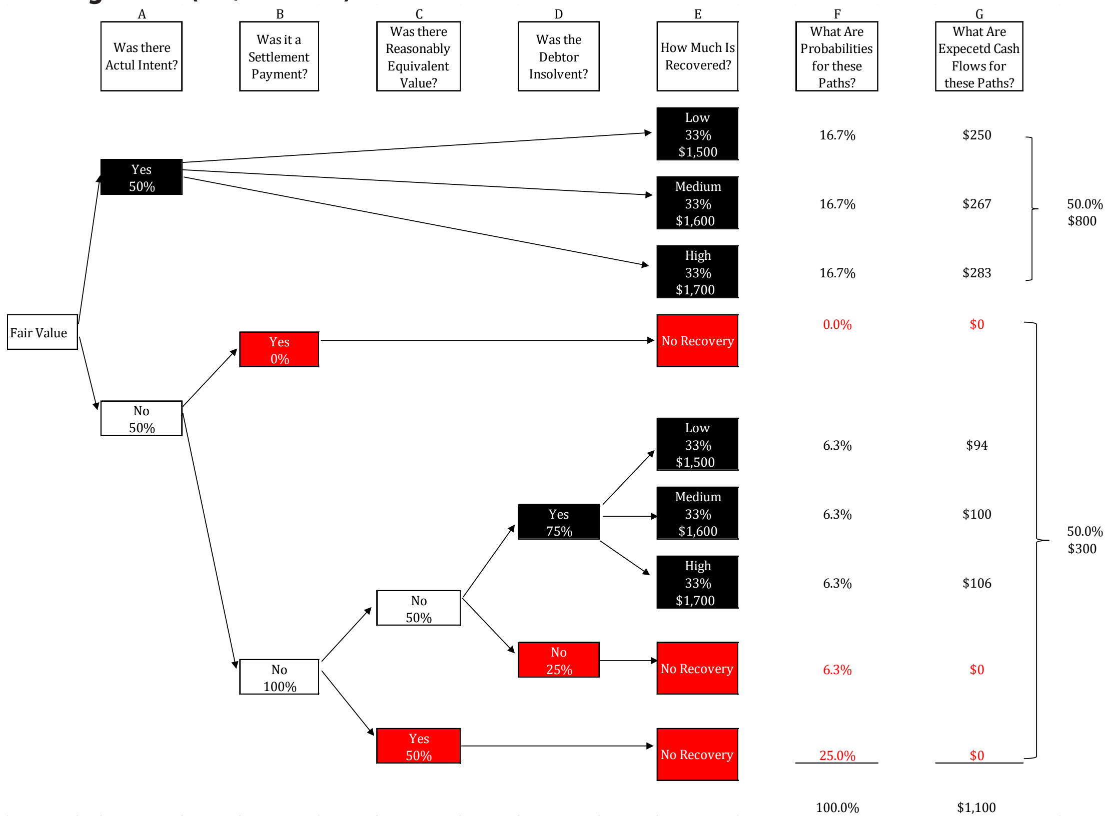
Get	Give	Cents on $
$1.0	$1.0	100
$1.0	$1.1	91
$1.0	$1.2	83
$1.0	$1.3	77
$1.0	$1.4	71
$1.0	$1.5	67
$1.0	$1.6	63

Discount Rate and Prejudgment Interest Rate Considerations

Debates over how to value a litigation claim are not limited to differences over the previously discussed assumptions for (a) the probability that the litigation claim will be successful, (b) the amount of damages, and (c) the costs to pursue a litigation claim. Acknowledgement that a discount rate must be applied to account for the time value of money and risk (which decreases value) and availability of prejudgment interest (which increases value) are additional areas of contention.

Continued from p.9

Exhibit 4: High Case (in $millions)



What Is the Appropriate Discount Rate?

There is not a lot of established guidance regarding how to determine the appropriate discount rate when valuing litigation claims. For example, the International Valuation Standards Council's recently published exposure draft observed "a lack of guidance in the broader marketplace related to the valuation of non-financial liabilities."[7] The lack of guidance may lead to a large difference in views among practitioners when determining the appropriate discount rate.

The first step in determining the appropriate discount rate should be identifying the defendant's (in this case the sponsor's) cost of unsecured debt. The discount rate used to determine present value for this litigation claim should reflect the defendant's credit risk after taking the judgment into account. As a practical matter, the litigation claimholders effectively give the defendant an unsecured loan from Company A's bankruptcy filing date through the date they receive payment on their claim.

The second step is determining what compensation, if any, the litigation claimholders should receive for holding a litigation claim that may be riskier than an unsecured debt instrument. This step can lead to an interesting debate with a wide range of views.

On the one hand, a practitioner could highlight that this litigation claim has no incremental beta beyond what is implied in the defendant's cost of unsecured debt. That means a verdict from trial (or settlement of the litigation claim) has no correlation with changes in market conditions after the valuation date. A faithful application of the Capital Asset Pricing Model results in *no incremental compensation* for litigation claimholders.

This practitioner might also highlight Delaware appraisal cases as market support for the view that incremental compensation for litigation risk should be low. Petitioners in Delaware appraisal cases seek to get their shares bought out at an appraised amount that is greater than the change-in-control deal price. Petitioners also receive prejudgment interest at the Delaware statutory rate, which is the federal discount rate plus 5.0%. As shown in Exhibit 5, the Delaware statutory interest rate was 6.0% or lower for several years. This fact is noteworthy because many have observed that appraisal arbitragers have viewed the Delaware statutory interest rate as higher than the litigation claim's cost of capital (which implicitly was less than 6.0% for many years), which further incentivizes appraisal-related claims. The state of Delaware tried to stem this outcome by allowing companies to prepay appraisal claims to avoid paying prejudgment interest at the Delaware statutory rate.[8] Implicit in these observations is the view that a

7 IVS 220 Non-Financial Liabilities Exposure Draft was issued on January 4, 2019. Available at https://www.ivsc.org/files/file/view/id/1345.

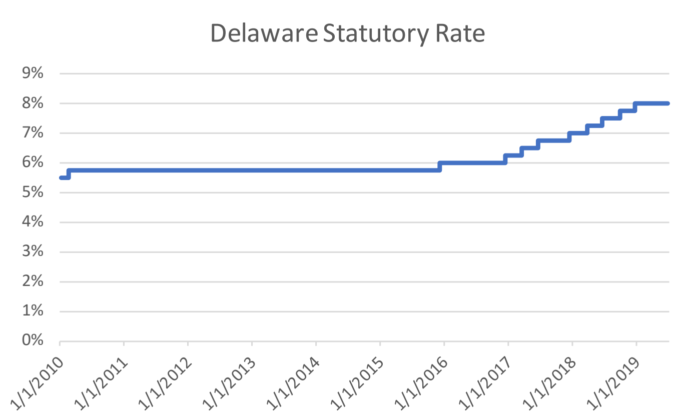
8 Observing the number of companies that prepay appraisal claims may not be relevant for this discussion because of unintended consequences. For example, prepaying appraisal-related claims, while it may be beneficial for present value-related purposes, results in funding litigation against the company. Companies that would prepay for present value purposes may choose to not prepay for this reason.

Delaware appraisal claim's cost of capital should not be massively higher than the company's unsecured cost of debt, which means limited incremental compensation for litigation risk.[9]

On the other hand, another practitioner might argue there is *a lot of incremental risk that is relevant for discount rate purposes*. Creditors know with certainty how much a debtor owes on a "vanilla" (basic or standard) debt obligation that is used to observe the cost of unsecured debt. The only risk associated with a vanilla debt obligation is the possibility that the debtor won't pay what is owed. A litigation claim, on the other hand, can have substantial volatility around what is ultimately owed, which is demonstrated in the decision trees depicted in Exhibits 2 and 4. If given a choice, a risk-adverse investor may logically choose to be the counterparty on a vanilla $100 debt obligation over owning a litigation claim that might ultimately be worth much more or less than $100 when they both have the same expected (i.e., probability of outcomes weighted) $100 value.

This practitioner might also highlight that Delaware appraisal claims are (much) less risky than most other litigation claims.[10] The petitioner will always receive payment in a Delaware appraisal case because he is entitled to the fair value of his shares. The only issue is whether the fair value will be high enough to justify the costs of pursuing litigation. By contrast, most other litigation claims have a substantial risk of receiving no payment because they only receive payment (damages) when liability is established.[11] As previously discussed, the assumptions used in this stylized example showed a significant (31% to 46%) probability of no revenue associated with the claim.

Exhibit 5: Delaware Statutory Prejudgment Interest Rate



The tiebreaker would appear to be a focus on litigation claimholders' ability to diversify the litigation claim-specific risk. While the litigation claim may have a zero beta, it does not necessarily follow that the litigation claim-specific risk can be diversified away. As a practical matter, the litigation claim-specific risk will likely never be diversified away if it is owned by the creditors who receive this claim because most (if not all) of them do not have a large portfolio of litigation claims. The ability to reduce litigation claim-specific risk through diversification is therefore dependent on an active market in trading litigation claims.

The litigation finance market is not as active as traditional debt or publicly traded equity markets. Therefore, it stands to reason that the market is not efficient enough to fully diversify litigation claim-specific risks. The largest publicly traded litigation finance company, Burford Capital, effectively makes this point when it states, "Our capital is expensive, with Burford's overall financial return expectations consistent with private equity and venture capital funds, not commercial banks.")[12,13] The International Valuation Standards' exposure draft generally echoes this point when it states that a market participant who takes over an obligation may require compensation to "reflect the risk that the actual cash []flows might differ from the expected cash []flows at the time of the transaction."[14] It seems reasonable to conclude that some incremental compensation should be included in the discount rate with the amount likely to be fervently contested among the parties.

9 Many lawyers have published views on appraisal arbitrage. For example, see Edward McNally and Patricia Winston of MorrisJames, "Is Appraisal Arbitrage Past Its Prime" (https://www.morrisjames.com/blogs-Delaware-Business-Litigation-Report,is-appraisal-arbitrage-past-its-prime); Jack Jacobs of Sidley Austin, "Pushbacks and Delaware Appraisal Arbitrage" (https://corpgov.law.harvard.edu/2016/06/28/pushbacks-and-delaware-appraisal-arbitrage/) and Daniel Atlas, Arthur Bookout and Andrew Kinsey of Skadden, "Delaware Appraisal Actions: When Does it Make Sense to Prepay?" (https://www.skadden.com/insights/publications/2018/05/insights-the-delaware-edition/delaware-appraisal-actions).

10 The focus of this discussion is the period when there were a substantial number of Delaware appraisal-related claims. The outlook may be different (and even less volatile due to lower upside) now given the recent emphasis on the deal price less synergies in the Delaware Supreme Court's decisions regarding *Dell*, *DFC Global*, and *Aruba Networks*.

11 Further increasing risk, some litigation claims may establish liability but no (or limited) damages.

12 See https://www.burfordcapital.com/faqs/

13 Burford Capital stated earlier this year that it has generated a 30% internal rate of return ("IRR") based on recoveries to date and would generate a 15% IRR "even if one assumes all current outstanding investments before 2016 are full losses." https://www.burfordcapital.com/wp-content/uploads/2019/03/Burford-FY2018-Investor-Presentation.pdf at p. 24.

14 IVS 220 Non-Financial Liabilities Exposure Draft was issued on January 4, 2019. Available at https://www.ivsc.org/files/file/view/id/1345. Note that the discussion in this document relates to cash outflows instead of inflows and a reduction instead of an increase to the discount rate. That discussion occurs because it frames the litigation claim from the liability perspective, not the asset perspective. A cash outlflow for a liability is a cash inflow for an asset. The discount rate is decreased for the liability because it would be counterintuitive to lower the liability due to extra risk that would require compensation to be paid to a third party to take on the exposure.

Continued from p.11

What Prejudgment Interest Will Be Obtained?

The availability and parameters for determining prejudgment interest is determined by the trial judge, subject to appeal. The rate that is ultimately applied will depend on the applicable law (e.g., the applicable rate varies by state) and other factors (e.g., the rate may be reduced to reflect the fact that some of the claim holders were not investors when the transfer was executed). The plaintiff will presumably argue for a relatively high prejudgment interest rate whereas the defendant will presumably argue for a relatively low (or no) prejudgment interest rate and the final judgment may be expected to be somewhere in between.

The process for calculating interest is also relevant, primarily because interest is received at the end of the case. Simple interest applies the interest rate to the original principal amount each year. Compound interest applies the interest rate to the original principal amount plus the accrued but unpaid interest. The benefit that plaintiffs receive via compound interest depends on how frequently (e.g., annual or quarterly) the interest is compounded.

The characterization of income taxes may also matter. A debt instrument is typically valued on a pre-tax basis but that does not mean that the timing of income tax expenses is irrelevant. The owner of a typical debt instrument earns interest and must pay income tax on that interest each year. The holder of a litigation claim does not pay income tax until it receives the interest in a lump sum that can reflect many years worth of interest payments. The ability to defer income taxes on several years of interest has some value.

Interaction Between Discount Rate and Prejudgment Interest Rate

We will revisit our stylized example to observe the interaction between the discount rate and prejudgment rate. Recall that Company A filed for bankruptcy on December 31, 2018. Prejudgment interest will begin accruing on that date. We will assume that the valuation date (i.e., the date the settlement offer must be assessed) is one year later: December 31, 2019. Finally, we will assume that payment under final judgment won't be rendered until 10 years after Company A filed for bankruptcy, which is 9 years after the valuation date.

The length of period between the valuation date and payment under final judgment may be the most relevant assumption. These cases can take many years (some take well over a decade) to reach a final judgment. A sensitivity analysis that considers shorter lengths of time will be discussed later in this article.

To fill in the analysis, we also need to make a few additional assumptions. We will assume interest will accrue at 5.0% at the end of each year on a simple basis. We will also assume the discount rate is 8.0%. Setting aside the income tax deferral issue, these assumptions result in 25% present value reduction. Said differently, each $1,000 of expected judgment has a present value of $750. See Exhibit 6.

To consider other interest rate and discount rate assumptions, we will also review a sensitivity table. As shown in Exhibit 7, there can be a wide range of present value adjustments depending on which combination of interest rate and discount rate is used.

Exhibit 6: Present Value of Expected Judgment

Expected Judgment	$1,000
Interest Rate	5.0%
Interest Method	Simple
Discount Rate	8.0%
Valuation Date	12/31/19

	Val Date	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	Payment on 12/31/28
Prejudgment Interest		$50	$50	$50	$50	$50	$50	$50	$50	$50	$50	$500
Expected Proceeds												$1,000
Total Proceeds												$1,500
Period for Discounting		0.0	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	9.0
Present Value Factor		1.00	0.93	0.86	0.79	0.74	0.68	0.63	0.58	0.54	0.50	0.50
Present Value of Total Proceeds	$750											$750
Relative to Expected Judgment	-25%											

Exhibit 7: Sensitivity Analysis

Present Value of Total Proceeds

Discount Rate	0.0%	1.0%	2.0%	3.0%	4.0%	5.0%	6.0%	7.0%	8.0%	9.0%	10.0%
5.0%	645	709	774	838	902	967	1,031	1,096	1,160	1,225	1,289
6.0%	592	651	710	769	829	888	947	1,006	1,065	1,125	1,184
7.0%	544	598	653	707	762	816	870	925	979	1,033	1,088
8.0%	500	550	600	650	700	750	800	850	900	950	1,000
9.0%	460	506	553	599	645	691	737	783	829	875	921
10.0%	424	467	509	551	594	636	679	721	763	806	848
11.0%	391	430	469	508	547	586	625	665	704	743	782
12.0%	361	397	433	469	505	541	577	613	649	685	721
13.0%	333	366	399	433	466	499	533	566	599	632	666
14.0%	308	338	369	400	431	461	492	523	554	584	615
15.0%	284	313	341	370	398	426	455	483	512	540	569

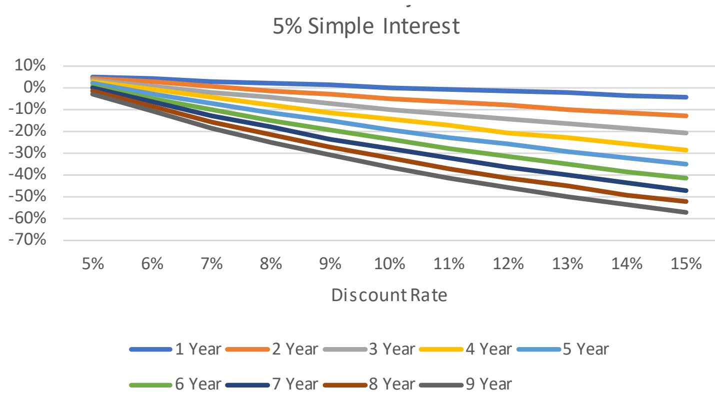
Relative to Expected Judgement

Discount Rate	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
5.0%	-36%	-29%	-23%	-16%	-10%	-3%	+3%	+10%	+16%	+22%	+29%
6.0%	-41%	-35%	-29%	-23%	-17%	-11%	-5%	+1%	+7%	+12%	+18%
7.0%	-46%	-40%	-35%	-29%	-24%	-18%	-13%	-8%	-2%	+3%	+9%
8.0%	-50%	-45%	-40%	-35%	-30%	-25%	-20%	-15%	-10%	-5%	+0%
9.0%	-54%	-49%	-45%	-40%	-36%	-31%	-26%	-22%	-17%	-13%	-8%
10.0%	-58%	-53%	-49%	-45%	-41%	-36%	-32%	-28%	-24%	-19%	-15%
11.0%	-61%	-57%	-53%	-49%	-45%	-41%	-37%	-34%	-30%	-26%	-22%
12.0%	-64%	-60%	-57%	-53%	-50%	-46%	-42%	-39%	-35%	-31%	-28%
13.0%	-67%	-63%	-60%	-57%	-53%	-50%	-47%	-43%	-40%	-37%	-33%
14.0%	-69%	-66%	-63%	-60%	-57%	-54%	-51%	-48%	-45%	-42%	-38%
15.0%	-72%	-69%	-66%	-63%	-60%	-57%	-55%	-52%	-49%	-46%	-43%

A key driver of the present value analysis shown in Exhibits 6 and 7 is duration. The analysis assumes final adjudication occurs 10 years after the bankruptcy filing date, which is 9 years after the valuation date. The size of the present value adjustment reduces (increases) as duration decreases (increases) because there is less (more) time for the difference between interest rate and discount rate to compound. This is illustrated in Exhibit 8, which shows the present value adjustment when assuming a 5% simple interest rate and durations ranging from 1 year (final adjudication on 12/31/20) to 9 years (final adjudication on 12/31/28).[15]

15 The adjustment is positive when the discount rate is greater than the interest rate in some short duration scenarios because there is one year of prejudgment interest before the valuation date.

Exhibit 8: Present Value Adjustment Curves



Closing Thoughts

Valuing litigation claims is not easy. There are many variables that are likely to be contested. That is especially the case when trying to determine the value of a litigation claim prior to the start of formal discovery when the potential outcomes are more volatile due to the lack of information.

A decision tree is a tool that can add transparency to the process. While there may be hotly contested debates over the underlying assumptions, use of a decision tree forces practitioners to focus on and disclose the key assumptions that drive the valuation.

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THE END OF LIBOR

GREGORY HARRINGTON and ARTURO CARABALLO
Arnold & Porter

LIBOR, the "world's most important number," is being phased out. Created 50 years ago on August 15, 1969—opening day of the Woodstock music festival—LIBOR began as a floating, market-determined interest rate for syndicated loans, but over time has become the benchmark interest rate for an estimated $350 trillion in outstanding financial arrangements around the world[1]. These contracts include public and private loans and bonds, consumer financial products such as credit cards, mortgages and student loans and some $200 trillion in interest rate derivatives.

Due in large part to concern that the determination of LIBOR is based on fewer and fewer interbank transactions, and therefore is an increasingly unreliable benchmark for the global financial markets, regulators worldwide have been working to develop alternative benchmarks. Over the past few years, the US Federal Reserve, the UK's Financial Conduct Authority (FCA) and other regulators have convened industry-led working groups to develop risk-free rates (RFRs) as an alternative to LIBOR, with the goal of replacing LIBOR by the end of 2021.

In the US, the Alternative Reference Rates Committee (ARRC)—a private industry group convened by the Federal Reserve Board and the New York Federal Reserve Bank to plan the market's transition away from US dollar LIBOR—has selected SOFR (the Secured Overnight Financing Rate) as the new interest rate benchmark for US dollar-denominated transactions in bond and loan markets. In the UK, SONIA (the Sterling Overnight Index Average) has been chosen as the new interest rate benchmark for pound sterling transactions. Other financial markets, including for transactions denominated in euro, Swiss franc and Japanese yen, have developed their own risk free rates (EONIA, SARON and TONAR, respectively).

Differences Between LIBOR and SOFR

The transition away from LIBOR by the end of 2021 presents a series of significant challenges to the financial markets, for numerous reasons. Many of the challenges stem from the basic differences between LIBOR and the proposed replacement rates, for example SOFR.

First, LIBOR is an inter-bank, unsecured lending rate, whereas SOFR is based on overnight transactions secured by US Treasury securities, a rate considered "risk free." As a result, LIBOR is generally higher than SOFR, often by 20 basis points or more, which difference tends to widen at times of stress in the credit markets. Therefore, a simple switch from LIBOR to SOFR, without more, would mean a lower interest rate, so in an existing transaction a transition from LIBOR to SOFR would require an upward adjustment—referred to as a "replacement benchmark spread"— to ensure that the pre- and post-amendment rate levels are compatible. The negotiation between creditors and borrowers of the amount of the replacement benchmark spread may present a challenge, because SOFR—which is tied to

1 LIBOR, the London Interbank Offered Rate (formally known as ICE LIBOR), is calculated and published each day by the Intercontinental Exchange (ICE) as a benchmark interest rate, based on the interest rate at which major global banks would lend to one another at different maturities. Prior to 2014, LIBOR was set by the British Bankers Association (BBA), but LIBOR's demonstrated weaknesses during the financial crisis of 2008 led market watchdogs to replace the BBA with a new administrator, ICE.

the securities repurchase (repo) market—is at times subject to significant volatility, particularly at month-, quarter- and year-ends. In the US, the ARRC is expected to recommend a specific methodology for determining the replacement benchmark spread, but when amending existing contracts creditors and borrowers will be under no obligation to accept it.

Second, while LIBOR is available for various tenors (e.g., one-month, three-month, six-month, etc.), SOFR is currently only available as an overnight rate, on the website of the SOFR benchmark administrator (the Federal Reserve Bank of New York). For now, the lack of forward-looking term SOFR makes corporate treasurers reluctant to agree to use SOFR in their credit agreements, as they cannot predict how the new benchmark will perform. While private parties are developing forward SOFR curves for different periods (the CME Group, for example, currently publishes one-month and three-month SOFR futures), it will take time for curves to be developed and then gain widespread market adoption.

Finally, given the absence (so far) of a published forward-looking term SOFR, other methods of calculating SOFR are under consideration, each with its own challenges. For example, should SOFR be accrued from the beginning of an interest period on a daily (overnight) basis, with the final interest rate for the period only determined at the end of each interest period? Or should SOFR instead be determined for a given interest period by compounding daily SOFR for the previous one-, three-, or six-month period? While the first option would better reflect market interest rates during the interest period, neither the creditor nor the borrower would have predictability in terms of future interest income/expense. Many corporate treasurers would be informed immediately preceding the payment date how much interest would need to be paid, raising operational back- and middle-office issues both for creditors and borrowers. The problem is compounded for those non-US borrowers required to close a foreign exchange transaction in advance to effect US dollar payments.

Amending Existing Contracts

Perhaps the greatest challenge to the transition from LIBOR to SOFR will be to amend the contractual terms of existing financings that are due to mature after the LIBOR transition date. An estimated $35 trillion of currently outstanding LIBOR-linked financial transactions expire after 2021 (in comparison, the US national debt is $22 trillion). The problem is particularly acute if, prior to the parties successfully amending the contracts, LIBOR itself is no longer published or is otherwise no longer considered a reliable measure of inter-bank lending rates. Concern has been raised about so-called "Zombie LIBOR," where LIBOR remains in legacy contracts after the point when it is no longer supported or reported.

Credit agreements for LIBOR-based loans generally provide a definition of LIBOR, with that definition providing certain "fallbacks" in case LIBOR is no longer determinable based on the method provided in the document (generally a designated display page on a Reuters or Bloomberg rate screen). However, these fallbacks are—particularly for many older agreements—generally triggered only when LIBOR is *unavailable* (for example, if for some reason LIBOR is not displayed on the designated rate screen on the interest rate determination date), but do not consider a scenario where LIBOR *no longer exists*. Credit agreements also typically contain provisions that apply an alternate base rate in the event that either (a) LIBOR cannot be determined, (b) dollar deposits are not being offered in the London interbank market or (c) LIBOR no longer reflects the lender's cost of funding a loan. Those alternate base rates are often based on the Prime Rate, the Fed Funds rate or some other agreed upon rate, but these alternate rates were added as a short-term solution for a temporary disruption, not as long-term replacements for LIBOR, in particular as those rates are often significantly more expensive than LIBOR.

More recent LIBOR definitions will generally provide a different fallback, already contemplating a time when LIBOR no longer exists, and industry groups have been working to develop a consistent approach. In 2018, the ARRC released market consultations on potential fallback language for syndicated loans, floating rate notes, bilateral loans and securitizations. In April 2019, the ARRC published its recommendations of fallback language for syndicated loans and floating rate notes, based on feedback it received from market participants. The ARRC published its recommended fallback language for bilateral business loans and securitizations in May 2019. Even so, while at least some market participants have adopted the ARRC recommendations in whole, fallback language is still being developed and it will be difficult for the market to develop adequate language until the uncertainties surrounding SOFR are resolved.

Loan modification itself will be a challenge, even after market-standard fallback language has become more fully developed. Loan modification negotiations for bilateral loans between lenders and sophisticated borrowers should be relatively straightforward, though any discussion of a benchmark spread adjustment may be a challenge, especially if negotiated at a time of market stress, when LIBOR and SOFR diverge more significantly. Syndicated loans, the documentation of which often require the approval of lenders holding 100% of the outstanding loan for any proposed modification of the method for calculating interest, will be a greater challenge, particularly if there are numerous members of the lending syndicate with different levels of sophistication regarding the market shift from LIBOR

Continued from p.15

to SOFR. In addition to the obvious LIBOR provisions, amendments may also need to be made to provisions regarding break-funding, make-whole and increased costs, among other clauses. The coordination role of administrative agents will be critical.

But the greatest challenge will likely be to modify floating rate notes (FRNs) that have been widely distributed, as generally the approval of noteholders holding 100% of the outstanding notes is required to amend existing terms and conditions affecting interest rates. To the extent a LIBOR-based FRN is held by a significant number of retail investors, and the terms of the FRN require 100% approval for amendments and have an old-style LIBOR definition, then liability management exercises (such as debt-for-debt exchange offers) should be considered to help mitigate the risk, if at least in part.

New Credit Agreements Prior to LIBOR Cessation

For new credit agreements being entered into now and using LIBOR as the interest rate benchmark, the ARRC has proposed two different approaches for making future amendments when LIBOR ceases: the "amendment" approach and the "hardwired" approach. (And each of these approaches varies slightly when applied to syndicated loans as opposed to bilateral loans.) Generally, if a credit agreement has adopted the amendment approach, then upon the occurrence of a defined replacement trigger (certain LIBOR cessation or pre-cessation events), the lender (in the case of a bilateral loan) or the borrower and the administrative agent (in the case of a syndicated loan) may agree to amend the credit agreement to replace LIBOR with an alternate benchmark rate (which may include term SOFR), which rate becomes effective unless the other party or parties to the credit agreement (for example, a certain percentage of "required lenders") object in writing within a specified timeframe. However, if instead a credit agreement has adopted the hardwired approach, then upon the occurrence of a defined LIBOR replacement trigger, LIBOR is automatically replaced with a rate determined in accordance with a pre-agreed "waterfall": first, term SOFR (if available), then compounded SOFR (if available), and then finally another alternate benchmark rate. Each of these two approaches—amendment approach and hardwired approach—has advantages and disadvantages.

Generally speaking, the amendment approach provides the parties with greater flexibility in establishing a rate to replace LIBOR upon the occurrence of a LIBOR replacement trigger. However, one disadvantage to the amendment approach is that the parties may not be able to agree on a replacement rate when LIBOR replacement is triggered and, in that case, the existing (and inadequate) fallbacks will remain in the credit agreement. Depending on the specific wording of these fallbacks and the then-current market, the result will either be inadequate, unduly expensive or unworkable (particularly for loans having longer tenors), and will inevitably in some cases lead to litigation. Another disadvantage is systemic: market-wide adoption of the amendment approach will lead to a critical bottleneck when a cessation trigger occurs. In 2021, lenders—and particularly administrative agents—will be hard-pressed to effect simultaneous amendments to a tsunami of credit agreements.

At the same time, while the hardwired approach has the advantage of not depending upon the parties reaching agreement to a replacement rate in the future at the time a LIBOR replacement trigger occurs, the parties do risk agreeing in advance to a replacement rate (e.g., term SOFR) that does not currently exist and may never fully develop. The ARRC's hardwired approach includes a required benchmark spread adjustment based on spread adjustments (or adjustment methodologies) published by relevant governmental bodies or ISDA. While the amendment approach contemplates that the parties will select a benchmark spread adjustment at the time of the amendment, the parties would still need to agree on the amount (or the methodology for determining the amount) of the adjustment, though giving "due consideration" to certain defined factors. Given that LIBOR is generally higher than SOFR, these spread adjustment provisions are important. Without such provisions, borrowers and the lenders will have different incentives in determining whether a LIBOR replacement was actually triggered, with borrowers likely preferring an early switch to SOFR and lenders likely preferring a later switch (all other things being equal). For this reason, the ARRC spent considerable effort to develop objective and knowable triggers as part of its consultations.

Our recent experience suggests that, in the case of credit agreements, parties are more comfortable with the amendment approach than with the hardwired approach until more information regarding replacement rates becomes available. On the other hand, in the case of transactions where post-closing amendments are difficult (for example, in FRNs), the hardwired approach is generally preferred.

Other Considerations

The migration away from LIBOR presents other risks to both creditors and borrowers.

Hedging – ISDA is undertaking separate consultations for the derivatives markets, and consulted with the market in July 2018 regarding derivatives referencing GBP LIBOR, CHF LIBOR, JPY LIBOR, TIBOR, Euroyen TIBOR and BBSW,[2] announcing final recommendations at the end of 2018. In May 2019, ISDA published two new market consultations. The first consultation sought feedback concerning benchmark rate fallback adjustments for derivatives referencing USD LIBOR, Hong Kong's HIBOR, Canada's CDOR and Singapore's SOR. The second consultation sought market input regarding the use of pre-cessation triggers for USD LIBOR and certain other IBORs. Because ISDA is conducting its own separate market consultations, there is concern that the ISDA fallbacks and ARRC fallbacks may not align, generating worries of fallback misalignment between loans / notes and their respective interest rate hedges.

For example, an area of potential divergence between the LIBOR replacement proposals applicable to the cash (loan) and derivatives markets relates to the method of determining replacement benchmark itself. ISDA has announced that it expects to utilize a compounded replacement rate calculated in arrears as its fallback for derivatives. To the extent the loan market adopts a forward-looking term SOFR (or some other methodology for determining the replacement benchmark) instead of a compounded SOFR in arrears, there will be a mismatch between loans and their associated hedges. The ARRC has included a "hedged loan" option in its recommended fallback language for bilateral business loans. This option contemplates that the loan will fall back to the benchmark replacement rate and spread adjustment selected by ISDA, thereby mitigating the risk of misalignment between the loan and any associated hedge.

Another potential area for misalignment concerns the use of pre-cessation triggers (e.g., a public statement by the regulator for the administrator of LIBOR that LIBOR is no longer representative). Based on the preliminary results of its market consultation, it is not clear whether the ISDA proposal will include pre-cessation triggers. Accordingly, if ISDA decides not to use pre-cessation triggers, credit agreements that include the ARRC's pre-cessation trigger may result in the replacement of LIBOR before it has ceased to be published, while any associated hedges using ISDA's fallback language would continue to be based on LIBOR until it is officially discontinued.

2 "BBSW" refers to the Australian dollar Bank Bill Swap Rate.

Regulation – For financial institutions in particular, there is increased regulatory focus on ensuring that banks are prepared. The FSB (Financial Stability Board) and IOSCO (the International Organisation of Securities Commissions) have been coordinating international efforts for interest rate benchmark reform. In recent months, the US's Federal Deposit Insurance Corporation (FDIC) focused its Winter 2018 issue of *Supervisory Insights* to the end of LIBOR, while the US Securities and Exchange Commission (SEC) has identified it as a disclosure and operational concern for both reporting companies and securities industry participants.

Taxation – In the US, several issues have been raised about the tax impacts of converting existing loans and other financial instruments from LIBOR to a replacement rate. For example, there is concern that the conversion could result in a determination that there was a material modification of the indebtedness, potentially resulting in a taxable exchange. A similar concern is raised under FATCA, where a material modification to an existing financial instrument can cause the issue to be deemed a new issuance, jeopardizing the "grandfathering" exemption from FATCA withholding for instruments issued before July 1, 2014. This would be a particular concern in the context of an older, existing securitization, where the documentation establishing the issue likely contains no provisions contemplating FATCA withholding. In October 2019, the US Treasury and the US Internal Revenue Service proposed regulations aimed at relieving some of the US tax burdens arising from LIBOR transition.

Accounting Treatment – Similar in some ways to the discussion about tax aspects of LIBOR transition, concerns have been raised about the accounting treatment of modified financial contracts. Much of this focus has been on the accounting treatment for hedges, as under both US GAAP and IFRS a material modification of a hedging instrument (for example, of its interest rate) may result in the instrument being deemed terminated, resulting in the de-designation of the associated hedging relationship. Each of FASB and IASB is considering changes to its existing accounting standards to address LIBOR transition.

Potential for Disputes – For many of the reasons discussed above, there may be instances where it will be a challenge to incorporate fallback provisions into an existing financial instrument prior to the cessation of LIBOR because of the inability to obtain requisite consent from the relevant constituents. Absent a statutory or other "fix" that applies across the different market segments, the potential for disputes in these cases is a real concern that should be considered as firms analyze their needs and objectives.

Continued from p.17

Recommendations

Both creditors and borrowers should already be preparing for the transition from LIBOR to SOFR. We would recommend the following:

First, parties should take stock of their LIBOR exposure under existing loans, notes and derivatives, focusing on transactions maturing after 2021. The definition of LIBOR should be reviewed, as well as the provisions for amending the terms and conditions of the regarding modification. Discussions with counterparties should begin as soon as possible to ensure that counterparties are also aware of the conversion from LIBOR to SOFR.

Second, parties should review standard documents that are likely to be used for future transactions, such as under medium term note (MTN), commercial paper (CP) or certificate of deposit (CD) programs, to check whether amendments should be made in contemplation of future issues. For example, consideration should be given to changing existing program documentation to permit less than 100% approval for amending LIBOR-related interest rate provisions, reducing the ability of small groups of holdout creditors to block necessary amendments. Parties should monitor developments in standard LIBOR replacement language and the developments involving potential term SOFR and "replacement benchmark spread." In addition, given the concern that both SOFR and LIBOR fallbacks may develop in different directions between standard lending/securities documentation and standard ISDA documentation, companies should review credit and hedging documents carefully to avoid potentially costly gaps.

Third, parties, particularly lenders and agents, should review their internal systems to understand what adjustments may be required for loan accrual in SOFR, whichever SOFR calculation method is ultimately used by the market. Back- and middle-office systems and procedures, such as client invoicing, will also need to be adapted.

Finally, parties—again, particularly lenders and agents—should already begin advising their client borrowers and issuers that LIBOR is coming to an end, preparing them for the changes to come. Less sophisticated counterparties may need additional time to educate themselves on the upcoming changes to LIBOR and the adoption of SOFR.

Final Thoughts

While 2021 may still seem well in the future, the adjustments that market participants will need to make will be significant, and these adjustments will be undertaken while replacement rates and fallback provisions remain unresolved. The time to take stock of your company's exposures, and to map a path forward, is now. One of the last bands to perform at Woodstock was Blood Sweat & Tears: if the issues raised by the transition to risk-free rates remain unresolved by the end of 2021, LIBOR may well end on a similar note.

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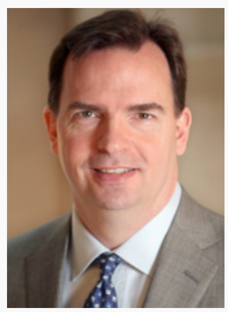

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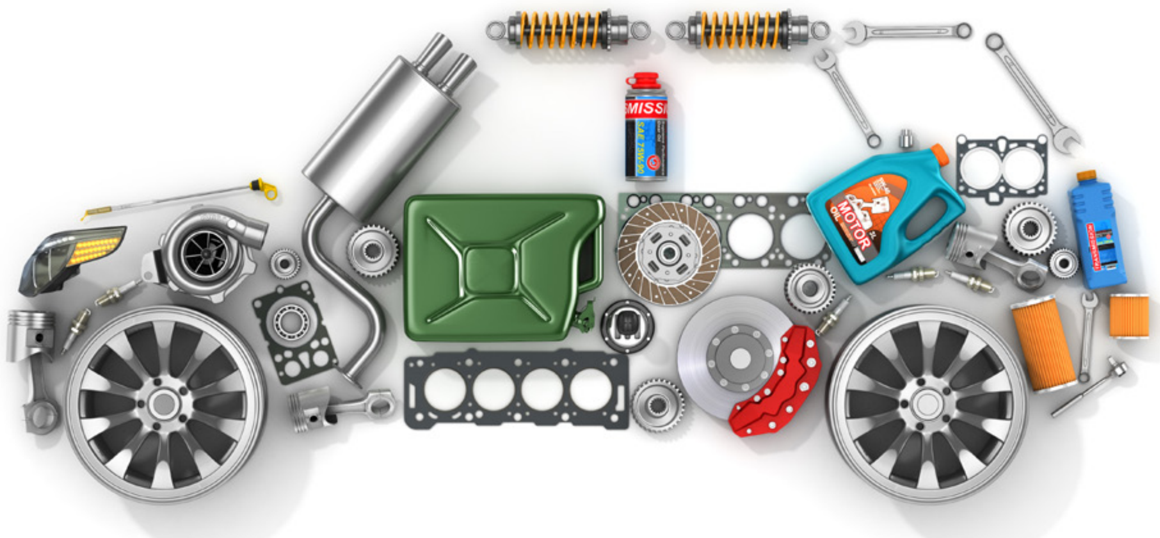
AUTOMOTIVE INDUSTRY SLOWDOWN AND RESPONSES BY SUPPLIERS[1]

BRENDAN JOYCE, CIRA
Alvarez & Marsal



Introduction

It's been quite a ride for the automotive industry. Automakers and suppliers have enjoyed more than 10 years of steady growth since the Great Recession of 2007–2008 and recently completed an unprecedented four years of sales of 17 million or more units in the United States. As the U.S. entered its longest economic expansion in history this year, unemployment rates have declined to near historic lows, boosting the purchasing power and confidence of consumers. However, other macroeconomic and industry factors are casting doubt on the next chapter.

In one of the largest sales rebounds experienced by the industry since the Depression in the 1930s, consumers fueled the growth and the automakers were there to offer them exciting new products. The consumers took advantage of higher employment levels, growing income and persistently low interest rates — even 0% loan offers for new vehicles — to relieve pent up demand from last decade's recession.

Fierce competition by the automakers helped feed that demand as products improved and the technology inside those products was appreciated by the consumers. The success of the automakers allowed suppliers to build capital and helped shape the next chapter facing the industry. What effect will this pending downturn have on fundamental changes in the industry, and specifically on automotive parts suppliers?

Here we are in 2019, and sales are heading south, at least for the short term. The industry is facing pressures: sales and production are slowing; technology is transforming the industry; capital investment requirements are straining operational planning; and macroeconomic headwinds from trade agreements, signals from the bond markets, regulatory environments and an uncertainty from domestic and global economic slowdown all threaten to force action by the industry.

Longer term, big emerging trends in transportation mean the industry must continuously innovate, and capital planning is vitally important. Consider just a few trends: how people move from point A to point B is changing in previously unfathomable ways. Whether it's autonomous vehicles, emerging subscription car services (why own when you can subscribe? Gen Z wonders) or the way everything from refrigerators to vehicles now connects us with the internet, the industry faces unprecedented opportunities.

Automakers and suppliers face both short-term and long-term challenges, and for those well-positioned to

1 This article was produced with research and support from the A&M Insight Center. The author thanks others at A&M for research and market commentary that supported the article. See list of sources on page 28.

Continued from p.19

take advantage of the big trends — electric vehicles being the chief catalyst for change — these challenges can become extraordinary opportunities.

Preparing for the changes in the industry requires a sober look at the present, a guide to help brace for a downturn and an understanding of how companies — and suppliers in particular — can navigate a distressed situation and transform themselves to meet the industry's needs in the future.

Industry Snapshot

Sales and Production Trending Down

The signs of a slowdown are becoming obvious, as new vehicle sales have peaked and automakers are enacting workforce reductions and adjustments to the production mix and capacity. Sales volume in the U.S. is forecasted to decline to 16.3 million units in 2019 and further decline to approximately 14.0 million in 2021–2022 before rebounding, according to Bank of America Merrill Lynch Global Research (BAML) (Exhibit 1). This would cause substantial issues for an industry that produces low margins, has a fixed cost structure and requires significant capital for product, engine development and technology.

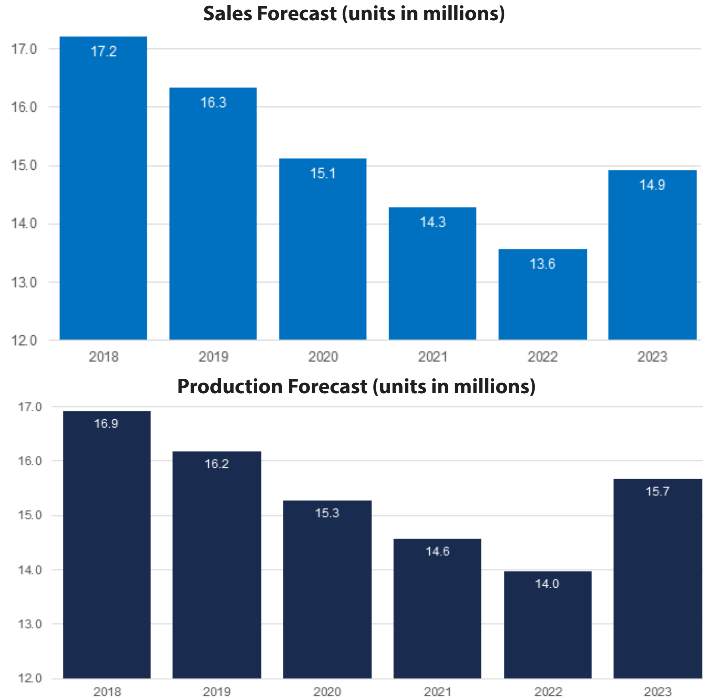
Two of the factors driving the slowdown in volumes are consumer choices and new vehicle affordability. Costs for product technology coupled with consumers' raging demand for truck and SUV vehicles over cars is causing higher price tags for new vehicles.

For consumers, the ability to absorb higher prices may be waning. Automakers anticipate a bubble effect in three years, as a high volume of vehicles come off lease and flood the used market, driving down industry pricing. As the volume of used vehicles grows, trade-in values decline, which will influence production and sales of new vehicles as consumers will have to finance more of the final price tag.

Consumers looking to trade in a vehicle may find they owe more than it's worth. That potential for negative equity means they'll look for cheaper alternatives, such as lower trim levels, or even forego new purchases altogether, opting instead for a late-model or certified used vehicle.

Anticipating a change in the weather for the industry, automakers and suppliers have begun to take actions on their cost structure to preserve margin and liquidity with the pending downturn. In 2018, many automakers announced substantial adjustments to their production schedule to manage inventory and prepare for softening demand. For example, General Motors stated it would close three plants and stop building the Chevy Impala and Cadillac XTS sedans. Ford Motor Company revealed it will have reduced 7,000 salaried employees, or 10% of its salaried workforce, by September 2019 and plans

Exhibit 1: Sales and Production Will Decline Before Rebounding in 2023



Source: WardsAuto, BAML Global Research estimates – report dated January 2019

to phase out production of most of the cars it sells in North America (its iconic Mustang and another future vehicle will remain in the portfolio). Finally, Fiat Chrysler Automobiles (FCA) is extending downtime at its plants to better align its production with sales and recently sold its automotive components division to add to its capital reserves.

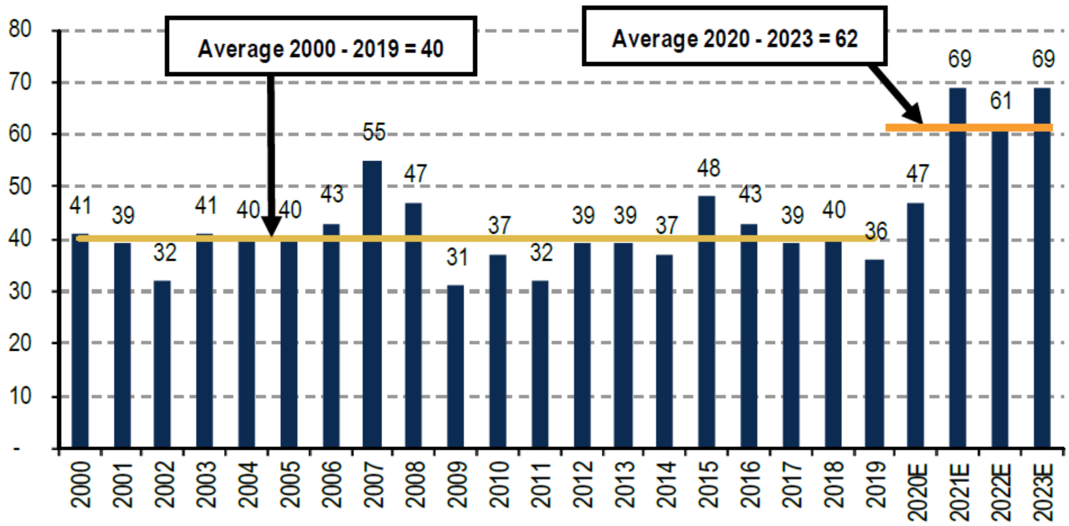
Another major tactic in the industry is seen in automakers' acceleration of the product cycle to maintain or grow market share. Companies are forecasted to launch an average of 62 new vehicles annually from 2020 to 2023, compared with an average annual rate of 40 new units over the past 20 years (Exhibit 2). From 2020 to 2023, the industry will replace 79% of its products, according to forecasts from BAML. It is noteworthy that more than 70% of new vehicles in the pipeline are either trucks or crossovers.

For the suppliers, the faster replacement rate will add pressure, especially as they face production demands to reliably manufacture new products coupled with uncertain timing and levels of demand from the automakers.

Technology and Realignment Require Heavy Investments

A significant challenge facing executives and directors in the boardroom is the pace of technological change required to satisfy consumers' demands. The industry continuously invests in technology, providing an incremental return in the short term; however, the

Exhibit 2: New U.S. Product Launches Reflect Accelerating Product Cycle



Source: BAML Global Research – report dated June 2019

investment is massive and necessary for long-term returns on investment for fully autonomous and 100% electric vehicles.

Anticipated future returns have attracted companies from beyond the traditional automotive industry due to real prospects for growth in their respective sectors. Apple, Google, Uber and Samsung lead the list of well-capitalized non-industry organizations that see advantages to autonomous deliveries, ride sharing, and vehicle connectivity and mobility, among others.

The following discussion highlights three key technologies:

- **Autonomous vehicles –** Technology which allows for driverless operation could increase the demand for those applications in many areas beyond ride sharing and product delivery. Therefore, automakers expect their investments to pay off in the long term. Part of that payoff includes greater efficiencies in travel and improved travel speed, two factors anticipated to drive future demand. Additionally, automakers must address consumer safety concerns, as well as a lack of standardized infrastructure to operate an effective autonomous fleet. In the meantime, the lack of return on autonomous vehicle investment in the short term will be a drag on the industry.
- **Electric vehicles** – Another technological catalyst, fully electric vehicles, is likely to take years for consumers to completely adopt but seems inevitable. The cost to manufacture an electric vehicle is currently higher than traditional vehicles based on the components but is expected to decrease over time, making them more and more attractive to the marketplace. That tipping point, according to BAML, will likely be in the mid-2020s as the total cost of electric vehicles will be equivalent to the total cost of traditional internal combustion engine powered vehicles. Today, the material costs of an electric vehicle are estimated at $33,600, more than double the $14,500 average cost of components in an internal combustion engine powered vehicle.

  Led by China, the U.S. and Norway, the global electric vehicle fleet exceeded 5 million units in 2018, nearly double the 2 million units from the previous year. Automakers have pledged higher production of electric vehicles in recent years. General Motors announced it will produce 20 new electric vehicles worldwide by 2023, and Volvo said it would only produce new vehicles with alternate powertrains after 2019, including five new electric vehicles by 2021. Volkswagen is making an aggressive bid to become the largest electric vehicle manufacturer among traditional automakers starting in 2020, when it intends to start selling a planned 22 million electric vehicles over the next decade under its goal of discontinuing internal combustion engines in its product portfolio.
- **Enhanced connectivity** – Finally, enhanced connectivity is a major influence in the industry and requires major research and development resources. Connectivity, in this sense, is how vehicles communicate to one another and to the internet. It forms the backbone of any efficient autonomous fleet in the future. However, significant investment in infrastructure to create the "smart road network," as BAML calls it, is vital for successful autonomous vehicle operation on scale, and there's little interest from the government sector so far to invest.

We can expect investments in these three technologies to impact earnings and cash flow across the industry in the near term. However, development over time will fuel demand and growth as consumers benefit from cost effectiveness and efficiencies which could produce an impressive economic stimulus. By far the most

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rapidly expanding technology is electric vehicles, which are expected to overtake internal combustion engine vehicles by 2037.

Macroeconomic Headwinds Produce an Uncertain Climate

Although the pillars of economic activity – gross domestic product, income growth, consumer confidence – are positive, market signals have moved from green to yellow. Ten years of growth continued through the second quarter of 2019 as the economy in the United States grew by 2.1%, down slightly from 3.1% in the first quarter.

The Federal Reserve, which was poised to raise rates at the end of 2018, cut rates for the first time since the financial crisis by a quarter point at the end of July, clearly signaling their concern with near-term activity and unsatisfying levels of inflation in the market. It followed with another quarter point reduction in September. Lower interest rates are a major factor in financing a large purchase such as a vehicle, which should provide some stimulus to the industry.

Similarly, the unemployment rate is near historic lows, and recent wage growth should fuel confidence of consumers to continue to purchase durable goods.

Finally, and most positively, is the pent-up demand for new vehicles. The average life of a vehicle on the road is nearly 12 years, much higher than the historical average. In comparison, the average life of a vehicle at the turn of this century was nine years, according to the U.S. Bureau of Transportation. Improving reliability has assisted with duration and life of vehicles, but at some point, vehicles wear out. The question then is whether consumers will purchase a new or used vehicle to replace it.

Going in the opposite direction, the stock market fell 800 points in mid-August as bond yields are signaling trouble ahead with the 10-year Treasury Bond declining below the two-year Treasury Bond ("the inverted yield curve") for the first time since 2007. Analysts consider this a key predictor of a pending economic recession.

Despite favorable economic conditions, the industry is facing headwinds that will negatively affect vehicle sales and production in the middle of the historic transformation of the industry, which may divert focus.

Additional influencing factors:

- **Raw materials** – From 2011 to 2016, the industry benefited from declining raw material inputs, as the cost of materials in the average vehicle fell by more than half to $2,000. Suppliers particularly benefited, since lower raw material costs increased margins. In 2018, the trend began to reverse and is expected to persist as a headwind through 2019 and possibly beyond. While still near historically low levels, raw material costs are now going in the wrong direction for the industry. Costs for steel, resin, plastics and other component materials have increased, with steel taking on the added burden of the trade war with China.
- **Trade policies** – The tension between countries that are intertwined with the supply chain is causing executives to evaluate their production footprint and long-term plans. Governmental policies and standards are a driving force in the sector. For example, the United States–Mexico–Canada Agreement (USMCA), signed in September 2018 to replace the North American Free Trade Agreement (NAFTA), will require more of a vehicle's parts to be made in North America for the vehicle to avoid tariffs. The USMCA will also require that 40% of motor vehicles be manufactured in facilities where workers earn at least $16 per hour. And since the agreement allows automotive workers in Mexico to form trade unions, manufacturing south of the border will become more expensive.[2]
- **Government regulation** – Meanwhile, higher energy efficiency regulations are putting pressure on the industry to respond. In the United States, regulators set a target of 54.5 miles per gallon (mpg) for a fleet-wide average by 2025, which compares to 25.0 mpg in 2017. While automakers support these targets, they also realize further innovation and change is required to achieve the targets. The Trump Administration aims to freeze mpg goals at the 2020 level and prevent California from setting its own, stricter mandates. If passed, the measure would provide some relief to automakers in the short term. In July 2019, four major automakers announced they reached a deal with the State of California to increase fuel efficiency standards.
- **Fuel prices** – Volatility in gas prices may affect consumers in a negative manner in the short term. For the past decade, consumers have enjoyed low gas prices and have opted for higher margin trucks and crossovers, and the automakers are predicting gas prices will remain at a low, sustainable level. If an event (i.e., geo-political) caused a dramatic increase in gas prices, that would divert disposable income to paying for gas and impact consumers' ability and appetite to purchase or lease a new vehicle. Separately, the automakers have made significant adjustments to their product portfolios, which means, if gas prices were to remain elevated for a long period of time, the consumer would have fewer options for smaller, more fuel-efficient vehicles.
- **Interest rates** – Consumers, buoyed by favorable interest rates, have been opting for higher-priced vehicles with longer-term loans. As the Federal

2 At the time of this publication, the USMCA had been passed by Mexico but was still pending ratification by the legislatures of the U.S. and Canada.

Reserve begins to reduce rates to counter the anticipated lower economic activity levels and global influences, this will provide stimulus to the industry and may push some consumers who are on the fence into local dealerships. In this historically low interest rate environment, automobile financing has been very favorable for consumers, so any change in the cost to finance would have negative effects on sales volume of new vehicles.

- **Intra-industry hurdles** – Challenges within the industry also threaten to slow growth. In general, the automotive industry produces low margins, has a fixed cost structure and requires significant capital for product development and technology. Product recalls and testing violations present challenges to the automakers and have caused a significant drain on resources and reputations over the past few years.

  In addition, customers are pressuring suppliers to reduce prices in the face of lower volume forecasts over the next few years. The automakers are enacting cost reduction programs and are concurrently demanding the same from the suppliers. Another indicator of softening demand is the increasing incentives for new vehicles offered by automakers. In August 2019, the industry reported an average incentive of $3,825 per vehicle, exceeding 10% of the total price of the vehicle.

- **Tariff uncertainty** – A final macroeconomic headwind facing the industry is the uncertain tariff environment prompted last year as the United States set off a trade war with various countries, including China, a significant player in the manufacturing industry in North American and an essential market for automakers based in the United States. While the Trump Administration earlier this year eased restrictions with China, the climate is volatile. Any implementation of tariffs will increase consumer prices for new vehicles, further lower sales volumes, impact U.S. GDP and raise the overall cost of vehicle ownership.

  So far in 2019, U.S.-sanctioned tariffs on China have driven up the cost of raw materials such as steel and aluminum. Continued negotiations between the U.S. and China may result in higher costs for other raw materials that will impact the industry.

Supplier Responses to the Industry's Challenges

In a distressed situation, a supplier can find relief by simultaneously taking actions on both the operational and financial side of their business. While the industry has experienced a good decade, below is a refresher of some typical tactics suppliers can deploy to counter the impacts of falling revenue, or if in distress, ways to conduct a restructuring to address many of the most disruptive challenges.

Tactics to Prepare or Shield Suppliers in a Downturn

Automotive suppliers have done well the past decade to bolster their financial health with steady earnings growth and a reduction in leverage. But based on the expected slowdown in the industry, now may be the time to work with the balance sheet to find additional liquidity and flexibility and make operational adjustments. The good news is that suppliers have several options to prepare for and react to declining revenues and margins.

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Exhibit 3: Financial Information for Hypothetical Mid-Market Supplier

Sales and Expenses (based on 250 production / sales days)

	Annual Total	Per Day
Sales	$500 million	$2.0 million
Cost of Goods Sold (COGS)	$425 million	$1.7 million
COGS Minus Labor Costs	$300 million	$1.2 million
Capital Expenditures and Debt Service	$75 million	

Selected Balance Sheet Amounts as of June 2019 (in $millions)

Total Assets (in millions)	$850	Total Liabilities and Equity	$850
Cash and Cash Equivalents	$50	Current Portion of L-T Debt	$75
Accounts Receivable, Production	$100	Accounts Payable	$50
Accounts Receivable, Tooling	$15	Long Term Debt	$225
Inventory	$100	Other Liabilities	$135
Property, Plant, Equipment, Net	$585	Equity	$365

Alvarez & Marsal, Illustrations

The automotive industry is a relatively low-margin, capital-consuming industry – fixed costs are high as a percentage of total costs, and based on the product turnover, demand for elevated amounts for tooling and equipment expenditures are significant. When suppliers work to strengthen their financials by trimming costs, it's important that they focus on two goals: cash conservation and providing as much liquidity as possible for the operational and commercial teams to resolve, or develop a plan to resolve, the issues.

Exhibit 3 presents illustrative financial information for a hypothetical mid-market supplier that will be used to demonstrate areas owners and operators should examine in order to find sources of incremental liquidity for the business.

As suppliers take steps to resolve some of the pressures, such as reduced production days and required capital expenditures and debt service, there are a few common ways to generate additional liquidity via the balance sheet. They include seeking avenues for increased credit, negotiating temporary changes in terms for accounts receivable and/or accounts payable, and encouraging equity contributions or investments in the business.

Following is a discussion of common ways to utilize the balance sheet to generate additional liquidity, using information from Exhibit 3 for illustration.

Borrowing or increased credit lines (using an ABL)

Our supplier has approximately $200 million of working capital assets, or accounts receivable and inventory. As this supplier does not already have an asset-based loan (ABL), they have a valuable option in front of them: they can utilize the saleable collateral on the balance sheet to offer coverage to lenders that will provide them credit. This is very common in this industry that allows the supplier to access funds to pay bills at very manageable interest rates. This would result in more leverage for the business but the market factors may require it, the debt is usually inexpensive since the loan is secured by collateral and the lender has the ability to exit when the value of the collateral no longer supports the borrowed amounts.

In a more pressing situation, seeking accommodations from an existing lender may provide temporary relief. However, suppliers should develop a comprehensive game plan before approaching lenders as any request will most likely prompt a strong reaction, straining the relationship between the parties.

Further tactics to extract liquidity (without an ABL)

- **Accounts receivable, production** – One of the ways our supplier can make the current assets work harder for the company is by negotiating a reduction in payment terms from their customer(s). It's a lever that quickly helps the supplier's liquidity situation. This straightforward request accelerates the payment cycle to the supplier and benefits cash flow. This usually involves a tough negotiation, depending on the supplier's perceived value to the customers. Negotiating will require clear communication and a sound game plan to manage the potentially negative consequences from customers who prefer the status quo. To illustrate the working capital benefit of renegotiated terms, our supplier in Exhibit 3 has an accounts receivable balance at the end of June 2019 of $100 million, and the current contractual payment terms are 45 days from receipt of the good or service. By implementing a five-day reduction in terms, the supplier would see incremental liquidity of approximately $10 million, or 5 x $2 million sales per day.

- **Accounts receivable, tooling** – Using a similar strategy, incremental liquidity can be achieved by requesting accelerated payments related to the tooling invoices. The tooling documentation must be approved by the customer's quality department, but once completed and the accommodation granted by the customer, the supplier can pay off the liabilities to the tooling vendor or for general corporate purposes.
- **Property, plant and equipment** – Asset sales are becoming more commonplace in the current environment to generate capital to pay off secured debt and provide financial relief for the business. Based on its current business plan, our illustrative supplier should be asking whether operating assets are being put to the best use and whether there are likely buyers for certain assets that will not be core to the long-term objectives.
- **Accounts payable, trade** – Just as suppliers can use accounts receivable to generate incremental liquidity, they can also renegotiate on the other side of the balance sheet — accounts payable. By getting an extension in the time to pay bills, suppliers can save cash. In our example, the supplier has an accounts payable balance at the end of June 2019 of $50 million with contractual payment terms set at 45 days from receipt of the good or service. By extending the terms by five days, the supplier will realize incremental liquidity for the business of approximately $6 million, or 5 x $1.2 million cost of goods sold (COGS), less labor costs, per day. This tactic is also difficult to negotiate and implement unless the supplier has a compelling reason and the vendors are in good financial shape. These negotiations typically involve extensive communication with vendors, so they have a full understanding of the reasoning behind the concessions and their duration.
- **Long term debt** – Suppliers may be able to seek accommodations on their long-term debt, such as requesting a forbearance or asking for a deferment of quarterly or monthly debt service.
- **Equity** – Finally, owners of the supplier can be another source of funding. In a distressed condition, however, suppliers will need a concise plan from the management team that describes how all other avenues have been explored for additional liquidity and that a solid recovery plan has been developed so any capital infusion is not wasted. If the situation is bleak, the owners may be unwilling to continue investing in the business and have the management team seek other options.

Arming themselves with key tactics and a solid plan to return to optimal performance can help suppliers weather short-term downturns in the economy or industry. Choosing the best option depends on the supplier's immediate- and medium-term needs. The time for action is now.

What to Expect in Restructuring for a Supplier in Distress

The supply chain in this industry is well defined and the automakers depend upon a network of suppliers for goods and service (Exhibit 4). This framework is like other industries where the supply chain is vertical and the success of a customer depends on the success and performance of their suppliers.

For suppliers experiencing distress, building a thoughtful plan to relieve pressure and directly address their customers' demands can mean the difference between failing and thriving during tough times. When the winds of misfortune blow, leadership within the supplier's organization should work with the equity owners to map out a strategy before approaching customers and other constituencies. With appropriate preparation, suppliers can guard against the tendency to battle on numerous fronts when difficult decisions are required.

What does the restructuring process look like for suppliers in the automotive industry? The following analysis may serve as a playbook to help suppliers understand the typical steps in restructuring and the options available to them.

When the operational and financial initiatives discussed above fail to resolve the issues for suppliers, it's time to develop the plan and reach out to others for help. One of the key documents in a distressed situation is a short-term agreement referred to as an accommodation agreement. This document is heavily negotiated and details terms (or accommodations) among the four major stakeholders: the supplier, customer(s), lender and owner(s).

This agreement works as a bridge to carry the stakeholders from the current situation to a resolution. Establishing terms that will be conducive for a favorable outcome is crucial, so finding experts that are experienced with these agreements is important to

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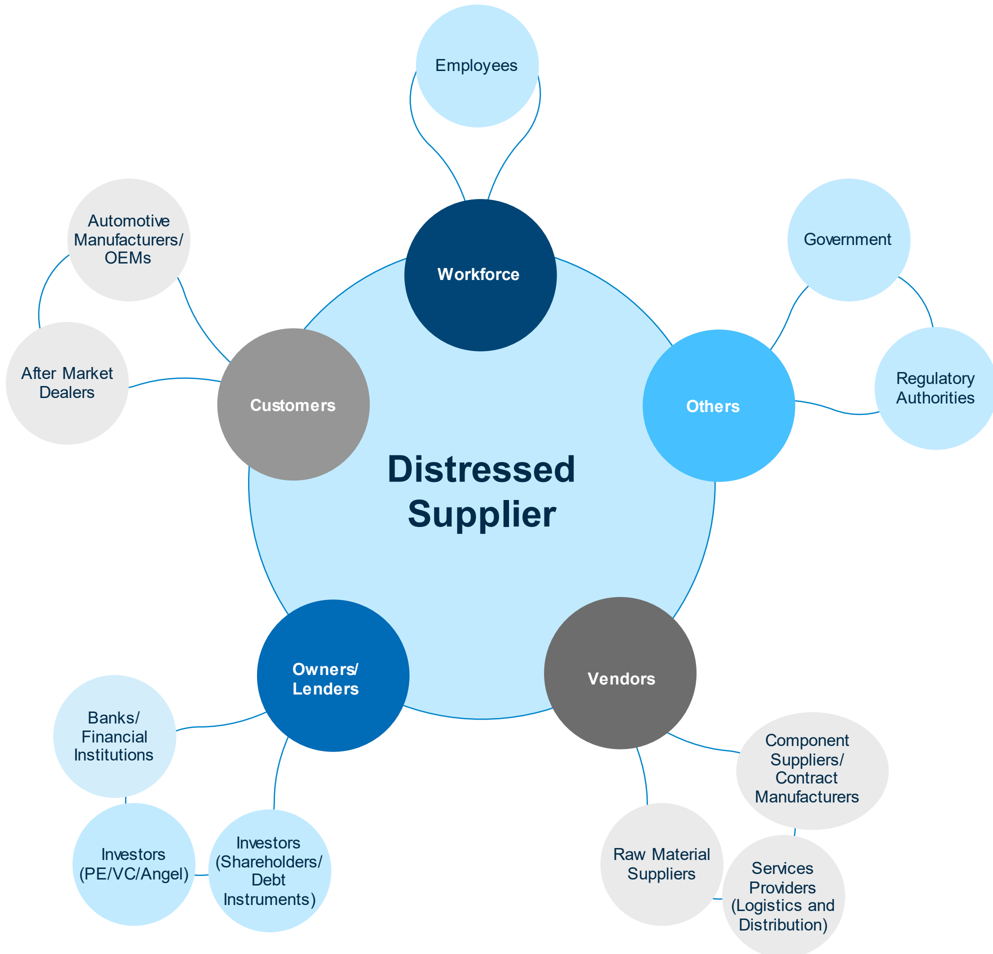
Exhibit 4: Supplier Restructurings Involve Many Stakeholders



help suppliers properly evaluate the terms and overall agreement. Below are some of the most common terms of an accommodation agreement.

Accommodations suppliers may make to the customer(s)

During times of distress and a restructuring process, suppliers will need to assure stakeholders that they can continue to perform under certain conditions. Typically, the supplier agrees to:

- Commit to produce parts, including service parts, and to develop a parts bank (inventory) to provide additional supply, if requested by the customers;
- Grant access to customer(s) that allows them to effectively operate the business and production facilities if certain operational disruptions occur, usually a separate agreement called an access agreement;
- Allow additional oversight and access to information by customers to work through the process;
- Consent to allow customer(s) to evaluate any buyer of the distressed supplier, if the supplier agrees to be sold; and
- Make other accommodations for customer(s), such as providing a purchase option for the machinery and equipment and inventory, which allows the customer to get access to the operating assets to maintain supply.

Accommodations lenders may make to the supplier

In any restructuring process, suppliers need to give lenders assurance the plan will result in improved operations or a path forward to resolve the situation. Accommodations by lenders can help suppliers with required liquidity to provide additional runway. Typical accommodations from lenders include:

- Adjusting the terms of the credit agreement, including higher advance rates on accounts receivable and inventory for ABL lenders to allow the supplier to borrow more, and change economic terms for other debt to provide additional liquidity for the supplier on a short-term basis;
- Committing to fund a reasonably acceptable operating budget and expect that the supplier will coordinate with the lender's workout group or outside advisors;
- Developing a short-term forbearance agreement with terms acceptable to the parties so that the lender does not make a collateral call or tighten

access to liquidity before the final restructuring plan is developed; and

- Entering into an access agreement giving customer(s) a right to operate the supplier's facilities if production issues arise and an option to purchase the machinery, equipment and inventory at a negotiated amount if there is a default.

Accommodations customer(s) may make to the supplier

Terms from the customer(s) to the supplier will depend upon the supplier's unique situation and often change during negotiation. Typical terms from customer(s) include both operational and financial agreements that must work hand-in-hand for a successful resolution of the situation.

Operational accommodations

- Prohibit customers from sourcing the product or service elsewhere, which provides stability to the supplier and usually comes with conditions on performance and milestones;
- Utilize suppliers' understanding of their own underperforming programs or parts to allow coordination with the customer to resource the work if negotiations fail on financial accommodations such as price increases (see below), strengthening the financial outlook for the supplier;
- Employ the customers' operational experts to help resolve a supplier's production problem or to make a change in tooling design to stabilize production;
- Endorse plans to move supplier production sites and pay for the transportation costs, which can help reduce costs (e.g., from a smaller production footprint); and
- Establish an exit strategy for the customer(s) if the process breaks down, which may include a coordinated transfer of production of parts, tooling, or equipment to another supplier to protect the customer's supply.

Financial accommodations

Working in conjunction with the operational improvement plan, financial accommodations offer suppliers numerous options to help bridge the gap between a distressed situation to the ultimate resolution. Automakers and other customers are focused on avoiding supply disruptions and will insert their own operational and financial teams into the situation if there is a threat or potential threat to their supply. Financial accommodations offer the ability to stabilize a distressed situation while the parties negotiate and develop a plan to resolve the situation. However, suppliers must be aware of accommodations from customers that come with conditions that may be onerous for the supplier and could cloud the future of the supplier, based on future sourcing direction from the customers.

- *Accelerated payments* – One of the most common ways to provide immediate liquidity to a supplier is for a customer to accelerate payments for production parts or tooling. This action fast tracks cash to the supplier to pay bills and may help calm the supplier's vendors, but the duration of this accommodation is usually temporary. This action is muted if the supplier is managing liquidity through an ABL. In that case, the accelerated payments provide marginal benefit since the supplier is already borrowing on the accounts receivable from their customers. In general, accelerating payments is a convenient accommodation as it is only a working capital impact to the customers and doesn't affect earnings.
- *Resolution of unsettled commercial issues* – Another way to improve liquidity for suppliers is to resolve their unsettled commercial issues with their customers. Those issues may include unpaid production or tooling invoices or warranty disputes. Putting the resolution on a fast track is a common activity in the restructuring process with suppliers.
- *Limitation of setoff rights* – Suppliers can seek liquidity support by having customers agree to limit any setoff rights, such as costs incurred because of expedited shipping, quality defects or product recalls. Based on the standard agreements, customers can reduce, or "setoff," costs incurred by them on behalf of the supplier and deduct those amounts from payments to the supplier. If the customers agree to limit the setoff to 2 to 5% of the supplier's accounts receivable, this will avoid a bad situation becoming worse because of a rapid drain on liquidity.
- *Other working capital options* – In addition to limiting setoff rights, suppliers can look to other working capital options that are beneficial. For example, customers can reimburse suppliers for research, development, or engineering costs in monthly or quarterly installments rather than amortized in the price of the part over the duration of the program. In cases where there's a disruption of supply or a problem with delivering new tooling in a timely fashion, automakers can make direct installment payments to the production or tooling vendors.
- *Pricing adjustments* – One of the more difficult accommodations to achieve is pricing

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adjustments. Customers are usually averse to higher prices for production parts, but if successful, it could result in incremental liquidity for the supplier. Increasing production parts prices would provide incremental liquidity. Reaching agreement on these terms depends upon the suppliers' position in the market and what alternatives are available to the customers.

- *Loans or other participation agreements* – Finally, customers may agree to make loans to suppliers or establish other forms of participation agreements with lenders in more challenging situations to protect supply. This is typically a bridge to a resolution of the situation such as a sale or transfer of business, since customers prefer not to extend loans to their supply chain.

Conclusion

The market indicators for the automotive industry are flashing a cautionary yellow light right now. With weakening new vehicle demand, diminished affordability, various headwinds and intra-industry pressures, suppliers should look for ways to strengthen operations and implement liquidity measures to conserve cash and prepare for the downturn in order to be well-positioned for the next chapter.

If market forecasts are accurate, and an industry slowdown gains momentum, we can expect an elevated level of restructuring activity from suppliers. For suppliers in distress and facing challenges like production volume declines, product launch issues, unforeseen recalls, tension with customers and lending difficulties, understanding their options in a restructuring context can be beneficial. Fortunately, the restructuring process is well-defined for this industry and offers many options to help a supplier meet the demands of all its stakeholders – from customers and vendors to lenders and owners and to its workforce.

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NOT A SURE THING:

Application of Surety Bonds to Landlord Claims in Light of Bankruptcy Code Section 502(b)(6)

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DLA Piper

So, you are a landlord feeling really good about your recent negotiations with a new tenant. Your lawyer tells you he was able to get the tenant to post a surety bond that will protect you on lease payments if the tenant defaults under the lease, and that even if the tenant files bankruptcy, the surety bond won't be tied up in the bankruptcy because its proceeds are not deemed property of the bankruptcy estate. But did your lawyer also advise you of the potential limitations of the surety bond if damages are from the termination of the lease? Oops.

Section 502(b)(6) of the Bankruptcy Code (the "502(b)(6) Cap") caps claims of a lessor for damages resulting from termination of a lease of real property made against the bankruptcy estate.[1] Of course the capped amount is just the maximum claim amount (the "502(b)(6) Claim") and the actual distribution on such claim remains to be seen, and can vary from $0 to satisfaction in full. To best protect landlords and get around such nil or partial payment from the bankruptcy estate, deposits (more frequently) and letters of credit (less frequently) have been utilized. Certainly, letters of credit, since they do not constitute property of the estate, are the favorable choice as compared to a deposit in which the estate is deemed to hold an interest. However, what is the limitation of application of letters of credit to a capped landlord's claim? And what about surety bonds?

Case law is clear that a landlord must apply a cash security deposit to its capped 502(b)(6) Claim. In an effort to avoid the 502(b)(6) Cap, landlords consider alternative payment guarantees in place of cash security deposits – letters of credit and surety bonds. But what is less clear, however, is whether the proceeds of a letter of credit or a surety bond should be applied to reduce the landlord's entire claim or just to reduce the amount of the 502(b)(6) Cap. These questions have been developed (albeit, with divergent case law) in the context of letters of credit, but remain open and, as far as we found, unaddressed in the context of surety bonds. Nevertheless, lessons from the cases on letters of credit can be applied to surety bonds so we can perhaps predict that similar conclusions may be reached.

1 Section 502(b)(6) of the Bankruptcy Code provides that a claim will be allowed "except to the extent that . . . if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—(6) (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of— (i) the date of the filing of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates[.]"

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This article begins by providing a cursory high-level background on the structure of surety bonds and letters of credit and the key parties in both arrangements. Next, this article discusses section 502(b)(6) of the Bankruptcy Code and the case law and commentator analysis on the applicability of proceeds from letters of credit to a landlord's 502(b)(6) Claim. Finally, this article concludes by discussing how this reasoning may well be expanded to apply to proceeds of surety bonds, and highlights questions that remain unanswered.

Overview of Surety Bonds and Letters of Credit[2]

Surety bonds

A surety bond is a three-party agreement between the surety, the principal and the obligee. The surety provides a financial guarantee, up to the "penal sum" (*i.e.*, the bonded amount), to the obligee in support of the principal's performance. If the principal breaches the bonded contract in a manner covered by the surety bond, the surety is obligated to pay up to the penal sum, and seek reimbursement from the principal.

A landlord (the obligee) may require a surety bond to guarantee payment of rent and other leasehold obligations of the tenant (the principal). The tenant will go to a surety bond provider and request that it posts a bond in favor of the obligee for some fee. Occasionally, the surety will require some form of security from the principal. If the tenant breaches the lease, the landlord is guaranteed payment up to the penal sum from the surety.

It is worth noting that surety bonds are not insurance. While the surety provides a financial guarantee to the obligee, the principal is typically required to execute a general indemnity agreement to the surety stating that, if the obligee calls on the bond, the principal will *fully* indemnify the surety. This is distinct from insurance where, aside from premiums and a deductible, the risk is borne by the insurer. Sureties sometimes require financial assurance from the principal for some portion of the bonded amount.

Letters of credit

Letters of credit are a distinct form of payment guarantee. Where a letter of credit is issued, the issuer, typically a bank, issues a letter of credit to a party requiring payment guarantee and, if the conditions in the letter of credit are met, the bank will make payment independent of the underlying contract. This "independence" from the underlying contract is fundamental and essential to the use of letters of credit in commercial transactions. To mitigate their risks, issuers often require the party for whom it is substituting performance to post security, to have funds on deposit at the issuer that can be frozen or otherwise post security in favor of the issuer.

A landlord may require that the tenant obtain a bank to post a letter of credit in its favor to ensure payment. If the landlord presents the required documentation to the bank, it will be paid the amount stated on the letter of credit, independent of the underlying contract.

Both surety bonds and letters of credit are beneficial when the principal files for bankruptcy. Proceeds from neither surety bonds[3] nor letters of credit[4] are property of a debtor's bankruptcy estate, and courts generally hold that, given this independence, there is no need to obtain relief from the automatic stay to collect against the principal amount.[5] Nevertheless, there is some question regarding whether surety bonds and letters of credit provide benefits beyond these, including whether a landlord must reduce its 502(b)(6) Claim against the bankruptcy estate in the amount of proceeds received from a surety or the issuer of a letter of credit.

Section 502(b)(6) of the Bankruptcy Code

Generally, without any statutory cap, in a bankruptcy case a landlord would be entitled to an allowed claim of all rent remaining under a lease if the lease was breached or rejected under section 365 of the Bankruptcy Code. Congress recognized that such claims could be significant and expressed concern over landlord claims enveloping the amount of allowed general unsecured claims.[6] To address this concern, Congress enacted section 502(b)(6) of the Bankruptcy Code. Section 502(b)(6) of the Bankruptcy Code provides that a claim will be allowed:

> except to the extent that . . . if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds—(6) (A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of— (i) the date of the filing

2 This is a simple overview of the relevant concepts. For purposes of this analysis, a more detailed understanding is not necessary.

3 *In re McLean Trucking Co.*, 74 B.R. 820, 827 (Bankr. W.D.N.C. 1987) ("This conclusion—that the Protective surety bond is not property of the Debtor's estate—is supported by numerous decisions under the Bankruptcy Code.") (gathering cases).

4 Collier on Bankruptcy ¶ 549.04 (Richard Levin & Henry J. Sommer eds., 16th ed.) ("Property of the estate also does not include the proceeds of a letter of credit paid to a creditor of the debtor who is beneficiary of the letter."); *see In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 209 (3d Cir. 2003) ("Under similar circumstances, some courts have adopted the 'independence principle' to separate proceeds from a letter of credit from the debtor's estate.").

5 *See, e.g., In re Illinois-California Exp., Inc.*, 50 B.R. 232, 235 (Bankr. D. Colo. 1985) ("[P]ayment of a letter of credit is not a transfer of assets in violation of the automatic stay provisions of 11 U.S.C. § 362."); *McLean Trucking Co.*, 74 B.R. at 827 (finding that collecting against surety bonds is not prohibited by the automatic stay).

6 Collier on Bankruptcy ¶ 502.03 ("As the legislative history discloses, section 502(b)(6) is 'designed to compensate the landlord for his loss while not permitting a claim so large as to prevent other general unsecured creditors from recovering a dividend from the estate.'") (quoting H.R. Rep. No. 595, 95th Cong., 1st Sess. 353 (1977)).

of the petition; and (ii) the date on which such lessor repossessed, or the lessee surrendered, the leased property; plus (B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates[.]"[7]

Importantly for purposes of this article, it is well-settled that where there is a cash security deposit that can be applied to a landlord's claim, such security deposit will be applied to the 502(b)(6) Cap, rather than to the landlord's total, uncapped, potential claim, and reduce the amount that may be recovered from the bankruptcy estate.[8] Because of the estate's interests, setoff under section 553 of the Bankruptcy Code typically requires court approval, either in the form of relief from the automatic stay or through a stipulation with the debtor.

Application of Security Deposit and Letter of Credit Proceeds to 502(b)(6) Cap

In light of the black letter bankruptcy law discussed above, a fundamental question with differing interpretations has emerged: As opposed to a security deposit, given that proceeds of a letter of credit are not property of a debtor's estate, should those proceeds be applied to reduce a landlord's total claim or applied to reduce the 502(b)(6) Cap? The law with respect to letters of credit is developed (but inconsistent); we found no case law on this issue with respect to surety bonds.

Will letter of credit proceeds be applied to a landlord's 502(b)(6) cap?

Both the U.S. Courts of Appeal for the Third Circuit, *In re PPI Enterprises (U.S.), Inc.*,[9] and Ninth Circuit, in *In re AB Liquidating Corp.*,[10] have applied the proceeds of a letter of credit to the 502(b)(6) Cap, at least in certain circumstances. The Bankruptcy Appellate Panel for the Ninth Circuit famously opined on this subject in *In re Mayan Networks Corp.*[11]

The Third Circuit

In *PPI Enterprises*, the Third Circuit addressed the issue of whether the proceeds of a letter of credit should be applied to reduce the commercial landlord's 502(b)(6) claim. Relying on *Oldden v. Tonto Realty Corp.*, 143 F.2d 916, 921 (2d Cir.1944), "which established the pre-Code practice of deducting security deposits from § 502(b)(6) calculations," the Court applied the proceeds of a letter of credit to reduce the landlord's 502(b)(6) Claim.[12]

In reaching this conclusion, the Court considered the differences between letters of credit, which are collected from the third-party issuer directly, and security deposits which are funded with cash paid by the debtor. The Third Circuit highlighted the "independence principle" that separates letter of credit proceeds from the bankruptcy estate, and found that this suggests that the 502(b)(6) Cap should not be reduced because payment is being made from non-estate property.[13] Next, however, the Third Circuit considered the contrary view that, in not applying letter of credit proceeds to the 502(b)(6) Cap, the third-party issuer would still be entitled to seek recovery from the debtor for all amounts paid, effecting an "end run around" the 502(b)(6) Cap.[14]

Despite considering both sides of the argument, the Court ultimately avoided the issue and concluded that the letter of credit in the subject agreement was intended as a security deposit and on that basis followed *Oldden* and held that the letter of credit should be applied to reduce the landlord's 502(b)(6) Cap.

The Ninth Circuit Bankruptcy Appellate Panel

The next important case on this issue was decided by the Bankruptcy Appellate Panel for the Ninth Circuit in *Mayan Networks*.[15] The lease at issue in *Mayan Networks* described the letter of credit as "security" and provided for the letter of credit to be fully secured by property of the debtor. In light of the pledged security, the Bankruptcy Appellate Panel distinguished *PPI Enterprises*, which did not on its face have a

7 11 U.S.C. (§)502(b)(6). Calculating a claim under section 502(b)(6) of the Bankruptcy Code is somewhat complicated by the fact that there are at least two methodologies: one is whether the cap applies to time remaining under the lease and the second is whether the cap applies to total rent reserved under the lease. Different courts have applied different standards to answer these questions.

8 *See* Collier on Bankruptcy ¶ 502.03 (16th 2019) ("Accordingly, to the extent that a landlord has a security deposit in excess of the amount of the claim allowed under section 502(b)(6), the excess will be turned over to the trustee to be administered as part of the debtor's estate. To the extent that the security deposit is less than the amount of the allowable claim as provided for by section 502(b)(6), the security deposit will be applied toward the satisfaction of the allowed claim.").

9 324 F.3d 197, 200 (3d Cir. 2003).

10 416 F.3d 961, 965 (9th Cir. 2005).

11 306 B.R. 295 (B.A.P. 9th Cir. 2004).

12 *PPI Enterprises*, 324 F.3d at 209. Notably, *Oldden* did address, at least in *dicta*, whether a guarantor or surety could *itself* seek reimbursement from the bankruptcy estate and concluded that such guarantor or surety would be subject to the same limits. This is distinguished from the question of whether recovery on those amounts will limit a landlord's claim.

13 *Id.* (citing *Kellogg v. Blue Quail Energy Inc.,* 831 F.2d 586, 589–90 (5th Cir.1987) (holding that "the independence principle [is] the cornerstone of letter of credit law"); *Musika v. Arbutus Shopping Ctr., L.P.,* 257 B.R. 770, 772 (Bankr. D. Md.2001) (determining the § 502(b)(6) cap without regard to the letter of credit); *see also* 5 *Collier on Bankruptcy*, § 549.04[1] ("Property of the estate does not include the proceeds of a letter of credit paid to a creditor of the debtor who is a beneficiary of the letter."); and Geoffrey L. Berman et al., *Last in Line: Landlords Use Letters of Credit to Bypass the Claim Cap of § 502(b)(6),* 20 Am. Bankr. Inst. J. 16 (Dec. 2001)).

14 *Id.* Interestingly, there are a number of earlier cases in the surety bond context that found the "domino theory"—liability against the debtor based on a surety or guarantor's payment—unpersuasive, at least in the context of the automatic stay. *See, e.g., McLean Trucking Co.*, 74 B.R. at 828 (gathering cases).

15 306 B.R. 295 (B.A.P. 9th Cir. 2004).

Continued from p.31

requirement of pledged security.[16] Nevertheless, the Court in *Mayan Networks* reached the same conclusion on the facts present before it because the debtor had posted security for the letter of credit, and concluded that the proceeds of the letter of credit should be used to reduce the landlord's 502(b)(6) Claim. The Panel explained that:

> From the standpoint of the Debtor's other creditors, the letter of credit has the same effect as a cash security deposit. That is, the amount of money left in the estate to pay unsecured claims is reduced by $650,000. Meanwhile, the landlord has received the full amount of its secured claim, from both the cash security deposit and from the letter of credit.
>
> In this case, the Debtor pledged $1 million as security for its lease. Of that amount, $350,000 was given to the landlord, and $650,000 was deposited in a bank, with a letter of credit then being issued by the bank. The only effective difference between the letter of credit and the cash security deposit was the location of the funds. To allow the landlord to obtain an advantage simply by keeping the money pledged as security in the tenant's bank would defeat the purpose of § 502(b)(6).[17]

Notably, U.S. Bankruptcy Judge Christopher Klein[18] issued a now-famous concurrence in *Mayan Networks* reaching the same conclusion as the majority through application of principles in the Uniform Commercial Code and the Bankruptcy Code, rather than relying on *Oldden*.[19] Judge Klein announced three key principles underlying statutory caps in the Bankruptcy Code:

> The §§ 502(b)(6) & (7) caps, then, reflect a Congressional balance between allowing the creditor with the big rent or employment termination claim to be paid a reasonable sum without unfairly diluting or squeezing out other creditors.
>
> The second principle is a corollary of the first. The key focus in assessing a security deposit is on the effect on the estate (not the creditor) and whose property is in question. If the refund obligation is owed to the estate and, hence, property of the estate that must be returned to the estate, then the analysis is straightforwardly the Oldden result.
>
> …
>
> The third principle complements the first. While the caps operate to limit the estate's liability by way of disallowing claims that are otherwise valid under nonbankruptcy law, they do not limit the capped creditor's damages, and right to recover from others, under applicable nonbankruptcy law. Under § 524(e), any other person who is liable for the disallowed portion of the capped creditor's damages remains liable for damages that are otherwise available under applicable nonbankruptcy law. As noted above, the Bankruptcy Code does not confer independent rights against the estate on co-obligors. In other words, the estate's cap shelters the estate but not co-obligors.[20]

In light of these principles, Judge Klein's analysis differed from *PPI Enterprises* in substance based on, among other reasons, the second principle because it focuses on the effect of draw down to the bankruptcy estate. Since the debtor had posted security for its letter of credit, the issuer could collect against immediately available funds that would otherwise be property of the debtor's estate. Of course, this remains subject to the 502(b)(6) Cap.

As explained by one commentator:

> If the security is not property of the estate (for example, when it is deposited by a third-party guarantor entitled to its return upon the performance of the tenant's obligations), or if the security is in the form of a letter of credit not backed by a lien on assets of the tenant, then it should not reduce the section 502(b)(6) cap.[21]

Additionally, it is notable that Judge Klein expressly recognizes a limit on the 502(b)(6) Cap—it does not apply to non-rejection damages (such as damage to the leased premises or other, similar damages). It is likely that these claims that fall outside of the 502(b)(6) Cap could be covered by a letter of credit, as a matter of non-bankruptcy law, and in such a case the letter of credit would not be applied to the 502(b)(6) Cap.

Although many commentators have analyzed Judge Klein's thorough concurrence, to date, no Circuit has adopted his reasoning.

16 *Id.* at 300.

17 *Id.* at 301. Since the *Mayan Networks* opinion was issued, the Third Circuit has cited it with approval for the proposition that "where the claim centers around the collateral pledged to the bank and not the distribution of the proceeds themselves, 'the fact that letters of credit themselves are not property of the estate is a red herring.'" *In re Kaiser Grp. Int'l Inc.*, 399 F.3d 558, 566–67 (3d Cir. 2005) (quoting *Mayan Networks*, 306 B.R. at 299). It is unclear whether this holding has impacted the conclusions of *PPI Enterprises*.

18 Judge Klein sits both as a bankruptcy judge in the U.S. Bankruptcy Court for the Eastern District of California and as a panel judge for the Ninth Circuit Bankruptcy Appellate Panel.

19 *Mayan Networks*, 306 B.R. at 310 (Klein, B.J., concurring).

20 *Id.* at 307.

21 *See* Alan N. Resnick, Letter of Credit As A Landlord's Protection Against A Tenant's Bankruptcy: Assurance of Payment or False Sense of Security?, 82 Am. Bankr. L.J. 497, 511.

The Ninth Circuit

The Ninth Circuit has also touched upon this issue, though its ultimate reasoning is not entirely clear:

> Rather than simply applying *Oldden* to all letters of credit that are provided as security deposits, AMB [the Debtor] urges us to adopt reasoning set forth by Judge Klein of the Bankruptcy Appellate Panel. AMB contends that Judge Klein's majority opinion in *In re Condor Systems, Inc.*, 296 B.R. 5 (9th Cir. BAP (Cal.) 2003),[[22]] and his concurrence in *In re Mayan Networks*, 306 B.R. 295, 301 (9th Cir. BAP (Cal.) 2004), present the appropriate framework for analyzing the interplay between letters of credit and statutory caps under the Bankruptcy Code. However, despite AMB's argument, the resolution of this appeal does not require that we decide whether Judge Klein has set forth the appropriate procedure for applying letter of credit security deposits to landlords' claims. Regardless of whether we apply *Oldden*, or adopt Judge Klein's reasoning, the result is the same; the judgment below stands. **Under either rationale, the proceeds of the letter of credit were properly subtracted from AMB's allowed claim**.[23]

This discussion expressly refers to the allowed claim as the amount subject to the 502(b)(6) Cap.

Surety Bonds and Unanswered Questions

Although there is clearly a framework for considering whether the proceeds from a letter of credit should be applied to and reduce a landlord's 502(b)(6) Claim, the law on the issue is inconsistent. *PPI Enterprises* would have the proceeds of a letter of credit reduce the 502(b)(6) Cap when there is clear intention that the parties to the lease intend a letter of credit to be a security deposit. The Ninth Circuit Bankruptcy Appellate Panel in *Mayan Networks* would limit this to circumstances where there is estate property posted as security for the draw on a letter of credit. The Ninth Circuit current view of the law on this issue remains unclear as between *PPI Enterprises* and *Mayan Networks*. Despite the similarity of letters of credit and surety bonds, the law on how this would apply to surety bonds is entirely undeveloped.

In light of the scant guidance on letters of credit and apparently no guidance on the issue of surety bonds, a surety bond may provide better security to a commercial landlord just given the possibility that bond proceeds will not reduce the 502(b)(6) Cap because they are less often backed by security than letters of credit. If Judge Klein's reasoning in *Mayan Networks* is ultimately adopted as the proper analysis by the relevant bankruptcy court (and assuming the surety bond is not secured or subject to a lien against estate property), it could be used as support for finding that the proceeds of a surety bond do not apply to the 502(b)(6) Cap but rather, reduce the entire claim amount independent of the 502(b)(6) Cap**.** The key takeaway for landlords is that, based on the jurisdiction, a surety bond with a secured component is much more likely to be found to be a replacement for a security deposit than one without it.

An opportunity for creative drafting

Judge Klein's analysis raises a related, but interesting issue. What happens if there are non-rejection damages related to the lease that are not subject to the 502(b)(6) Cap? Given that the cases that analyze application of a letter of credit to the 502(b)(6) Cap do so based on the express language of the subject leases, it is apparently possible to craft a lease to provide that any letter of credit should first be applied to the non-breach damages (that are not subject to the 502(b)(6) Cap) and, only once those are satisfied in full, to the breach/rejection damages subject to the 502(b)(6) Cap. This question may be more academic than practical because letters of credit rarely exceed the 502(b)(6) Cap, which would mean that the total claim against the estate would be the same regardless of how the letter of credit proceeds are applied. There are occasions that non-breach damages are or may be entitled to administrative priority and in such a circumstance it might be beneficial to have the proceeds not be applied to administrative amounts, since those will be more likely to be paid in full in a chapter 11 proceeding. Nevertheless, landlords and tenants should be mindful of the likely 502(b)(6) Cap relative to the requested amount of a letter of credit or surety bond.

Additionally, both *PPI Enterprises* and *Mayan Networks* found it important that the subject letters of credit were being posted, based on the language of the subject leases, as a form of a security deposit. Despite both *Oldden*'s and *Mayan Networks'* caution against "crafty draftsmanship," both *PPI Enterprises* and *Mayan Networks* found the intention of the parties that the letter of credit functions as a security deposit informative in their analysis in applying the proceeds to the 502(b)(6) Claim. To the extent it is possible while drafting a lease, parties should be cognizant of this issue and be clear if they intend a surety bond to be a substitute for a security deposit (which, in our experience, is in fact often the intention). While it has not been tested, commercial landlords may wish to include language that states that it is understood the surety bond is not being provided in place of a security deposit and include express terms for the application of the proceeds. However, the bankruptcy court is a court of equity and it is not clear

22 *In re Condor Sys., Inc.*, 296 B.R. 5, 18 (B.A.P. 9th Cir. 2003) held that there was no reason to apply proceeds from a letter of credit to reduce the section 502(b)(7) Cap (which applies to terminated employment agreements) under applicable case law.

23 *In re AB Liquidating Corp.*, 416 F.3d 961, 965 (9th Cir. 2005) (emphasis added).

how issues of first impression may be addressed or how courts in different districts may approach these issues. Landlords may also wish to provide that any excess proceeds remain property of the landlord rather than that of the tenant, where the claim exceeds the Sec. 502(b)(6) Cap.

Do excess proceeds need to be turned over to the estate?

Finally, there is an open question on whether proceeds of either a letter of credit or a surety bond that exceed the 502(b)(6) Cap should be turned over to the bankruptcy estate, even though such proceeds are uniformly found to not be property of the estate. At least one commentator has suggested that it is the logical extension of *PPI Enterprises* that letter of credit proceeds should.[24] Indeed, the Eleventh Circuit has similarly held that, where a letter of credit proceeds exceed the total amount of a landlord's claim (in that case, the total claim was less than the 502(b)(6) Cap), the letter of credit proceeds need to be turned over notwithstanding the fact that such proceeds are generally understood to not be property of the bankruptcy estate, as discussed above.[25] It is unclear whether the same result is suggested by *Mayan Networks*. While this result is not necessarily required under applicable case law, and seems contrary to the independence principle, it is a risk for landlords to consider.

Conclusion

Although they are not identical, bankruptcy courts will likely consider the similarities and rely on the letter of credit precedent in deciding whether to apply the proceeds of a surety bond to a landlord's 502(b)(6) Cap—the result of such application will depend on whether the bond is secured by property of the estate, whether the parties intended the surety bond to be a substitute for a security deposit, and in what jurisdiction the case is pending. From a landlord's perspective, it may be the best to seek to have a surety bond posted as an absolute protection and only discharged upon complete satisfaction of all lease obligations. A tenant should seek to treat a surety bond as much like a security deposit as possible so that, in a bankruptcy, there are strong arguments that the proceeds should be applied to reduce the estate's obligations subject to the 502(b)(6) Cap.

24 Alan N. Resnick, Letter of Credit As A Landlord's Protection Against A Tenant's Bankruptcy: Assurance of Payment or False Sense of Security?, 82 Am. Bankr. L.J. 497, 506 (2008) ("Finally, because the court relied on *Oldden v. Tonto Realty Corp.*, the logical extension of *PPI Enterprises* is that if a letter of credit exceeded the section 502(b)(6) cap on the landlord's claim, the landlord would have to give the excess to the bankruptcy estate.").

25 *In re Builders Transp., Inc.*, 471 F.3d 1178, 1192 (11th Cir. 2006).

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ASSESSING THE REASONABLENESS OF RIGHTS OFFERINGS:

Raising Exit Financing in a Chapter 11 Proceeding

MARTI P. MURRAY[1]
The Brattle Group

Historically, one of the public policy objectives of business reorganization under Chapter 11 of the U.S. Bankruptcy Code was that a bankrupt company be afforded a "time-out" from its pre-petition obligations so as to have a chance to address deficiencies in its business, operations and finances, and then take appropriate steps towards rehabilitation. Ultimately, the entity would emerge from bankruptcy with a "fresh start," providing greater long-term benefit to stakeholders than it would have if liquidated.

As part of the Chapter 11 reorganization process, debtors are often required to raise new capital to finance their exit from bankruptcy (referred to as "exit financing") with funds deployed to pay off legacy creditors and/or to have sufficient cash on hand on emergence to finance ongoing operations. However, it may be challenging for a debtor to obtain exit financing through traditional means; for example, by raising new debt financing or issuing equity securities through the capital markets. Traditional debt and equity investors may not be interested in investing new capital in a company just emerging from bankruptcy, particularly if the reason for the bankruptcy stemmed from a challenging environment for the debtor's industry.

In such a circumstance, a debtor may look to legacy stakeholders to provide exit financing. Investors that already hold debt or equity in a debtor may be the most natural parties for a debtor to turn to for exit financing. Such investors have typically been involved with the company for some time and are knowledgeable about its investment profile and management team.[2] These investors may also have an incentive to provide exit financing, which is often used to pay off existing obligations of the debtor to the same investors, among others.

Generally, by the time a bankrupt company considers exit financing, many of its original creditors have sold out and its investor base consists of hedge funds and private equity firms specializing in distressed and bankrupt companies ("distressed debt investors"). These distressed debt investors are looking for ways to leverage market inefficiencies to make attractive returns for their clients. Such inefficiencies can arise because traditional investors may be limited by mandate from maintaining investments in companies of low credit quality or otherwise uncomfortable with investing in bankrupt companies.

Distressed debt investors are highly sophisticated and familiar with the bankruptcy process and many are

1 The author wishes to acknowledge Julia Zhu, of The Brattle Group, for assistance with preparation of this article.

2 There is generally less sell-side analyst coverage of companies in bankruptcy relative to more financially stable competitors in the industry. Typical investors in a particular industry may be unfamiliar with the idiosyncrasies of investing in the debt or equity securities of bankrupt companies and may shy away.

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willing to play an active role to effect the outcome of a bankruptcy reorganization, as opposed to simply being passive investors. In fact, in the context of exit financing it is not unusual for investors to proactively approach debtors with proposals for exit financing.

Rights Offerings as Exit Financing

Conducting a rights offering as part of a bankruptcy proceeding is a well-established and effective technique to raise exit financing. In rights offerings, stakeholders are given the right, but do not have the obligation, to invest additional money in a company. Historically, rights offerings were used by public companies with reasonably concentrated equity ownership that desired to raise additional equity capital. The use of rights offerings for this purpose has declined over time and currently is most often associated with bankruptcy cases of middle-market and large corporations. Since 2002, there have been approximately 70 rights offerings completed in Chapter 11 cases, with deals ranging in size from $20 million to $2.8 billion, measured by the amount of exit financing raised. For example, Lyondell, one of the largest chemical companies in the world, conducted a rights offering in 2010 that raised $2.8 billion. In the same year American Media, holding company of the *National Enquirer*, also conducted a rights offering as part of its bankruptcy plan, raising $140 million. More recently there have been several rights offerings undertaken in the energy industry, including BreitBurn Energy Partners (exploration and production) and Peabody Energy (coal). During 2016 and 2017 there were over $4.5 billion in rights offerings with over half of them in the oil and gas sector.[3]

In the bankruptcy context, the rights are generally granted to creditors. Due to the fact that creditors have an option but not an obligation to invest additional funds, in order to ensure the requisite amount of capital is raised, certain parties must agree to purchase any unsubscribed portion, thus making sure the rights offering will be fully funded at emergence. The commitment to buy up the undersubscribed portion of a rights offering is referred to as a "backstop commitment," and the party that provides it is referred to as the "backstop party."[4] In exchange for the backstop commitment, the backstop party receives substantial fees paid in the form of either cash or the reorganized company's securities.

The form of securities to be issued is most frequently new common stock but could also be preferred stock, convertible notes or other forms of debt instruments. An important component of a rights offering is the price at which investors have the option of purchasing the new securities (the "rights offering price"). For securities with an equity component, the rights offering price is set at a discount to what the price would otherwise be, based on the valuation of the debtor, as determined by its investment banker/financial advisor (the "plan value"). The purpose of the discount is to provide an inducement to investors.

In order for a debtor in possession to proceed with a rights offering, the terms must first be approved in bankruptcy court. There can be objections from certain stakeholders who do not find the transaction to be fair and reasonable. The most typical areas for controversy include:

- whether or not the debtor sufficiently explored possibilities for alternative, less costly financing;
- whether the amount of the backstop fee is appropriate and justified;
- whether other creditors have been excluded from the backstop group and thus the lucrative fees that the backstop parties will earn;
- whether the debtor's agreement to pay those fees essentially amounts to the debtor improperly "buying the votes" of the backstop parties in order to gain approval from a particular class of creditors; and
- whether the rights offering will result in unequal treatment of similarly situated creditors.

Evaluating the Key Elements of Rights Offerings

While it is clear that rights offerings can be an important tool in carrying out corporate reorganizations, the process around rights offerings is often opaque. It can, for example, be difficult to assess whether other options were available that might have been less costly for the company and other stakeholders, or whether the payment of backstop fees at such high levels was necessary to induce a backstop party.

In a transparent, competitive market, one might assume that if the terms of a given rights offering were too expensive, including with respect to the backstop fees to be paid, other parties would emerge with a less costly alternative for the debtor. In reality, a fully transparent and open process in bankruptcy can at times be difficult to achieve for a variety of reasons, including because the opportunity to backstop a rights offering has not been fully exposed to the market (referred to as a "market test"), or because of the particular incentives of various stakeholders. Nonetheless, investors that are proactive, willing to become restricted in order to review material, non-public information, and ready, willing and able to write a sizable check to be a backstop party and fund a plan of reorganization, may be in a strong position to bargain both for attractive terms for the new securities

3 Debtwire, 2016-2017 *Rights Offerings Restructuring Data Report.*
4 The backstop party can be one entity or entities working as a group.

to be issued and for the backstop fees to be earned.[5]

In evaluating the reasonableness of rights offering terms, there are a number of key elements to consider, including the following questions:

- Did the debtor conduct a market test?
- How was the discount to plan value determined?
- Is the level of fees being paid to the backstop party fair and reasonable?
- What are the terms and potential limitations to the backstop party's commitment?[6]

These are discussed below, together with some observations gathered through a review of 15 selected completed rights offerings undertaken between 2007 and 2018. The 15 cases are recent, high profile transactions of interest, selected from among 69 identified rights offerings between 2002 and 2018 with diversity across industries.

Background of Selected Rights Offerings

The 15 selected transactions consist of public and private companies across nine industries. The highest concentration of rights offerings was in the Oil & Gas sector, representing five out of the 15 rights offerings evaluated. Industry classifications of the selected deals are as follows:

Aerospace - 1

Casinos - 1

Chemicals - 3

Coal - 1

Construction - 1

Healthcare - 1

Oil & Gas - 5

Publishing - 1

Retail - 1

The number of deals by year are as follows:

2007 - 1

2009 - 2

2010 - 2

2016 - 5

2017 - 5

Nine of the 15 companies were publicly traded prepetition, seven of which emerged as public companies with two transitioning to private ownership upon emergence from bankruptcy. Six of the 15 companies were privately owned prepetition; three of them remained private while the other three were taken public upon emergence.

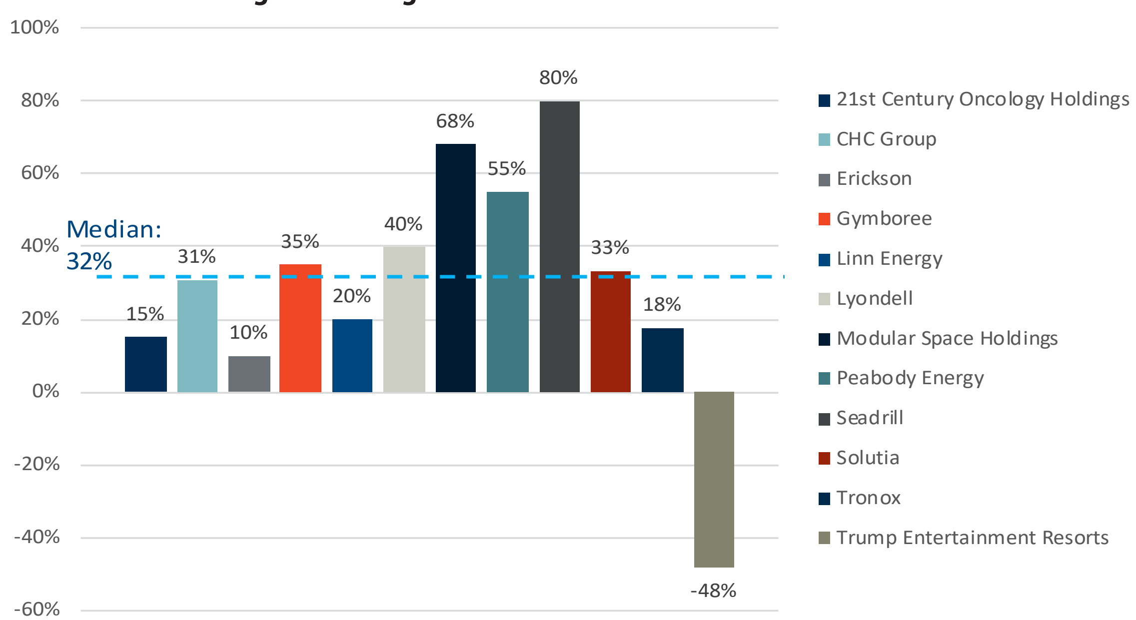
Did the Debtor Conduct a Market Test?

In evaluating the reasonableness of rights offering terms, it is important to consider whether the debtor conducted a market test. A market test would involve

5 Backstop parties will typically have to agree to restrict themselves from trading for a period of time, to the extent they are in receipt of material non-public information.

6 In addition, consideration might also need to be given to whether or not it could be argued in a particular case that the proposed rights offering would result in unequal treatment of similarly situated creditors.

Exhibit 1: Selected Rights Offerings Discount to Plan Value

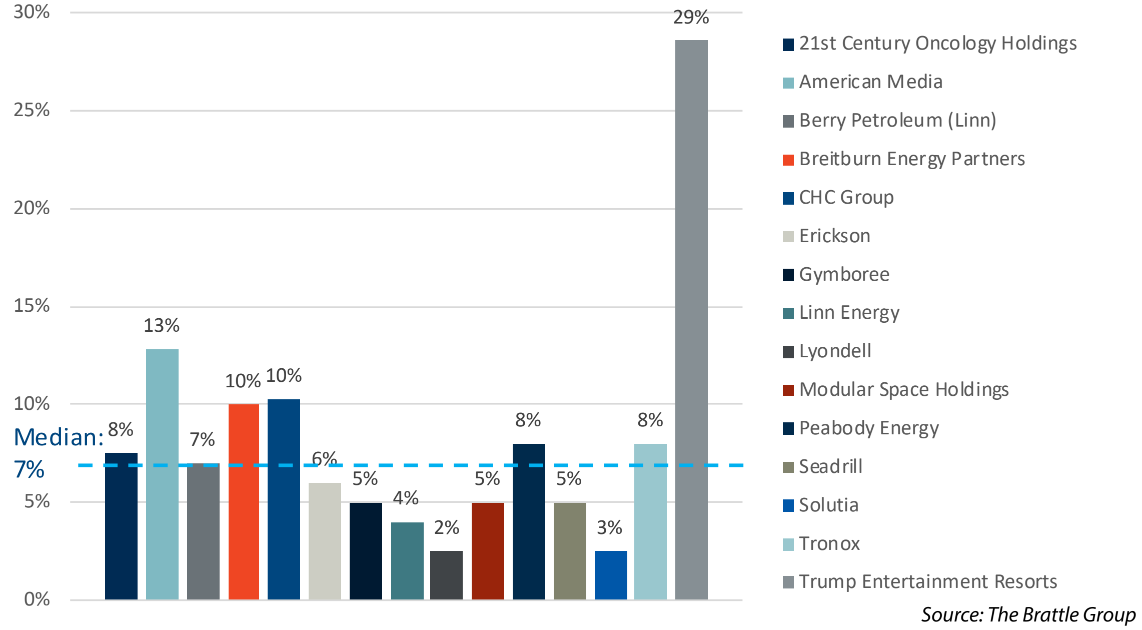


Source: The Brattle Group.

Notes: Discounts for American Media, Berry Petroleum (Linn), and BreitBurn are not available. American Media conducted a "notes offering." No plan equity value was available for Berry Petroleum (Linn). BreitBurn's rights offering was to purchase 100% of equity and therefore a discount was not applicable.

Continued from p.37

Exhibit 2: Backstop Fee as Percent of Rights Offering Amount



Source: The Brattle Group

the debtor engaging with the market and seriously evaluating other options to emerge from bankruptcy. These options could include potentially engaging in an M&A process for all or part of the debtor in order to establish a valuation range, or otherwise exploring an alternative capital raise or rights offering proposal from a qualified alternative backstop party. A debtor that performs a market test and makes disclosures about the contours of the test is providing more transparency to the parties in interest so they can assess the reasonableness of the rights offering terms before them. In approximately 50% of the rights offerings observed, debtors did not explicitly disclose whether any type of market test was conducted.

How Was the Discount to Plan Value Determined?

As described, plan value is determined by the debtor's investment banker using generally accepted valuation methodologies, such as the discounted cash flow method, comparable public company method or precedent transactions method. Equity securities issued through a rights offering are issued at a discount to plan value. The higher the discount, theoretically the better the deal will be for those that receive the rights or backstop the rights offering. Of the 15 rights offerings observed in the study, the median discount to plan value was 32%, as shown in Exhibit 1 on p.37.

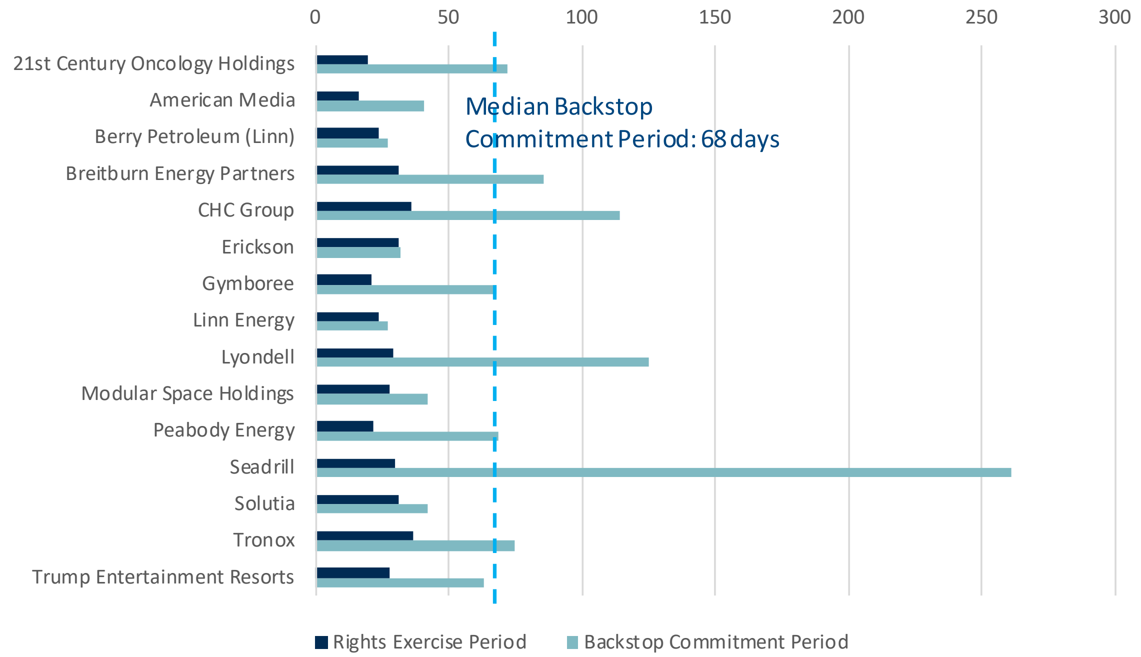
Is the Level of Fees Being Paid to Backstop Parties Fair and Reasonable?

In exchange for providing the backstop commitment, the backstop party is entitled to receive a backstop fee. This fee is either paid in cash or in the form of the newly issued securities, which can also be issued at a discount to plan value. The backstop fees observed ranged from 2.5% to 28.6% of the rights offering amount, with a median of 7%, as shown in Exhibit 2. However, the actual fee could be higher or lower than the stated fee percentage to the extent the fee is paid in the form of newly issued securities. If the dollar amount of the fee is paid with discounted securities, then the backstop party will be paid with more securities than it would otherwise have received if the fee was calculated based on plan value for the new securities. If the newly issued securities trade above the price at which they were issued, then the effective backstop fee could be even higher than the stated fee. Of course, the fee could also turn out to be lower than 7% if the newly issued securities were to trade at a price below the discounted rights offering price.

It can be a challenge to determine whether the level of the backstop fee is truly justified. The reason to pay a fee is to ensure that the rights offering is fully subscribed so the debtor can receive all the funding it requires to successfully emerge from bankruptcy. However, if it were clear that everyone who received rights was going to exercise them, then there would be no need to have a backstop party and therefore no need to pay backstop fees.

Several factors related to the way rights offerings are structured, as well as the paucity of information with respect to subscription levels, make it difficult to determine whether the level of backstop fees is justified. To begin with, rights distributed to stakeholders in a bankruptcy are generally not transferable separately from the security to which they attach. This means a market for the rights cannot develop separately; if it could, it might provide additional information with respect to the appetite for the newly issued security at the discounted price. It may be the case that the involvement of the backstop party gives other market

Exhibit 3: Backstop Commitment Period



Source: The Brattle Group

participants added confidence to subscribe to the rights. However, it could also be the case that, due to the discount at which the new securities are offered in the rights offerings, investors would subscribe for them anyway, even in the absence of the backstop party.

In addition, rights offerings in bankruptcy typically do not permit a rights holder to oversubscribe by asking for more of the newly issued securities than is their entitlement based on their holdings of the legacy securities. It is possible that if rights holders were able to oversubscribe, there would be less of a need for the backstop party, and therefore less of a requirement to pay all or part of the backstop fees.

Limited information is available about historical participation levels in rights offerings. Of the 15 rights offerings observed, it was only possible to obtain information on subscription levels for four of them. This limited transparency makes it difficult to evaluate the extent to which backstop parties were actually called upon to provide additional funding in excess of their pro-rata share of the rights offering based on their holdings of legacy securities. If rights offerings historically have had very high subscription rates before having to call on the backstop party to take up any unsubscribed rights, it would tend to argue against the need to pay high fees to the backstop party: they would in essence be receiving payment to guarantee a full subscription that was likely to occur in any event.

What Are the Terms and Potential Limitations of the Backstop Party's Commitment?

The backstop commitment period is the length of time that the backstop parties are exposed to the funding obligation. The longer the time period, the more risk and opportunity cost the backstop party may have, and therefore, the more the backstop party might be entitled to additional compensation. The median backstop commitment period observed in the sample set is 68 days, as shown in Exhibit 3.

The conditions under which a backstop party can terminate its backstop commitment would also be an important factor to consider in establishing the overall reasonableness of the terms of the rights offering. The value of the backstop commitment might decline if the contracts provide conditions under which the backstop

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Marti P. Murray, a principal of The Brattle Group, has had a 35+ year career in the financial services industry, serving in leadership roles at both alternative investment management and financial advisory firms, on numerous boards of directors, and as a court-appointed SEC Receiver for an investment advisor accused of fraud. Earlier in her career, she founded Murray Capital Management, an SEC-registered distressed debt hedge fund firm, which she ran from 1995 until the distressed debt business was acquired by Babson Capital in 2008. Ms. Murray taught graduate-level courses at the NYU Stern School of Business for over a decade and has spoken at conferences worldwide.

Continued from p.39

party can terminate its commitment, for example, a material adverse change provision that is broadly defined.

A detailed analysis of key elements for the selected transactions is presented in Exhibit 4.

Conclusion

Rights offerings will continue to play an important role in corporate restructurings, as companies seek risk capital to emerge from bankruptcy to pay off legacy creditors and to invest in the future. Rights offerings represent a transfer of valuable consideration between parties. A bankrupt company is receiving critical financing in order to effectuate a successful emergence from bankruptcy, while the rights offering subscribers are being granted an option to increase their ownership position at a discount to the plan value. At the same time, the company is paying substantial fees to the backstop party to provide assurance that the deal will ultimately happen.

Despite the effectiveness of rights offerings in the bankruptcy context, it is important to ensure that their economic terms are fair and reasonable and do not result in an inappropriate transfer of value to the backstop parties, an issue that is often disputed in bankruptcy courts. Increased transparency about the process would allow all parties in interest to have greater confidence in determining whether terms of a proposed rights offering are fair and reasonable.

Exhibit 4: Analysis of Data for Key Elements of Selected Rights Offerings

Company	Rights Offering			
	$ Amount to be Raised	Security	Discount to Plan Value	Rights Transferable?
[1] 21st Century Oncology Holdings	$275,000,000	New Preferred Equity + New Second Lien Notes	15.0%	No
[2] American Media	$140,000,000	New Second Lien Notes	N/A	No
[3] Berry Petroleum (Linn)	$335,000,000	Reorganized Berry Preferred Stock	N/A	No
[4] Breitburn Energy Partners	$775,000,000	New Common Stock	N/A	No
[5] CHC Group	$300,000,000	New Second Lien Convertible Notes	30.8%	No
[6] Erickson	$20,000,000	New Common Stock	10.0%	No
[7] Gymboree	$80,000,000	New Gymboree Common Shares	35.0%	No
[8] Linn Energy	$530,000,000	Reorganized Linn Common Shares	20.0%	No
[9] Lyondell	$2,800,000,000	Class B Shares	39.8%	No
[10] Modular Space Holdings	$90,000,000	New Common Equity	68.0%	No
[11] Peabody Energy	$750,000,000	Reorganized PEC Common Stock	55.0%	No
[12] Seadrill	$167,000,000	New Seadrill Common Stock + NSNCo New Secured Notes	80.0%	No
[13] Solutia	$250,000,000	New Common Stock	33.3%	No
[14] Tronox	$185,000,000	New Common Stock	17.6%	No
[15] Trump Entertainment Resorts	$225,000,000	New Common Stock	-48.1%	No
Max	$2,800,000,000		80.0%	
Min	$20,000,000		-48.1%	
Median	$250,000,000		32.0%	
Mean	$461,466,667		29.7%	

Company	Backstop						Rights Exercise Period	Backstop Commitment Period	Disclosure of Market Test?
	# of Backstop Parties	Backstop Fee $	Backstop Fee % R.O	Oversubscription Privilege	Actual Subscription	Actual Backstop			
[1] 21st Century Oncology Holdings	Unknown	$20,625,000	7.5%	No	Unknown	Unknown	20	72	N/A
[2] American Media	2	$17,950,000	12.8%	No	35.0%	65.0%	16	41	Yes
[3] Berry Petroleum (Linn)	Unknown	$23,450,000	7.0%	No	Unknown	Unknown	24	27	N/A
[4] Breitburn Energy Partners	12	$77,500,000	10.0%	No	Unknown	Unknown	31	86	Yes
[5] CHC Group	8	$30,814,815	10.3%	No	98.9%	1.1%	36	114	Yes
[6] Erickson	8	$1,200,000	6.0%	No	53.7%	46.3%	31	32	N/A
[7] Gymboree	Unknown	$4,000,000	5.0%	No	Unknown	Unknown	21	68	N/A
[8] Linn Energy	Unknown	$21,200,000	4.0%	No	Unknown	Unknown	24	27	N/A
[9] Lyondell	3	$69,750,000	2.5%	No	Unknown	Unknown	29	125	Yes
[10] Modular Space Holdings	11	$4,500,000	5.0%	No	Unknown	Unknown	28	42	N/A
[11] Peabody Energy	17	$60,000,000	8.0%	No	Unknown	Unknown	22	69	Yes
[12] Seadrill	6	$8,350,000	5.0%	No	Unknown	Unknown	30	261	Yes
[13] Solutia	6	$6,250,000	2.5%	Yes	Unknown	Unknown	31	42	N/A
[14] Tronox	28	$14,800,000	8.0%	No	Unknown	Unknown	37	75	Yes
[15] Trump Entertainment Resorts	13	$64,285,714	28.6%	No	0.1%	99.9%	28	63	N/A
Max	28	$77,500,000	28.6%		98.9%	99.9%	37	261	
Min	2	$1,200,000	2.5%		0.1%	1.1%	16	27	
Median	8	$20,625,000	7.0%		44.3%	55.7%	28	68	
Mean	10	$28,311,702	8.1%		46.9%	53.1%	27	76	

Source: The Brattle Group. Analysis based on company filings.

Notes:

[2]: Rights offering was referred to as a notes offering, with option for creditors to put New Second Lien Notes to backstop parties. Backstop fee was paid in 5% of New Common Stock + cash equaled to 5% of 2L face.

[3]: Based on maximum rights offering amount including $35 million increase. No plan equity value available for Berry.

[4]: Comprised of a $310mm direct placement to backstop parties and a $465mm general rights offering to unsecured creditors. Non-backstop eligible offerees may subscribe by the Early Election Date and receive 10% Early Election Premium in shares. Rights offering was to purchase 100% equity and therefore discount to plan value not applicable.

[5]: Subscription includes that of backstop parties. Non-backstop subscription was 33%.

[11]: Excludes private placement of $750mm of preferred equity. Backstop parties were also entitled to an additional 2.5% backstop fee per month beginning April 3, 2017, approximately one month after the rights expired, until the Effective Date.

HAS BANKRUPTCY CODE SECTION 523(A)(6) BECOME THE WILDCARD FOR NONDISCHARGEABILITY?

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Most lawyers recognize that bankruptcy is about a fresh start for a debtor burdened by obligations he or she can no longer afford to repay. This fresh start comes from the Bankruptcy Code's broad discharge of prepetition debts. The Bankruptcy Code lays out twenty-one (or so) very specific exceptions to discharge, covering a variety of policy-based exclusions – including debts incurred by fraud and driving under the influence of alcohol, among others.[2]

These exceptions are all grounded in sound policy, to prevent a debtor from escaping the consequences of particularly bad behavior. Exceptions to discharge are also intended to be construed narrowly, in favor of the debtor. One of those exceptions, however, has become something of a wildcard, due to the vagaries of statutory interpretation, combined with a series of cases with compelling facts – the "intentional harm" exception of section 523(a)(6).

Section 523(a)(6) excepts from discharge debts "for *willful* and malicious injury by the debtor to another entity or to the property of another entity."[3] Section 523(a)(1)(C) excepts from discharge any debt with respect to which the debtor "*willfully* attempted in any manner to evade or defeat tax."[4]

The Ninth Circuit has held that section 523(a)(6) willfulness requires only a showing that the debtor was "substantially certain" injury would result.[5] In the more recent case of *Hawkins v. Franchise Tax Board*, however, the Ninth Circuit held that "willful" in section 523(a)(1)(C) requires a heightened showing of "specific intent."[6]

Whether the "substantially certain" standard remains good law in light of *Hawkins* is an open question, which issue is currently pending at the Ninth Circuit Court of Appeals.[7]

1 The author would like to thank Paul J. Leeds, bankruptcy partner at Higgs Fletcher & Mack, LLP, for his editorial contributions to this article.
2 11 U.S.C. § 523(a).
3 11 U.S.C. § 523(a)(6).
4 11 U.S.C. § 523(a)(1)(C).
5 *Petralia v. Jercich (In re Jercich)*, 238 F.3d 1202 (9th Cir. 2001) ("*Jercich*").
6 *Hawkins v. Franchise Tax Board of California*, 769 F.3d 662, 666 (9th Cir. 2014) ("*Hawkins*").
7 *Hamilton v. Elite of Los Angeles, Inc. (In re Hamilton)*, No. 18-60027 (9th Cir. filed May 1, 2018). The debtors are currently represented by Higgs Fletcher & Mack, LLP.

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Willful Injury Under Section 523(a)(6)

The story begins at the United States Supreme Court, in the seminal case of *Kawaauhau v. Geiger*.[8] In *Geiger*, Kawaauhau sued Dr. Geiger for medical malpractice claims arising out of his treatment of a foot injury, which ultimately resulted in an amputation.[9] Dr. Geiger admitted that he intentionally departed from the appropriate standard of care in order to save on treatment costs, including prescribing a less-effective antibiotic and cancelling the patient's treatment with an infectious disease specialist. The jury found Dr. Geiger liable for medical malpractice, and awarded the Kawaauhaus over $350,000 in damages.[10]

Dr. Geiger then petitioned for bankruptcy, and the Kawaauhaus sought to except the debt under section 523(a)(6).[11] The bankruptcy court agreed with the Kawaauhaus, but the Eighth Circuit reversed, holding that, because the debt was based on negligent or reckless conduct, rather than intentional conduct, it remained dischargeable.[12]

The Supreme Court affirmed the ruling of the Eighth Circuit, and reiterated that exceptions to discharge should be narrowly construed in favor of the debtor's fresh start.[13] The Court specifically framed the issue as follows: "Does § 523(a)(6)'s compass cover acts, done intentionally, that cause injury (as the Kawaauhaus urge), or only acts done with the actual intent to cause injury …?"[14]

The Court held that section 523(a)(6) covers "only acts done with the actual intent to cause injury."[15] The Court explained: "The word 'willful' … modifies the word 'injury,' indicating that nondischargeability takes a deliberate or intentional *injury*, not merely a deliberate or intentional *act* that leads to injury."[16] Thus, "debts arising from recklessly or negligently inflicted injuries do not fall within the compass of § 523(a)(6)."[17]

What Is "Actual Intent"?

It is clear then, under *Geiger,* a finding of section 523(a)(6) willfulness requires actual intent to injure. Otherwise, as the Supreme Court explained, every traffic accident stemming from an intentional act, and any knowing breach of contract, could meet the definition of willfulness.[18] This result would be at odds with the overarching policy that exceptions to discharge are to be narrowly construed.

The question then becomes, what is "actual intent"? A few courts have argued that *Geiger* neither defined nor articulated the precise state of mind necessary for a finding of willfulness.[19] On the other hand, in interpreting both federal criminal statutes and the Bankruptcy Code, courts often use the terms "actual intent and "specific intent" interchangeably.[20] A few bankruptcy courts have concluded, that by using the term "actual intent," *Geiger* in fact imposed a specific intent requirement.[21]

Courts Have Held That Section 523(a)(6) "Willfulness" Requires Only "Substantial Certainty of Harm"

Despite the *Geiger* court's holding that section 523(a)(6) willfulness requires "actual intent to injure," several Courts of Appeal have held that a deliberate act, with knowledge that the act is substantially certain to cause injury, is sufficient to establish willfulness under section 523(a)(6). One notable example is the Ninth Circuit case of *In re Jercich*.[22] In *Jercich*, Petralia sued his employer (Jercich) for various statutory violations, including for unpaid wages, and punitive damages.[23] The court granted judgment in favor of Petralia, finding that Jercich had the clear ability to pay Petralia's wages, but chose not to do so, instead using company funds to pay for a wide variety of personal investments, including a horse ranch.[24] Jercich filed for bankruptcy, and Petralia sought to except the judgment from discharge pursuant to section 523(a)(6).[25] The bankruptcy court found that the debt was dischargeable, and the district court affirmed.[26]

The Ninth Circuit panel reversed. In analyzing the "willful" requirement of section 523(a)(6), the court posited that *Geiger* had not defined the "precise state of mind required to satisfy section 523(a)(6)'s

8 *Kawaauhau v. Geiger*, 523 U.S. 57 (1998) ("*Geiger*").
9 *Id.* at 59.
10 *Id.*
11 *Id.* at 60.
12 *Id.*
13 *Id.*, at 62. *See also United States v. Sotelo,* 436 U.S. 268, 280 (1978).
14 *Id.* at 61.
15 *Id.*
16 *Id.* (emphasis in original).
17 *Id.* at 64.
18 *Id.* at 63.

19 *See e.g., Jercich*, 238 F.3d at 1202.
20 *See e.g., United States v. Nicklas*, 713 F.3d 435, 439 (8th Cir. 2013) (equating "actual intent" to "specific intent"); *Little v. Trombley*, 443 F. App'x 989, 991 (6th Cir. 2011) (specific intent crime requires proof of an actual intent); *In re Schifano*, No. ADV 96-1350-WCH, 2003 WL 26085845, at *10 (B.A.P. 1st Cir. Sept. 26, 2003) ("the creditor must prove that the act was done with *actual intent* to hinder, delay or defraud a creditor; absent *specific intent* to defraud creditors, a discharge should not be denied. . ."); *In re Howard*, 73 B.R. 694, 702–03 (Bankr. N.D. Ind. 1987) (equating actual intent with specific intent in the context of false financial statement); *Scherber v. Online Auctions, LLC*, No. 3:13CV530, 2014 WL 3908114, at *3 (N.D. Ohio July 3, 2014), citing *Paul's Auto World v. Boyd,* 881 F.2d 1077 (6th Cir. 1989) (claim required "actual intent" to defraud: i.e., "a willful act done with specific intent to deceive a purchaser of the mileage on a car."); *Benavente v. Hedgpeth*, No. 1:08-CV-00085JMD(HC), 2010 WL 2196008, at *5 (E.D. Cal. May 26, 2010), *objections overruled*, No. 1:08-CV-00085JMD, 2010 WL 2850790 (E.D. Cal. July 19, 2010), citing *Briceno v. Scribner*, 555 F.3d 1069, 1078-79 (9th Cir. 2009) ("it is not acceptable to prove specific intent absent some direct or circumstantial evidence of the petitioner's actual intent.").
21 *See e.g., In re Tomlinson*, 220 B.R. 134, 137–38 (Bankr. M.D. Fla. 1998) (*Geiger* imposed a specific intent requirement); *In re Jenkins*, 258 B.R. 251, 257 (Bankr. N.D. Ala. 2001) (same).
22 *Jercich*, 238 F.3d at 1204.
23 *Id.*, at 1204.
24 *Id.*
25 *Id.*
26 *Id.*

'willful' standard."[27] The court, therefore, looked to a pre-Bankruptcy Act Supreme Court conversion case, *McIntyre v. Kavanaugh*.[28] To define "willful" under §17(2) of the Bankruptcy Act of 1898, the predecessor of section 523(a)(6), *McIntyre* quoted a prior Supreme Court case, *Tinker v. Colwell*.[29]

Tinker stated that "[a] willful disregard of what one knows to be his duty, an act which is against good morals and wrongful in and of itself, and which *necessarily* causes injury and is done intentionally, may be said to be done willfully and maliciously, so as to come within the exception [under §17(2).]"[30] One court noted that *Tinker's* use of the word "necessarily" requires that the "act itself inevitably produce the injury in all circumstances."[31] The Ninth Circuit in *Jercich* reasoned, however, that this language supported a conclusion that willful injury requires a deliberate act with knowledge that the act is substantially certain to cause injury.[32]

Notably, in enacting section 523(a)(6) of the Bankruptcy Code, the Legislature expressly stated that *Tinker* has been overruled to the extent it has been interpreted to apply a lesser standard than "deliberate or intentional."[33]

Jercich also relied upon the Restatement of Torts for its definition of "intent." In *Geiger,* after the Court defined willfulness to mean acts done with "actual intent to cause injury," it cited to the Restatement *only* to support the analogy referenced by the Eighth Circuit: the "(a)(6) formulation triggers in the lawyer's mind the category 'intentional torts,' which generally require that the actor intend the *consequences* of an act, not simply the act itself."[34] Despite the fact that the *Geiger* Court did not adopt the latter portion of the Restatement regarding the more encompassing "substantial certainty" of harm, *Jercich* concluded that it meant to do so.[35] Notably, *Jercich* is not alone – as other circuit courts have similarly adopted the broad substantial certainty of harm standard.[36]

The Ninth Circuit Defined "Willful" in Section 523(a)(1)(C) as Requiring Specific Intent

The Ninth Circuit recently looked to *Geiger* to define the term "willful" in the context of section 523(a)(1)(C), which excepts from discharge any debt with respect to which the debtor "willfully attempted in any manner to evade or defeat tax."[37]

As the old saying goes, bad facts make for bad law. Not true in this case – perhaps recognizing the problematic expansion of nondischargeability associated with the bad facts of *Hawkins*, the Ninth Circuit held a principled line.

The debtor/taxpayer, Hawkins, had received an undergraduate degree in Strategy and Applied Game Theory from Harvard University, and an M.B.A. from Stanford. He was one of the earliest employees at Apple, and later left to co-found Electronic Arts, Inc., and his net worth rose to $100 million. The IRS alleged that he and his wife, Lisa, enjoyed the "trappings of wealth," such as a private jet, private school for their children, an ocean-front condo in La Jolla, California, and a large private staff.

Hawkins also created a variety of business entities and offshore accounts, specifically designed to generate large losses on his federal tax returns. Ultimately, Hawkins owed over $40 million in unpaid taxes and penalties to the FTB and IRS.[38] After Hawkins filed for bankruptcy, the FTB and IRS claimed their tax debts were nondischargeable pursuant to section 523(a)(1)(C).[39] The primary argument was that the Hawkinses' maintenance of a rich lifestyle after their living expenses exceeded their income constituted a willful attempt to evade taxes. The bankruptcy court found that the Hawkinses' personal living expenses during the period of insolvency were "truly exceptional," in that they exceeded their income by $516,000 to $2.35 million. The bankruptcy court therefore held that the debts were nondischargeable.[40] The district court affirmed.[41]

The Ninth Circuit reversed, and set to define "willful" in section 523(a)(1)(C).[42] The Court argued that "philosophy of the Bankruptcy Code argues for a stricter interpretation of 'willfully' than an expansive definition."[43] The *Hawkins* Court cited to *Geiger* both

27 *Jercich,* at 1207.

28 *Id.* at 1207-08, citing *McIntyre v. Kavanaugh*, 242 U.S. 138 (1916) ("*McIntyre*"). §17(2) of the 1898 Bankruptcy Act provided: "A discharge in bankruptcy shall release a bankrupt from all of his provable debts, except ... judgments in actions for ... willful and malicious injuries to the person or property of another."

29 *See McIntyre*, 242 U.S. at 142-43, citing *Tinker v. Colwell,* 193 U.S. 473 (1902).

30 *Tinker,* 242 U.S. at 485, emphasis added.

31 *See e.g., In re Cobham*, 551 B.R. 181, 193 (E.D.N.C.), *aff'd*, 669 F. App'x 171 (4th Cir. 2016). ("*McIntyre's* requirement than an injury necessarily result from the occurrence of a bad act, in essence, requires that the act itself *inevitably produce the injury in all circumstances*," emphasis added), citing *Oxford English Dictionary*.

32 *Id.*

33 "Paragraph (6) excepts debts for willful and malicious injury by the debtor to another person or to the property of another person. Under this paragraph, 'willful' means deliberate or intentional. To the extent that *Tinker v. Colwell,* 193 U.S. 473 (1902), held that a looser standard is intended, *and* to the extent that other cases have relied on *Tinker* to apply a 'reckless disregard' standard, they are overruled." H.R. REP. 95-595, 365, 1978 U.S.C.C.A.N. 5963, 6320-21. *See also In re Plyam*, 530 B.R. 456, 464 (B.A.P. 9th Cir. 2015) (*Geiger* excluded from the definition of willfulness "all degrees of reckless conduct, whether arising from recklessness simple, heightened, or gross; conduct that is reckless merely requires an intent to act, rather than an intent to cause injury as required under *Geiger*. To the extent that *Tinker* [] held that a looser standard is intended, and to the extent that other cases have relied on *Tinker* to apply a 'reckless disregard' standard, they are overruled.")

34 *Geiger*, 523 U.S. at 61-62 (internal quotation marks omitted).

35 *Id.* at 62; *Jercich*, 238 F.3d at 1208.

36 *See e.g., In re Levasseur*, 737 F.3d 814, 818 (1st Cir. 2013); *In re Miller*, 156 F.3d 598, 604 (5th Cir. 1998); *Gerard v. Gerard*, 780 F.3d 806, 811 (7th Cir. 2015); *Roussel v. Clear Sky Properties, LLC*, 829 F.3d 1043, 1048 (8th Cir. 2016).

37 *Hawkins*, 769 F.3d at 666 (9th Cir. 2014).

38 *Id.* at 664-65.

39 *Id.* at 665.

40 *Id.* at 665-666.

41 *Id.* at 666.

42 *Id.*

43 *Id.* at 666–67.

Continued from p.43

for the proposition that courts must narrowly interpret exceptions to the broad presumption of discharge, and that "willful" in section 523(a)(6) requires "a deliberate or intentional injury." Ultimately, *Hawkins* squarely held that the term willful in section 523(a)(1)(C) "requires a showing of *specific intent*."[44]

Is *Jercich* Still Good Law After *Hawkins*?

One of the most well-recognized canons of statutory interpretation is that the same word in the same statute has the same meaning.[45] Currently, however, in the Ninth Circuit, the word "willful" in Bankruptcy Code section 523(a) has two different meanings.

Hawkins held that "willful" in section 523(a)(1)(C) as requiring specific intent, which comports with *Geiger's* requirement of actual intent.

Jercich, however, defined section 523(a)(6) willfulness to mean something less than actual, or specific intent. The similar facts in *Jercich* and *Hawkins* highlight the conflict in the outcome. *Jercich* involved a knowing violation of a statutory duty to pay money. Jercich knew wages were owed to Petralia and failed to pay them. In *Hawkins*, the debtor knew he owed over $25 million in tax debt, that he was insolvent, and continued to fund a lavish (and unnecessary) lifestyle knowing he would be unable to pay his tax debt.[46] Under the "substantially certain" standard articulated in *Jercich*, *Hawkins'* debt would, arguably, be nondischargeable.

This issue is currently pending at the Ninth Circuit – which has the opportunity to clarify the meaning of willful in section 523(a). Otherwise, section 523(a)(6) will remain as the wildcard in nondischargeability law.

44 *Id.*

45 *Envtl. Def. v. Duke Energy Corp.*, 549 U.S. 561, 584 (2007).

46 The Bankruptcy Court found that several of the expenses represented, or could represent, an effort to prevent the collection of tax. *In re Hawkins*, 430 B.R. 225, 238 (Bankr. N.D. Cal. 2010), *aff'd sub nom. Hawkins v. Franchise Tax Bd.*, 447 B.R. 291 (N.D. Cal. 2011), *rev'd sub nom. Hawkins v. Franchise Tax Bd. of California*, 769 F.3d 662 (9th Cir. 2014).

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IS THE BUSINESS CYCLE NEARING AN END?

FOUR SIGNALS TO WATCH

JOSEPH BRUSUELAS
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The U.S. economy is signaling that the decade-long business cycle upswing following the global financial crisis and the Great Recession is nearing – or might have already reached – its apogee. This should be recognized as neither unexpected, given the length of the recovery, nor a surprising development, given the proliferation of risks to the outlook. Even so, the U.S. Federal Reserve appears to have shifted the focus of policy from responding to a growing economy (and the effects of unconstrained fiscal policy) to responding to spillovers from a global economic slowdown that is largely related to trade policy. We anticipate that the Fed will move to cut the federal funds rate by 50 basis points before the end of the year in an attempt to provide a cushion for an economy that is decelerating amid slower hiring and wage growth.

Inertia is almost always a factor when forecasting economic cycles and when making investment decisions based on those expectations. After all, it's human nature to make personal or business judgments based on past experiences and using those experiences to extrapolate future outcomes.

Unfortunately, a business decision to expand capacity can take years to implement, only to find that technology and tastes have moved on or that the demand for additional goods has been damped by unforeseen events, such as periodic oil shortages or financial crises. Invest in the face of a downturn and capital will be underused and unprofitable. Fail to invest in the face of an upturn and risk losing market share and potential profits to competitors. This is a sustained management challenge for businesses of all sizes.

The current business cycle expansion is now the longest in the post-World War II era – absent a ruling otherwise from the National Bureau of Economic Research (NBER), the authority on U.S. business cycles. That alone lends to the adage that all good things must come to an end. But there are also indications in the financial markets and the real economy that conditions for a downturn are falling into place.

The following discussion explores some of those signals, the estimated probability of a recession, and how it might affect expectations of further investment.

Signal 1 – An Inverted Yield Curve

Financial markets have been anticipating a slowdown for the past nine months. The government bond market yield curve has become inverted since the third quarter of 2018, with money market rates moving higher than the yield on 10-year Treasury notes (Exhibit 1 on next page). While not necessarily forecasting a recession in the months ahead, the bond market is nonetheless signaling that the conditions necessary for a downturn are in place. The bond market is now anticipating that

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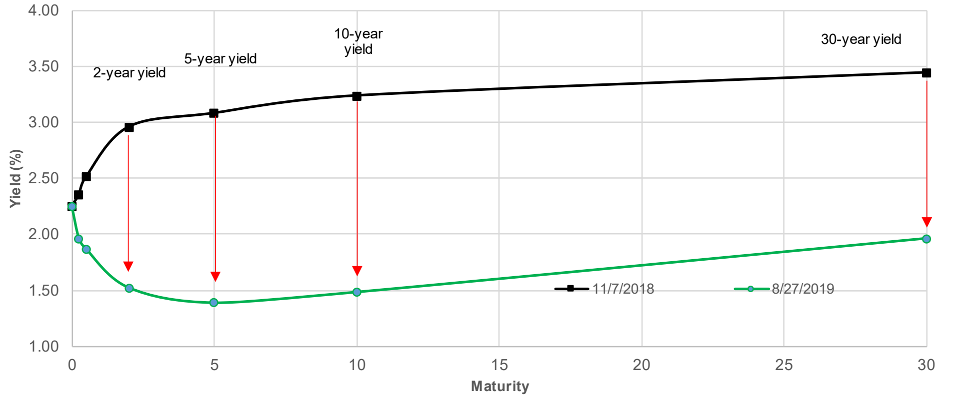
Exhibit 1: Changes in the U.S. Treasury yield curve since Q4 2018

(Yields as of November 7, 2018 and August 27, 2019)



Source: Bloomberg; RSM US

the Federal Reserve will seek to avert the onset of lower growth by cutting short-term interest rates in hopes of stimulating investment and consumption.

Signal 2 – A Downturn in the Leading Economic Indicator

In the real economy, recent data releases suggest a climate of slower growth. The Conference Board's Leading Economic Index – a composite of trends in manufacturing orders, labor-market activity and consumer spending (as well as the financial sector) – has been trending down since the third quarter of 2018, suggesting a pivot point for the economy (Exhibit 2).

While the economy is far more complicated than the 10 components that comprise the leading indicator, it is a useful tool to ascertain where the economy is going. While the intent of The Conference Board is to provide estimates of the turning points in economic activity rather than to present a forecast of future growth, we can nevertheless argue that the leading indicator is pointing toward GDP growth centered on a 1% rate.

Signal 3 – Reduced Wage Growth

Wages likely peaked at 3.43% in the current cycle, which should signal to businesses that a broader slowdown is coming. On a three-month average annualized pace, wage growth slowed to 2.73% in May, which implies a much slower trend than the reported top line. The wage decline has continued in the months since then.

With fewer jobs being added so late in the business cycle, and with expectations for downward revisions to the household survey data, which is used to estimate the unemployment rate, the unemployment rate is likely to rise in coming months. See Exhibit 3.

Signal 4 – Slipping into a Low-growth Profile

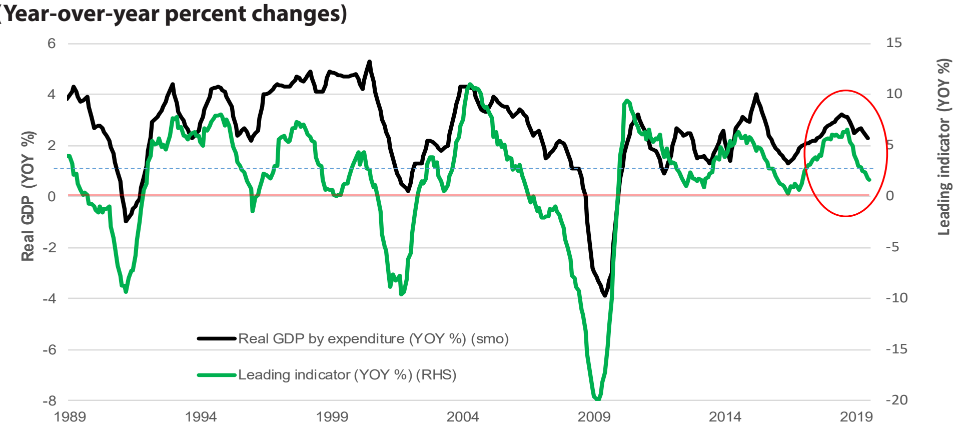
Real GDP for the U.S. in the first quarter of 2019 increased by 3.1%, arguably a robust rate of growth so late in a business cycle. But there is lots of room for interpretation, with about two-thirds of that increase due to "a huge inventory build-up, a substantial decline in imports, surprising strength in exports and a bulge in state and local spending due to road repairs associated with this winter's storms," according to Professor David Shulman in a June 2019 report by the UCLA Anderson Forecast.[1]

The consensus among analysts was that the 5% first-quarter inventory growth rate was outsized (see Exhibit 4), and we would argue perhaps transient, with inventory

1 https://www.anderson.ucla.edu/centers/ucla-anderson-forecast/june-2019-economic-outlook

Exhibit 2: Real GDP and leading economic indicator

(Year-over-year percent changes)



Source: BEA; Bloomberg; RSM US

Exhibit 3: Average growth rate of hourly earnings at the end of business upcycles, in the first quarters of recessions and at the end of recessions

		Average Wage Growth				
Business Cycle Peak	Business Cycle Trough	in quarter prior to recession (YOY %)	in 1st quarter of recession (YOY %)	in second quarter of recession (YOY %)	at the end of the recession (YOY %)	Acceleration (+) / Deceleration (-) in wage growth (ppt)
Dec-1969	Nov-1970	6.60	6.10	6.10	5.60	-1.00
Nov-1973	Mar-1975	6.13	6.00	6.27	8.07	1.93
Jan-1980	Jul-1980	7.47	7.33	7.83	7.80	0.33
Jul-1981	Nov-1982	8.97	8.87	7.70	4.77	-4.20
Jul-1990	Mar-1991	4.23	4.17	3.77	3.27	-0.97
Mar-2001	Nov-2001	4.13	4.07	3.87	3.47	-0.67
Dec-2007	Jun-2009	3.90	3.80	3.77	3.10	-0.80
	1969-82 Average	7.3	7.1	7.0	6.6	-0.8
	1990-2009 Average	4.1	4.0	3.8	3.3	-0.7
		as of Dec 2018	Jan-Mar 2019	Apr-May 2019		
Current Period (for reference)		3.20	3.43	3.37		0.17

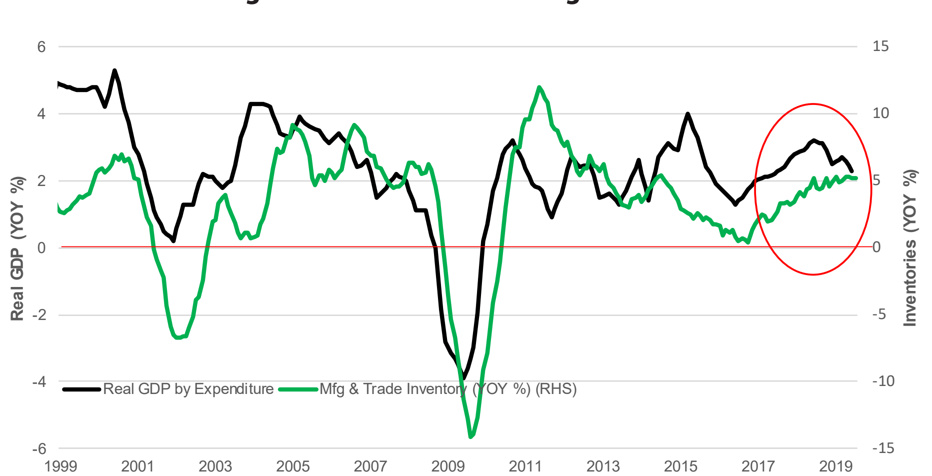
Source: BEA; Census; Bloomberg; RSM US

stockpiling leading to reduced production in coming quarters if future consumption outlays are reconsidered. Disregarding the one-off surges in inventories and other sectors listed above, the UCLA analysis suggests the core economy grew by only 1.2% in the first three months of the year. This supports our call and the interpretation of the leading economic indicator that the real economy is decelerating in a manner not reflected by top-line growth. Indeed, overall real GDP growth in the second quarter dropped to 2.1%.

Looking forward, estimates for third-quarter real GDP growth from the Federal Reserve Banks of Atlanta and New York are centered on 2% (Exhibit 5 on next page). Note that these NowCast models react to the staggered release of economic indicators and will therefore move as the quarter progresses and new data becomes available. Also note that the range of estimates from the Bloomberg survey of economic analysts has moved lower during the quarter, with the survey now indicating median expectations of 1.8% third-quarter growth.

As shown in Exhibit 6 on the next page, economic growth leading into a recession can often be at high rates, like "garbage time" at the end of a blow-out basketball game, where even benchwarmers are able to score lots of points. We observe that slipping below 2% growth appears to be a significant threshold – like the inverted yield curve discussed above, growth in the 1% range suggests a climate ripe for the economy to

Exhibit 4: Real GDP growth and manufacturing & trade inventories



Source: BEA; Census; Bloomberg; RSM US

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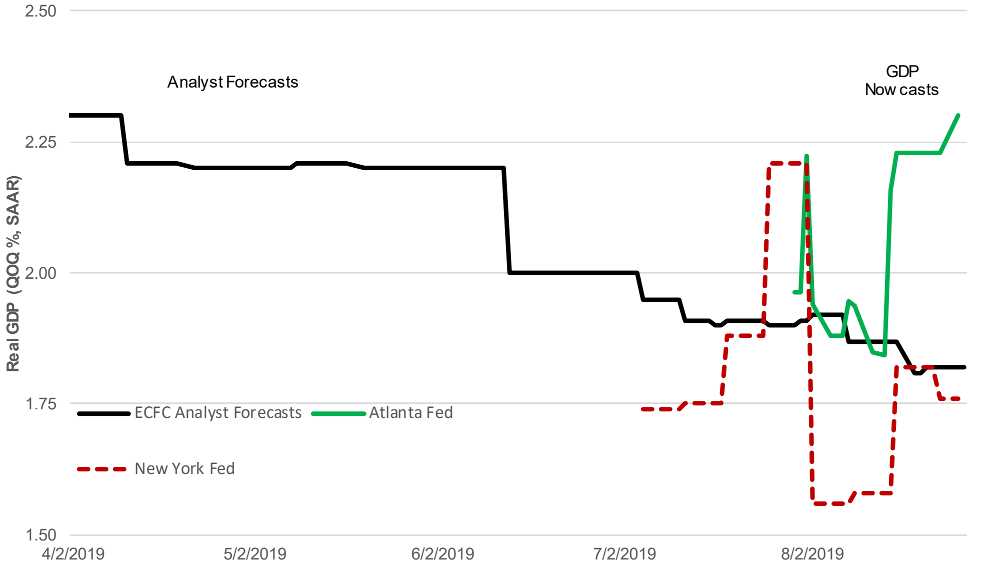
Exhibit 5: Evolution of forecasts for U.S. Q3 real GDP growth



Source: Atlanta Fed GDPNow; NY Fed Nowcast; ECFC Bloomberg; RSM US

slide into recession. Meanwhile, as shown in Exhibit 7, average growth rate during the first quarter of modern-era downturns was 2.5%, with a range of 1.4% to 4.3%. But growth in the second quarter of the downturns has averaged only 0.6%, with a range of -0.8% to 1.3%. So if the core economy grew by only 1.2% in the first quarter of this year, and if the overall economy were to continue growing by only 2% or less, then the stage would be set for an event (Brexit perhaps, or repercussions from the U.S.-inspired trade war with its allies and China) to push the economy into outright recession.

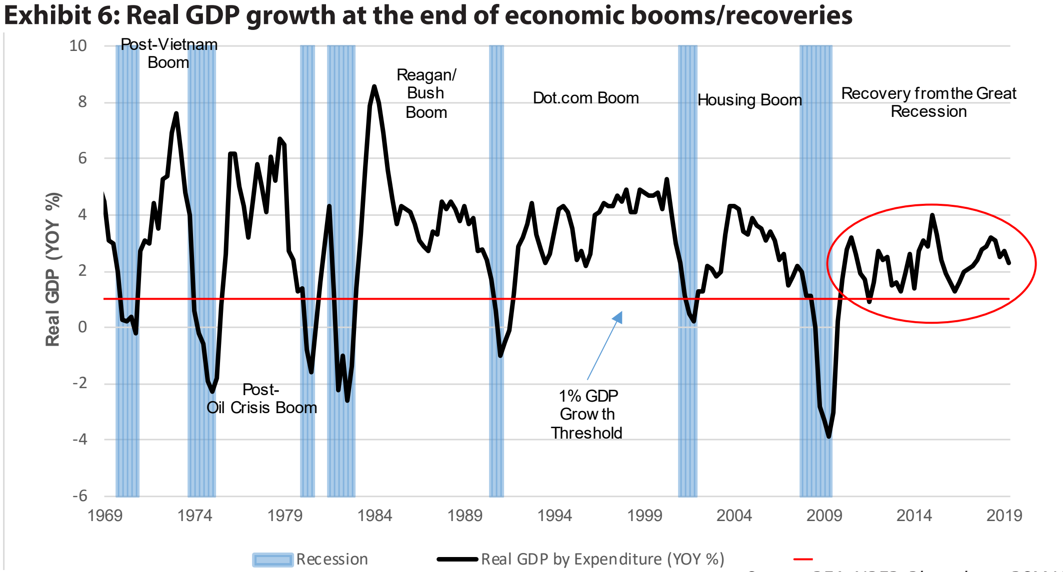
Calculating the Likelihood of Recession

In June 2019, the UCLA Anderson School of Management Conference featured the presentation, "Looking for Recession Precursors among the Contributions to GDP Growth," by Edward Leamer, UCLA Anderson Distinguished Professor of economics and statistics.[2] Leamer finds that the bond market yield curve, reduced household consumption and residential investment, combined with an environment of slow growth, can together signal the advent of a recession.

The primary takeaway is that UCLA's "3, 2, 1" forecast, which calls for growth of 3% in 2018, 2.1% in 2019 and 1.4% in 2020, remains on track. Even with the projected growth for this year and next, Leamer's recession probability estimate implies rising risk of a recession in 2020.

2 https://www.anderson.ucla.edu/centers/ucla-anderson-forecast/june-2019-economic-outlook

Exhibit 6: Real GDP growth at the end of economic booms/recoveries



Source: BEA; NBER; Bloomberg; RSM US

Exhibit 7: Real GDP growth at the end of business cycle uptrends

Business Cycle Uptrends	Business Cycle Peak Date	Business Cycle Trough Date	GDP Growth in 1st Qtr. of Downturn (YOY %)	GDP Growth in 2nd Qtr. of Downturn (YOY %)
Post-Kennedy/Great Society Boom	12/31/1969	11/30/1970	2.0	0.3
Post-Vietnam Boom	11/30/1973	3/31/1975	4.0	0.6
Post-Stagflation Boom	1/31/1980	7/31/1980	1.4	-0.8
1980s Double-Dip/Volker Recession	7/31/1981	11/30/1982	4.3	1.3
Post-Reagan/Bush Expansion	7/31/1990	3/31/1991	1.7	0.6
Post Dot.com Boom	3/31/2001	11/30/2001	2.3	1.1
Post-Housing Global Financial Crisis	12/31/2007	6/30/2009	2.0	1.1
	Average Growth Rates		2.5	0.6

Leamer offers a roadmap for anticipating the end of economic expansions, concluding:

1. the yield curve is important;
2. "negative durables and nondurables and consumption and weak services" warn of the end of an expansion;
3. "weak GDP growth does occur near" the end of an expansion;
4. we should pay attention to residential investment;
5. exports and imports are not good predictors of recessions;
6. government spending is not a good predictor; and
7. the age of an expansion is a "suspicious" variable.

Leamer's analysis suggests the big news is that the bond market emerges as an important part of a recession alarm, reflected in an inverted yield curve. But that's Wall Street speaking. Main Street's contributions to the recession warning include weak investment in intellectual property, increases in the rate of inventory investment, strong exports and declining imports (which make the contribution of imports positive), and that each additional month of expansion subtracts "27% of a quarter from the expected life" of that expansion.

Leamer proposes that the 3.1% growth in the first quarter was "not cause for celebration" and policymakers and investors should pay attention to the 1.2% increase in real final private demand which is a better proxy for business conditions in the real economy. Rather, Leamer's models suggest 5.5 to 8.4 quarters of growth remaining in the current expansion, depending on the inclusion of an age variable, or duration of the economic expansion, in the model. Thus, he concludes there is a 50% probability of recession in 2020 or 2021.

RSM's own recession probability model implies that once the probability rises above 50% there is a strong likelihood of a recession within the next 12 months. This model will be updated once all data for the current quarter have been collected.

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Joe Brusuelas provides macroeconomic perspective to help RSM clients anticipate and address the unique issues and challenges facing their businesses and the industries in which they operate. In 2015, he helped launch The Real Economy, the only monthly economic report focused on the middle market, and helps lead the firm's cutting-edge Industry Eminence Program. Prior to joining RSM as chief economist, Joe was a senior economist at Bloomberg, LP and the Bloomberg Briefs newsletter group. During that time, he was named one of the 26 economists to follow by the Huffington Post. Joe has over 20 years of experience in finance and economics, with emphasis on analyzing U.S. monetary policy, labor markets, fiscal policy, economic indicators and the condition of the U.S. consumer.

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