AIRA Journal

Volume 33 No. 4

WHAT'S INSIDE

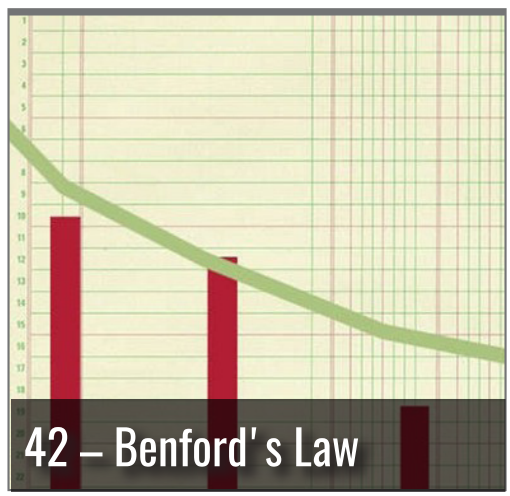
NYIC/AIRA Joint Virtual Event on Jan 20, 2021 2-5pm ET, see p. 47 for more information and registration.

CONTENTS

PAGE#

VOL.33: NO.4

AIRA Journal is published four times a year by the Association of Insolvency and Restructuring Advisors, 221 Stewart Avenue, Suite 207, Medford, OR 97501.



From the Executive Director's Desk

JAMES M. LUKENDA, CIRA

AIRA

For AIRA, 2020 will go down as a transition year. In January, we began with leadership transitions. An Executive Director retired and another took the helm, but who would have predicted the other ways that the concept of transition would present itself? Yes, AIRA's CIRA and CDBV programs have been offered online for quite a few years, but 2020 moved us further along the electronic frontier. The transformation also spilled over to the annual and specialty conferences as AIRA converted those live events to virtual formats with great success.

The key is that we recognize these transitions are not complete. There is more to learn, improve, and accomplish as the virtual world anchors itself in our day-to-day lives. Most expect that at some point by summer 2021 we will regain the privilege to meet, learn, and socialize in "live formats" and life may begin returning to "normal." The next steps for our industry, our association, and our lives is to bring together the best of what we have learned this past year about living and working remotely and apply them to a post-COVID-19 world. And so, as Executive Director, I am planning to devote considerable time in 2021 to reshaping and expanding AIRA's training and conference programs, applying what we have learned about executing successful presentations in the virtual world and redeveloping our already successful live programs. Drawing an analogy to the racing industry, I envision 2021 as the year that we begin *simulcasting* our programs.

In his President's letter, Dave Bart provides a comprehensive overview of AIRA's programs and achievements in 2020. I won't duplicate what he has so eloquently communicated; however, I embrace what Dave has said, and I echo his thanks with my own: to everyone, the membership, the speakers, the sponsors, AIRA's board, and our staff, for making 2020 a year to look back on with pride.

Virtual presentations offer us the opportunity to participate regardless of geography. Along that line, we have an upcoming event that I encourage you all to attend: the **NYIC/AIRA Joint Bankruptcy & Restructuring Event** on January 20, 2021. AIRA has joined with the New York Institute of Credit for many years to provide a signature bankruptcy and restructuring "event" in early January. Traditionally centered around a luncheon in New York's historic garment district (we'll miss this part!), this educational program has brought together practitioners, credit officers, members of the bar, and a respectable representation of the judiciary for astute dialogue on timely topics. With the program going virtual this January, there is an opportunity for many more to attend from wherever you are located – see details and registration at: https://business.instituteofcredit.org/event-calendar.

AIRA also encourages you to support the NYIC/AIRA event since NYIC donates a portion of the proceeds to the **Grant Newton AIRA Educational Endowment Fund**. The fund provides an annual scholarship in accounting at Pepperdine University, which provided significant support to AIRA for many years and was the long-time home of Grant Newton, AIRA's founder.

The pivot to a virtual environment in 2020 eliminated the chance to reach out personally to each of you during the annual conference. So, with year-end generosity in mind, I conclude this letter with a two-fold request: please consider making a tax-deductible donation to the **Grant Newton AIRA Educational Fund** (see www.aira.org), and please register for the **NYIC/AIRA Joint Event** on January 20th.

But most of all, please accept my best wishes for the New Year. Stay safe and stay well.

Jim

*For more information on the **AIRA Grant Newton Educational Endowment Fund,** please refer to p.41 or visit www.aira.org/aira/endowment_fund.*

A Letter from AIRA's President

DAVID BART, CIRA, CDBV

RSM US LLP

To AIRA's membership and supporters:

As 2020 draws to a close, we are grateful to everyone that has contributed to AIRA this year. It has been a most unusual period, and we look forward to a 2021 where we can all resume live activities.

EVENTS – We are thoroughly engaged in conference planning for **AIRA's 37th Annual Bankruptcy & Restructuring Conference (AC21)**, scheduled for June 9-12, 2021 at the Newport Beach Marriott Hotel & Spa. At this point, circumstances permitting, we do plan for this to be our first live event since VALCON in February 2020. Please plan ahead so we can look forward to seeing everyone in person in sunny California.

Thank you to everyone who participated in the virtual **2020 Energy Summit**. It was a highly successful event presented over two successive online sessions. AIRA co-sponsored the Summit with the Turnaround Management Association (TMA) and The Secured Finance Network (SFN, formerly Commercial Finance Association), and recognizes the generosity of sponsors FTI Consulting, Huron Consulting, and AlixPartners. The Summit featured keynote speakers Ryan Sitton, Texas Railroad Commissioner, and Artem Abramof of Rystad Energy. We also thank conference chairs Peter Heinz (FTI), Eli Columbus (Haynes & Boone), and Phil Patman (Huron), as well as all panelists and speakers.

In October, AIRA participated in the **INSOLVENCY2020** virtual conference, organized by ABI. INSOLVENCY 2020 provided the vehicle to present the education program planned for the National Conference of Bankruptcy Judges (NCBJ) Conference, which was cancelled due to the pandemic. Our thanks go to Steve Darr and Huron Consulting for his panel presentation on Subchapter V developments, which was originally scheduled as a breakfast program at the NCBJ.

Congratulations and thanks to everyone who participated in the **19th Annual Advanced Plan of Restructuring and POR Conference (NYPOR)** in November. Our virtual event was spread over two days, and we had a terrific turnout. We are grateful to all our speakers, judges, co-chairs (Michael Lastowski, Brian Rynicker, and myself), the AIRA staff, and especially our sponsors: AlixPartners, CohnReznick, DailyDAC, Deloitte, and Duane Morris.

We are looking forward to the **16th Annual NYIC/AIRA Joint Bankruptcy and Restructuring Event** in January 2021 and **VALCON 2021** in May (note the date change for 2021). Please see AIRA's website for more details.

2020 SUCCESSES – AIRA has had a great year in 2020, despite the pandemic. Thanks to you, our members, who have stepped up and stepped in, AIRA's activities have flourished as events, publications, and training programs transitioned to a virtual world where they were well supported and attended. We thank all participants and sponsors; extending particular thanks to AIRA's staff for their hard work in making this such a successful year. Without these dedicated individuals, AIRA would cease to function: Jim Lukenda (Executive Director), Terry Jones (Director of CIRA & CDBV Programs), Cheryl Campbell (Conference Director), Michael Stull (Director of Information Technology), Michele Michael (Director of Member Services), and Valda Newton (Assistant Editor, AIRA Journal).

OPPORTUNITIES – AIRA continues to offer its members a chance to learn, share experiences, and meet one another, whether virtually or in person in the near future. AIRA welcomes you and your staff to be presenters, authors, teachers, and sponsors, to fully engage with your profession. We invite you to step forward and lead the AIRA and the profession by participating in conference planning committees, teaching and speaking at events, writing articles, and in other roles. Please contact the board members, executive director Jim Lukenda, or me, so that we can gladly draw you into AIRA's leadership. There is a role for everyone, and we welcome your contributions.

Finally, don't forget that AIRA continues to provide educational courses and professional certification training online. See www.AIRA.org for information about AIRA's nearly two dozen CPE offerings as well as online CIRA and CDBV training programs. For more information, please contact Jim Lukenda at jlukenda@aira.org.

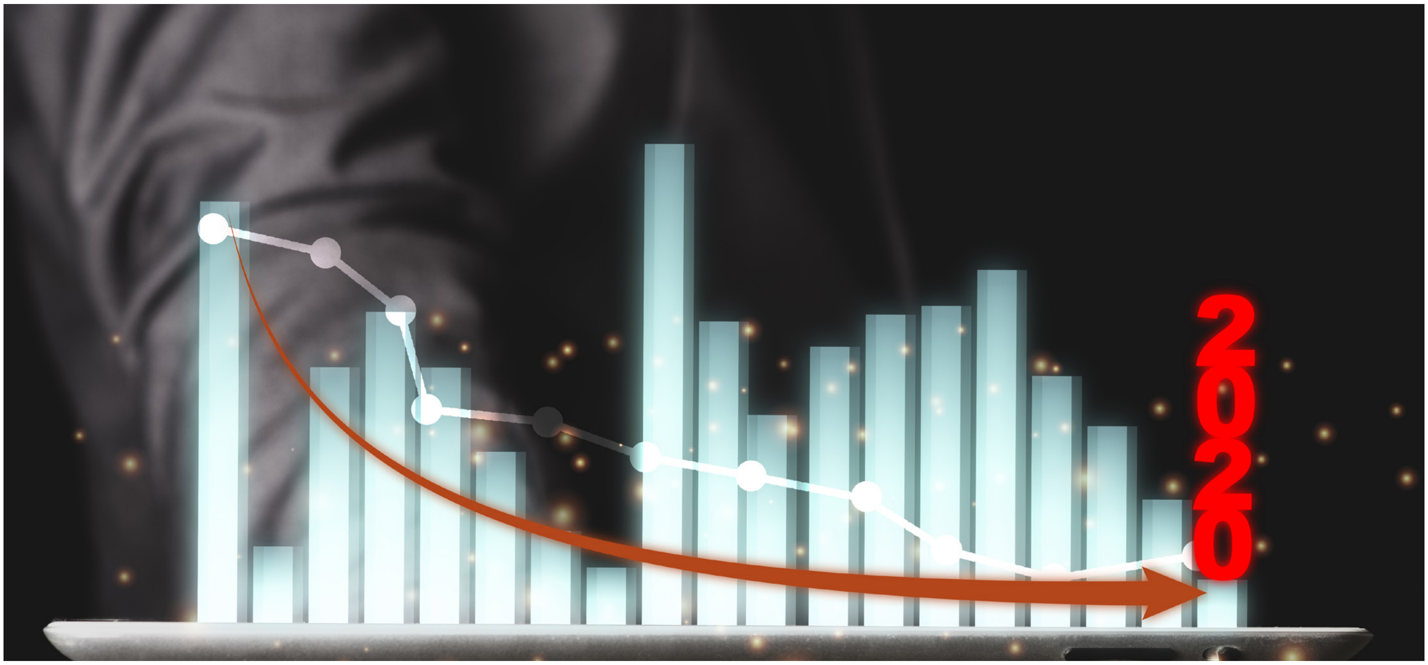
2021 OUTLOOK – I am excited about the things to come in 2021. The AIRA is planning new programs and outreach that will be announced soon; meanwhile, our established conferences, education, and publications are moving forward in great shape for the coming year. We hope to see you all participating in these activities.

I wish you, your colleagues, and your families all the best this holiday season.

David Bart

BUSINESS VALUATION CONSIDERATIONS IN A CORONAVIRUS ENVIRONMENT

DAVID BART, CIRA, CDBV and DAN JARES, CFE
RSM US LLP



Since the coronavirus emerged in early 2020, valuations within and outside of court have faced questions of whether and how they account for the impact of the changing economic environment and the shifting short and long term outlooks affected by the pandemic. While business valuation opinions should not stem from simple mechanical computations, the thoughtful and diligent consideration of valuation fundamentals and principles become even more important when preparing business valuations in today's dynamic and uncertain environment. Traditional valuation approaches and methods can be used to incorporate the impact of the coronavirus pandemic, but they need to be carefully administered and executed with thoughtful consideration.

Valuation Date and Knowledge

A business valuation opinion reaches a conclusion about the value of a business at a specific point in time, the valuation date. When performing the analysis, it is important to understand what information was known or knowable as of that valuation date. This applies to the impact of the coronavirus pandemic as well.

For valuation dates occurring in 2020 and going forward for the near term, the valuation analyst should consider the implications from the spread of the pandemic on the business; the economic effects on the business, the industry, and the economy at large; government and industry and business responses; and the market's and investing community's views and outlook in response to the available information.

Information that is not known or knowable as of the valuation date is often considered a subsequent event, which is generally defined in valuation reports as an event that occurs after the valuation date but before a valuation report has been issued.[1] A variety of accounting rules also govern the concept of subsequent events as applied in financial statement reporting and for regulated disclosures about company financial results.[2] These follow similar logic, where subsequent events are generally defined as events that occur after the financial reporting period but before the financial statements have been issued.

In bankruptcy litigation, the court's analysis often focuses on what information was available at the valuation date, but courts do explore management's or others' perspectives about the outlook for the business at that date. Courts consider the reasonableness of the company's projections, not with hindsight, but with respect to whether they were prudent when made.

[1] For example, see Uniform Standards of Professional Appraisal Practice (USPAP) and publications from the American Society of Appraisers; *Statements On Standards For Valuation Services VS Section 100* (Statement on Standards for Valuation Services No. 1) issued by the AICPA; *Standards for Distressed Business Valuation* issued by the Association of Insolvency and Restructuring Advisors; as well as court rulings and regulatory agency publications and opinions, i.e. IRS rulings.

[2] A detailed review of regulations and guidance regarding the reporting of subsequent events is beyond the scope of this article.

Business valuations are often performed under a going concern premise of value at the valuation date. This premise of value may need to be tested and not simply assumed for the subject company given the widespread operating risks and financial difficulties that are emerging from the pandemic. Furthermore, this premise of value may become inappropriate at a later date due to changes in the company's fortunes.

When dealing with valuation dates occurring during, or near the onset of, coronavirus, care should be taken to determine the relevant information that was available as of the valuation date, while avoiding hindsight and separating the impact of subsequent events. If values after the valuation date may be significantly affected by subsequent events, disclosure of these may be warranted.

Government Responses

Professional standards governing appraisal and valuation practices direct valuation analysts to develop a range of economic, industry, and subject company outlooks. Those standards already indicate that financial and valuation analyses may include financial, accounting, and valuation adjustments when reaching an opinion of value.[3]

Government and other responses to the pandemic may have significant impacts upon the valuation of a business since they may directly affect cash flows, balance sheets, and capital structure. In March 2020, Congress enacted the Coronavirus Aid, Relief and Economic Security (CARES) Act, H.R. 748. Specific provisions include direct financial support and business tax provisions provided by a range of programs, including the:

- Paycheck Protection Program (PPP),
- Emergency Economic Injury Grants (EEIG),
- Economic Injury Disaster Loans (EIDL), and
- Small Business Debt Relief Program (SBDRP).

The treatment of stimulus receipts by the subject company and any tax impacts upon the subject company, as well as the accounting for any obligations stemming from participation in these programs, should be addressed in the business valuation. Guidance has been provided by the Treasury Department and Small Business Administration (SBA) as well as professional organizations that focus on appraisal practice.

The specific date of the valuation and the subject company interest, among other items, can affect the treatment of those programs and the interpretation and computation of their impact within the valuation analysis. Knowledge of potential sources of income and/or cash, potential liabilities and repayment terms, potential debt forgiveness, and other items can raise questions about the extent they were known or knowable at the valuation date.

Therefore, valuation analysts should consider developing questions and lines of inquiry that probe into the potential ramifications of these items on both a macro-economic and micro-economic as well as industry and subject company levels.

Financial Projections

The interpretation of company financial projections provides an important foundation for business valuations that rely upon income approaches or transaction approaches which incorporate outlooks for future income.[4]

The pandemic has caused significant disruption to previously anticipated income, expenses, and cash flows. Business closures, economic disruption, rapidly changing consumer purchasing methods and preferences, demand shocks, and supply shocks, are just some of the items that may be causing revenue declines (or increases), and expense contractions (or increases) that can have a major impact on cash flow and net income analysis. They can also affect the ability to assess the performance of comparable companies and ownership interests. Changes to tax laws and the use of government stimulus support, and the potential for repayment of those funds, may have created unanticipated surges and depletions of cash flow. These and other impacts may be short term, intermediate, or longer term.

Important questions may center upon the length of time before business operations are projected to achieve a "new normal" steady state, the new normal revenue and cost structure of the business, and the near and intermediate term cash flows during the crisis or transition period. Does the company have sufficient cash and liquidity to weather the downturn, and over what period? Evolving challenges and responses may place pressure on working capital, planned or unanticipated capital expenditures, and other sources and uses of cash that may be temporary or that may leave in place a longer term shift for the foreseeable future under a new normal environment.

Business experiences in a coronavirus environment have led some to conclude that financial projections should incorporate scenario analysis of potential outcomes. Consideration may extend to incorporating a weighted conclusion among, or judgmental assessment of, multiple scenarios to evaluate the most likely outcome and implied financial results that can be applied when

[3] Supra, note 1.

[4] For additional discussion on this topic, see, for example: D. Bart and E. Daucher, *Developing the Evidence: Using Prospective Financial Information in Bankruptcy and Other Litigation for Business Valuation, Damages, and Other Applications.* American Bankruptcy Institute, 2020.

Continued from p.7

calculating indications of value under various valuation methods to reach an opinion of value. The mechanisms, computations, and professional judgement applied in developing scenarios, interpreting them, and weighing their outcomes to reach a conclusion will need to be justified and explained.

Adjusting EBITDA and EBITDAC

While the severity and length of the pandemic remain uncertain, longer-term outlooks and recovery timing also remain unclear. To some, pre-crisis historical financial data may seem useless, and a wide range of predictions about the economy and individual companies for 2020 and subsequent years may appear to render a precise valuation determination unlikely. Others argue that traditional valuation tools can be applied with adjustments made for the pandemic.

Financial analysis of historic and projected business results often computes earnings before interest, taxes, depreciation, and amortization (EBITDA) as an important metric. When adjusting EBITDA to calculate "normalized" EBITDA for use in a valuation analysis, some valuation analysts are now considering whether to utilize "EBITDAC," representing EBITDA before coronavirus, as a normalized measure of income.

Thus, coronavirus is being considered as an extraordinary, nonrecurring, or unusual event; with potential adjustments being made to revenues/ expenses and sources/uses of cash as well as balance sheet items to isolate the impact of coronavirus on the business while assuming a return to pre-coronavirus normalcy in the future. Employing this methodology permits the impact of coronavirus on the business to be separately quantified and treated as an adjustment.

These types of adjustments are consistent with recently released guidance for disclosing the financial impact of coronavirus on business operations; as in, for example, SEC related financial reporting and financial reporting under Generally Accepted Accounting Principles (GAAP).[5]

It is important to quantify and support the basis for financial adjustments. The use of subjective rationales that are not supported by some type of measurement, logic, and other evidence may undermine the credibility of the adjusted financial projections. Some examples of potential adjustments may include:

- revenue losses and replacement,
- cost increases and stabilization,
- supply chain disruption,
- increased costs due to operational inefficiencies that are later reduced,
- losses of key customer and/or supplier contracts, and
- pandemic response expenses (e.g. supplies, modifications to physical environment, hazard pay, and planning expenses).

Adjusting Debt

Participation in U.S. or other government stimulus programs, debt forgiveness, loan forbearance, interest deferrals, rent and other lease concessions, severance obligations, obtaining additional borrowings, and other items may require detailed analysis to determine their effects on actual and projected financial results. For example:

- Loan modifications can have a significant impact on key financial measures, and they could alter the financial metrics used in loan covenants.
- Significant changes to the financial structure and temporary or ongoing changes to income could affect whether the subject company meets eligibility and loan forgiveness criteria.

In practice, uncertainties about current and projected financial outlooks, and the evolving environment for government stimulus and lender support could lead to different approaches and diversity in the manner and timing in which the accounting is recognized and taken into account within a valuation analysis. This, in turn, may require additional effort and scrutiny and deeper consideration regarding the use of debt related financial and valuation adjustments.

Cost of Capital

Discount rates and the cost of capital consider the returns available to debt and equity interests based on comparisons made to hypothetically similar investors who are investing in the subject company at the valuation date. The interpretation of investor returns are, in turn, based on what was known or knowable at that date. Some issues may include, for example:

- What is the appropriate risk-free rate given the abnormal market conditions?
- Are restrictions on trading creating limitations on the ability of prospective buyers to acquire interests?
- What are the current outlooks for the economy, industry, and subject company?
- What are the potential impacts of these and other factors on growth rates and measures of risk?

Important changes that are affecting the business may require interpretation, such as: the loss of customer traffic, supply chain interruptions, mandated business closures, loss of customer contracts, regulatory changes,

[5] A detailed review of the regulations and guidance regarding permissible accounting and valuation adjustments and any disclosures that may be required by various regulatory and/or professional practices is beyond the scope of this article.

and other items. Evaluation of these issues may require the application of business and professional judgement to reach a final opinion about projected cash flows and their risks and returns as measured in the cost of capital and discount rates used within the valuation analysis.

Some professional firms propose including an additional alpha factor in the cost of capital to account judgmentally for forecast risk. If an alpha is considered, additional analysis may be necessary to assess the basis for inclusion and to quantify the amount selected as an additional measure of that risk in order for the alpha to be credible.

When computing or adjusting the cost of capital, the valuation analyst should differentiate the risk factors, only adding a premium for items not already included in the discount rate and for items that affect the risk associated with the cash flow projections. Valuation analysts should be careful to avoid double dipping on adjustments that pertain to the same factor, which may result in an under- or overstatement of the subject interest's value.

Instability in government debt markets, such as Treasuries, may affect the risk-free rates used in the discount rates. Instability in public markets may affect the equity market risk premium that is added to the risk-free rate to determine the cost of equity. Market displacements can have an impact on the discount rates that directly affect the computation of subject company indications of value.

For example, lower Treasury market yields caused by increased demand and higher prices for government debt may not be offset by higher market premiums, resulting in lower overall discount rates, leading to higher company values. Some questions to consider may include:

- Are those implied higher values reasonable and reliable?
- Should a normalized risk-free rate be considered instead to account for temporary market disruptions?
- What comparable rates for debt are public companies disclosing, and are they really comparable to the subject company?

Finally, the weighted average cost of capital utilizes assumptions regarding the cost of debt and its tax deductibility. The CARES Act, for example, can impact the subject company's cost of debt and its deductibility. Care should be taken to thoroughly analyze the subject company's balance sheet, debt recognition, and the impact of government stimulus to determine relevant adjustments to the cost of debt (short- and long- term) and the tax assumptions employed within the cost of capital analysis.

Bankruptcy Court Experiences

Pandemic related valuation issues are playing out in U.S. Bankruptcy Court and in other venues.

- For example, *Quorum Health*, a rural hospital chain, filed for Chapter 11 protection. The battle over the plan of reorganization included a fight over the reorganization value. The minority shareholder and its experts contended the value was $1.4 billion. The debtor company argued it was worth $965 million. The debate centered upon the impact from hundreds of millions of dollars in federal subsidies.
- In another case, *Jason Industries, Inc.*, a Wisconsin based manufacturer of lawn mower seats and other products, the fight focused on the assumptions used in the financial projections and other items, resulting in a $30 million difference between the debtor's valuation of $200 million and creditors' view that the debtor company was worth $230 million. This case settled during trial.

Courtroom battles that are resolved with a judicial opinion can be affected by many things in the trial or hearing and may come down to an assessment by the judge of the expert's credibility. The judge will likely assess the reasonableness of the valuation approach, the underlying documentation and other evidence, as well as the basis for assumptions and whether the valuation analyst was objective when performing calculations and reaching an expert opinion.

The remainder of this article comments upon some of the current considerations that may need to be resolved under each of the traditional valuation approaches.

Valuation Approaches

Traditional valuation analysis and techniques remain relevant in a pandemic environment. Each approach should be weighed for its appropriateness and applicability in every situation, including the adoption of potential adjustments specific for each approach.[6] Some considerations in this environment for each approach may include:

Market Approaches

Market approaches to valuation assume the fair market value of an asset can be derived from the comparative values assessed in the marketplace for similar guideline transactions. For example, the Guideline Public Company Method focuses on public company trading prices. Other methods use alternative concepts of measuring markets and prices, e.g. the Mergers and Acquisition Method.

[6] Note, the application of different standards of value (e.g. fair market value versus fair value) may result in the use of different techniques and assumptions within the analysis. For purposes of this article, we refer to the fair market value standard of value as an example for discussion.

Continued from p.9

Assessments of comparability may include, for example, company size, income and cash flow, balance sheet strength, customer composition, geography, and other factors that can greatly affect entities in similar lines of business. Understanding the differences between how the subject company and guideline companies have qualified for and utilized the stimulus options available to them may result in additional adjustment considerations.

It is possible that coronavirus has created a situation where market outlooks and transactional changes are occurring so rapidly that reliable information lags real time reported changes in operations, income, implied values, and actual transaction prices. In addition, the merger and acquisition marketplace may be challenging deal commitments made prior to coronavirus, and pre-closing valuation multiples may be overstated compared to post-closing valuation multiples. Modifications to cancelled deals can result in re-pricing, which may not be reflected immediately within publicly disclosed information. Some predict the risk that greater divergence may start to appear in pricing multiples and other valuation metrics, highlighting market instability and the shifting perceptions about the economy, industry differences, and company performance.

Significant volatility in the capital markets at various times in 2020 may raise questions about the guideline public company method, such as:

- Are market prices and trading multiples artificially and temporarily depressed compared to normalized pricing, or are the pricing trends more permanent?
- What is the impact of market dislocation and instability, and over what period did that dislocation or instability occur?
- Do public transactions reflect pre- or post-coronavirus financial results?
- Is the timing of the financial information in sync with the transaction pricing dates; i.e., pre-coronavirus financial information versus post-coronavirus pricing, and should any adjustments be made?
- Can adjusted transaction prices and adjusted income be matched so as to compute a reliable "adjusted" transaction value guideline?

The guideline mergers and acquisitions method relies on disclosed M&A pricing for transactions that occurred during a period preceding the valuation date that can reach back one or more years. Use of a 2019 transaction as a guide may no longer be relevant to determining 2020 market multiple comparisons for the subject company. Valuation analyses performed in the current environment may place increased importance on only using 2020 guideline transactions to measure purchase prices for guideline companies, thus reducing the pool of candidate transactions for analysis, and potentially decreasing the reliability of this approach if comparable transactions cannot be determined. If comparisons can be identified, questions may arise whether the transactions provide consistent results that can be applied to the subject company to determine a reliable indication of value.

Income Approaches

Income approaches to valuation assume the fair market value of an asset can be derived from the present value of all future benefits expected to be generated by the asset. For example, the Discounted Cash Flow Method focuses on multi-period earnings over a specified time horizon, with perpetuity earnings thereafter. Other methods use alternative concepts of measuring period income and applying discount rates to future periods to reflect the time value of money, e.g. the Single Period Capitalization Method.

Income based approaches may need additional assessment to address how coronavirus has and may continue to impact the subject company's valuation, and whether these impacts are temporary or longer term. These issues can affect both the financial projections as well as the discount or capitalization rates applied to the subject company. Pre-coronavirus assumptions about the stability of supply chains, human resources, and capital availability may no longer be relevant. Similarly, the timing and quantification of projected cash flows, discount and capitalization rates may be affected by both systemic and unsystemic risks.

Balance sheets may require closer assessment due to the subject company's ability to take advantage of market dislocation, its ability to initiate new strategies, and its nimbleness to source and utilize capitalization and resources relative to peers and competitors.

Preparation and assessment of multiple alternative scenarios is recommended to address a range of possible outcomes and to evaluate outliers and probabilities of those on the indications of value and the valuation opinion. It is possible that one model alone may not be adequate to project the current environment.

Added consideration may need to be given to the subject company's ability to refinance existing debt. For example, the Great Recession of 2008 demonstrated the resilience of companies that were able to refinance short term debt as liquidity dried up.

Income based approaches depend on discount rates and an assessment of the cost of capital. Current professional practices contemplate placing the focus on the financial projections, rather than judgmentally applying large adjustments to the cost of capital for subject company specific risk. This focuses the uncertainty on the future activity. However, discount rates themselves may be affected by market forces that have already reacted to the presence of coronavirus. This raises a significant issue: how far out do you apply a coronavirus affected discount rate compared to the timing of coronavirus affected financial projections? Some element of pandemic risk may still be present in terminal value calculations. This could have the effect of undervaluing the subject company. In contrast, underestimating the measures of risk in combination with optimistic assumptions for a recovery can overvalue the subject company.

Asset Based Approaches

Asset based approaches to valuation assume the fair market value of an asset can be derived from analyzing the cost to acquire or replace the asset. For example, the Adjusted Net Asset Method or Adjusted Book Value Method or the Liquidation Value Method focuses on the fair market value of individual assets or classes of assets and liabilities.

Valuations prepared under the asset approach may need to consider whether changing business tax provisions applicable to the subject company generate any assets or liabilities which are not already reflected on the subject company's financial statements as of the valuation date.

For solvency and liquidity tests (e.g., testing whether the fair market value of assets exceeds liabilities), the market value of debt may not be determinative. Additional emphasis may be needed to determine whether the company can meet obligations as they become due or whether the subject is adequately capitalized. The market value of debt may not be reliable for purposes of valuing that debt unless satisfaction is imminent. Consideration may be needed to determine whether to use the book value of debt obligations or some other metric as a measure of liabilities.[7]

Conclusion

The manifestations of coronavirus may be present for some time in the future. The adoption of coronavirus related financial and valuation adjustments as incorporated into business valuation analysis and appraisal opinions may become the new norm.

Classic valuation methodologies and approaches already accommodate the structural means to address these issues. Since valuation theory focuses on a longer perspective about the returns available to investors and lenders, the ongoing uncertainty may lead, over time, to more commonly utilized approaches to address this evolving environment.

[7] For example, certain financial tests performed under the Bankruptcy Code (e.g. solvency tests) or state laws may require an assessment of claims against the debtor or some other metric as the appropriate measure of liabilities.

References

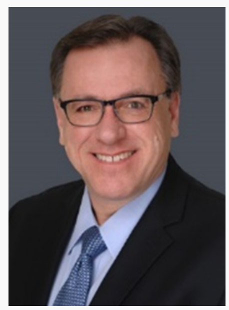
DiNatale, N., et al. "Valuation Considerations Related to the CARES Act." American Institute of Certified Public Accountants (AICPA), aicpa.org/interestareas/forensicandvaluation/resources/businessvaluation/valuation-considerations-related-to-cares-act.html.

Hill, J. "In Covid Bankruptcy Valuation Brawls, the Best Spreadsheet Wins." *Claims Journal*, Sep. 10, 2020.

Nus, J. and Tamulis, M. "Shining a Light on Earnings Adjustments." *CFO Magazine*, June 24, 2020.

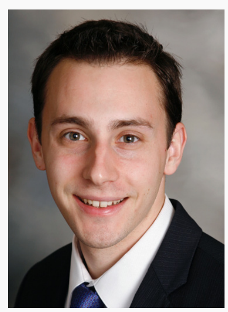
Van Vleet, D. R. "Bankruptcy and Business Valuation in the Current Environment" *ABI Journal*, American Bankruptcy Institute, Oct. 30, 2020, p. 60.

ABOUT THE AUTHORS



David Bart, CIRA, CDBV, CFE, ASA, ABV
RSM US LLP

David Bart is the Senior Director of the Great Lakes Financial Investigations and Dispute Services practice at RSM US LLP in Chicago. He is a graduate of the University of Chicago (BA, MBA). He is the former Chair of ABI's Task Force on Litigation Trusts and is currently AIRA's president and co-editor of *AIRA Journal*.



Dan Jares, CFE
RSM US LLP

Dan Jares is a Manager in the Great Lakes Financial Investigations and Dispute Services practice at RSM US LLP in Chicago. He is a graduate of the University of Illinois (BS in Finance and BS in Accountancy). He is responsible for the delivery of forensic accounting, financial investigative and financial consulting services involving commercial disputes, forensic accounting investigations, feasibility analysis, financial and economic analysis, bankruptcy litigation and business valuation matters.

CHALLENGES OF EMERGING MARKET RESTRUCTURINGS IN THE AGE OF COVID-19[1]

STEVEN T. KARGMAN
Kargman Associates / International Restructuring Advisors

Since the onset of the COVID-19 pandemic, the global economy has entered fairly treacherous territory. Global economic growth has already contracted very sharply in the first half of 2020, and in a report released in June, the World Bank forecast in a baseline scenario that global GDP could shrink by 5.2% for the full calendar year 2020, which the World Bank indicated would be the deepest global recession since World War II.

According to the World Bank report, in 2020 advanced economies are forecast to shrink 7% and emerging economies and developing countries are forecast to shrink by 2.5% (which the World Bank said would be the lowest rate of growth for emerging and developing economies since at least the 1960s). However, in its baseline scenario, the World Bank forecast the possibility of a moderate recovery for the global economy in 2021.

Our focus in this article is the emerging economies, and the rather bleak outlook for the emerging markets in particular represents a sharp turnaround for the emerging economies since many of those economies have been performing fairly well in the last few years. But many of the gains the emerging economies have made in recent years risk being wiped out by the current COVID-19-related economic crisis — with the possibility, for example, that millions of citizens of these countries could be thrown back into poverty — and it is expected that the impact of the current economic slowdown on emerging economies could be long-lasting.

The COVID-19 pandemic has generally arrived in the emerging economies and developing countries later than it arrived in various advanced economies. Nevertheless, the public health impact of the COVID-19 crisis could be particularly pronounced if and when the pandemic makes major inroads into the emerging economies and developing countries. Many of these countries do not necessarily have strong healthcare infrastructure to begin with. Furthermore, a number of emerging economies and developing countries enter the COVID-19 health crisis starting from a fairly low base of available medical supplies and may therefore eventually face shortages of vital equipment such as ventilators, surgical masks, and other personal protective equipment.

COVID-19 arrived in the emerging economies at a particularly inauspicious moment, as there were already significant negative economic trends affecting the emerging economies. Most notably, there was already a collapse of key commodity prices underway, starting with the price of oil but extending to a broad array of other commodities, such as various metals including copper and zinc. And the global economic slowdown associated with COVID-19 has led to decreased demand for a range of commodities, thereby putting further downward pressure on commodity prices.

Since many of the emerging economies are heavily dependent on commodity exports as one of the central pillars of their economies, the price collapse of commodities has been an especially serious blow to many emerging economies, particularly in many oil-producing countries around the globe. For example, in Africa, oil-producing countries such as Nigeria, Angola, and Algeria, among others, are likely to face major financial pressures since their economies and national budgets are so dependent on oil revenues.

Many emerging market economies also rely to a significant extent on the tourism sector. Indeed, in a number of emerging economies and developing countries, tourism may account for as much as 10% or more of GDP (and, in some cases, even 20% or more),

[1] A version of this article originally appeared in *International Insolvency & Restructuring Review 2020/21*. It is reprinted with the kind permission of Capital Markets Intelligence (http://www.capital-markets-intelligence.com). This article was first published in June 2020 and, unless otherwise noted, speaks to events as of that date.

and the tourism sector may also be a major source of employment in these countries. Lockdowns around the world and the closing of national borders essentially shut down most international air travel which in turn led to a drying up in many emerging economies of the revenues generated from foreign tourists.

In recent months, there has been a significant weakening of the currencies of many emerging economies. For instance, there have been sharp declines in the value of emerging market currencies such as, among others, the Turkish lira, the Brazilian real, the Mexican peso, the South African rand, the Nigerian naira, the Colombian peso, and the Indonesian rupiah. [Update: Some emerging market currencies have recovered some value in recent months, *vis-à-vis* the U.S. dollar, but a number of emerging market currencies remain substantially weakened against the US dollar from where they stood earlier this year.]

These widespread declines in the value of emerging market currencies could pose a serious challenge to emerging economies because many of these economies have, both at the sovereign and corporate level, incurred debt denominated in hard currencies, such as the US dollar. These depreciations in the value of emerging market currencies threaten to make the servicing of foreign currency-denominated debt that much more difficult.

In this article, we will briefly discuss how the COVID-19 economic crisis could affect different types of emerging market restructurings involving sovereign debt, corporate debt, and infrastructure projects, as well as related issues concerning state-owned enterprises and non-performing loans.

Sovereign Debt Restructurings

Even before the COVID-19 crisis began, there were a number of emerging market sovereigns that were experiencing financial distress to one extent or another. Yet, the COVID-19 crisis is only likely to make these particular sovereign debt situations even more challenging.

In Latin America, there are several countries that had sovereign debt travails prior to the arrival of COVID-19. Venezuela, for instance, has been in default on its outstanding debt for over two-and-a-half years, and has a huge stock of outstanding debt and other liabilities (estimated to be US$150 billion or more). The pandemic potentially aggravates the existing grave humanitarian/ social crisis in Venezuela, which is accompanied by a financial/economic crisis and a political crisis.

Argentina, with its well-deserved reputation as a serial defaulter, was already facing a debt crisis before the arrival of COVID-19, and the pandemic has only exacerbated the difficulties facing Argentina. The Argentine government must now make greater expenditures on health care as well as fund economic stimulus measures, thereby further unbalancing its budget. With more of a whimper than a bang, Argentina entered into default once again on May 22, 2020, by some counts the ninth such default in its history as an independent nation. As of this writing in mid-June 2020, Argentina was still engaged in discussions with its creditors to see whether a restructuring deal could be reached. [Update: Argentina reached a deal with its creditors in early August 2020 and a bond exchange in connection with the restructuring was approved overwhelmingly by bondholders in late August 2020.]

Another Latin American sovereign, Ecuador, which has been dealing with the economic fallout from the drop in the price of oil as well as one of the worst coronavirus-related public health crises in Latin America, reached an agreement in April 2020 with its bondholders to postpone for four months debt service payments on bonds in the amount of US$800 million. [Update: In August 2020, Ecuador's bondholders approved a restructuring of US$17.4 billion of Ecuador's debt.]

Other non-Latin American countries were also experiencing financial distress prior to COVID-19, including countries such as Lebanon and Zambia. Lebanon defaulted on a US$1.2 billion bond in March 2020, and Zambia, a copper-producing country, has been hard hit by the major drop in copper prices and the decline in its currency *vis-à-vis* the US dollar. In late May, Zambia appointed a financial advisor to assist in exploring options for restructuring its debt burden of approximately US$11 billion.

As the COVID-19 crisis takes a greater toll on emerging economies with the passage of time, it is expected that many more countries will enter into debt distress, triggering either debt restructurings or debt defaults. As a possible harbinger of the troubles to come, approximately 100 countries have already approached the International Monetary Fund for emergency financial assistance.

It should be noted, though, that there are even concerns in some quarters that the IMF, which currently has resources of approximately US$1 trillion at its disposal, may nonetheless not have enough available firepower to deal with all of the financing requests it may ultimately receive from distressed sovereigns around the globe. Moreover, in a further sign of the seriousness of the current situation, the G-20 countries, in their capacity as bilateral creditors, recently agreed to a debt service moratorium *vis-à-vis* the poorest 77 countries in the world that will last until December 31, 2020. [Update: In October, the G-20 extended the debt service moratorium until June 30, 2021.]

Continued from p.13

A number of recent issuers of sovereign debt were first-time issuers which were taking advantage of the ample supply of liquidity in the international capital markets and the relatively low interest rates associated with the Federal Reserve's low interest rate policy in the years after the 2008-09 financial crisis. For example, in Sub-Saharan Africa, first-time issuers included, among others, countries such as Ghana, Gabon, Senegal, Namibia, Nigeria, Zambia, and Rwanda. However, in the current adverse global economic environment, countries such as these may now face serious debt sustainability issues, and this could ultimately give rise to the need for some form of debt restructuring and/or debt relief.

Traditionally, in the sovereign debt world, the International Monetary Fund (IMF) — the multilateral institution that financially stressed countries would invariably approach for financial assistance in their hour of need — has occupied center stage in many, if not most, sovereign debt restructurings. Yet, in the current environment, there is a new player that cannot be ignored: China. China has become the world's largest official creditor, and its global lending now apparently dwarfs lending from the World Bank and the IMF combined.

Nevertheless, China's lending arrangements in the emerging economies and developing countries have been marked by a fair amount of opacity, and it is not clear what approaches or principles will guide China in dealing with sovereign debt restructurings in the current COVID-19-related economic environment. In some recent cases, China has apparently been willing to grant only limited debt relief to sovereign debtors (although in an article a year ago, *The Economist* cited a study that found that China engaged in at least 140 restructurings and write-offs of external debt since 2000).

In other cases, such as in the case a few years ago of the Sri Lankan port of Hambantota, China essentially effectuated a debt-for-equity swap when the Sri Lankan government could not repay a loan from China. In that case, China effectively exchanged the debt owed by Sri Lanka for a 99-year lease of the Sri Lankan port (which happens to be strategically located in the Indian Ocean region). In yet another set of cases, China is reportedly believed to be trying to take additional collateral to back up its loans in exchange for any debt relief that China grants to sovereign debtors.

China is not a member of the long-established Paris Club of bilateral creditors, so China does not need to abide by any of the Paris Club principles (e.g., the principle of transparency) nor does it need to feel obligated to work in concert with other bilateral creditors that are members of the Paris Club. Yet, in a multi-creditor situation, the non-China bilateral and multilateral creditors may well be disinclined to grant debt relief to a sovereign if they believe that China would not make any comparable sacrifices. These non-Chinese creditors may be concerned that whatever debt relief they grant the sovereign in question would end up being used to repay debts to China (and, importantly, in the current environment would not be used by the governments to fund necessary public health expenditures and economic stimulus measures).

A first test case of this multi-creditor scenario may arise in Zambia which as mentioned above is seeking to restructure its loans with external creditors. Zambia apparently owes approximately US$3 billion on US dollar bonds, and it also owes approximately US$3 billion to China. And at the same time, Zambia has also sought financing under a so-called rapid credit facility from the International Monetary Fund to help it address the fallout from the coronavirus crisis. [Update: Zambia defaulted on one of its Eurobonds in mid-November 2020.]

How Zambia's debt situation is ultimately resolved could shed light on whether China will be able to pursue a go-it-alone approach in debt restructurings even where there are other external creditors and financing sources, or whether China will eventually have to work with other parties in such multi-creditor situations in order to reach an overall debt restructuring solution.

Separately, another issue worthy of our attention is how holdout creditors — sometimes referred to a "vulture funds" — will seek to maximize their recoveries in the next round of sovereign debt restructurings. In connection with Argentina's default in 2001 and the ensuing restructurings, a group of hedge funds pursued a strategy of fairly aggressive litigation focused on advocating a somewhat unconventional interpretation of the *pari passu* clause in the relevant New York law-governed bond documentation.

What will be their legal hook this time? It may be hard to say now with any specificity until some concrete sovereign debt restructuring disputes develop. Yet, distressed debt funds can be expected to scour the underlying bond documents to identify any clauses that they believe they might be able to use to their advantage in any potential litigation against the sovereign in question. Crucially, the willingness of some distressed debt funds to pursue bold and fairly aggressive — and even costly and drawn-out — legal strategies should not be underestimated, especially given the possibility of such funds achieving hefty returns if their strategies and plans work out successfully.

At a very practical level, to the extent that the situation presents itself, one could also look for holdout creditors to exploit series-by-series voting in the first-generation collective action clauses (CACs) adopted in the early 2000s. In pursuing such a strategy, a holdout creditor would seek to amass a blocking position in a particular series of the sovereign's debt and thereby prevent the restructuring of the series of debt in question. That would free the holdout creditor to pursue litigation to recover the full face value of the debt of that series (notwithstanding the fact that the holdout may have purchased the debt at a substantial discount).

Corporate Debt Restructuring

In recent years, companies in the emerging markets borrowed heavily in the capital markets, particularly with interest rates being as low as they were. Even before the COVID-19 crisis, many of these companies were possibly overleveraged, and thus with COVID-19-related global economic slowdown, many of these companies may, to the extent they are not granted forbearance by their lenders, face financial distress as they navigate a landscape in which their revenues decline due to the overall economic slowdown.

This recalls in some respects the situation in the wake of the Asian financial crisis when there was widespread financial distress in the corporate sector in countries such as Thailand, Indonesia, the Philippines, and Korea, and numerous companies fell into default or sought a debt restructuring.

In a positive development in the last two decades — dating to the Asian financial crisis itself — insolvency laws have been reformed in many emerging markets around the globe. While creditors can take some comfort from the fact that the insolvency laws in many emerging market economies have been modernized, they must still reckon with the fact that there could be a gap, sometimes even a very substantial gap, between law and practice. For certain creditors which do not have extensive experience in the emerging markets or lack a sophisticated understanding of the restructuring dynamics in these markets, this realization could come as a rude awakening.

Furthermore, creditors may be confronted with the harsh reality that some local courts in certain emerging market jurisdictions may suffer from a lack of independence and capacity, and that, in certain situations, some of those courts may even possibly be tainted by corruption.

It should be noted that, in response to the COVID-19 pandemic, numerous jurisdictions around the world have modified their insolvency laws in a variety of different ways, such as among other things the steps taken in certain jurisdictions to temporarily suspend for the duration of the pandemic any mandatory duty to file for insolvency that would apply under normal circumstances. Thus, debtor companies and their creditors should familiarize themselves with any changes that have been made to the relevant jurisdiction's insolvency law in response to the pandemic.

Creditors in emerging market jurisdictions—particularly foreign creditors—also need to recognize that, as a general matter, they may well not be playing on a level playing field with the debtor. In the emerging markets, a large number of companies are controlled by so-called controlling shareholders, who are often powerful and influential families in the local jurisdictions.

In certain emerging market restructurings, the controlling shareholders may strongly resist any restructuring plan, whether formulated in an in-court or out-of-court process, that seeks to diminish or set limits on their control of the company in question. This may be the case, for example, with restructuring plans involving debt-for-equity swaps that would give the creditors a large equity stake in the company and which would therefore diminish the control of the controlling shareholders over the company. Accordingly, circumstances may force creditors to realign their expectations as to potential recovery values on their outstanding debt in light of these stubborn realities on the ground.

Foreign creditors, in particular, will also need to be mindful of the fact that they cannot simply extrapolate from their restructuring/insolvency experiences in their developed home country jurisdictions. Those experiences and their knowledge of the home country insolvency laws generally may be of little avail and/or relevance when these foreign creditors are addressing restructurings in emerging market jurisdictions, particularly where cases end up (or there is a possibility that they might end up) in a local insolvency proceeding. Moreover, strategies that might work in their home country jurisdictions—e.g., a "loan to own" strategy— may have difficulty gaining any traction in many emerging economy jurisdictions.

There is another pitfall that creditors in emerging market restructurings need to be aware of in certain emerging market jurisdictions, and that is the potential on the part of certain debtors/controlling shareholders for corporate frauds or malfeasance on a scale that can be truly mind-boggling. The debtor companies and in particular their controlling shareholders may have diverted corporate funds through sham sale transactions, the deposit of corporate funds in offshore banks wholly owned by the controlling shareholders, and/or various types of non-transparent related party transactions, and debtor companies may have earlier incurred substantial financial losses that were not previously disclosed to creditors.

Yet, these diversions of funds and losses can literally run into the hundreds of millions of dollars (as was the case in several suspect transactions in the US$13.9 billion Asia Pulp & Paper restructuring in the early 2000s), and these diversions and losses, of course, can represent a substantial loss of value for creditors. That is why creditors, to the extent possible, are well advised

Continued from p.15

to press debtors/controlling shareholders early in any emerging market restructuring process to establish cash monitoring programs for the debtor companies so that the creditors can carefully and closely monitor future cash outlays by the company. Similarly, the creditors would also be well served by undertaking comprehensive and thorough due diligence on the debtor company so that they can be made aware of any suspect transactions.

In some restructurings in recent years, certain emerging market debtors have turned to foreign jurisdictions to take advantage of more favorable insolvency laws to reach a successful restructuring outcome. For example, such debtors have proceeded under a UK scheme of arrangement (as in a situation several years ago involving Vinashin, a Vietnamese state-owned shipbuilder, in which it was seeking to bind holdout creditors) and under Chapter 11 in the US (as in the recent filings by two of the largest Latin American airlines, Avianca Holdings SA and LATAM Airlines Group SA).

Of course, as is true in the world of international restructuring generally, many emerging market debtors have sought recognition of the local insolvency proceeding in a foreign jurisdiction pursuant to national statutes that have been enacted implementing the UNCITRAL Model Law on Cross-Border Insolvency. For instance, this has become fairly routine for many Brazilian debtors in recent years where those debtors, acting through a foreign representative of the local insolvency proceeding, have sought Chapter 15 recognition in the US in order to bind US bondholders to a plan approved in the relevant Brazil reorganization (*recuperação judicial*) proceeding.

Infrastructure Project Restructurings

In the last decade or longer, many emerging economies have undertaken ambitious infrastructure projects, in the form of new power/renewable energy projects, ports, airports, toll roads, telecom projects, and so forth. Many such projects were structured as public-private partnerships (PPPs), where the host governments granted concessions of one type or another to private parties and where there was equity investment provided by private sponsors and debt financing provided by, among others, banks and bondholders.

Nonetheless, the COVID-19 crisis could put a great deal of pressure on these projects, just as the Asian financial crisis put a great deal of pressure on the infrastructure projects of that era, particularly those in Southeast Asia. Ultimately, many of those projects from that era required major restructurings, and the restructurings were often incredibly complex and very messy and not infrequently took several years to complete.

There are two basic sources of potential COVID-related pressures for the recent crop of infrastructure projects structured on a PPP basis. The first is that if the COVID-19 economic crisis plays out in the same way that the Asian financial crisis did, any severe slowdown in the affected national economies could lead to a sharply lower level of demand for the services provided by or the product produced by the infrastructure project in question.

For instance, such a scenario could lead potentially to a far lower level of demand from the offtaker for the power being produced by an independent power project (IPP). Thus, the basic economics of the affected projects could come under stress as the project may not be generating the expected revenues due to the lessened demand.

The second basic source of pressure could flow from any major depreciation of the local currency. If there has been a sharp depreciation of the local currency (and the currency risk has not been hedged), then it could become unaffordable for, say, an offtaker of power from an IPP to pay the tariff at the contractual rate set forth in the original power purchase agreement. The basic problem is that there would be a currency mismatch: the offtaker receives revenues from its customers in the local currency, and yet the offtaker needs to pay the project effectively in a hard currency.

The scenarios described above of lower demand and a depreciated local currency could lead to serious pressures on the original contractual arrangements. The project may wish to hold its counterparty (e.g., the offtaker) to the original contractual arrangements, whereas the project's counterparty may argue that it should no longer be bound by the original contractual arrangements because there has been a major change of circumstances since the date that the relevant contracts were entered into.

These conflicting perspectives on the part of the project and its counterparties could result in a default under the relevant operating agreements (and even ultimately under the financing documents), a renegotiation/restructuring of the project's operating and/or financing arrangements, or even a dispute between the parties in the form of litigation or arbitration.

Any discussion these days of infrastructure projects in the emerging economies would not be complete without a reference to China's expansive and ambitious Belt and Road Initiative (BRI). China has financed and constructed BRI projects around the world, but in the current COVID-19 environment, many of these projects may be rendered uneconomic by the downturn in the local economies where the projects are based and may require renegotiation with the relevant Chinese parties.

Even pre-COVID, certain countries such as Malaysia were already trying to renegotiate some of their BRI projects with China. Malaysia, for example, claimed that the costs of the BRI projects in question in Malaysia were too high and needed to be renegotiated.

As China has BRI projects far and wide in so many emerging economies, it will be very interesting to see whether over time China develops a standard playbook for dealing with situations of distressed BRI projects, and if so, what that playbook entails. To be sure, the way that China deals with distressed BRI projects may be intertwined with China's approach to dealing with sovereign debt issues where sovereign borrowers are experiencing financial distress and may have trouble repaying bilateral loans from China.

State-Owned Enterprises and Non-performing Loans

As a final matter, two other areas bear mentioning in any discussion of emerging market restructurings: state-owned enterprises (SOEs) and non-performing loans (NPLs). We will highlight selected key issues related to SOEs and NPLs in the brief overview discussion that follows.

In many emerging markets, there may be a significant presence of SOEs in the local economy, a number of which may be unprofitable. Despite this, the relevant national governments often continue to pour money into these SOEs from year to year to keep them afloat.

Due to the pressures on a sovereign's public finances from the COVID-19 crisis, a moment of reckoning may have finally arrived for a number of national governments in terms of how they handle unprofitable (and possibly even insolvent) SOEs. Specifically, the governments may have to face a stark choice. They will have to decide whether such SOEs will need to be restructured (if that is possible) and/or privatized (either through a public sale of stock or by a sale to a private investor), or whether they will need to be liquidated.

A separate issue relates to non-performing loans (NPLs) in national banking systems. In view of the financial distress that many companies in emerging market jurisdictions are likely to face in the current crisis, it is likely that banks in the relevant emerging market jurisdictions will start to accumulate many non-performing loans on their balance sheets. If the banks just sit on the NPLs and do not take any action to remediate the NPLs, the ability of the banks to lend will be curtailed to the extent that the banks are required to set aside loan loss reserves in connection with the NPLs. This will not be beneficial to the banks since after all they are in the business of lending, and it will not be beneficial to the relevant national economy because lending is key to spurring new economic activity.

Thus, banks and national governments will have to develop effective strategies for addressing any significant build-up of NPLs in the national banking system. For banks, if they do not already have such a capability in place, they will need to establish a unit within the bank that is dedicated exclusively to handling the bank's NPLs with the aim of maximizing recovery on the NPLs.

In addition to considering recovery options based on litigation, restructuring, and/or an insolvency filing, banks might seriously explore whether there are any private investors interested in purchasing the NPLs at a discount from their face value (either individually or as part of a portfolio of NPLs). This would be a relatively straightforward way for the banks to clean up their balance sheets.

As to the national governments, they might consider an approach that has been used in prior situations where national banking systems are confronting a huge volume of NPLs: establishing a so-called asset management company (AMC). The AMC would acquire the NPLs from the banks for a negotiated purchase price, and the AMC would then be tasked with realizing value on the NPLs it had acquired.

Perhaps the COVID-19 economic crisis will stimulate creative new thinking on innovative approaches for handling NPLs on a large scale beyond the tried-and-true approach of establishing AMCs. The bottom line, though, is that there will need to be effective ways to address the issue of NPLs so that, first, the health of the banks and the banking system can be preserved, and, second, new lending (and therefore new or renewed economic activity) can take place.

ABOUT THE AUTHOR

Steven T. Kargman
Founder & President, Kargman Associates

Steven T. Kargman is the Founder and President of Kargman Associates, a New York City-based strategic advisory firm specializing in providing strategic advice to clients involved in complex and challenging international restructuring situations, with a special focus on emerging markets around the globe. Mr. Kargman is a leading expert on international debt restructurings and cross-border insolvency, and he formerly served as General Counsel of the New York State Financial Control Board and Lead Attorney with the Export-Import Bank of the United States. He has worked on numerous high-profile and complex restructuring transactions in the emerging markets, and he has also advised multilateral institutions and national governments in emerging markets and developing countries on a wide range of financial and commercial matters.

Email: **skargman@kargmanassociates.com**
Website: **www.kargmanassociates.com**

TRENDS IN DISTRESSED COMPENSATION: OIL & GAS COMPANIES SHIFT FOCUS TO RETENTION AS COVID-19 REMEDY

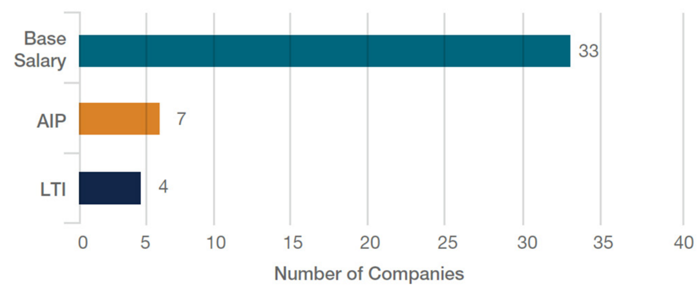
J.D. IVY, BRIAN CUMBERLAND, and ALLISON HOEINGHAUS
Alvarez & Marsal

So far, 2020 has seen over 80 oil and gas companies file for Chapter 11 bankruptcy.[1] An oversupply of crude, driven in part by the Russia-Saudi Arabia oil price war, weakened demand caused by COVID-19 fears and travel restrictions, and a mounting wave of maturing debt all culminated in a significant increase in energy sector bankruptcies.[2] In a historical first, the price to take physical delivery of a barrel of West Texas Intermediate briefly turned negative, as speculators rushed to unload orders that suddenly exceeded short-term storage capacity.[3] With little sign of a recovery in sight, the energy sector has largely missed out on recent market rallies, lagging behind nearly all other industries.[4]

The collapse of the oil and gas market was met with swift changes in compensation plans at many of the largest oil and gas companies. A study by Alvarez & Marsal (A&M) of executive compensation practices of the largest US public Exploration & Production (E&P) and Oilfield Services (OFS) companies found that 56% and 69% of E&P and OFS companies, respectively, announced reductions in executive compensation in the first half of 2020.[5]

[1] *Haynes & Boone Oil Patch Bankruptcy Monitor* (2020).
[2] Houstonchronicle.com (2020). "Energy bankruptcies up 62 percent from last year.". Retrieved from https://www.houstonchronicle.com/business/energy/article/Energy-bankruptcies-up-62-percent-from-last-year-15566899.php.
[3] BBC.com (2020). "US Oil Prices Turn Negative as Demand Dries Up." Retrieved from https://www.bbc.com/news/business-52350082#:~:text=The%20price%20of%20US%20oil,world%20have%20kept%20people%20inside.
[4] ETF.com (2020). "Best and Worst Sectors ETFs of the Year." Retrieved from https://www.etf.com/sections/features-and-news/best-worst-sector-etfs-year?nopaging=1
[5] See *2020/2021 Alvarez & Marsal Oil and Gas Exploration & Production (E&P) Compensation Report* (2020), ("2020/2021 A&M E&P Report"); https://www.alvarezandmarsal.com/insights/2021-oil-and-gas-exploration-production-ep-compensation-report; and *2020/2021 Alvarez & Marsal Oil and Gas Oilfield Services (OFS) Compensation Report* (2020), ("2020/2021 A&M OFS Report"), https://www.alvarezandmarsal.com/insights/2021-oil-and-gas-oilfield-services-ofs-compensation-report.

Exhibit 1: Oilfield Services Companies Reducing Compensation (first half of 2020)



Source: Alvarez & Marsal, analysis of data from SEC filings.

Reducing executive compensation was not unique to the energy industry, as over 350 companies announced similar reductions over that time period, with the retail sector leading the count.[6] For E&P and OFS companies, base salary reductions were most common, followed by annual and long-term incentives (see Exhibits 1 and 2).[7]

It was also found in the A&M study that although a majority of OFS companies reduced base salary equally for all executives, E&P companies were more likely to provide a greater percent reduction for the CEO than other executive officers.[8]

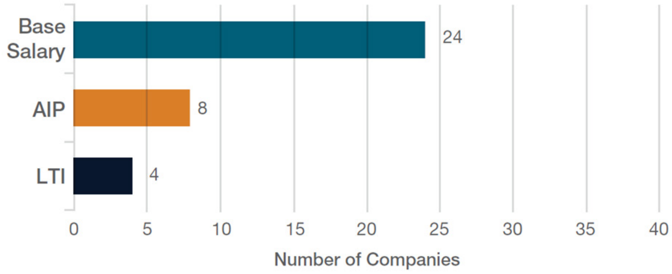
Recent compensation changes in the oil and gas industry have gone beyond simply reducing executive salaries. Some of the most significant trends in the sector are presented in the following discussion.

Refocusing Incentives

As many companies teetered on the edge of insolvency, employee retention became an increased focus in 2020. Future uncertainty often tips the scales in favor of short-

[6] Based on A&M's analysis of SEC Form 8-Ks and other public announcements.
[7] 2020/2021 A&M E&P Report and 2020/2021 A&M OFS Report (Op. cit., fn. 5).
[8] Id.

Exhibit 2: Exploration & Production Companies Reducing Compensation (first half of 2020)



term security at the expense of long-term upside. For distressed companies, the trend has been to adjust annual and long-term incentives to better address the current post-COVID-19 environment.

For annual incentive programs, an increase in the following practices has been observed:

- adjusting existing metrics downward to better reflect post-COVID-19 forecasts;
- replacing metrics that are difficult to forecast (such as revenue or EBITDA) with metrics that are more within management's control (such as safety and cost reductions);
- eliminating metrics and making all or a portion of the payout based solely on continued employment; and
- increasing payout frequency to semi-annually or quarterly.

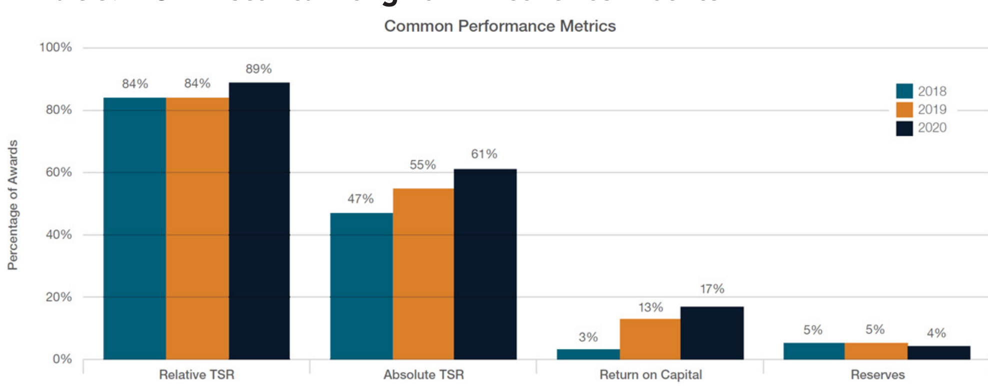
Depressed share prices and uncertain long-term prospects have resulted in similar changes to equity-based incentive plans, including:

- collapsing long-term and short-term programs into a single, annual program;
- granting cash instead of equity, to both limit downside and slow the burn rate on rapidly depleting share reserves; and
- utilizing industry-relative metrics that account for systemic underperformance in the sector as a whole.

The use of industry or peer-relative long-term incentive metrics is nothing new. Over the last several years, relative Total Shareholder Return (TSR) has remained the most widely used performance metric in the OFS and E&P sectors (Exhibits 3 and 4).

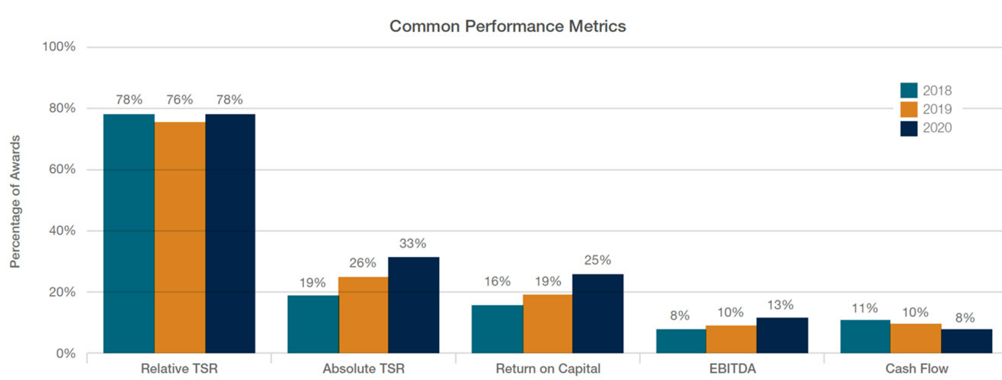
It is expected this trend will continue in the years ahead, as the E&P and OFS sectors attempt to navigate uncertain global markets.

Exhibit 3: E&P Historical Long-Term Incentives Metrics



2020/2021 A&M E&P Report.

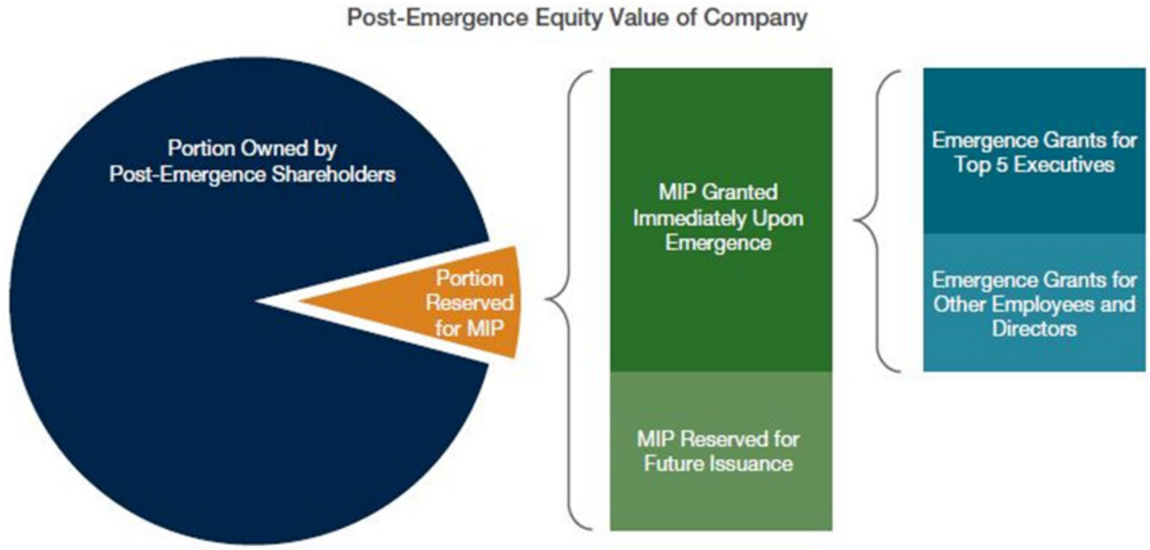
Exhibit 4: OFS Historical Long-Term Incentives Metrics



2020/2021 A&M OFS Report.

Continued from p.19

Exhibit 5: Illustration of Management Incentive Plan for Emergence



Source: Alvarez & Marsal, analysis of data from SEC filings.

Shifting to Retention

When simply modifying existing incentive programs is not enough, companies often resort to more aggressive measures. This often takes the form of a pre-paid retention bonus program that replaces all or a portion of the recipients' existing incentive compensation. There have been public announcements by over 40 companies about the adoption of such plans since the beginning of the COVID-19 pandemic.[9]

Pre-paid retention programs contain two main components:

- an immediate, up-front cash payment (sometimes representing the entire award amount or the first in a series of installments); and
- a clawback provision that requires the recipient to repay the value of the award if they voluntarily resign prior to the end of a designated retention period (commonly one year from the date of grant).

A more recent trend for these programs is to also include performance-based conditions, in which all or a portion of the award is clawed back if preestablished performance criteria are not satisfied.

These programs have many benefits. By making the payment up front, there is less concern about an employer's ability to pay bonuses after year end – a legitimate worry for employees of a struggling company. Receiving cash now subject to a risk of repayment appears to have a greater retentive effect than the promise of a future payment. For the rank and file, this has the added benefit of putting cash in the hands of employees at a time when many are struggling to make ends meet. For highly compensated employees, the prepayment results in immediate taxation at current rates, avoiding the uncertainty of future tax policy.

Taking the Dive into Chapter 11

Once a company has entered bankruptcy, most post-petition compensation must be approved by the court, and programs are often challenged by the UCC, the US Trustee, and other creditors. Payments to "insiders" are subject to increased scrutiny of the metrics, payout levels, and plan design.[10] Insider incentive plans with metrics deemed to be "lay ups" are tossed out as a matter of law.[11]

Once in bankruptcy, the job of designing performance metrics that are challenging yet attainable and drive corporate performance does not become any easier. The unpredictable commodities market and post-COVID-19 downturn makes forecasting traditional financial and operational performance metrics difficult, if not impossible. And the risk of error runs both ways: while conservative projections may lead to easily achievable metrics and undeserved payouts, aspirational goals can quickly become impossible to achieve, losing all incentivizing effect and leading to a mass exodus of key talent.

Despite these difficulties, the traditional KEIP and KERP are still mainstays in the bankruptcy process and are often used in conjunction with, not as a replacement for, pre-paid retention programs. The following are also notable trends in COVID-19 bankruptcy programs:

- Quarterly payout structures for both insiders and non-insiders are now the norm.

[9] Based on analysis by A&M of SEC Form 8-K announcements.

[10] See 11 U.S.C. § 503(c)(3).

[11] *In re Hawker Beechcraft, Inc.,* 479 B.R. 308, 313 (Bankr. S.D.N.Y. 2012).

- Traditional top-line metrics like production and revenue are being replaced with operational and safety metrics that are more easily forecasted.
- Traditional bottom-line metrics like EBITDA and net income are being replaced with cost reduction measures, such as reduction in SG&A expense, that management can control even as commodity prices swing.

Emerging Positioned to Succeed

Compensation challenges continue long after emergence from bankruptcy. Equity incentives are typically wiped out as part of the Chapter 11 process, leaving executive management with a lack of meaningful ownership in the emerging entity. To quickly align the interests of management and shareholders, companies typically establish a management incentive plan (MIP) that carves out a percentage of the company's equity to be reserved for grants to management at or after emergence (Exhibit 5). In the energy sector, approximately 10% of fully diluted equity is commonly reserved for this purpose. The majority of this pool is usually granted immediately, with a significant amount allocated to the executive officers and the remainder left available for future annual grants – providing additional "runway" for the company to establish a steady-state long-term incentive plan, file the required SEC forms, and seek shareholder approval.

While the size of the MIP pool and the initial grants are often the immediate focus of negotiations, unfortunately less time and effort are spent on the types of equity vehicles, their vesting terms, and related termination provisions. Advisors should carefully consider the effects of these provisions in connection with the post-emergence goals of the company and the current market environment.

While widespread restructurings dominated the headlines in 2020, we believe sector consolidation will be the story of 2021. Consolidation is not a new trend in the oil and gas industries. As widely reported, 2019 saw major players, like Occidental and Chevron, fight over high-value Permian Basin acreage.[12] Still, depressed current valuations and more attractive, restructured balance sheets could prove irresistible for mega-cap corporations and private equity with sufficient dry powder. For the E&P sector, M&A activity has already begun to accelerate with publicly noted large acquisitions by Chevron, ConocoPhillips, and Pioneer Natural Resources. Similar moves are expected in the OFS sector in 2021, particularly among the hardest-hit offshore drilling names.

Given the potential for consolidation in the coming months, companies nearing emergence from Chapter 11 should implement compensation packages that incentivize management, directing behaviors that maximize shareholder value. Executives are keenly aware of the risks of takeover. It is hard to motivate executives to actively pursue attractive bids, knowing all too well it may mean working themselves out of a job. Prudent advisors should keep these principles in mind when deciding the terms and provisions of executive MIP grants:

- Grants should be large enough – often 2 to 3 times the size of a typical annual grant for executive officers – to create a meaningful alignment between the interests of executives and shareholders;

[12] "Chevron drops Anadarko takeover battle after Occidental raises bid," Reuters.com (2019), retrieved from https://www.reuters.com/article/us-anadarko-petrol-m-a-chevron/chevron-drops-anadarko-takeover-battle-after-occidental-raises-bid-idUSKCN1SF1GX.

ABOUT THE AUTHORS

J.D. Ivy
Managing Director, Alvarez & Marsal

J.D. Ivy is a Managing Director with Alvarez & Marsal, where he co-leads the Compensation and Benefits practice. Mr. Ivy works with clients on executive compensation matters such as the development of compensation strategies, the design of annual and long-term compensation arrangements, the assessment of levels of competitive compensation and the evaluation of tax and accounting ramifications of compensation arrangements.

Brian Cumberland
Managing Director, Alvarez & Marsal

Brian Cumberland is a Managing Director with Alvarez & Marsal, where he leads the Restructuring Compensation practice. With more than 30 years of experience, Mr. Cumberland provides executive compensation advice to clients, development of compensation strategies, design of annual and long-term compensation arrangements, assessments of competitive compensation and evaluation of tax and accounting ramification of compensation arrangements.

Allison Hoeinghaus
Managing Director, Alvarez & Marsal

Allison Hoeinghaus is a Managing Director with Alvarez & Marsal, where she is part of the Compensation and Benefits practice. Ms. Hoeinghaus helps companies tackle how to effectively and efficiently pay and incentivize their employees while considering applicable tax, accounting, and regulatory ramifications. Ms. Hoeinghaus focuses on restructuring compensation matters including the design and benchmarking of incentive and retention plans as well as mergers and acquisitions, including golden parachute rules and due diligence.

Continued from p.21

Exhibit 6: Termination Benefits for Executives Following Change in Control

2020/2021 A&M E&P Report; 2020/2021 A&M OFS Report.

- Grants should contain accelerated vesting provisions that compensate executives in the event of involuntary termination following a change in control of the company; and
- Grants should contain "good reason" definitions that allow an executive to voluntarily terminate employment without forfeiting MIP awards if their compensation, duties, or responsibilities are materially diminished following a change in ownership.

While severance might naturally seem to be the main component of termination pay, the accelerated vesting of equity awards often represents the most valuable termination benefit following a change in control for executives in the E&P and OFS sectors (Exhibit 6).

If the Board's strategy is to immediately solicit a buyer, additional consideration should be given to granting full value awards – such as restricted stock or restricted stock units – as opposed to stock options that generally require time to generate appreciable value. It may also make sense to choose to grant time-vesting, as opposed to performance-vesting, awards due to the favorable valuation rules available under the "Golden Parachute" regulations – potentially limiting additional excise tax on the executive and lost compensation expense deductions for the company.[13]

Conclusion

From the start of a business downturn to the end of a restructuring, understanding current market trends in compensation and related strategies is essential to retaining and incentivizing a productive workforce. With over 150 additional E&P companies expected to file bankruptcy by the end of 2022, oil and gas companies should actively assess their current compensation programs and consider appropriate adjustments when warranted.[14] Effective planning and forethought can help avoid costly restructuring compensation missteps before they occur. The biggest mistake is usually waiting until it is too late.

[13] See 26 USC §§ 280G and 4999.

[14] "Even at $40 WTI, about 150 more North American E&Ps will need Chapter 11 protection by end-2022." Rystadenergy.com (2020), retrieved from https://www.rystadenergy.com/newsevents/news/press-releases/even-at-%2440wti-about-150-more-north-american-eps-will-need-chapter-11-protection-by-end-2022/.

REJECTING FERC-JURISDICTIONAL AGREEMENTS IN BANKRUPTCY: PREDICTIONS AND PRACTICALITIES

JOHN P. COYLE
Duncan & Allen LLP[1]

The controversies surrounding rejection of agreements subject to the jurisdiction of the Federal Energy Regulatory Commission ("FERC")[2] under Section 365 of the Bankruptcy Code most recently made industry headlines in the 2019-2020 Chapter 11 proceedings for Pacific Gas & Electric Company ("PG&E") in the United States Bankruptcy Court for the Northern District of California[3] and the 2018-2019 Chapter 11 proceedings for FirstEnergy Solutions Corp. in the United States Bankruptcy Court for the Northern District of Ohio.[4] With somewhat less fanfare, the same issue arose in the Chapter 11 proceedings for Chesapeake Energy Corporation and its affiliates in the United States Bankruptcy Court for the Southern District of Texas.[5] The disputes raised in the *PG&E* and *Chesapeake Energy* cases over potential contract rejection under Section 365 of the Code have become moot.[6] As a result, these cases will not resolve the perceived conflict between FERC's oversight of utility and pipeline rates, terms and conditions of service, and the extent of the bankruptcy court's authority over rejection of FERC-jurisdictional agreements under Section 365. The *FirstEnergy* case was ultimately remanded to FERC,[7] where it appears likely that much or all of the matters remaining at issue may be resolved by settlement. The controversy, which has affected this particular intersection of utility regulation and bankruptcy reorganization for over twenty years,[8] will likely occupy insolvency professionals on both sides of the dispute for some time to come.

In fact, the Bankruptcy Code (in particular, Sections 362(b)(4) and 1129(a)(6)) was designed to accommodate the longstanding structure of federal utility and pipeline regulation without interfering with its processes or effectiveness, and the regulatory process informs rather than impedes the reorganization of insolvent regulated utilities and pipelines. Settled propositions of federal law regulating utilities and pipelines undercut claims to preeminence on behalf of contract rejection under Section 365(a) of the Bankruptcy Code. First, under the FPA, the NGA and the surviving provisions of the

---

1 The views expressed in this article are solely those of the author, and are not to be attributed to the author's law firm or any of its clients.

2 As relevant to this discussion, FERC has jurisdiction over the rates, terms and conditions of the transmission and sale of electric energy in interstate commerce under Section 201(b)(1) of the Federal Power Act of 1935, as amended (16 U.S.C. §§ 791a-828c (the "FPA"), 16 U.S.C. § 824(b)(1). FERC has jurisdiction over "the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, and to the importation or exportation of natural gas in foreign commerce and to persons engaged in such importation or exportation" under the Natural Gas Act of 1938, as amended (15 U.S.C. §§ 717-717w (the "NGA"), § 717(b)). Finally, FERC has "the duties and powers related to the establishment of a rate or charge for the transportation of oil by pipeline or the valuation of that pipeline that were vested on October 1, 1977, in the Interstate Commerce Commission or an officer or component of the Interstate Commerce Commission." 49 U.S.C. § 60502. *See United Airlines, Inc. v. FERC*, 827 F.3d 122, 127-128 (D.C. Cir. 2016).

3 Chapter 11 Case Nos. 19-30088 *et al.*, *In re PG&E Corp. and Pacific Gas & Elec. Co., Debtors* (Bankr. N.D. Cal.).

4 Chapter 11 Case Nos. 5:18-bk-50757 *et al., In re FirstEnergy Solutions Corp.* (Bankr. N.D. Ohio).

5 Chapter 11 Case Nos. 20-33233 *et al., In re Chesapeake Energy Corp. et al., Debtors* (Bankr. S.D. Tex.).

6 In an unpublished Order issued October 7, 2020 in Case Nos. 19-71615 *et al.*, the United States Court of Appeal for the Ninth Circuit dismissed as moot the consolidated appeals of, and vacated, FERC's declaratory orders holding that "the Commission and the bankruptcy courts have concurrent jurisdiction to review and address the disposition of wholesale power contracts sought to be rejected through bankruptcy" in *Exelon Corp. v. Pac. Gas & Elec. Co.*, 166 FERC ¶ 61,053 at P 25 (2019) and *NextEra Energy, Inc. v. Pac. Gas & Elec. Co.*, 166 FERC ¶ 61,049 at P 28 (2019), and Judge Dennis Montali's June 7, 2019 decision in *PG&E Corp. v. FERC*, 603 B.R. 471, 490 (Bankr. N.D. Cal. 2019) holding that "that (1) FERC does not have concurrent jurisdiction over [the bankruptcy court's] decision to permit Debtors to reject (or assume) executory contracts under Section 365; and (2) that the FERC Denial and its two prior rulings described above are of no force and effect and are not binding on Debtors in these cases"). The mootness resulted from PG&E's confirmation of a plan of reorganization that assumed all of its power purchase agreements.

7 *Energy Harbor LLC*, 170 FERC ¶ 61,278 at PP 14-16 (2020) (order on remand requiring briefing on whether proposed rejection of power purchase agreements satisfies the "public interest" version of the FPA's statutory just and reasonable standard most recently explained by the Supreme Court in *NRG Pwr. Mktg. v. Me. Pub. Utils. Comm'n*, 558 U.S. 165, 167 (2020)); *Energy Harbor LLC*, 172 FERC ¶ 61,003 (2020) (holding proceeding in abeyance pending bankruptcy court review of proposed settlements).

8 *See, e.g., FERC v. FirstEnergy Solutions Corp. (In re FirstEnergy Solutions Corp.)*, 945 F.3d 431, 444-445 (6th Cir. 2019) (holding that "the public necessity of available and functional bankruptcy relief is generally superior to the necessity of FERC's having complete or exclusive authority to regulate energy contracts and markets"); *Official Committee of Unsec. Creditors v. Potomac Elec. Pwr. Co. (In re Mirant Corp.)*, 378 F.3d 511, 519-520 (5th Cir. 2004) ("the FPA does not preempt Mirant's rejection of the Back-to-Back Agreement because it would only have an indirect effect upon the filed rate"); *Cal. Dept. Water Res. v. Calpine Corp. (In re Calpine Corp.)*, 337 B.R. 27, 35 (S.D.N.Y. 2006) ("Having determined that the Bankruptcy Code does not expressly limit FERC's jurisdiction, and that it contemplates agency action during the pendency of a reorganization, it is clear the bankruptcy court's authority cannot be exercised so as to interfere with the jurisdiction of a federal agency acting in its regulatory capacity").

Continued from p.23

Interstate Commerce Act, even courts with appellate jurisdiction (which the relevant regulatory statutes do not grant to bankruptcy courts) can review orders setting rights, but cannot themselves establish rates.[9] Second, the Supreme Court has long recognized that FERC has the authority to direct the continued performance of utility obligations notwithstanding the termination of the contract under which those obligations arose.[10] Congress has long recognized that courts are not equipped to set utility or pipeline rates, and has therefore consistently limited the role of the courts to review of agency orders to ensure that the power to set rates was exercised in a reasoned and rational manner. Nothing in the Bankruptcy Code disturbs that proposition.[11] For these reasons, a bankruptcy debtor's rejection under Section 365(a) of the Bankruptcy Code of a power purchase agreement, transmission service agreement or pipeline transportation agreement may not necessarily have much of an impact on the rejecting debtor's obligations under the arrangement it seeks to avoid through rejection.

Controversy over the allocation of "jurisdiction" between the bankruptcy courts and the FERC seems to misperceive the role that the Bankruptcy Code envisions for each in the process of restructuring regulated entities.[12] That misperception may result from imprecise formulations of what is actually at issue in Section 365 rejection in the context of FERC-jurisdictional agreements, from a limited appreciation of the factual nuances that underlie some of the case law in this area, or from diffidence arising out of an incomplete understanding of the law on both the bankruptcy and regulatory sides of the dispute. Unless there is some tactical reason for pursuing the controversy during the pendency of the bankruptcy proceeding, the outcome of the debate often appears to have relatively limited impacts on the ultimate resolution of the reorganization. Overall, the formulation advocated by Judge Richard Allen Griffin in his partial dissent from the Sixth Circuit's *FirstEnergy* decision represents the soundest course for debtors seeking to reject FERC-jurisdictional agreements in reorganization proceedings:

> First, the debtor should file a motion in the bankruptcy court to reject the executory contract. The only difference is the heightened standard the bankruptcy court must use in evaluating the rejection motion. Second, the debtor in possession should petition FERC for relief from its filed-rate obligations, a process that operates the same way inside and outside of bankruptcy.[13]

This is largely the approach that FERC has followed since it first analyzed the potential jurisdictional issues surrounding efforts to reject agreements subject to its jurisdiction under Section 365 of the Code.[14] Left to its own devices, this is the approach that FERC still follows today – convening an expedited "paper hearing" that typically takes between 30 days and 90 days from start to finish on whether or not the abrogation of the contract or contracts at issue is just and reasonable based on the "public interest" application of that standard.[15] The public interest application of the statutory just-and-reasonable standard is "intended to reserve the Commission's contract-abrogation power for those extraordinary circumstances where the public will be severely harmed."[16]

---

9 *Burlington Northern, Inc. v. United States*, 459 U.S. 131, 141 (1982) (regulatory agency has primary jurisdiction over rates; "federal-court authority to reject Commission rate orders for whatever reason extends to the orders alone, and not to the rates themselves"); *Consolidated Rail Corp. v. Nat'l Ass'n Recycling Indus., Inc.*, 449 U.S. 609, 612 (1981) ("The authority to determine when any particular rate should be implemented is a matter which Congress has placed squarely in the hands of the [Interstate Commerce] Commission").

10 *See, e.g., Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137, 155 (1960) ("The obligation that petitioner will be under after the contract term will not be one imposed by contract but by the Act"); *Pa. Water Pwr. Co. v. FPC*, 343 U.S. 414, 422 (1952) ("The duty of Penn Water to continue its coordinated operations with Consolidated springs from the Commission's authority, not from the law of private contracts").

11 *Merck & Co. v. Reynolds*, 559 U.S. 633, 648 (2010) ("We normally assume that, when Congress enacts statutes, it is aware of relevant judicial precedent"); *Midlantic Nat'l Bank v. N.J. Dept. of Env. Protection*, 474 U.S. 494, 501 (1986) ("The normal rule of statutory construction is that if Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific").

12 *Compare Celotex Corp. v. Edwards*, 514 U.S.300, 308 (1995) ("'Congress intended to grant comprehensive jurisdiction to the bankruptcy courts so that they might deal efficiently and expeditiously with all matters connected with the bankruptcy estate'") (internal quotation omitted) *with Bd. of Govs. of Fed. Res. v. MCorp Financial, Inc.*, 502 U.S. 32, 40 (1991) ("MCorp's broad reading of the stay provisions would require bankruptcy courts to scrutinize the validity of every administrative or enforcement action brought against a bankrupt entity. Such a reading is problematic, both because it conflicts with the broad discretion Congress has expressly granted many administrative entities and because it is inconsistent with the limited authority Congress has vested in bankruptcy courts").

13 *FERC v. FirstEnergy Solutions Corp.*, *supra*, 945 F.3d at 459. Judge Griffin's reference to "the heightened standard the bankruptcy court must use in evaluating the rejection motion" is to the "public interest" application of the FPA's statutory just and reasonable standard, as explained in *Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1*, 554 U.S. 527, 533-535 (2008) and *FPC v. Sierra Pac. Pwr. Corp.*, 350 U.S. 348, 352-353 (1956): unilateral modification of a contracted rate filed with the FERC is only permissible where continuation of the filed rate would "adversely affect the public interest – as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory."

14 *Blumenthal v. NRG Pwr. Mktg., Inc.,* 103 FERC ¶ 61,344 at PP 57-68 (2003) (establishing ground rules and timetable for "paper hearing" on contract termination); *Blumenthal v. NRG Pwr. Mktg., Inc.*, 104 FERC ¶ 61,210 at PP 46-58 (2003) (evaluating public interest application of justness and reasonableness of terminating obligations under agreement), *settlement approved in Blumenthal v. NRG Pwr. Mktg., Inc.*, 105 FERC ¶ 61,292 at PP 15-16 (2003).

15 *See, e.g., Rockies Express Pipeline LLC*, 173 FERC ¶ 61,099 at PP 40-62 (2020) (examining proposed termination of obligations under contracts proposed to be rejected in bankruptcy); *ETC Tiger Pipeline LLC*, 171 FERC ¶ 61,248 at P 29 (2020) ("The Commission has consistently emphasized that its jurisdiction is concurrent with, not superior to, that of the bankruptcy courts. The Commission has held that, 'to give effect to *both* the FPA and the Bankruptcy Code,' a party to a Commission-jurisdictional contract must obtain approval from the bankruptcy court to reject the contract in bankruptcy and must also obtain approval from the Commission to modify or abrogate the filed rate").

16 *Morgan Stanley Capital Group, Inc. v. Pub. Util. Dist. No. 1*, *supra*, 554 U.S. at 551.

This "heightened standard" to which Judge Griffin refers does not apply in all cases. The "public interest" application of the FPA's statutory just and reasonable standard is a default standard, *i.e.*, it applies where the parties to a power purchase agreement or pipeline transportation agreement have not contracted for a different standard for unilateral modification of the filed rate for their agreement. The parties to such agreements are free to waive or modify the protection to which their bargain is entitled under the public interest application of the just and reasonable standard.[17]

The Rejection Controversy in the PG&E and FirstEnergy Bankruptcies

The PG&E Proceeding

As its potential liability arising from wildfires caused by its electric transmission facilities between 2015 and 2018[18] became clearer and more imminent, on January 14, 2019, PG&E gave its employees fifteen days' notice that it would be seeking relief under Chapter 11 of the Bankruptcy Code. On January 18, 2019, NextEra Energy, Inc. and NextEra Energy Partners, L.P. – which at the time directly or indirectly owned and sold the output of approximately 945 MW of renewable generation under long-term power purchase agreements with PG&E – petitioned the FERC for a declaratory order holding that "if it files a petition for bankruptcy, PG&E may not abrogate, amend or reject in bankruptcy any of the rates, terms and conditions of its wholesale power purchase agreements subject to this Commission's jurisdiction ('Wholesale Contracts') without first obtaining approval from this Commission under FPA sections 205 or 206." On January 22, 2019, Exelon Corporation – the ultimate owner of the 230 MW Antelope Valley Solar Ranch 1 solar generating facility near Lancaster, California, the output of which is sold to PG&E under a twenty-five year power purchase agreement[19] – petitioned the FERC for a substantively identical declaratory order. On January 25, 2019 FERC granted the declaratory relief requested by NextEra; on January 28, 2019, FERC granted Exelon's request for declaratory relief.[20]

On January 29, 2019, PG&E filed its petition for relief under Chapter 11 of the Bankruptcy Code. Concurrently, PG&E filed an adversary proceeding seeking declaratory and injunctive relief against FERC's *NextEra* and *Exelon* orders. PG&E requested the Bankruptcy Court for the Northern District of California to:

> (i) issue a declaratory judgment confirming its exclusive jurisdiction over the Debtors' rights to reject certain executory power purchase agreements or other FERC-regulated agreements (collectively "**PPAs**") under section 365 of title 11 of the United States Code (the "**Bankruptcy Code**"), and further declaring that FERC does not have "concurrent" jurisdiction, or any jurisdiction, over the determination of whether the Debtors' rejection of any of their PPAs should be authorized, and that the Debtors do not need to obtain approval from FERC to reject any of their PPAs; and (ii) pursuant to section 362 of the Bankruptcy Code, issue an order enforcing the automatic stay as to the FERC Proceedings, any entity's attempt to enforce the FERC Order, and any action by FERC, or any other entity, that would attempt to divest or otherwise nullify or impede this Court's exclusive authority to approve or deny the Debtors' requests to assume or reject executory contracts under section 365 of the Bankruptcy Code (collectively, "**FERC Action**"); and (iii) to the extent the automatic stay does not apply, exercise its powers under section 105 of the Bankruptcy Code to preliminarily and permanently enjoin any FERC Action, in order to preserve the Bankruptcy Court's jurisdiction, as well as to prevent irreparable harm to the Debtor's estates and the reorganizational goals of the Bankruptcy Code.

PG&E simultaneously sought rehearing from FERC of its *NextEra* and *Exelon* orders under Section 313(a) of the Federal Power Act (16 U.S.C. § 825*l*(a)), a prerequisite for petitioning for judicial review of those orders in an appropriate United States Court of Appeals. On March 12, 2019, the United States District Court for the Northern District of California denied motions by NextEra and FERC to withdraw the reference from the Bankruptcy Court. On May 1, 2019, FERC denied PG&E's requests for rehearing of the January 2019 declaratory orders,[21] and PG&E shortly thereafter petitioned the

[17] *United Gas Pipe Line Co. v. Memphis Light, Gas and Water Div.*, 358 U.S. 103, 110-113 (1958).

[18] *In re PG&E Corp.*, 617 B.R. 671, 673 (Bankr. N.D. Cal. 2020) ("These cases are among the most complex in U.S. bankruptcy history. . . . They were filed because of overwhelming damage claims following the devasting 2015 - 2018 Northern California wildfires, leaving thousands of victims who suffered from those wildfires owed billions of dollars, plus thousands more of traditional non-fire creditors of various types, also owed billions of dollars").

[19] According to Electric Quarterly Reports filed with the FERC by the Exelon-owned special purpose entity that is the direct owner of the Antelope Valley Solar Ranch project, AV Solar Ranch 1, LLC, the contract pricing for Antelope Valley's sale of its entire output to PG&E is between $147.34 per MWh and $259.97 per MWh.

[20] *NextEra Energy, Inc. v. Pac. Gas & Elec. Co.*, 166 FERC ¶ 61,049 at P 28 (2019); *Exelon Corp. v. Pac. Gas & Elec. Co.*, 166 FERC ¶ 61,053 at P 25 (2019). Shortly thereafter, FERC dismissed subsequently filed petitions by other sellers of renewable energy to PG&E for this declaratory relief as moot, based on the view that FERC's clarification of its position on contract rejection in *NextEra* and *Exelon* had clarified FERC's position on contract rejection. *EDF Renewables, Inc. v. Pac. Gas & Elec. Co.*, 166 FERC ¶ 61,059 at P 14 (2019).

[21] *NextEra Energy, Inc., et al.*, 167 FERC ¶ 61,096 (2019).

Continued from p.25

United States Court of Appeals for the Ninth Circuit for review of the FERC's declaratory orders.

On June 7, 2019, Judge Montali issued his Memorandum Decision on Action for Declaratory and Injunctive Relief in *PG&E Corp. v. FERC (In re PG&E Corp.)*, 603 B.R. 471 (Bankr. N.D. Cal. 2019). The Memorandum Decision granted the declaratory relief sought by PG&E, and deferred the issue of injunctive relief to any actual application by PG&E for authorization to reject a power purchase agreement. The Memorandum Decision disposed of two primary arguments advanced by FERC and the sellers under various power purchase agreements with PG&E that had intervened in either or both of the administrative proceedings before FERC or the adversary proceeding in bankruptcy challenging FERC's assertion of "concurrent jurisdiction" with that of the Bankruptcy Court in connection with rejection of FERC-jurisdictional agreements.

First, the Memorandum Decision rejected FERC's argument that statutory review under Section 313(b) of the Federal Power Act was the only permissible means of challenging FERC's declaratory orders,[22] and that PG&E's adversary proceeding was therefore an impermissible collateral attack on those declaratory orders. The Memorandum Decision stated:

> FERC has acted outside of its statutory authority. Its decisions before bankruptcy were advisory in nature, have no impact on anyone; once the bankruptcy cases were filed they presented an immediate conflict with the Bankruptcy Code and can be challenged and dealt with in this court.
>
> ****
>
> The issue here is Section 365 and not any of the permutations and applications of the filed rate doctrine. This is the only issue before this court, and there is nothing collateral or indirect about the attack. It is direct because it goes to the precise bankruptcy issue of exclusive authority under 28 U.S.C. § 1334(a). This court is not considering the FPA or reviewing any FERC decisions regarding any matter within its exclusive jurisdiction. The rejection of an executory contract is solely within the power of the bankruptcy court, a core matter exclusively this court's responsibility. 28 U.S.C. § 157(b)(2).[23]

Next, the Memorandum Decision rejected FERC's claim to concurrent jurisdiction with that of the bankruptcy courts. The Memorandum Decision repeated its characterization that the FERC had acted "outside of its statutory authority," based exclusively on the view that:

> FERC and FPA are not mentioned in any exceptions [enumerated in Section 365]. Section 365's lack of an exception for FERC simply means that FERC has no jurisdiction over the rejection of contracts. See *FCC v. NextWave Pers. Commc'ns, Inc.*, 537 U.S. 293, 302 (2003) ("[W]here Congress has intended to provide regulatory exceptions to the Bankruptcy Code, it has done so clearly and expressly."
>
> As a result, if an executory contract does not fall into the exceptions set forth by Congress in the Bankruptcy Code, only the Bankruptcy Court can issue a ruling on rejection. . . .This court can declare FERC's attempt to interpret and apply the Bankruptcy [Code] void.

Finally, the Memorandum Decision concluded that the "business judgment rule must be applied"[24] in evaluating application to reject FERC-jurisdictional power purchase agreements, but stated that:

> The business judgment standard in regular rejection is more deferential than that given to contracts that are in the 'public interest.' But public interest may need to be considered in the context of a specific rejection of a specific PPA. That outcome will be fact-driven based on the particular motion to reject and the responses of the opposing party. That is for another day.[25]

Appeals were duly noticed by FERC and the PPA counterparties, which the United States Court of Appeals for the Ninth Circuit ultimately consolidated for briefing, argument, and decision.

On March 13, 2020, PG&E filed its proposed Plan of Reorganization in the Chapter 11 proceeding. Section 8.1 of the proposed Plan stated:

> Notwithstanding the foregoing, as of and subject to the occurrence of the Effective Date and the payment of any applicable Cure Amount, all power purchase agreements, renewable energy power purchase agreements, and Community Choice Aggregation servicing agreements of the Debtors shall be deemed assumed.

On June 17, 2020, Judge Montali issued his Order Confirming Joint Plan of Reorganization[26] -- almost two weeks prior to the expiration of the June 30, 2020, deadline established in AB 1054, the California Legislature's utility wildfire insurance legislation, for plan confirmation.[27] Section 8.1(b) of the Confirmed Plan provided, *inter alia*, that all renewable power purchase agreements would be deemed assumed. As the Court

[22] *City of Tacoma v. Taxpayers of Tacoma*, 357 U.S. 320, 336 (1958) ("So acting, Congress in § 313 (b) prescribed the specific, complete and exclusive mode for judicial review of the Commission's orders . . . . It thereby necessarily precluded *de novo* litigation between the parties of all issues inhering in the controversy, and all other modes of judicial review").

[23] *PG&E Corp. v. FERC, supra,* 603 B.R. at 485-486.

[24] *PG&E Corp. v. FERC, supra,* 603 B.R. at 488.

[25] *PG&E Corp. v. FERC, supra,* 603 B.R. at 490.

[26] *In re PG&E Corp.*, 617 B.R. 671 (Bankr. N.D. Cal. 2020).

[27] Assembly Bill No. 1054, Cal. Stats. 2019, ch. 79, *codified in relevant part at* Cal. Pub. Utils. Code §§ 3280-3297. The June 30, 2020 confirmation deadline appears at Cal. Pub. Utils. Code §§ 3291(b)(1) and 3292(b).

of Appeals subsequently confirmed (see footnote 6 above), confirmation of PG&E's Plan of Reorganization with its assumption of all power purchase agreements conclusively mooted the controversy over contract rejection in PG&E's Chapter 11 proceeding. On October 7, 2020, the United States Court of Appeals for the Ninth Circuit vacated as moot FERC's January 2019 declaratory orders and the Bankruptcy Court's June 7, 2019, Memorandum Decision.[28]

PG&E Post-Mortem

Deferring discussion of the Bankruptcy Court's now-vacated June 7, 2019 Memorandum Decision for the moment, three other issues related to the power purchase agreement rejection dispute in the *PG&E* bankruptcy help to illuminate the implications of rejection of FERC-jurisdictional agreements in reorganizations of utilities and pipelines. The challenges surrounding the funding of power supply for a reorganized utility are multi-dimensional, and may well militate against rejection of this particular type of contract for reasons unrelated to its "jurisdictional" modalities.

First, the pass-through to PG&E's retail electricity customers of the costs of most, if not all, of the power purchase agreements involved in its Chapter 11 proceeding had been approved by the California Public Utilities Commission. The costs of these power purchase agreements therefore had a decidedly limited impact on PG&E's prospects for reorganization given that it was guaranteed recovery from its retail customers of whatever costs these power purchase agreements might impose. Notwithstanding the highly deferential, pro-debtor orientation of the "business judgment rule" ordinarily applied in the context of Section 365 rejection disputes, it is not clear that PG&E – had it chosen to pursue rejection of its power purchase agreements in whole or in part – would have been able to satisfy the business judgment rule.[29]

Second, all public reports indicate that negotiations between PG&E and representatives of the individuals and entities holding tort claims based on the 2015 through 2018 wildfires apparently caused by failures of PG&E's transmission equipment (collectively, the "Tort Claimants") were complex and challenging throughout the Chapter 11 proceeding. In these circumstances, it is difficult to envision a reason for PG&E to have injected the risk, by rejecting power purchase agreements, of creating a second potentially impaired class of creditors capable of opposing confirmation. Rejection of power purchase agreements on any material scale could very well have jeopardized PG&E's prospects for plan confirmation under 11 U.S.C. § 1129(a)(7), (8) and (10).

Third, in light of California's settled policies favoring decarbonization of the State's power supply (among other spheres of activity), there is little discernable incentive for PG&E to have incurred the displeasure of State government and (in particular) the displeasure of the California Public Utilities Commission by rejecting renewable power purchase agreements. Rejection of these agreements on a substantial scale would likely have jeopardized the regulatory requirements for confirmation under 11 U.S.C. § 1129(a)(6). In addition, the enactment of AB 1054 in July 2019 added specific requirements for the California Public Utilities Commission's (1) approval of PG&E's plan of reorganization, and (2) determination that "the reorganization plan and other documents resolving the insolvency proceeding are (i) consistent with the state's climate goals as required pursuant to the California Renewables Portfolio Standard Program and related procurement requirements of the state and (ii) neutral, on average, to the ratepayers of the electrical corporation" as prerequisites for PG&E's participation in the State utility wildfire insurance fund.[30] Finally, the FERC itself is unquestionably a "governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor" for purposes of Section 1129(a)(6) of the Code. Thus, in whatever manner the consolidated appeals

[28] *United States v. Munsingwear, Inc.,* 340 U.S. 36, 39-40 (1950) ("The established practice of the Court in dealing with a civil case from a court in the federal system which has become moot while on its way here or pending our decision on the merits is to reverse or vacate the judgment below and remand with a direction to dismiss. . . . That procedure clears the path for future relitigation of the issues between the parties and eliminates a judgment, review of which was prevented through happenstance. When that procedure is followed, the rights of all parties are preserved; none is prejudiced by a decision which in the statutory scheme was only preliminary"); *A.L. Mechling Barge Lines, Inc. v. United States*, 368 U.S. 324, 329 (1961) ("We think the principle enunciated in *Munsingwear* at least equally applicable to unreviewed administrative orders, and we adopt its procedure here").

[29] In *Agarwal v. Pomona Valley Med. Grp., Inc. (In re Pomona Valley Med. Grp., Inc.)*, 476 F.3d 665, 670-671 (9th Cir. 2006), the United States Court of Appeals for the Ninth Circuit specifically embraced the formulation of the business judgment rule explained by the Fourth Circuit in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1046-1048 (4th Cir. 1985). As the Supreme Court observed in *Mission Prod. Holdings v. Tempnology, LLC,* ___ U.S. ___, 139 S. Ct. 1652, 1664, 203 L.Ed.2d 876 (2019), the Fourth Circuit's *Lubrizol* decision was legislatively overruled in part on other grounds by the addition of Section 365(n) to the Bankruptcy Code (11 U.S.C. § 365(n)) in 1988.

[30] Cal. Pub. Utils. Code § 3291(b)(1)(C) and (D).

Continued from p.27

were resolved, to the extent that the plan contemplated rejection of wholesale power purchase agreements that it had not reviewed and accepted, FERC would very likely have had another opportunity in the plan confirmation process to assert its position that it had not approved rate changes provided for in the plan.

The FirstEnergy Proceeding

In response to the Ohio Legislature's 2001 initiative for restructuring the electric power industry,[31] FirstEnergy Corporation transferred all of its physical and contractual generating assets to a corporate entity separate from the holding company subsidiary that owned and controlled FirstEnergy's transmission and distribution assets. At the risk of some oversimplification, the predominance of nuclear and coal-fired generating assets on its balance sheet left this generation-only subsidiary, First Energy Solutions Corporation, with high and ultimately uncompetitive operating costs. These competitive disadvantages eventually caused FirstEnergy Solutions to seek relief under Chapter 11.

On March 26, 2018, Ohio Valley Electric Corporation (a joint venture owner of two large coal-fired plants located in Gallipolis, Ohio and Madison, Indiana) filed a complaint in FERC Docket No. EL18-135-000 seeking a declaration from FERC that FirstEnergy Solutions was not entitled to reject the Inter-Company Power Agreement ("ICPA"), which defined the obligations of OVEC's utility owners to support the two jointly owned, coal-fired power plants, in the event that it sought relief in bankruptcy. On Saturday, March 31, 2018, FirstEnergy Solutions filed its Chapter 11 petition. On Sunday, April 1, 2018, FirstEnergy Solutions filed an adversary proceeding seeking a judicial declaration, as well as temporary and permanent injunctive relief, preventing FERC from interfering with the jurisdiction of the United States Bankruptcy Court for the Northern District of Ohio to consider two motions to reject executory contracts – one of which was directed to the ICPA, and the other of which was directed to nine power purchase agreements with various suppliers of renewable energy. The Bankruptcy Court issued a temporary restraining order against the FERC on April 2, extended the temporary restraining order on April 16, and entered a preliminary injunction against the FERC on May 11, 2018.[32]

The Bankruptcy Court's preliminary injunction found that FERC's administrative processes – whatever they might otherwise have been – would contravene the automatic stay imposed by Section 362(a) of the Code and were not exempted from the stay by Section 362(b)(4). The preliminary injunction further found that, to the extent that the automatic stay did not preclude FERC from acting with respect to the contracts nominated for rejection by FirstEnergy, injunctive relief under Section 105(a) of the Code was appropriate and necessary to protect the Bankruptcy Court's jurisdiction over rejection under Section 365(a).[33] The preliminary injunction prohibited the FERC:

> …from initiating or continuing any proceeding before FERC, and from issuing any order, to require or coerce the Plaintiffs to continue performing under the Executory Contracts or limiting the Plaintiffs to seeking abrogation of any of the Executory Contracts under the Federal Power Act
>
> and
>
> …from entering any order that would require or coerce the Plaintiffs to continue performing on the Executory Contracts in a manner that would interfere with this Court's exclusive jurisdiction to hear and determine the Rejection Motions or any other motion regarding such contracts brought pursuant to 11 U.S.C. § 365.[34]

On FERC's appeal from the Bankruptcy Court's injunction, the United States Court of Appeals for the Sixth Circuit both strove to reconcile the competing jurisdictional claims of the FERC under the Federal Power Act (and several generations of precedent) with the Bankruptcy Code's express authorization of rejection of executory contracts in Section 365(a), and also analyzed the stunning breadth of the Bankruptcy Court's preliminary injunction. The Court of Appeals first concluded, after a comprehensive review of the precedent on both sides of the issue, that:

> …the public necessity of available and functional bankruptcy relief is generally superior to the necessity of FERC's having complete or exclusive authority to regulate energy contracts and markets. This means that, for present purposes, the ICPA and the PPAs are not *de jure* regulations but, rather, ordinary

[31] Am. Sub. Sen. Bill No. 3, 148 Ohio Laws, Part IV, 7962, *codified at* Ohio Revised Code ch. 4928.

[32] *FirstEnergy Solutions Corp. v. FERC*, 2018 Bankr. LEXIS 1488 at *3-4 (Bankr. N.D. Ohio 2018).

[33] *Id.* at *60.

[34] *FERC v. FirstEnergy Solutions Corp.*, *supra*, 945 F.3d at 446 (summarizing preliminary injunction). The above-quoted language is taken directly from decretal paragraphs 4 and 5 of the Bankruptcy Court's preliminary injunction.

contracts susceptible to rejection in bankruptcy. This rather simple decision does not end this appeal, but it is a critically important start. Moreover, as there is clearly a public interest in both 'necessities,' we must further conclude that, as between them, if the bankruptcy court's jurisdiction is not exclusive—and,as will be explained, it is not—its position in the concurrent jurisdiction is nonetheless primary or superior to FERC's position.

The bankruptcy court has jurisdiction to decide whether FES, as a Chapter 11 debtor-in-possession, may reject the ICPA and PPA contracts, meaning that FES can reject the contracts subject to proper bankruptcy court approval and FERC cannot independently prevent it. [35]

The Court of Appeals next examined the Bankruptcy Court's "two alternative bases for its authority to issue [its] overwhelming injunction" against FERC under Sections 362(a) and 105(a) of the Code, and concluded that neither of those sections supported the breadth of the Bankruptcy Court's injunction. The Court of Appeals concluded that the Bankruptcy Court had misapplied the "public-policy test" explained in *Chao v. Hospital Staffing Services, Inc.*, 270 F.3d 374 (6th Cir. 2001) as a basis for determining whether or not regulatory proceedings against a bankruptcy debtor are exempted from the automatic stay by Section 362(b)(4) of the Code.[36] *Chao's* explanation of the Sixth Circuit's "public-policy" test for determining the applicability of Section 362(b)(4) "governmental entity police and regulatory power" exemption from the automatic stay holds that:

> . . . [W]hen the action incidentally serves public interests but more substantially adjudicates private rights, courts should regard the suit as outside the police power exception, particularly when a successful suit would result in a pecuniary advantage to certain private parties vis-a-vis other creditors of the estate.

The Sixth Circuit characterized the Bankruptcy Court's preliminary injunction as "[b]randishing *Chao* like a magic wand, the bankruptcy court went much farther than necessary and enjoined FERC from doing *anything at all*."[37] The Sixth Circuit defined the permissible scope of the Bankruptcy Court's authority to restrain agency conduct not exempted from the automatic stay by Section 362(b)(4) in the following terms:

> Under *Chao*, once the bankruptcy court determined that the anticipated FERC action of ordering contract performance (or forbidding contract rejection) would fail the public-policy test and, therefore, not qualify as a regulatory-powers exception to the automatic stay, then it could enjoin FERC from issuing such an order. But the bankruptcy court was not entitled to enjoin FERC from risking its own jurisdictional decision, conducting its business (otherwise mandated by regulation), or issuing orders that would not conflict with the bankruptcy court's rulings.[38]

The Court of Appeals also found that the Bankruptcy Court had misplaced reliance on Section 105(a) of the Code as authority for its preliminary injunction. The Court of Appeals held that "§ 105(a) did not give the bankruptcy court unlimited power—i.e., 'to act as roving commission to do equity'—to prohibit FERC from taking *any* action whatsoever or to enjoin all of FERC's regulatory functions. The bankruptcy court here went far too far."[39]

The Court of Appeals then concluded that the appropriate way to harmonize the requirements of the Federal Power Act and Sections 362 and 365 of the Code "is by holding that the bankruptcy court may, based on the particular facts and circumstances before it, enjoin FERC from issuing an order (or compelling an action) that would directly conflict with the bankruptcy court's orders or interfere with its otherwise-authorized authority, but the bankruptcy court may not enjoin FERC from risking its own jurisdictional decision, conducting its (otherwise regulatory mandated) business, or issuing orders that do not interfere with the bankruptcy court."[40] This left the Court of Appeals to explain the decisional criteria to be applied by the Bankruptcy Court in the exercise of its concurrent jurisdiction with that of the FERC over the rejection of FERC-jurisdictional agreements. On this final and pivotal point, the Court of Appeals concluded that:

> . . . [A]n adjusted standard best accommodates the concurrent jurisdiction between, and separate interests of, the Bankruptcy Code (court) and the FPA (FERC). On remand, the bankruptcy court must reconsider its decision under this higher standard, considering and deciding the impact of the rejection of these contracts on the public interest—including the consequential impact on consumers and any tangential contract provisions concerning such things

[35] *FirstEnergy Solutions Corp.*, *supra*, 945 F.3d at 445-446

[36] *Chao* is a paradigmatic illustration of the adage that "hard cases make bad law." *Chrome Plate, Inc. v. Dist. Dir. Int. Rev. (In re Chrome Plate, Inc.),* 614 F.2d 990, 1000 (6th Cir. 1980), *quoting Northern Securities Co. v. United States*, 193 U.S. 197, 400 (1904) (Holmes, J., dissenting). It involved a "hot goods" proceeding by the Secretary of Labor under Sections 16(c) and 17 of the Fair Labor Standards Act (29 U.S.C. §§ 216(c), 217) to restrain the movement in interstate commerce of medical records prepared by employees of a medical services agency that had failed to pay the employees in the process of converting from a Chapter 11 reorganization to a Chapter 7 liquidation, and turns on the precise nature of the alleged "hot goods" (the medical records) involved in the case. 270 F.3d at 392 ("In this particular case, however, that significant public interest in protecting other businesses from unfair competition is not present because the 'goods' are merely records relating to services already rendered by employees").

[37] *FERC v. FirstEnergy Solutions Corp., supra*, 945 F.3d at 448.

[38] *Id.* at 449. Under Sixth Circuit precedent, agency action that a bankruptcy court determines not to qualify for the Section 362(b)(4) exemption from the automatic stay is voidable, not "void *ab initio*" (the Bankruptcy Court's formulation). *Easley v. Pettibone Mich. Corp.*, 990 F.2d 905, 909-912 (6th Cir. 1992).

[39] *FERC v. FirstEnergy Solutions Corp., supra*, 945 F.3d at 451.

[40] *Id.* at 452.

Continued from p.29

as decommissioning, environmental management, and future pension obligations—to ensure that the 'equities balance in favor of rejecting the contracts[.]'

In a compelling concurring and dissenting opinion, Judge Griffin took issue with a number of premises for the Sixth Circuit's construction of a "concurrent jurisdiction" in which the bankruptcy court occupies the primary role and the FERC provides largely advisory input on the proposed rejection of contracts subject to its regulatory jurisdiction. Judge Griffin's concurring and dissenting opinion canvasses the competing precedents, and concludes:

Here, the majority opinion explicitly rules that 'the bankruptcy court's jurisdiction is . . . primary or superior to FERC's position.' This holding ignores our duty to 'harmonize' the Bankruptcy Code and the FPA as two coequal acts of Congress. *Traynor v. Turnage*, 485 U.S. 535, 548 (1988). We 'are not at liberty to pick and choose among congressional enactments, and when two statutes are capable of co-existence, it is the duty of the courts, absent a clearly expressed congressional intention to the contrary, to regard each as effective.' *Morton v. Mancari*, 417 U.S. 535, 551 (1974). And where, as here, the two statutes at issue 'have separate scopes and purposes,' they should be 'implemented in full at the same time, if possible' *POM Wonderful LLC v. Coca-Cola Co.*, 573 U.S. 102, 118, 134 S. Ct. 2228, 189 L. Ed. 2d 141 (2014).

FirstEnergy Post-Mortem

On March 30, 2020, almost exactly two years after the filing of FirstEnergy Solutions' Chapter 11 petition, FERC issued an order on remand from the Sixth Circuit, establishing a paper hearing under Section 206 of the Federal Power Act to make the "public interest" determination required by the decision in *FERC v. FirstEnergy Solutions Corp.*[41] On July 1, 2020, FERC issued a letter order granting Energy Harbor's request to hold the proceedings in abeyance pending settlement negotiations.[42] On September 24, 2020, Energy Harbor filed a status report with the FERC, requesting termination of the Section 206 proceeding on the grounds that all remaining disputes over contract rejection in the Chapter 11 proceeding had been resolved by settlement.

Observations and Conclusions

Bankruptcies of FERC-jurisdictional public utilities (a statutory category that includes most merchant generating facilities) and pipelines have become more common since FERC has moved progressively into a system of market-based rates for wholesale electricity and natural gas transportation. These are expensive, complicated, often ungainly proceedings. Judge Montali deserves particular recognition for having overseen not one, but two, PG&E Chapter 11 reorganizations in the past twenty years. The two cases discussed above illustrate some system disharmony between bankruptcy practitioners (and judges) and regulatory practitioners (and regulators) over the intersection of their respective corners of the law in this area. The disharmony is neither necessary nor constructive, from the perspective of either side of these controversies – nor is it inevitable. The following observations hope to reduce heat and increase light in this area.

1. FERC-Jurisdictional Contracts and Obligations of Regulated Entities. The bankruptcy courts and some reviewing courts seem to have difficulty absorbing the idea – embedded in the regulatory jurisprudence since at least the Supreme Court's *Penn Water* decision in 1952 – that the obligation of a regulated entity to provide FERC-jurisdictional services at regulated rates, terms and conditions established by FERC can and does exist independently of a specific contract, and the termination of the contract does not terminate the service obligation. Without recanvassing the case law reviewed at length in both the majority opinion and the concurring and dissenting opinion in *FERC v. FirstEnergy Solutions Corp.*, the separation of and separate authority over the two sets of obligations are most productively viewed as established facts. As the Supreme Court summarized the development of the symmetry between contract and service obligations at the wholesale level:

The way rates were regulated as between businesses (by the National Government) was in some respects, however, different from regulation of rates as between businesses and the public (at the state or local level). In wholesale markets, the party charging the rate and the party charged were often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them. Accordingly, in the Federal Power Act of 1920, 41 Stat. 1063, and again in the Natural Gas Act of 1938, 52 Stat. 821, Congress departed from the scheme of purely tariff-based regulation and acknowledged that contracts between commercial buyers and sellers could be used in rate setting, 16 U.S.C. § 824d(d) (Federal Power Act); 15 U.S.C. § 717c(c) (Natural Gas Act). See *United*

41 *Energy Harbor LLC*, 170 FERC ¶ 61,278 at P 14-16 (2020). The FERC noted that "FES went forward with the reorganization approved by the bankruptcy court, which involved FES converting the debt of certain FES creditors into equity of a newly-established corporation (New HoldCo), and merging FES into New HoldCo, leaving FES as the surviving corporation owned by its former creditors instead of FirstEnergy Corp"; that FERC had approved the restructuring transaction under Section 203 of the Federal Power Act (16 U.S.C. § 824b); and that, when the reorganization closed on February 27, 2020, "FES emerged from Chapter 11 bankruptcy protection, renamed as Energy Harbor." *Id.* at P 11.

42 *Energy Harbor LLC*, 172 FERC ¶ 61,003 (2020).

> *Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U.S. 332, 338-339 (1956). When commercial parties did avail themselves of rate agreements, the principal regulatory responsibility was not to relieve a contracting party of an unreasonable rate, *FPC* v. *Sierra Pacific Power Co.*, 350 U.S. 348, 355 (1956) ('its improvident bargain'), but to protect against potential discrimination by favorable contract rates between allied businesses to the detriment of other wholesale customers.[43]

Against seven decades of Supreme Court precedent between *Penn Water* and the present, it is not an answer that Congress knows how to draft exemptions from rejection under Section 365(a) of the Code but has not provided an exemption for power purchase agreements or gas transportation agreements.[44] It might be more illuminating to ask how, in a system in which "federal-court authority to reject Commission rate orders for whatever reason extends to the orders alone, and not to the rates themselves,"[45] Congress can be understood to have implicitly vested bankruptcy courts with authority that it has consistently chosen not to entrust to Article III courts.

2. Business Judgment vs. Public Interest. Applying the business judgment test for contract rejection under Section 365 of the Code to FERC-jurisdictional agreements that are subject to the "public interest" application of the FPA's just and reasonable standard is problematic. Using the debtor-deferential business judgment test does considerable violence to the settled understandings that the public interest application "does not overlook third-party interests; it is framed with a view to their protection," and that a "presumption applicable to contracting parties only, and inoperative as to everyone else – consumers, advocacy groups, state utility commissions, elected officials acting *parens patriae* – could scarcely provide the stability *Mobile-Sierra* aimed to secure."[46]

3. Distrust of the FPA Process for Judicial Review. The comment that "Kafka might have designed" the FPA's judicial review process[47] appears to misunderstand the process FERC usually deploys to deal with a proposed contract rejection in bankruptcy. The usual procedure involves a paper hearing on a 30-day to 90-day schedule. The federal courts of appeals having jurisdiction over FERC orders have processes for expediting their review. In terms of procedural efficiency, the process outlined in Judge Griffin's concurring and dissenting opinion in *FERC v. FirstEnergy Solutions* compares favorably to the two-year round trip in that bankruptcy.

ABOUT THE AUTHOR

John Coyle
Partner, Duncan & Allen LLP

John Coyle is the managing partner of Duncan & Allen LLP, a boutique energy practice in Washington, D.C. For the past 33 years, he has served as a trusted advisor to consumer-owned utilities, independent power developers, State regulatory agencies and consumer advocate coalitions in proceedings before the Federal Energy Regulatory Commission, federal and state trial and appellate courts, the United States bankruptcy courts, and arbitration tribunals. He is known for his keen understanding of traditional and innovative financial structures and his ability to construct, deconstruct, and restructure complex utility and project financing transactions.

e-mail: **jpc@duncanallen.com**

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@provincefirm.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

---

43 *Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 479 (2002).

44 *See, e.g., NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 522-523 (1984) ("Obviously, Congress knew how to draft an exclusion for collective-bargaining agreements when it wanted to; its failure to do so in this instance indicates that Congress intended that § 365(a) apply to all collective-bargaining agreements covered by the NLRA"); *PG&E Corp. v. FERC*, 603 B.R. 471, 487 (Bankr. N.D. Cal. 2019) ("Section 365's lack of an exception for FERC simply means that FERC has no jurisdiction over the rejection of contracts").

45 *Burlington Northern, Inc. v. United States*, 459 U.S. 131, 141 (1982).

46 *NRG Pwr. Mktg., LLC v. Me. Pub. Utils. Comm'n*, 558 U.S. 165, 175 (2010).

47 *PG&E Corp. v. FERC*, *supra*, 603 B.R. at 484-485. *See also FirstEnergy Solutions Corp. v. FERC*, 2018 Bankr. LEXIS 1488 at *55-56 ("The delay resulting from such review would presumably impose on any debtor an imperative to settle with the counterparty so as to have time to confirm a reorganization plan before financing expires, professional fees mount to an unsustainable level, and/or the creditors who must vote to accept the plan lose their patience").

ATTRIBUTE REDUCTION RULES FOR SEPARATE COMPANIES AND FOR CONSOLIDATED RETURN GROUPS

MICHAEL BARTON
RSM US LLP

Distressed debt workouts and restructurings have dramatically increased during the current economic downturn. To the extent a debtor is insolvent or a debt discharge occurs in a title 11 bankruptcy, such cancellation of debt ("COD") income is not taxable to the debtor.[1] However, section 108(b) provides that the excluded COD income shall be applied to reduce tax attributes.

The first part of this article reviews the general attribute reduction rules for stand-alone C corporations. The second part of the article provides an overview discussing how these rules are applied to federal consolidated return groups under regulation section 1.1502-28.

Part I: Application of Attribute Reduction Rules for Separate Company C Corporations

Section 108 – General Rules

Section 61(a)(12) of the Internal Revenue Code provides that gross income includes income from the discharge of indebtedness, except as provided by law. Section 108(a) provides that gross income of a C corporation does not include any amount that would otherwise be includible in gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer if the discharge occurs in a title 11 case (section 108(a)(1)(A)), the discharge occurs when the taxpayer is insolvent, but only to the extent of the insolvency (section 108(a)(1)(B)), or the indebtedness discharged is qualified farm indebtedness (section 108(a)(1)(C)).

Although section 108 does not require certain taxpayers to include discharge of indebtedness income in gross income, it does require the reduction of tax attributes. Section 108(b)(1) provides that if a taxpayer excludes an amount from gross income under section 108(a)(1)(A), (B), or (C), the taxpayer must reduce its tax attributes by the amount excluded. Absent an election under section 108(b)(5) (described below), pursuant to section 108(b)(2), tax attributes are reduced in the following order:

(A) *Net Operating Loss (NOL)* — Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) *General business credit* — Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).[2]

(C) *Minimum tax credit* — The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) *Capital loss carryovers* — Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(E) *Basis reduction* —

(i) *In general* — The basis of the property of the taxpayer.

(ii) *Cross reference* — For provisions for making the reduction described in clause (i), see section 1017.

(F) *Passive activity loss and credit carryovers* — Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) *Foreign tax credit carryovers* — Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

Any amount of debt discharge that remains after attribute reduction is not includible in income.[3] These provisions are designed to ``preserve the debtor's `fresh start' after bankruptcy."[4] In addition, they are intended to ``carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge."[5] By making attributes unavailable to offset income in later years, the provisions offer the debtor a temporary, rather than a permanent, deferral of tax.[6]

For example, a debtor that is insolvent by $90 realizes $100 of COD income. $10 of the COD income is taxable under section 61(a)(12). The remaining $90 of COD income is excluded from income under section 108(a)

[1] Section 108(a)(1),(2).

[2] Note that Section 163(j) carryforwards are subject to section 382 limitations but are not subject to attribute reduction under section 108.

[3] See H.R. Rep. 96-833 at 11 (1980); S. Rep. No. 96-1035 at 12 (1980).

[4] H.R. Rep. 96-833 at 9 (1980); see S. Rep. No. 96-1035 at 10 (1980).

[5] *Id.*

[6] Section 108 discussion is adapted from the Preamble to the Temporary Regulation Section 1.1502-28T, FR DOC #03-22453, Page 52488.

(1)(B).[7] Debtor has $40 of NOLs and $70 of tax basis in section 197 intangibles with a 5-year remaining life. Debtor does not elect under section 108(b)(5) to first reduce basis in depreciable assets. Of the $90 of COD that is excluded, the $40 NOL is reduced to $0 and $70 of tax basis in section 197 intangibles are reduced to $20. As such, $90 of tax attributes have been reduced ($40 of NOLs and $50 of section 197 intangibles). If the debtor were profitable in a future year, the $40 of NOLs would not be available to offset taxable income.[8] Moreover, the taxpayer would lose $50 of amortization deductions over the following 5 years.

Alternatively, assume the debtor's only tax attributes were the $40 of NOLs. Such attributes would be reduced to zero, and $50 of the excluded COD would thus not reduce any attributes. As stated above, any amount of debt discharge that remains after attribute reduction is not includible in income. Excluded COD that does not reduce attributes is colloquially referred to as "black hole" COD.

Section 108 – Amount of Reduction and Ordering Rules

- The reductions for general business credits, minimum tax credits,[9] and foreign tax credits shall be 33 1/3rd cents for each dollar excluded by subsection (a).[10] All other reductions shall be one dollar for each dollar excluded by subsection (a).[11] For example, $300 of excluded COD income would reduce $100 of general business credits, but would otherwise reduce $300 of NOLs.
- The reductions shall be made after the determination of tax for the taxable year of discharge.[12] In other words, the tax return for the year is first tentatively prepared before attribute reduction and then attribute reduction is applied. As such, any carrybacks to prior years are taken before attribute reduction. For CARES Act NOL carrybacks, this can be very taxpayer friendly. For example, an insolvent taxpayer carries back a $100 NOL from 2020 to 2016. The taxpayer would receive a $35 refund (as 2016 had a 35% corporate tax rate). In the alternative, the NOL may be been reduced to zero in attribute reduction if it had not been carried back.
- The reductions to NOLs and capital loss carryovers shall be made first in the loss for the taxable year of the discharge, and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.[13]
- The reductions to general business credits and foreign tax credits shall be made in the order in which carryovers are taken into account for the taxable year of the discharge.[14]

Section 108 – Election to Apply Reduction First Against Depreciable Property

The taxpayer may elect to apply *any* portion of attribute reduction to the reduction in section 1017 of the basis of depreciable property of the debtor.[15] The amount to which such an election applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.[16] For affiliated and consolidated return groups, tax basis in subsidiary stock is treated as depreciable property only to the extent that the subsidiary consents to a corresponding reduction in the basis of its depreciable property.[17]

In the case of a discharge in bankruptcy, or to the extent the taxpayer is insolvent, reduction in tax basis of assets cannot exceed the excess of the aggregate bases of the property held by the taxpayer immediately after the discharge, over the aggregate liabilities of the taxpayer immediately after the discharge.[18] However, this "liability floor" limitation does not apply to any reduction in basis by reason of an election under 108(b)(5) to first reduce basis in depreciable assets.[19]

For example, a taxpayer has $100 of excluded COD and does not make an election under section 108(b)(5). The corporation has $20 of NOLs, $100 of tax basis in depreciable assets, and will have $70 liabilities immediately after the discharge. In this case, the $20 of NOLs will be reduced. As the reduction in tax basis in depreciable assets cannot exceed the liabilities remaining, only $30 of tax basis in assets will be reduced. As only $50 of attribute reduction occurred, there will be $50 of "black hole" COD that will not reduce any attributes.

If the taxpayer had elected under section 108(b)(5) to first reduce basis in depreciable assets, the liability floor limitation would not apply. As such, all $100 of excluded COD would reduce the tax basis in its depreciable assets

7 The amount excluded under Section 108(1)(B) shall not exceed the amount by which the taxpayer is insolvent. Section 108(a)(3).

8 However, the NOLs may have been subject to Section 382 limitation(s) and/or the 80% Section 172(a) limitation for losses that arise in tax years after 2017.

9 It is unlikely a taxpayer would still have minimum tax credits remaining as they became fully refundable in 2018 or 2019. See Section 53(e)(5) for election to take 100% refundable credit amount in 2018 – per CARES Act Section 2305(b).

10 Section 108(a)(3)(B).

11 Section 108(a)(3)(A).

12 Section 108(a)(4)(A).

13 Section 108(4)(B).

14 Section 108(4)(C).

15 Section 108(b)(5)(A).

16 Section 108(b)(5)(B).

17 Section 1017(b)(3)(D).

18 Section 1017(b)(2).

19 Section 1017(b)(2)(B).

Continued from p.33

to zero. The corporation would still have $20 of NOLs after attribute reduction.

Part II – Application of Attribute Reduction Rules to U.S. Federal Consolidated Return Groups

Consolidated Return Groups – Separate or Consolidated Approach?

Prior to the issuance of the section 1.1502-28T regulations in 2003, it was not settled whether attribute reduction would only occur to the debtor(s) in the group (separate) or to the group as a whole (consolidated).

In the early 1990's the Treasury took the view that consolidated return groups should apply separate company attribute reduction.[20] However, by the late 90's, the Treasury had reconsidered and decided that consolidated attribution should apply,[21] though the issue remained unsettled.

This issue dramatically presented itself when WorldCom, Inc. ("WorldCom") filed for bankruptcy in 2002 after an $11 billion accounting scandal.[22] It was the largest bankruptcy ever in the United States when it filed. [23]

WorldCom was formed in 1993 and had acquired many communications companies, such as the former MCI, Inc. telecom with which it had previously merged with in 1997.[24] As MCI, Inc. had a less tarnished name than WorldCom, WorldCom renamed itself MCI, Inc. (MCI) in 2003[25] (further use of the name "MCI" in this article refers to the renamed WorldCom).

Virtually all of the subsidiaries of MCI had NOLs. The subsidiaries paid a management commission to the parent. As such, the parent had no NOLs but had incurred most of the third-party debt. If separate entity attribution reduction occurred, MCI would have no separate company NOLs to reduce, and would only reduce its basis in its first-tier subsidiaries, after recognizing approximately $35 billion of excluded COD income in the bankruptcy. Under consolidated attribute reduction, MCI would instead lose virtually all of its NOLs.[26]

MCI had generated great antipathy with its competitors. William Barr, then Verizon's general counsel, "helped orchestrate objections to the reorganization plan (in order to force MCI to liquidate rather than reorganize in bankruptcy). . . Mr. Barr contends the (fraud) turned the phone company into a 'criminal enterprise' and that 'bankruptcy is not a mechanism for laundering stolen goods.'"[27]

Besides trying to force MCI liquidate, its competitors lobbied Congress to enact legislation that would force consolidated groups to apply consolidated attribute reduction such that the reorganized MCI would not have billions of NOLs to shield future taxable income. "In the summer of 2003, Senator Santorum introduced legislation to resolve this issue …. (but) the Senate Judiciary Committee took no action of the Santorum proposal."[28]

Preamble to the Section 1.1502-28T Regulations – Consolidated Approach

After Congress failed to enact legislation, the Treasury issued the 1.1502-28T regulations with an effective date of August 29, 2003. The preamble to the temporary regulations state that:

> The IRS and Treasury Department have considered a separate entity approach and various consolidated approaches to the application of the attribute reduction rules of section 108(b) in the consolidated group context. As explained below, *these regulations adopt a consolidated approach that reduces all attributes that are available to the debtor* (emphasis added).
>
> The IRS and Treasury Department have rejected a separate entity approach. Such an approach would reduce only the attributes attributable to the member with excluded discharge of indebtedness income. The IRS and Treasury Department have rejected this approach because it fails to take into account the fact that consolidated attributes that are attributable to other members will be available to offset income of the debtor member as long as the debtor is a member of the group. A separate entity approach could result in the permanent exclusion of discharge of indebtedness income when there are other attributes available to the debtor member.[29]

20 See PLR 9121017 (Feb. 21, 1991).

21 See FSA 199912007 (Dec. 14, 1998); CCA 200149008 (Aug. 10, 2001).

22 WorldCom, Inc. Form 10-K for the fiscal year ended December 31, 2002. https://www.sec.gov/Archives/edgar/data/723527/000119312504039709/d10k.htm

23 "WorldCom Files for Largest Bankruptcy in U.S. History." PBS News Hour, July 12, 2003. https://www.pbs.org/newshour/economy/business-july-dec02-worldcom_07-2

24 "Justice Department Clears WorldCom /MCI Merger after MCI Agrees to Sell its Internet Business." United States Department of Justice, July 15 1998. https://web.archive.org/web/20090601034716/http://www.usdoj.gov/atr/public/press_releases/1998/1829.htm

25 WorldCom, Inc. Form 10-K for the fiscal year ended December 31, 2002. https://www.sec.gov/Archives/edgar/data/723527/000119312504039709/d10k.htm

26 "Tax Consequences from Discharging Debt," Norton Rose Fulbright, October 1, 2003. https://www.projectfinance.law/publications/tax-consequences-from-discharging-debt

27 "Verizon to MCI: Drop Dead; Campaign Is on for Liquidation," Wall Street Journal, May 15, 2003. The article noted that MCI would reduce its debt from $41 billion to $6 billion post-emergence, while Verizon had debt of about the $54 billion at the time.

28 "Recent Developments in Bankruptcy Tax." Jones Day Commentaries, October 2003. https://www.jonesday.com/files/Publication/87de9563-4fc6-435f-a3d7-e48ce4bbfe86/Presentation/PublicationAttachment/a1d3359a-799c-45c3-ad79-94aeddac1005/Recent%20Developments.pdf

29 68 FR 52487, Page 52488. https://www.federalregister.gov/documents/2003/09/04/03-22453/guidance-under-section-1502-application-of-section-108-to-members-of-a-consolidated-group

Overview of Section 1.1502-28 Regulations

The section 1.1502-28 regulations were issued in finalized form on March 21, 2005. While the Treasury stated the regulations take a "consolidated" approach, in actuality the regulations adopt a hybrid approach. For example, the first section of the regulation, 1.1502-28(a)(1), states that section 108(a)(1)(A) and (B) is applied separately to each member that realizes excluded COD income, and insolvency is tested based on the assets and liabilities of only the member that realized excluded COD income.

The "consolidated" provisions of the regulation are contained in a subsequent three-part analysis: -28(a)(2) debtor attribute reduction; -28(a)(3) look-through (or 'push down") rules and -28(a)(4) "fan out." These three steps are described below:

1) *Section 1.1502-28(a)(2) – Reduction of tax attributes attributable to the debtor* – With respect to a member that realizes excluded COD income in a taxable year, the tax attributes attributable to that member shall be reduced as provided in sections 108 and 1017 and this section. Basis of subsidiary stock, however, shall not be reduced below zero pursuant to paragraph (a)(2) of this section.
2) *Section 1.1502-28(a)(3) – Look-through ("push down")* rules – To the extent the stock basis of a lower-tier member is reduced in -28(a)(2), that subsidiary is treated as having recognized excluded COD in amount equal to such basis reduction.
3) *Section 1.1502-28(a)(4) – Reduction of certain tax attributes attributable to other members ("fan out")* To the extent that, pursuant to paragraph (a)(2) of this section, the excluded COD income is not applied to reduce the tax attributes attributable to the member that realizes the excluded COD income, after the application of paragraph (a)(3) of this section, such amount shall be applied to reduce the remaining consolidated tax attributes of the group, as provided in section 108 and this section.

Example 1 – Parent of a consolidated return group (P) directly owns 100% of S1 and S2. P has no other attributes. P has a basis of $100 in S1 and a basis of $0 in S2. P has no NOLs. S1 and S2 each have $60 of NOLs, assets with a tax basis of $0, and no other attributes. P recognizes $150 of excluded COD.

Step 1 – Under -28(a)(2), P would reduce its basis in S1 by $100. P cannot reduce S2's basis below zero.

Step 2 – Under -28(a)(3), S1 would be treated as having recognized $100 of excluded COD (equal to the amount that P reduced its basis in the stock of S1). S1 would then reduce its $60 NOL to zero.

Step 3 – Under -28(a)(4), P had $150 of excluded COD but only reduced $100 of attributes in -28(a)(2). As such, P would have to reduce up to $50 of remaining consolidated tax attributes ($150 less $100). In this case, the only other consolidated tax attribute is the $60 NOL at S2. Thus, under -28(a)(4), S2 would reduce its $60 NOL by $50.

Example 2 – P owns 100% of S. P recognizes $150 of excluded COD. P has no assets except for a $120 tax basis in the stock of S and has liabilities after the discharge of $70. S has $60 of NOLs, tax basis in assets of $0 and no liabilities after the discharge.

Step 1 – Under -28(a)(2), P would reduce its basis in S1 by $50 as it is limited by the section 1017(b)(2) liability floor. In other words. P cannot reduce basis in assets below the $70 of liabilities remaining after discharge. In this case, P will have a $70 basis in the stock of S after attribute reduction, and $70 of liabilities – resulting in net assets of $0. The section 1017(b)(2) liability floor is designed to prevent the creation of negative net liabilities after attribute reduction.

Step 2 – Under -28(a)(3), S would be treated as having recognized $50 of excluded COD (equal to the amount that P reduced its basis in the stock of S). S1 would then reduce its $60 NOL to $10.

Step 3 – Under -28(a)(4), P had $150 of excluded COD but only reduced $50 of attributes in -28(a)(2), but there are no more attributes left to reduce in the group.

Other Regulation Section 1.1502-28 Provisions

Section 1.1502-28(a)(3) limitation – To the extent that the excluded COD income realized by the lower-tier member pursuant to this paragraph (a)(3) does not reduce a tax attribute attributable to the lower-tier member, such excluded COD income shall not be applied to reduce tax attributes attributable to any member under paragraph (a)(4) of this section and shall not cause an excess loss account[30] to be taken into account under regulation § 1.1502-19(b)(1) and (c)(1)(iii)(B).

For example, P reduces tax basis in S stock by $100. S only has $60 of tax attributes to reduce. The remaining $40 would not be applied to reduce tax attributes of other members under -28(a)(4).

Multiple Debtors – If in a single taxable year multiple members realize excluded COD income, paragraphs (a)(2) and (3) of this section shall apply with respect to the excluded COD income of each such member before the application of paragraph (a)(4) of this section.[31]

Election under section 108(b)(5) – The group may make the election described in section 108(b)(5) for any member that realizes excluded COD income. The election is made separately for each member. Therefore, an election may be made for one member that realizes

[30] An excess loss account is essentially negative tax basis in the stock of a subsidiary of a consolidated return group. See regulation section 1.1502-32(a)(3)(ii).

[31] Regulation section 1.1502-28(b)(1).

Continued from p.35

excluded COD income (either actually or pursuant to paragraph (a)(3) of this section) while another election, or no election, may be made for another member that realizes excluded COD income (either actually or pursuant to paragraph (a)(3) of this section). For purposes of applying section 108(b)(5)(B), the basis of stock of a subsidiary that has an excess loss account shall be treated as zero.[32]

Application of section 1017 –

(i) Timing of basis reduction – Basis of property shall be subject to reduction pursuant to the rules of sections 108 and 1017 and this section after the determination of the tax imposed by chapter 1 of the Internal Revenue Code for the taxable year during which the member realizes excluded COD income and any prior years and coincident with the reduction of other attributes pursuant to section 108 and this section. However, only the basis of property held as of the beginning of the taxable year following the taxable year during which the excluded COD income is realized is subject to reduction pursuant to sections 108 and 1017 and this section.

(ii) Limitation of section 1017(b)(2) – The limitation of section 1017(b)(2) on the reduction in basis of property shall be applied by reference to the aggregate of the basis of the property held by the member that realizes excluded COD income, not the aggregate of the basis of the property held by all of the members of the group, and the liabilities of such member, not the aggregate liabilities of all of the members of the group.

(iii) Treatment of shares with an excess loss account – For purposes of applying section 1017(b)(2) and § 1.1017-1, the basis of stock of a subsidiary that has an excess loss account shall be treated as zero. [33]

Summary

As described above, section 108 is designed to preserve the debtor's `fresh start' after bankruptcy. In addition, section 108 is intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge. By making attributes unavailable to offset income in later years, the provisions offer the debtor a temporary, rather than a permanent, deferral of tax.

The liability floor in section 1017(b)(2) is designed to prevent the creation of negative net assets after attribute reduction. In a consolidated return context, an excess loss account, or negative tax basis in subsidiary stock cannot be created in attribute reduction.[34]

[32] Regulation section 1.1502-28(b)(2).
[33] Regulation section 1.1502-28(b)(3).
[34] Regulation section 1.1502-28(a)(2)(i).

While the regulation section 1.1502-28 rules are designed to "reduce all attributes that are attributable to debtor," the mechanics of the regulations, in combination with the section 1017(b)(2) liability floor, may result in certain attributes remaining after attribute reduction.

In a consolidated return group setting, determining where the post emergence debt should reside (between parent and/or subsidiaries) can have a large impact on asset attribute reduction due to the liability floor, depending on the group's facts and circumstances.

MCI – Post Note

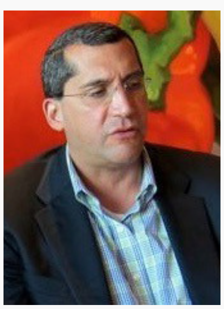
MCI emerged from bankruptcy on April 20, 2004, shedding $35 billion of debt. If it had been allowed to apply separate company attribute reduction, it would have reduced tax basis in first-tier subsidiaries and retained all other tax attributes, including its NOLs. However, the section 1.1502-28T regulations were written to prevent that outcome. MCI thus emerged bankruptcy shorn of substantial tax attributes.[35]

On July 13, 2005, Bernie Ebbers, the co-founder and CEO of MCI, was sentenced to 25 years in prison for securities fraud and conspiracy charges.[36]

On January 6, 2006, Verizon, who had previously tried to force MCI into liquidation, merged with MCI. The business unit was renamed "Verizon Business."[37]

[35] "Following the application of the attribute reduction rules, (MCI) estimates all of its federal NOL, capital loss and credit carryforwards and the majority of its state NOL and credit carryforwards (totaling approximately $15.5 billion) will be eliminated and will not be available for use in future periods." MCI Form 10-K for the fiscal year ending December 31, 2004. http://getfilings.com/o0001193125-05-052451.html
[36] *United States v. Bernard Ebbers*, 458 F.3d 110, (2006).
[37] "Verizon and MCI close merger creating stronger competitor for advanced communications services," (January 6, 2006). https://www.verizon.com/about/news/verizon-and-mci-close-merger-creating-stronger-competitor-advanced-communications-services

ABOUT THE AUTHOR



Michael Barton, JD, MBA, LLM, CPA, CGMA, CIRA
Senior Director, RSM US LLP

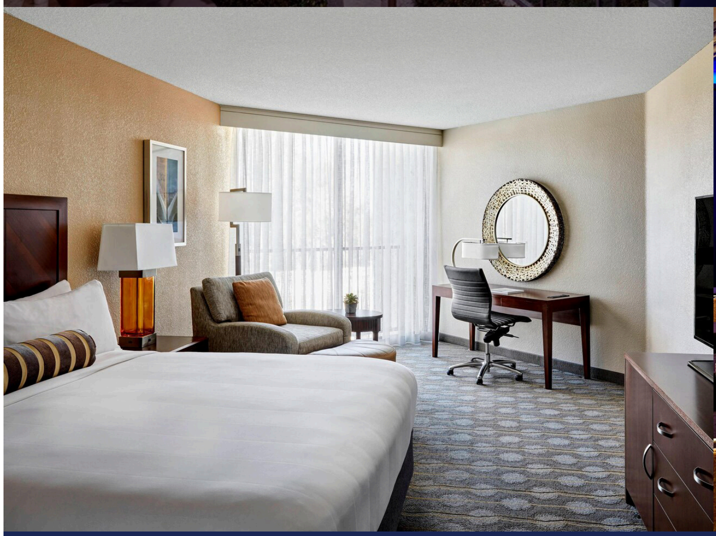
Mr. Barton is a Senior Director in the RSM Mergers and Acquisitions Tax group in New York. Michael has over 20 years of experience with distressed companies, corporate bankruptcies, loss preservation, stock basis, attribute reduction, loss disallowance, earnings and profits, and general M&A issues. He received a BA from Emory University, MBA and JD degrees from Tulane University, and an LLM in Taxation from NYU. Michael is a licensed attorney and holds CPA licenses in New York, California and Louisiana.

Email: **michael.barton@rsmus.com**

SAVE THE DATE: JUNE 9-12, 2021

37TH ANNUAL BANKRUPTCY & RESTRUCTURING CONFERENCE

Newport Beach, CA - Newport Beach Marriott Hotel & Spa



More information coming in early 2021!

AN EXPLORATION OF THE CONSEQUENCES OF DEVIATIONS FROM THE ABSOLUTE PRIORITY RULE

CARLOS A. ABADI
DecisionBoundaries, LLC

The Federal Bankruptcy Code allows shareholders of distressed firms to extract value from deviations from the absolute priority rule ("APR"); i.e., to retain some value even when creditors are not fully satisfied. Under Chapter 11, the most common shareholder tactic to retain value is drag out the automatic stay.

In this article, I analyze the negative ex ante effects resulting from ex post deviations from the APR. Such deviations have an adverse effect on ex ante management decisions made prior to the onset of financial distress, including investments, dividend distributions, and leverage. I will show that APR deviations aggravate this moral hazard.

For example, the possibility of deviating from the APR increases shareholders' (and incentivized managers') bias toward riskier investments (Jensen and Meckling (1976), Green (1984)), leading them to choose a riskier project over a safer one even if the risky project offers a lower expected NPV. I will show that the ex post deviations from the APR strengthen this distortion.

The intuition behind this is that deviations from the APR increase shareholder value at the expense of creditors in distressed times, which increases the bias toward risky projects. Moreover, the risk of APR deviations results in increased credit spreads to compensate creditors from the possible value transfer which, in turn, exacerbates the preference for risky projects.

While the model I propose focuses on the moral hazard for investment decisions based on expected deviations from the APR, the model also works for dividend payment and leverage decisions.

This article is organized as follows. Section 1 presents the framework of analysis. Section 2 analyzes ex ante behavior and share value in a regime without deviations from the APR. Section 3 analyzes behavior and share value allowing for deviations from the APR. Section 4 discusses the generality of the model's results. Section 5 concludes.

1 – The Model

Consider the following sequence of events. At time $t = 0$, a company borrows $D > 0$. At time $t = 1$, the shareholders choose between two projects: one is "safe" and the other "risky". Finally, at time $t = 2$, the firm's final output, W, is realized and divided between creditors and shareholders.

1.1 The Initial Debt Contract

I assume, for simplicity, that all participants are risk-neutral. Let i be the interest rate set by the participants at $t = 0$ for the entirety of the debt contract; i.e., at $t = 2$ the company will owe $D(1 + i)$ to its creditors. Let i_0 denote the risk-free interest rate. I assume that potential creditors compete to offer the interest rate i most favorable to shareholders, subject to i_0.

1.2 The Management Decision

I assume that shareholders make their investment decision at $t = 1$ and that the choice project is not verifiable, so that it cannot be specified in the debt contract.

If the shareholders choose the safe project, then the final output, W, will be $S > D(1 + i_0)$. If they choose the risky project, then the final output, W, is θR, where R is the positive expected return and θ is a random variable with expected value equal to 1. Let θ be distributed continuously with positive density throughout the interval $(0, \underline{\theta})$, where $\underline{\theta} > 1$. At $t = 1$, the shareholders observe R, but the value θ is realized at $t = 2$.

Given the information available at $t = 0$, the parties know S but only the distribution of R. Since the risky project may offer a higher or lower expected return than the safe one, we let R be distributed continuously with positive density throughout $(0, \underline{R})$, where $\underline{R} > S$. The moral hazard problem is that at $t = 1$, the shareholders may choose the risky project even if $R < S$.

1.3 The Final Period

The final output, W, is realized at $t = 2$ and is divided between creditors and shareholders. I assume that deviations from the APR are possible only under Chapter 11.

Under Chapter 11, the shareholders will be able to recover some value independently of the magnitude of W. Specifically, if $W < D(1+i)$, by filing for Chapter 11, the shareholders will be able to get αW, where $\alpha > 0$. Moreover, by availing themselves of protection, they will be able to obtain more than their legal right if the firm is close to insolvency, i.e., if W exceeds $D(1 + i)$ by an amount that is sufficiently small. For simplicity, I assume that the shareholders will always be able to get at least αW even if their legal entitlement $W - D(1 + i)$ is less than that. That is, if $0 < W - D(1 + i) < \alpha W$, shareholders will get $max[W - D(1 + i), \alpha W]$, and creditors will receive $min[D(1 + i), (1 - \alpha W]$.

1.4 The Equity Value

Let V_0 be the ex ante value of the equity. I assume that creditors cannot be "cheated" by Chapter 11, i.e., that creditors will always capture an expected return i_0. Therefore, whether V_0 will be higher in or out of bankruptcy depends on which regime leads to more efficient investment decisions.

Let $V_0{}^*$ denote the first-bet value for V_0. Then,

$$V_0{}^* = [Pr(R \leq S)]S + [Pr(R > S)]E[R|R > S] - D(1 + i_0). \quad (1)$$

As I will show, this value of V_0 cannot be achieved either in or out of bankruptcy.

2 – No Deviations from the Absolute Priority Rule

I start with a regime where Chapter 11 is not available and value is distributed according to the APR. I will analyze the outcome of this regime in the three subsections below.

2.1 The Shareholders' Choice Given an Interest Rate

In a regime without Chapter 11 and where the APR is strictly adhered to, at $t = 1$, given i, and once the shareholders observe R, they will choose the risky project if and only if:

$$E_\theta max[\theta R - D(1 + i), 0] \geq max[S - D(1 + i), 0]. \quad (2)$$

Let $R_N(i)$ denote the smallest nonnegative value of R that equates the left- and right- hand sides of (2). The shareholders will choose the risky project if and only if $R \geq R_N(i)$.

Using Jensen's inequality and the convexity of the max function in (2), we can show that if a risky project with $R = S$ does not always lead to insolvency, i.e., $\theta S > D(1 + i)$, then the left-hand side of (2) is always greater than its right-hand side for $R = S$. Furthermore, if $D(1 + i) \geq S$, then the right-hand side of (2) equals 0, and $R_N(i) = 0$. It follows that, for any given i,

$$R_N(i) < S \quad (3)$$

Inequality (3) implies that the shareholders may choose the risky project inefficiently, i.e., even if $R < S$. This result is the familiar moral hazard problem (see, e.g., Jensen and Meckling (1976)) and tells us that shareholders may choose inefficiently because they have more to gain from a favorable outcome than they have to lose from an unfavorable one.

2.2 The Equilibrium Interest rate

Let i_N be the interest rate set by the parties at $t = 0$ and let $F_N(i)$ be the expected creditors' recovery, in both cases under the no Chapter 11 (i.e., no deviations from the APR) regime. This expected recovery must satisfy:

$$\begin{aligned} F_N(i) = {} & Pr[R < R_N(i)]min[D(1 + i),s] \quad (4) \\ & + Pr[R \geq R_N(i)]E_R\{E_\theta min[D(1 + i), \theta R]|R \geq R_N(i)\} \end{aligned}$$

Let's assume that there exists some i that satisfies the creditors' constraint, $F_N(i) \geq D(1 + i_0)$, and provides shareholders with a positive expected value.[1] In a competitive market for debt, the equilibrium interest rate, i_N, will satisfy:

$$F_N(i_N) = D(1 + i_0). \quad (5)$$

Note that my assumption that there exists such an i_N that leaves shareholders with a positive expected value implies that this i_N allows some positive probability of solvency. Therefore, i_N satisfies $D(1 + i_N) < \theta R$, or $i_N < (\theta R/D) - 1$.

2.3 The Initial Value

Let $V_0{}^N$ be the ex ante value of the equity under the no-reorganization regime. Eq.(5) implies that, in this scenario, the creditors capture an expected return i_0. Therefore,

$$\begin{aligned} V_0{}^N = {} & Pr[R < R_N(i_N)]S \\ & + Pr[R \geq R_N(i_N)][E[R|R \geq R_N(i_N)] - D(1 + i_0). \quad (6) \end{aligned}$$

Note that, since $R_N(i_N) < S$ (see Eq. (3)), the $V_0{}^N$ in Eq. (6) falls short of the first-bet value $V_0{}^*$ in Eq. (1), Specifically, $V_0{}^N$ is lower than $V_0{}^*$ by the difference: $Pr[R_N(i_N) \leq R < S]E[S - R|R_N(i_N) < S]$.

[1] If the moral hazard problem is sufficiently severe, such i might not exist. In such a case, the moral hazard problem would prevent the firm from borrowing an amount D

3 – Allowing for Deviations from the Absolute Priority Rule

I now apply the same three steps to a bankruptcy regime where Chapter 11 is available and deviations from the APR can occur. Accordingly, I start with the question of how stockholders will choose between projects given an interest rate.

3.1 The Shareholders' Choice Given an Interest Rate

Consider the choice of a project at $t = 1$ when reorganization is allowed. Given i, once the shareholders observe R, they will choose the risky project if and only if:

$$E_\theta max[\theta R - D(1+i), \alpha\theta R] \geq max[S - D(1+i), \alpha S]. \quad (7)$$

Let $R_R(i)$ denote the unique value of R that turns (7) into an equality. There always exists such a value. The shareholders will choose the risky project if and only if $R \geq R_D(i)$.

We can now compare the project choices at $t = 1$ under the two regimes for any given i. As the following proposition indicates, for any given $i \leq [S(1-\alpha)/D] - 1$, the availability of Chapter 11 makes the shareholders more likely to choose the risky project.[2]

Proposition 1. $R_R(i) < R_N(i)$, *for any* $i \leq [S(1-\alpha)/D] - 1$.

The intuition of this result is that, under both regimes, shareholders have an inefficient incentive to invest in risky projects. The availability of Chapter 11, however, increases this incentive (given an interest rate) because it increase the attractiveness of a risky project for shareholders. (Proof available from the author).

3.2 The Equilibrium Interest Rate

Let i_R be the interest rate set by the parties at $t = 0$ under the reorganization regime. Let $F_R(i)$ be the expected payment to creditors for any given i under this regime. This payment must satisfy:

$$F_R(i) = Pr[R < R_R(i)]min[D(1+i), S(1-\alpha)] \quad (8)$$
$$+ Pr[R \geq R_R(i)]E_R\{E_\theta min[D(1+i), \theta R(1-\alpha)] | R \geq R_R(i)\}.$$

Let us assume that there exists some i that satisfies the creditors' individual rationality constraint, $F_R(i) \geq D(1+i_0)$.[3] In the competitive debt market, i_R will satisfy:

$$F_R(i_R) = D(1+i_0) \quad (9)$$

[2] Under this condition concerning i, only the risky project, but not the safe project, may lead to corporate reorganization.

[3] Again, if the moral hazard problem is sufficiently severe, such an i might not exist, in which case the moral hazard problem would prevent the firm from borrowing the amount D.

Let us also assume that $S(1-\alpha)/d$ is large enough to ensure that the creditors' constraint can be satisfied by some $i \leq [S(1-\alpha)/D]-1$, so that $i_R \leq [S(1-\alpha)/D-1$. This assumption implies that i_R is small enough that the safe project will not lead to bankruptcy (only a risky project will).

Proposition 2. *The equilibrium interest rate is higher under the reorganization regime with APR deviations allowed than under the no-reorganization regime:*

$$i_R > i_N.$$

The intuition is that allowing for deviations from the APR while maintaining the interest rate i_N would hurt creditors for two reasons. First, shareholders would be more inclined to choose a risky project (Proposition 1). Second, creditors would expect to get a smaller fraction of the final output in the event of insolvency. (Proof available from the author).

3.3 The Initial Value

Let us now consider the initial equity value under the reorganization regime and compare it to the value under the no-reorganization regime. Let V_0^R denote the ex ante value of the equity under the reorganization regime. We know, from Eq. (9), that creditors capture an expected return i_0 and, therefore:

$$V^R = Pr[R < R_R(i_R)]S + Pr[R \geq R_R(i_R)]E[R|R_R(i_R)] \quad (10)$$
$$- D(1+i_0).$$

Note that, since $R_R(i_R) < S$ (see Eq.(8)), V_0^R in Eq. (10) falls short of the first-best value V_0^* in Eq. (1) by the difference $Pr[R_R(i_R) \leq R \leq S]E[S - R|R_R(i_R) \leq R \leq S]$.

As before, the initial value depends upon the expected investment decisions given the equilibrium interest rate. Therefore, to compare V_0^R and V_0^N, we must begin with a comparison of $R_R(i_R)$ and $R_N(i_N)$.

Proposition 3. *The likelihood that a risky project will be chosen is greater under the reorganization regime than under the no-reorganization regime:* $R_R(i_R) < R_N(i_N)$.

The intuition is that the availability of Chapter 11 aggravates the moral hazard problem for two reasons. First, with Chapter 11 shareholders are more inclined to choose the risky project because reorganization shifts more downside risk from shareholders to creditors. Second, the equilibrium interest rate is higher when reorganization is available, which further reduces the attractiveness of the safe project relative to the risky one (proof available from the author).

The result that the moral hazard problem is more severe under Chapter eleven leads us to the following conclusion.

Proposition 4. *The initial equity value is lower under the reorganization regime than under the no-reorganization regime by the difference:*

$$Pr[R_R(i_R) \le R < R_N(i_N)]E[S - R|R_R(i_R) \le R < R_N(i_N)] \tag{11}$$

The shareholders bear the cost of any inefficient behavior because the creditors take the ex post shareholder opportunism into account ex ante.

4 – Conclusion

This article has analyzed how deviations from the APR have an adverse ex ante effect on management decisions. Such deviations exacerbate the problems of asset substitution, asset dilution, and claims dilution.

To determine whether deviations from the APR are overall undesirable, it would be necessary to compare the magnitude of their negative effects, which this article analyzes, with the magnitude of their positive effects.

Although the positive effects of deviations from the APR have been analyzed in the academic literature, no quantification of the net effect has been performed to date. I hope that this article will provide the basis for further research to determine, at very least, whether the net effect of deviations from the APR is positive or negative.

ABOUT THE AUTHOR

Carlos Abadi
DecisionBoundaries, LLC

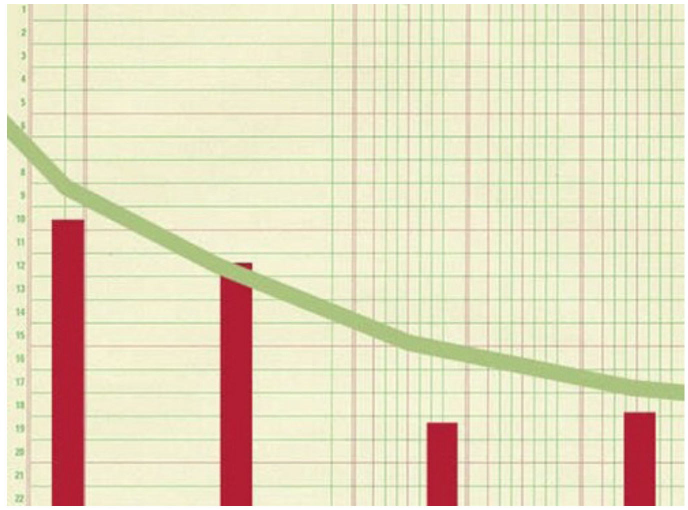
Carlos Abadi is the Managing Director of DecisionBoundaries, LLC, an international boutique financial advisory firm focused on financial restructuring, litigation support, and financial engineering.

Carlos is a 30-year veteran international investment banker who pioneered a number of financial products, such as the trading and swapping of emerging markets sovereign loans in the wake of the 1982 Mexican debt crisis, the trading market for derivatives on emerging markets bonds and loans, the first non-dilutive CET1 transaction compliant with Basel III rules, and the first Chapter 11 filing for a Latin American issuer.

Carlos holds a B.Sc./M.Sc. in Industrial Engineering from the Universidad de Buenos Aires, an MBA (Finance) from Cornell University, and academic certifications in Financial Engineering (Columbia University), Data Science (Johns Hopkins University), and Machine Learning (Stanford University).

BENFORD'S LAW STILL WORKS: PRACTICAL APPLICATIONS FOR FINDING FRAUD IN A BUSINESS SCENARIO[1]

VENKAT KESHAV PILLAI



Can Benford's Law practically identify fraud? It's one of many tests you can use to discover fictitious numbers in supposedly random data sets, such as monetary amounts of purchase transactions. In this case, a comptroller successfully uses Benford's Law to search for anomalies in warranty claims.

John, the controller of Rafal Inc., is in a quandary. Peter, the company's financial analyst, says he's found an abnormal spike in the warranty claims for FY 2019 as compared to FY 2018. John is perplexed as to how a discrepancy could have found its way into the payment process when he knows for certain that his team has been following tried-and-true documented "enterprise resource planning" procedures. He discusses the issue with Tim, a forensic consultant, who introduces him to the world of Benford's Law. The heralded law could settle the issue. (Names and details have been changed in this case history.)

Benford's Law and Its Historical Evolution

Benford's Law is a statistical method for detecting any manual intervention in an otherwise automated operational transaction activity.

In 1881, Simon Newcomb, an American astronomer, made an observation in the pattern of usage of logarithm tables. He found that the logarithm pages that began with "1" were more worn out than other pages. He inferred that pages commencing with 1 had far more frequent usage.[2]

In the 1920s, Frank Benford, a physicist at General Electric, observed — as did Newcomb — the pages of logarithm table books covering numbers with the initial digits "1" and "2" were more worn and dirtier than pages for "7," "8" and "9."[3]

Because the first few pages of a logarithm book list multi-digit logs beginning with the digits 1, 2 and 3, Benford theorized that scientists spent more time dealing with logs that began with those numerals. He also found that with each succeeding first digit, the amount of time scientists used it was decreased.

So, he concluded that in a population of naturally occurring multi-digit numbers, those numbers beginning with 1, 2 or 3 must appear more frequently than multi-digit numbers beginning with the digits 4 through 9. Also, the first digit of the numbers will be distributed in a predictable and expected way. Instead of the frequencies of the first digit being equal (a 1 out of 9 chance for each of the digits 1 through 9), the first digit of a multi-digit number typically follows a different pattern. Predictable patterns also occur in the second and third digits of multi-digit numbers. However, in this article, its application is limited to the first digit only.[4]

In 1938, Benford tested his hypothesis with data across 20 different domains with a total of 20,229 observations. His population of data included surface areas of 335 rivers, the sizes of 3,259 U.S. populations, 1,800 molecular weights, the street numbers of scientists listed in an edition of *American Men of Science* and the numbers in an issue of *Readers Digest*, among others. The premise was based on the idea that the first digit of a data set follows a logarithmic progression. The data analysis supported Benford's hypothesis.[5]

Mark J. Nigrini, Ph.D., published the article, "Using Digital Frequencies to Detect Fraud," in the April/May 1994 issue of the ACFE's *The White Paper*, the precursor to *Fraud Magazine*. "This article offers fraud examiners and auditors a new tool to consider in the detection

---

1 This article was originally published in *Fraud Magazine*, May/June 2020. Republished with permission from the ACFE. Available at: https://www.fraud-magazine.com/article.aspx?id=4295010575

2 Simon Newcomb, "Note on the Frequency of Use of the Different Digits in Natural Numbers," 1881, *American Journal of Mathematics,* 4:1, 39-40. Available at https://doi.org/10.2307/2369148.

3 See Mark J. Nigrini, *Digital Analysis Using Benford's Law* (Vancouver B.C.: Global Audit Publications, 2000).

4 For more information, see the online *ACFE Fraud Examiners Manual*, available at https://www.acfe.com/uploadedFiles/Shared_Content/Products/Books_and_Manuals/2018%20US%20FEM%20Main%20TOC.pdf.

5 Frank Benford, "The Law of Anomalous Numbers," March 31, 1938, *Proceedings of the American Philosophical Society*, 78:4. Available at https://idoc.pub/documents/the-law-of-anomalous-numbers-34wmpezegjl7.

of fraud," he wrote. And, indeed, it was a beginning. Nigrini, now a professor at West Virginia University, went on to help popularize Benford's Law in the latter part of the last century.

So, the goal of a Benford's Law analysis is to identity fictitious numbers. Most fraudsters fail to consider the Benford's Law pattern when creating false documentation of transactions to cover their tracks. Consequently, testing data sets for the occurrence or non-occurrence of the predictable digit distribution can help identify included numbers that are not legitimate.

Salient Features of Benford's Law

Benford's Law distinguishes between natural and non-natural numbers. Natural numbers are those that are not ordered in a numbering scheme and aren't generated from random number systems. For example, currency values that are natural numbers populate most vendor invoice totals or listings of payment amounts.

Conversely, non-natural numbers (such as identification numbers or assigned numbers, such as for Social Security accounts, bank accounts and car registrations) are designed systematically to convey information that restricts the natural nature of the number. Any number that's arbitrarily determined, such as the price of inventory held for sale, is considered a non-natural number.

Other Benford's Law features include:

- The formula is applicable for category variables. Continuous variables, such as age, height, weight, time and amounts, can be clustered into categories.
- The general rule is that a data set must contain at least 1,000 records to be effective. (More transactions will make the results more precise.)
- Transaction-level data will make for a better set than data organized in formats.
- Chi-squared statistics and "goodness-of-fit" tests will help interpret the results.

The application of the principles of Benford's Law will only provide indicators of intervention or compromise of data. We should not construe these indicators to be evidence of wrongdoing. Anomalies would require further assessment and/or evaluation with other substantive tests.[6]

Applicability and relevance of Benford's Law are more predominant in the functions of internal audit, forensic, risk and compliance, manufacturing operations, inventory analysis, supply-chain management, warranty claims and settlement, and financial payments.

[6] See Mark J. Nigrini, *Benford's Law: Applications for Forensic Accounting, Auditing and Fraud Detection* (New York: John Wiley & Sons Inc., 2000).

Transactions where we can apply Benford's Law:

- Payments to operational vendors.
- Commission payments to distributors and agents.
- Settlement of parts and labor warranty claims.
- Cash receipts in retail outlets.
- Bill of materials composition in an engineering manufacturing unit compared to actual consumption.
- Consumables such as oil and diesel in large manufacturing plants.
- Consumption of housekeeping materials in hospitals and hotels, such as linens, towels, bedsheets and toiletries.

We can use Benford's Law to uncover such frauds as:

- Shell company (fictitious vendor) schemes, in which the perpetrator concocts amounts to use on fraudulent invoices submitted by a supposed vendor.
- Cashiers who ring fictitious refunds on cash registers.
- Bid-splitting and other schemes involving limit circumvention, in which a fraudulent transaction often will begin with a digit that is just below the threshold.

Analysis of Benford's Law Results with Chi-Squared

And now for some statistical analysis. (Please consult your organizational statisticians if some of the following does not make sense.) Several tests can be used to analyze data sets to see if they conform to the expected frequency of occurrence as stipulated by Benford's Law, including Euclidean distance, Freedman-Watson, u-square, Z-statistics, chi-squared, Joenssen's JP-square, Kolmogorov-Smirnov and mean absolute deviation.

Simple descriptive statistics like mean, median, mode and standard deviation give the meaning of a distribution by removing the outliers. We can use regression analysis to examine relationships between continuous variables. However, when we're trying to determine patterns — such as customer preference, location and behavior — the chi-squared test is suitable. It can help us visualize data patterns and assist in informed decision-making.

This is the formula for calculating chi-squared statistics:

$X^2 = \sum (O-E)^2 / E$, where

X^2 = Chi-squared statistical value

O = Observed frequency of data set

E = Expected frequency

Continued from p.43

And here are the important variables for a chi-squared test:

- Data must be generated from a natural-number set, which means that we cannot consider assigned numbers, parts references, etc. A typical variable that can be considered to be natural is the total amount of accounts payable data set.
- Data should be capable of being characterized as "categorical variables." These variables can take on one of a limited, and usually fixed, number of possible values, assigning each individual or other unit of observation a group or nominal category based on some qualitative property.[7] They can be designated as attributes that would signify the qualities of a substratum of data set. In this case, the beginning of each data set would be associated with an identified first digit. We are likely to have digits starting from 1 to 9, or nine categories in all.
- "Degrees of freedom" is the number of independent category variables or similar information used in the computation of the chi-squared statistic, less one.

Here are the steps to follow in the computation:

1. Populate the expected frequency.
2. Populate the observed frequency.
3. Find the difference between observed and expected frequency.
4. Square the difference.
5. Divide the difference obtained in step 4 by the number of expected frequencies.

Back to Rafal Inc. and a Probable Manipulation in Warranty Claims Data

Rafal Inc. was in the business of manufacturing and selling cardio exercise machines across the U.S. for 10 years. The company sold its machines under warranty for spare parts and labor. End customers (mostly hospitals and nursing homes) could claim warranties either with authorized dealers or directly with the company.

The company consistently updated in its ERP financial software its list of warranty replacement parts (spares) plus standard costs for the parts and labor. And Rafal debited cost of goods sold (COGS) with the standard costs at the time of depletion of inventory and subsequent shipment for parts replacement.

The company included warranty spares and labor costs in the books of account based on a mathematical warranty estimation model that had a weighted average cost of past claims, their failure history, economic useful life, supply pipeline, availability of substitutes and their costs, plus the life of the substitutes and the U.S. regions in which customers made claims in nine-, five- and three-year periods.

Where records of spare part claims were available for less than three years, the basis of estimates was one of simple mean — an average of the actual claims made over the actual period of claim. The authorized dealers lodged their claims based on their technical mechanical evaluations. Rafal made the warranty claims payout to dealers after it approved them as per the authorization matrix.

In this case, Rafal gives John, the newly appointed controller, the task of reducing spiraling labor costs. John has his work cut out for him. He must figure out the reasons for the increasing trend, do a root-cause analysis and then ascertain steps to remediate the shortcomings, if any. He consults with Tim, the forensic professional, who suggests applying Benford's Law to discover any possible intrusions or compromises in the booking of labor claims by the authorized dealers to Rafal.

Tim gives these steps:

1. Determine and state the null and alternate hypotheses.
2. Set the criterion for rejecting the null hypothesis.
3. Calculate the "t-test statistic"; in this case, it will be chi-squared test statistics.
4. Tabulate research findings.
5. Interpret the results and decide whether to reject or accept the null hypothesis. (If they reject the null hypothesis, they use the results to investigate further on the variances or discrepancies.)
6. Draw conclusions.

These steps are illustrated in Exhibits 1 and 2 on the next page.

(Note: In this case, no statistical difference between observed and expected frequencies of the first digit of the data set means there's no compromise or intrusion in the data set. This forms the null hypothesis. However, we might need to test the null hypothesis using the "level of significance" test. Level of significance is the limit of probability of incorrectly rejecting the null hypothesis when it is actually true. Where the critical value computed by the chi-squared test on the observed frequencies is greater than that computed at a desired level of significance, it would be appropriate to reject the null hypothesis and go for the alternate hypothesis.)

[7] See Dan Yates, David S. Moore, and Daren S. Starnes, The Practice of Statistics, 4th ed (New York: W. H. Freeman, 2010).

EXHIBIT 1: Steps 1, 2 & 3; Computation of the Chi-Squared Statistic

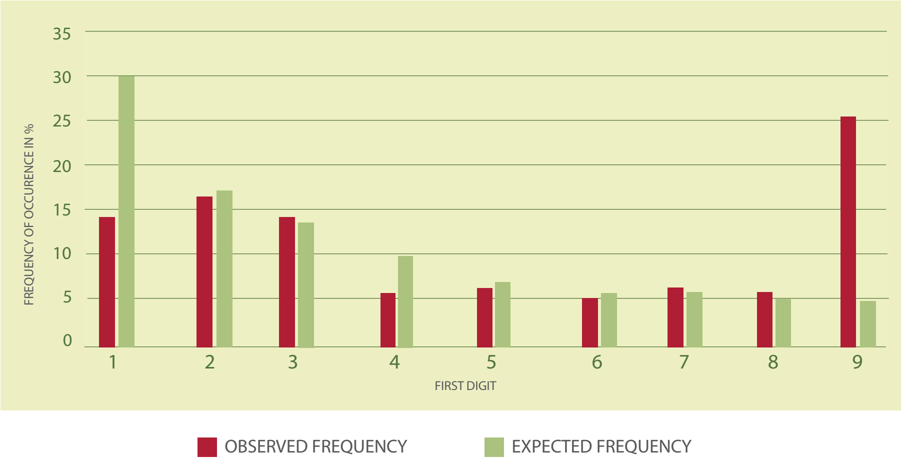
STEP 1 NULL HYPOTHESIS (Ho: 0) = E: There's no statistically significant difference between the observed and expected logarithmic frequencies of warranty labor claims as per Benford's Law.

STEP 2 ALTERNATIVE HYPOTHESIS (Hα: 0) ≠ E: There's a statistically significant difference between the observed and expected logarithmic frequencies of labor claims as per Benford's Law.

STEP 3 HERE'S THE COMPUTATION OF THE CHI-SQUARED STATISTIC:

FD (FIRST DIGIT)	COUNT OF FD	y [O] OBSERVED FREQUENCY	y[E] EXPECTED FREQUENCY	y[O-E] DIFFERENCE BETWEEN OBSERVED AND EXPECTED FREQUENCY	y[O-E]^2 DIFFERENCE BETWEEN OBSERVED AND EXPECTED FREQUENCY	y[O-E]^2/E DIFFERENCE BETWEEN OBSERVED AND EXPECTED FREQUENCY
1	1000	13.48982	30.103	-16.6132	275.9979	9.168452
2	1222	16.48455	17.60913	-1.12457	1.264662	0.071819
3	998	13.46284	12.49387	0.968962	0.938887	0.075148
4	471	6.353703	9.691001	-3.3373	11.13756	1.149268
5	510	6.879806	7.918125	-1.03832	1.078106	0.136157
6	370	4.991232	6.694679	-1.70345	2.901733	0.433439
7	487	6.56954	5.799195	0.770345	0.593432	0.10233
8	480	6.475111	5.115252	1.359859	1.849217	0.36151
9	1875	25.2934	4.575749	20.71765	429.2212	93.80348
Total	7413	100	100			105.3016

Exhibit 2: Steps 4, 5 & 6 with Graphical Representation of Two Forms of Benford's Law Applicability (for Warranty Labor Claims in Case Example)



STEPS 4, 5 & 6

TABULATE, INTERPRET AND DRAW CONCLUSIONS

- The chi-squared statistic is 105.3016 for the entire dataset. We've computed it to compare it to a desired level of significance and decide if we should accept or reject the null hypothesis.
- Degrees of freedom is 8, i.e. 9 to 1. (Degrees of freedom are the number of independent category variables or similar information used in the computation of the chi-squared statistic, less one.) We had 9 first-digit variables; hence the degree of freedom is 8.
- Critical values for chi-squared distribution for eight degrees of freedom:

LEVEL OF SIGNIFICANCE	CRITICAL VALUES FOR CHI-SQUARED DISTRIBUTION
1%	20.090
5%	15.507

- Derived chi-squared statistic of 105.3016 is far higher than the critical values at eight degrees of freedom — both at 1%and 5% levels of significance. Hence the null hypothesis is rejected. The alternative hypothesis holds good.

This would mean that observed frequencies don't follow the expected frequencies of Benford's Law.

Continued from p.45

Further analysis reveals a marked spike in the observed frequency of the first digit of numerical 9 and correspondingly lower frequency in the first digit of numerical 1. The rest of the first-digit numbers (2 to 8) seem to be approximately distributed in line with expected frequencies. John sees this as a major discovery to spur further investigation.

- John refers to the authorization matrix for processing labor claims. His hunch turns out to be supposedly true:

Labor claims in U.S. dollars	Approval
$1 to $999	Location claims manager
$1,000	Regional claims manager

It was quite evident that the majority of the warranty claims had the first digit as 9. Is this finding itself enough to establish that claims that otherwise would be in excess of $1,000 were purposefully made out to be less than $1,000 to circumvent the approval requirement of the regional claims manager? No, unless further substantive tests are made on the result.

- John further drills down the data population to specific authorized dealers and observes that the spike is most prominent in the southern region and more specifically with Smartcardio, the largest authorized dealer in that region.

- John analyzes the pattern of claims and concludes that even for minor services under warranty, the claims of which should have been in the range of $100 to $199, the actual claims preferred by Smartcardio were in the range of $900 to $999. This was quite alarming.

John finds the local claims manager at Smartcardio in the southern region had fraudulently approved all frivolous and minor claims in the range of $900 to $999, which otherwise should have been in the range of $100 to $199. He pocketed the difference of $700 per claim.

NOTE: The author emphasizes that this article does not test the veracity of Benford's Law but only aims to apply its principles and explain its usefulness in a business scenario.

ABOUT THE AUTHOR

Venkat Pillai, CFE, ACA

Venkat Pillai, CFE, ACA, is a double Chartered Accountant from the Institute of Chartered Accountants of England and Wales and The Institute of Chartered Accountants of India and a Certified Fraud Examiner from The Association of Certified Fraud Examiners, USA currently working in the controllership function of supply chain organization possessing diverse experiences in areas of controllership, internal controls, internal audit and fraud prevention & detection. His interests include profiling, assessing and modelling functional areas for risk mitigation and fraud prevention.

NYIC NEW YORK INSTITUTE OF CREDIT

AIRA

NYIC/AIRA Event

January 20, 2021 | 2:00pm - 5:00pm EST | Virtual Event

New York Institute of Credit and AIRA are holding a Joint Program for our Members and followers.

The two panel virtual webinar, followed by a Virtual Cocktail Party, will cover important and timely information.

This event will be eligible for 1.0 CPE credit.

Other event details to be announced soon.

AGENDA

2:00-3:00 PM EST - Panel 1: Industry Experts

3:00-4:00 PM EST - Panel 2: PPP

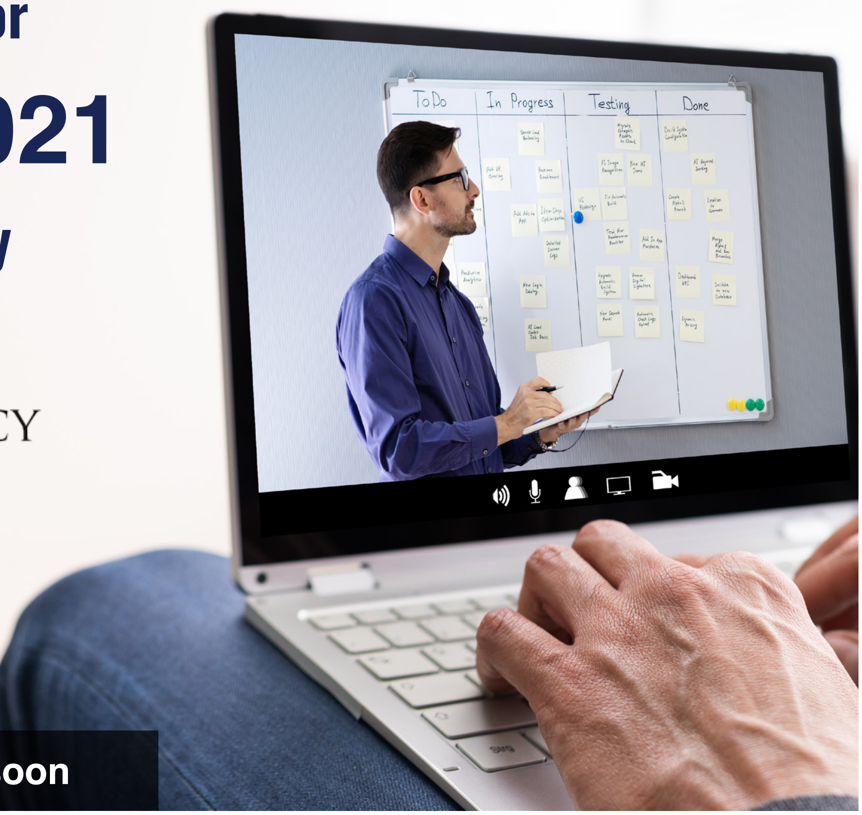
4:00-5:00 PM EST - Virtual Networking Happy Hour

Information and registration at www.instituteofcredit.org

Join us virtually for

VALCON 2021

Coming early May



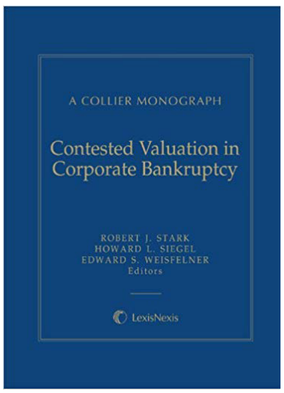
AMERICAN BANKRUPTCY INSTITUTE

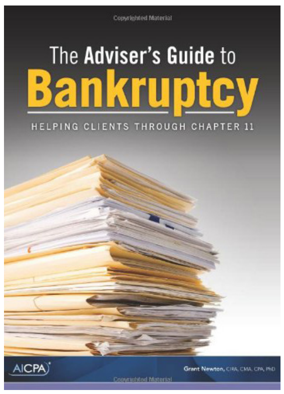
AIRA

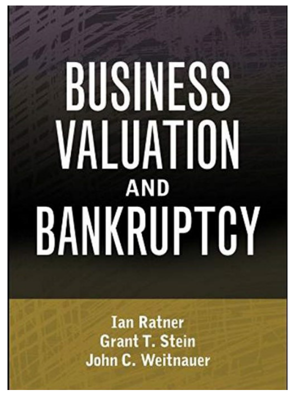
More information coming soon

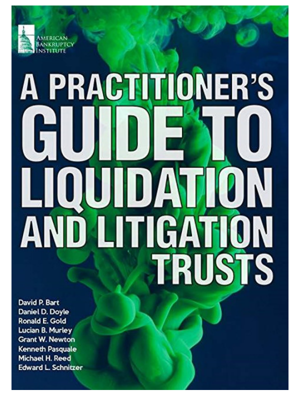
SALUTE TO AIRA AUTHORS

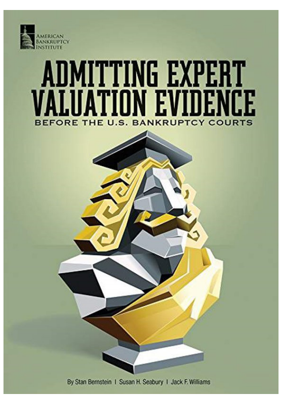
The AIRA congratulates and appreciates its members and conference participants whose publications have contributed to the body of knowledge in the restructuring field. *(Note: This recognition does not imply an endorsement or review of these publications.)*

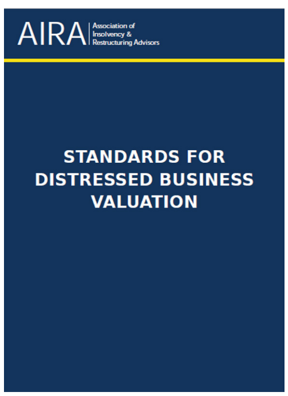


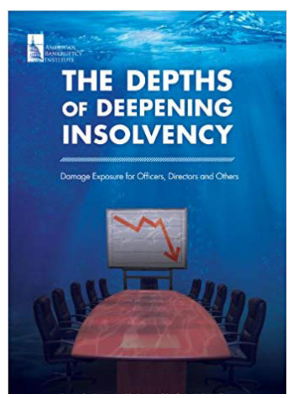


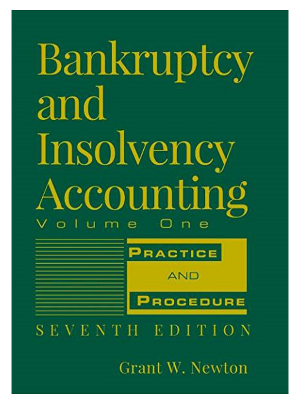


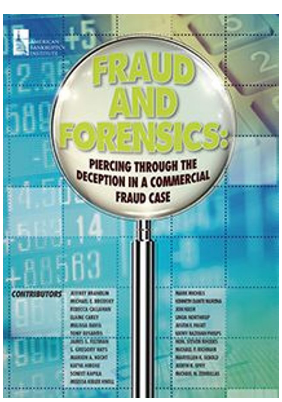


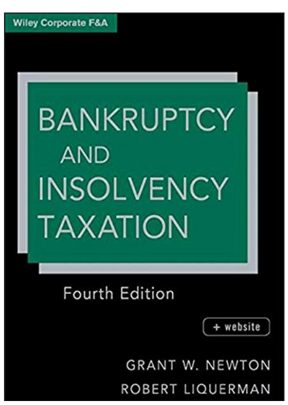












Have a published book? Do you know of other authors and publications we may acknowledge? Let us know by sending an email to aira@aira.org.

PRESS RELEASE: COHNREZNICK ELEVATES SIX PROFESSIONALS TO PARTNER/PRINCIPAL

CohnReznick LLP, one of the leading accounting, tax, and advisory firms in the United States, has announced the appointment of six professionals to its partnership, effective February 1, 2021:

Vikram Devanga is a principal in the Transactional Advisory Services practice. Based in New York, he has more than 20 years of diversified public accounting experience that includes helping strategic and financial buyers make informed decisions through the entire lifecycle of a transaction, including providing pre-deal and post-deal advice. Devanga works with clients in a wide range of industries including construction, auto components, life sciences, retail, and consumer products.

Tara Marino, ASA, is a principal in the Valuation Advisory Services practice, based in CohnReznick's Bethesda office. With more than 15 years of experience, she provides valuations of entire businesses, business interests, equity securities, and intangible assets for financial reporting, tax, and advisory purposes. Marino works with clients in a variety of industries including hospitality, retail and consumer products, technology and life sciences, and manufacturing and distribution.

Jeffrey Michelson, CPA, is a partner in CohnReznick's Transactional Advisory Services practice, based in New York. With more than 16 years of experience in finance and accounting, he leads buy-side transactions for private equity and corporate clients as well as sell-side transactions for privately held and family-owned businesses. Michelson has extensive experience in financial due diligence analysis, transaction structuring, and deal negotiation support in a variety of industries.

Abby Rollins, CFE, PMP, is a principal in CohnReznick's Government practice, focusing on emergency management services. Based in Austin, she is a firm leader in providing policy and operational support services to government agencies including compliance and monitoring, quality control and assurance, and policy and procedure development and documentation. Rollins recently served as Project Manager contracted by the Texas Division of Emergency Management, responsible for managing and administering a portfolio of over $6 billion in federal funds for federally declared disasters in the state of Texas.

Eric Rumberger, CPA, is an assurance partner with more than 16 years of diversified public accounting experience that encompasses audit, accounting, and tax services. Based in Charlotte, he has provided accounting services to clients in a variety of industries including real estate, construction, not-for-profit, and government, and to small businesses and investment funds. In this role, he provides financial statement audits, tax return preparation, evaluation of internal controls, and keeps clients updated on government required standards and various agreed-upon procedures engagements.

Garrett Wells, CPA, is a tax partner at CohnReznick and a member of the Commercial Real Estate practice. Based in Baltimore, he has more than 14 years of experience providing tax consulting and compliance services to a variety of clients in the real estate industry including commercial, multi-family housing, affordable housing, and hotels. Wells has extensive practical experience working with clients that are structured as both partnerships and corporations, including Real Estate Investment Trusts. Wells has a thorough understanding of various federal and state tax credit programs including New Markets Tax Credits, Low-Income Housing Tax Credits, and Historic Tax Credits.

CLUB 10

*Organizations with 10+ professionals who are active CIRAs or have passed all three parts of the exam**

AlixPartners, LLP	**81**
FTI Consulting, Inc.	**63**
Alvarez & Marsal	**54**
Ernst & Young LLP	**32**
Berkeley Research Group, LLC	**20**
Huron	**19**
Ankura Consulting Group, LLC	**17**
Conway MacKenzie, Inc.	**15**
Deloitte	**15**
PBGC	**15**
PricewaterhouseCoopers LLP	**15**
BDO USA, LLP	**13**
B. Riley Advisory Services	**12**
KPMG LLP	**12**
Office of the U.S. Trustee	**11**
SOLIC Capital Advisors, LLC	**10**

NEW MEMBERS

Petros Alexandrou
Cyprus University of Technology
Limassol, Cyprus

Paul Coloma
Alvarez & Marsal
Atlanta, GA

Daniel Gower
Ankura Consulting Group
Atlanta, GA

Cameron Jones
Alvarez & Marsal
Houston, TX

Daniel Miller
High Ridge Partners
Chicago, IL

Evin Morris
Equitas, P.C.
Seattle, WA

Michael O'Hanlon
Houlihan Lokey
Dallas, TX

Tomas Ortiz
Zuber Lawler & Del Duca LLP
Los Angeles, CA

Patrick Schuetz
Chicago, IL

Kushant Shah
Henry Ford Village
Dearborn, MI

Sean Tanner
Keegan Linscott & Associates, PC
Tucson, AZ

Yaxiong Wang
Cohn Reznick
Quincy, MA

David Webster
AlixPartners
Chicago, IL

NEW CIRAS IN 2020

Ramiro Balladares
Alvarez & Marsal
Humble, TX

James Bender
FTI Consulting
Toronto, ON

Carla Berlin
Larx Advisors, Inc.
Frisco, TX

Roger Bischof
BIRT International-restructuring.com
Shanghai, China

Alexander Canale
Alvarez & Marsal
New York, NY

Beatriz Capote
BC4 Consulting LLC
San Juan, PR

Jochen Chang
AlixPartners, LLP
Chicago, IL

Austin Cornwell
Larx Advisors
Roswell, GA

Spencer Curtiss
Mackinac Partners
Dallas, TX

Jeremy Dioso
AlixPartners, LLP
Dallas, TX

Matthew Ellis
FTI Consulting
San Francisco, CA

Luka Erceg
Erceg, LLC
San Diego, CA

Kyle Felix
FTI Consulting
Grapevine, TX

Bryan Fleming
Alvarez & Marsal
Atlanta, GA

David Gorelick
Huron Consulting Group
Chicago, IL

Thomas Grigg
FTI Consulting
Los Angeles, CA

Donika Hristova
Pension Benefit Guarantee Corporation
Washington, DC

John Jewell
Alvarez & Marsal
Chicago, IL

Mason Klement
PricewaterhouseCoopers
New York, NY

Jonathon LeGuen
Alvarez & Marsal
Dallas, TX

John Luster
Postlethwaite and Netterville
New Orleans, LA

Claus Mayer
Larx Advisors
Miami, FL

Cameron McKenzie
McKenzie & Associates
San Juan, PR

Michelle Meyer
AlixPartners, LLP
Chicago, IL

John Murdoch
Deloitte
Arlington, VA

Mai Nguyen
Crowe LLP
Dallas, TX

Zachary Rowe
Healthcare Management Partners
Nashville, TN

Michael Walsh
Alvarez & Marsal
Troy, MI

Alexander Weckenbrock
AlixPartners, LLP
Dallas, TX

NEW CDBVS IN 2020

Jeremy Burnstein
Globalview Advisors LLC
Boise, ID

Alexander Canale
Alvarez & Marsal
New York, NY

Robert Crockett
Ernst & Young
Camana Bay, Grand Cayman

Michael Fussman
Baker Tilly
Chicago, IL

Kevin Tavakoli
SOLIC Capital Advisors, LLC
Evanston, IL

BOARD OF DIRECTORS

The Association of Insolvency and Restructuring Advisors is governed by a board composed of up to 40 directors (several former directors continue to serve as directors emeritus). Directors are elected by majority vote at a meeting of the Board, serve for a term of three years (or such less term as the Board may determine or until their successors are duly elected and qualified) and may serve an unlimited number of terms, whether or not consecutive. The majority of the directors on the Board must have a CIRA Certificate; although most are financial advisors, a number of directors are attorneys. New officers assumed their duties at the end of the June AC20 Virtual Series and will serve for one year.

PRESIDENT & AIRA JOURNAL CO-EDITOR:
DAVID BART, CIRA, CDBV
RSM US LLP

CHAIRMAN:
BRIAN RYNIKER, CIRA
Ryniker Consultants, LLC

PRESIDENT-ELECT, VICE PRESIDENT - DEVELOPMENT & AIRA JOURNAL PUBLICATIONS CHAIRMAN:
MICHAEL LASTOWSKI
Duane Morris LLP

VICE PRESIDENT - CONFERENCES:
DAVID PAYNE, CIRA, CDBV
D. R. Payne & Associates

VICE PRESIDENT - PUERTO RICO:
JOSE MONGE-ROBERTIN, CIRA
Monge Robertin Advisors, LLC

TREASURER:
DAVID BERLINER, CIRA
BDO USA, LLP

SECRETARY:
DENISE LORENZO, CIRA
AlixPartners, LLP

AIRA JOURNAL CO-EDITOR :
BORIS STEFFEN, CDBV
Province, Inc.

LAWRENCE AHERN III
Brown & Ahern

CHUCK CARROLL, CIRA
FTI Consulting, Inc.

MARTIN CAUZ, CIRA
Lexington Health Network

KEVIN CLANCY, CIRA
CohnReznick LLP

ERIC DANNER, CIRA
CohnReznick LLP

STEPHEN DARR, CIRA, CDBV
Huron

LEAH EISENBERG
Foley & Lardner LLP

STEVEN FLEMING, CIRA, CDBV
PricewaterhouseCoopers LLP

MICHAEL GOLDSTEIN
Goodwin Procter LLP

S. GREGORY HAYS, CIRA
Hays Financial Consulting LLC

JEAN HOSTY
Piper Sandler & Co.

THOMAS JEREMIASSEN, CIRA
Development Specialists, Inc.

ERIC KERWOOD, CIRA
Epiq Systems

KARL KNECHTEL, CIRA
Knechtel Advisors, LLC

KENNETH MALEK, CIRA, CDBV
MalekRemian LLC

KEVIN MCCOY, CIRA
KapilaMukamal, LLP

JENNIFER MEYEROWITZ
Summit Investment Management LLC

RICHARD NEWMAN
Alvarez & Marsal

BEN PICKERING
Ernst & Young LLP

JOHN POLICANO
RPA Advisors, LLC

SUZANNE ROSKI, CIRA, CDBV
CR3 Partners, LLC

ANTHONY SASSO, CIRA
Deloitte CRG

MATTHEW SCHWARTZ, CIRA
Bederson LLP

ANGELA SHORTALL, CIRA
3Cubed Advisory Services, LLC

ANDREW SILFEN
Arent Fox LLP

WILLIAM S. SUGDEN
Alston & Bird LLP

JOEL WAITE
Young Conaway Stargatt & Taylor LLP

R. SCOTT WILLIAMS
RumbergerKirk

RICK WRIGHT, CIRA, CDBV
Berkeley Research Group, LLC

DANIEL ARMEL, CIRA*
Baymark Strategies LLC

ROBERT BINGHAM, CIRA*
Zolfo Cooper

SONEET KAPILA, CIRA*
KapilaMukamal, LLP

H. KENNETH LEFOLDT, JR., CIRA*
Lefoldt & Co., P.A.

GRANT STEIN*
Alston & Bird LLP

JEFFREY SUTTON, CIRA*
Friedman LLP

EXECUTIVE DIRECTOR:
JAMES M. LUKENDA, CIRA

EXECUTIVE DIRECTOR EMERITUS:
GRANT NEWTON, CIRA

EXECUTIVE DIRECTOR EMERITUS:
THOMAS MORROW, CIRA

RESIDENT SCHOLAR:
JACK WILLIAMS, CIRA, CDBV
Georgia State Univ. College of Law

SPECIAL COUNSEL:
KEITH SHAPIRO
Greenberg Traurig, LLP

*Director Emeritus

AIRA

Association of Insolvency & Restructuring Advisors

221 W. Stewart Avenue, Suite 207
Medford, OR 97501
Phone: 541-858-1665
Fax: 541-858-9187
aira@aira.org
www.aira.org

CIRA

Certified Insolvency & Restructuring Advisor

BECOME AN AIRA MEMBER
JOIN THE CIRA PROGRAM

Earn 20 CPE Credits (per Part)

The industry renowned CIRA Certification is proof of an individual's high degree of knowledge, integrity and proficiency across a wide spectrum of skills related to serving clients in situations involving distressed and/or insolvent entities.

3 CIRA COURSES TO CERTIFICATION

3 Financial Reporting, Taxes & Ethics

2 Plan Development

1 Managing Turnaround & Bankruptcy Cases

Attend from the comfort of your home or office with our online CIRA Course offerings

START THE PATH TO CERTIFICATION TODAY

To become a member and enroll in the CIRA program visit www.AIRA.org