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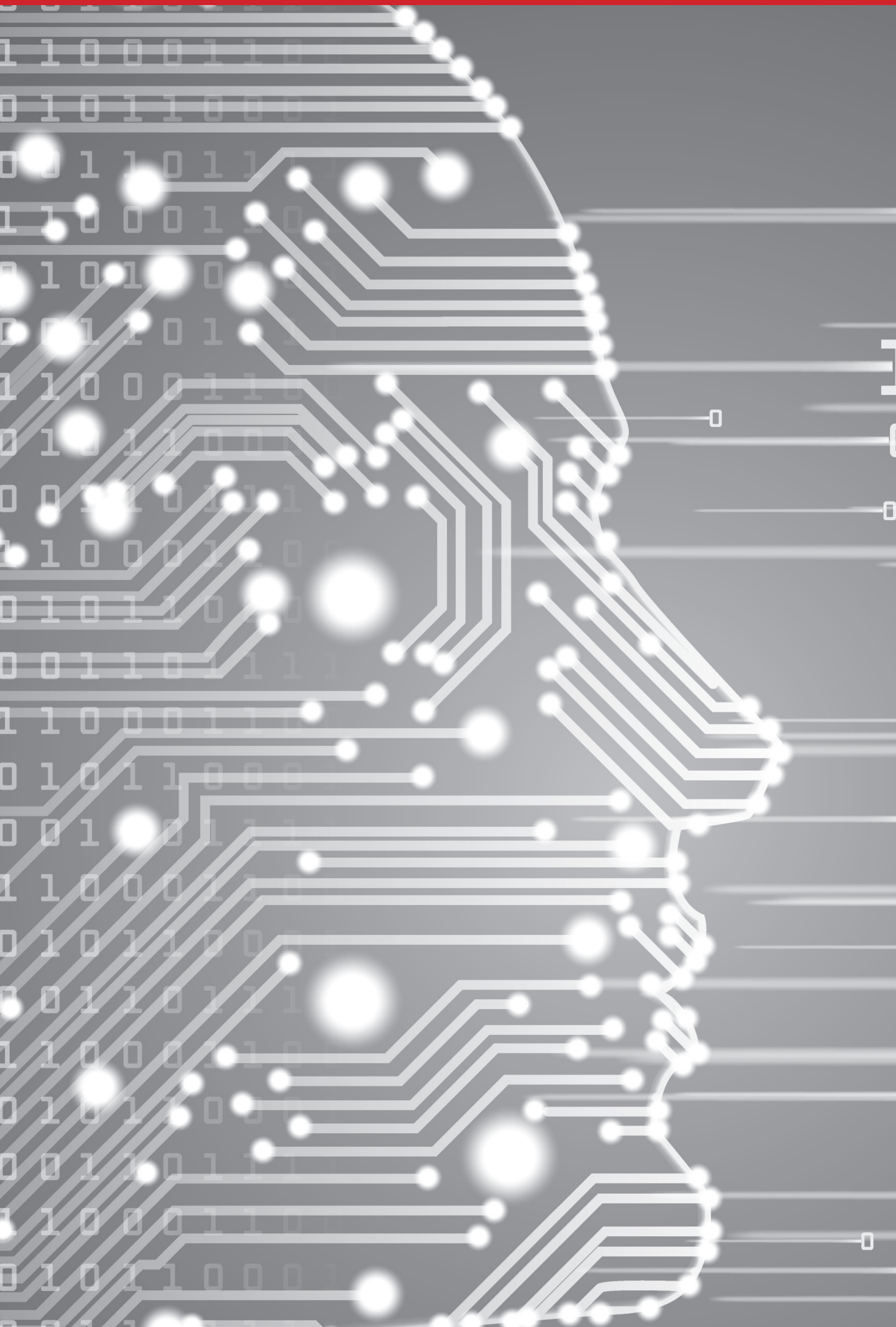

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From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

A belated happy New Year. January 1, 2023, began my fourth year as AIRA's Executive Director. One thing for which I am especially grateful is the collegiality and support received every day by the membership, AIRA's Board of Directors, and me from the staff at AIRA. On February 1, Michele Michael, AIRA's Director of Membership Service, completed 13 years with AIRA. On March 1, Cheryl Campbell, Conference Director, is celebrating 10 years. March 17, 2014, was both St. Patrick's Day and the day Mike Stull, Education and IT Director, began working with AIRA. Thank you, Michele, Cheryl, and Mike for your continuing efforts.

Mid-January is the time for AIRA to collaborate with New York Institute of Credit (NYIC) to provide our collective memberships with what is arguably the first educational program of the year. This program also benefits the **Grant Newton Educational Endowment Fund**. On January 19th AIRA/NYIC conducted two virtual sessions, ***"I've Been Appointed to Take Control of a Crypto Enterprise – What Do I Need to Know?"*** and ***"Litigation Funding."*** While there have been many sessions on matters related to digital assets, the uniqueness of the *"I've Been Appointed"* program is the practical guidance conveyed by **Ken Ehrler**, **Jason Nagi**, and **Erik Weinick**, focusing on what you need to know about operations and financial controls should you find yourself responsible for one of these digital entities. The *"Litigation Funding"* presentation conducted by **Sheryl Giugliano**, **Charlie Campbell**, **Joel Cohen**, and **Connor Murphy of Burford Capital**, provided an update on this area of financial resource furthering discussion that many recently viewed on a recent broadcast of CBS's *60 Minutes*.

In January, AIRA's Board approved, effective April 1, 2023, an increase to both membership fees and CIRA/CDBV program fees. AIRA has endeavored to maintain the costs of membership and programs: The last time AIRA adjusted fees was in 2015 for CIRA/CDBV programs and 2020 for membership. For more information on the increases and renewing or registering before they take effect, please see https://aira.org/aira/alerts.

2023 portends to be a busy year for AIRA. As detailed in David Payne's accompanying letter, the AIRA Board has commenced a strategic planning process. AIRA has also joined the Bankruptcy Diversity, Equity, and Inclusion Consortium organized to act as a repository of opportunities and resources for the member organizations' efforts to promote diversity, equity, and inclusion and facilitate opportunities for current and future bankruptcy practitioners. Be sure to read David's discussion of these two important developments on p. 5.

A few final points as we roll into March:

ABI has opened registration for ABI/AIRA's 2023 VALCON program. After many consecutive years in Las Vegas, ABI/AIRA are hosting VALCON 2023 at the Ritz-Carlton New Orleans on May 1-3. Please see https://www.abi.org/hybrid/conference/valcon23/page for additional details.

Planning is almost complete for **AIRA's 39th Annual Bankruptcy & Restructuring Conference.** We are returning to Newport Beach, CA to **VEA Newport Beach, A Marriott Resort & Spa,** on **June 7-10, 2023**. Cheryl Campbell plans to have registration open on or about March 1, 2023. I look forward to seeing many of you in California.

Finally, while so much of our communication today is digital, there are occasions where AIRA's physical address is important. Please note in your contact directories that effective January 1, 2023 AIRA's address changed. While we are still headquartered in the beautiful Rogue Valley city of Medford, OR, AIRA's street address is now 1314 Center Drive, Unit B-132, Medford, OR 97501. This address is for mail, package and express delivery by USPS, UPS, FedEx, or others.

Another informative and timely set of articles follows. Read, enjoy, learn.

Keep well.

— Jim Lukenda

A Letter from AIRA's President

DAVID R. PAYNE, CIRA, CDBV
D. R. Payne & Associates

2023 Cornerstone Year for Strategic Assessment

The leadership of our Association has identified 2023 to be a cornerstone year for assessing the organization's strategic opportunities for improvement. One of the cornerstone values of AIRA has been to provide credibility to its members in the marketplace by offering first in class education and recognized professional certifications. As the delivery of restructuring advisory services provided by our membership continues to mature and evolve, AIRA desires to remain relevant to both its cornerstone values and to its membership. Our relevancy as an organization within the restructuring community is fundamentally dependent upon assessing strengths and weakness, identifying risks and opportunities, and developing strategies for improvement. Simply stated, we will be undertaking a process that our members provide to their clients in everyday practice and applying it to ourselves as a professional organization. In furtherance of performing a comprehensive assessment of AIRA and developing a long-range strategic plan of support and service to our membership, the Board of Directors approved retention of Dynamic Change Solutions, LLC ("DCS") as consultant and strategy facilitator.

DCS has organized the strategic assessment process into phases that will be coordinated under the direction of the Strategic Planning Committee of the Board. DCS has completed its initial Planning and Framing Phase and directed a Focus Workshop at the January 2023 Board meeting. The kickoff of the Organizational Assessment Phase begins in February and will extend through our Annual Conference in Newport Beach in June. As part of the Organizational Assessment Phase, DCS will interface and gather information from seven membership/stakeholder Focus Groups. The Board will be responsible for organizing and recruiting diverse Focus Groups. Each Focus Group will have some commonality of experience: young members; senior non-Board members; attorney members, etc. DCS will also conduct a broader online membership survey. The information gathered during the February-to-May Organizational Assessment Phase will then be evaluated by the Strategic Planning Committee over the course of two days of deliberations, scheduled immediately preceding the Newport Beach Annual Conference. Following the conference, DCS will continue working with the Committee to finalize goals, tactics, priorities, and action plans into one final integrated strategic plan for presentation to the full Board at the October 2023 fall meeting. Communication of the plan to our full membership is anticipated by 2023 year end.

A preview of one of the goals and objectives of the strategic plan is to promote diversity and broaden inclusion/participation in both AIRA and within the restructuring community. To this end AIRA has been approved to participate in the Bankruptcy Diversity, Equity, and Inclusion Consortium ("Consortium") which is currently comprised of ten professional organizations and the executive office for the U.S. Trustees. The Consortium has been recently organized to act as a repository of opportunities and resources for the member organizations' efforts to promote diversity, equity and inclusion, and to facilitate opportunities for current and future bankruptcy practitioners. Member organizations include ABI, ABA – Business Bankruptcy, ACB, ACT 12, NABT, NACTT, NACBA, NAFER, NCBJ, EO-UST, and now AIRA.

— David Payne

A BANKRUPTCY GIANT'S SWAN SONG: JUDGE DRAIN EXPANDS THE LOOKBACK PERIOD FOR AVOIDANCE ACTIONS AND CALLS ON CONGRESS TO CURTAIL THE SAFE HARBOR EXCEPTION

BENJAMIN MINTZ and JUSTIN IMPERATO
Arnold & Porter

In the final written opinion of his illustrious career, Judge Robert D. Drain of the United States Bankruptcy Court for the Southern District of New York issued a decision in *Halperin v. Morgan Stanley Investment Management, Inc. (In re Tops Holding II Corporation)*[1] that imposes greater risk on targets of fraudulent transfer claims. This article analyzes the *Tops Holding* decision and its go-forward impact.

Introduction

The Bankruptcy Code provides mechanisms for trustees to avoid and recover certain transfers made by debtors before bankruptcy. These avoidance powers are subject to certain limitations. One limitation is the statutory lookback period during which purportedly fraudulent transfers can be avoided. Generally, the lookback period is two years for fraudulent transfer avoidance actions brought under Bankruptcy Code section 548 and four or six years if the trustee employs state law through Bankruptcy Code section 544. Following a recent trend among some bankruptcy courts, Judge Drain applied a ten-year lookback period, relying on the IRS's applicable statute of limitations, thereby allowing a fraudulent transfer claim to be asserted in respect of a transaction ten years before the petition date.

Another limitation on a trustee's avoidance powers is the safe harbor contained in Bankruptcy Code section 546(e) (the "Safe Harbor Provision"), which precludes the avoidance of: (i) a "settlement payment" or a transfer "in connection with a securities contract"; (ii) made by or to (or for the benefit of) a "financial institution." Because qualifying transactions are shielded from avoidance, the questions of: (i) what qualifies as a transfer made "in connection with a securities contract" or as a "settlement payment"; and (ii) who meets the statutory definition of a "financial institution" have been the subject of much litigation in recent years, resulting in a safe harbor that some critics say is now so broad that it swallows a trustee's general avoidance powers. Indeed, in *Tops Holding*, not only did Judge Drain hold that the dividend payments at issue were not safe-harbored, he directly called for Congress to narrow the Safe Harbor Provision's applicability.

Tops' and Tops Holding's Background

Notwithstanding its continually increasing liabilities and lackluster operating revenues, Tops II Holding Corporation ("Tops") paid dividends to a group of private investors (the "Investor Group") in 2009, 2010, 2012 and 2013 totaling $375 million (the "Dividend Payments"). On February 21, 2018, Tops and its affiliated debtors filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. On November 9, 2018, the bankruptcy court confirmed Tops' Chapter 11 plan. The trustee for the litigation trust established under the plan (the "Litigation Trustee") subsequently sued the former equity investors to avoid the Dividend Payments as actual and constructive fraudulent transfers under New York Debtor and Creditor Law (the "DCL") and Bankruptcy Code section 544(b). The Investor Group moved to dismiss the fraudulent transfer claims, asserting, among other defenses, that the Litigation Trustee's claims with respect to the 2009 and 2010 Dividend Payments were time-barred and that the Dividend Payments were safe harbored. Neither defense prevailed.

Extending the Lookback Period to Ten Years to Bring Avoidance Actions

Bankruptcy Code section 544(b) allows a trustee to step into the shoes of any creditor holding an allowed unsecured claim to avoid a prepetition transfer made by the debtor, provided the transfer is voidable under ***applicable law***. Voidable "under applicable law" generally means state law, and state law generally provides that avoidance actions are time-barred unless brought within four or six years of the time the transfer was made.

In contrast, the federal government is generally not limited by state statutes of limitations, including those in state fraudulent transfer laws, based on the doctrine *nullum tempus occurrit regi* ("no time runs against the king").[2] Indeed, the Internal Revenue

[1] Case No. 18-22279 (RDD), Adv. Pro. No. 20-08950, 2022 WL 6827457 (Bankr. S.D.N.Y. Oct. 12, 2022) ("*Tops Holding*").

[2] This doctrine was justified in modern times by the policy that revenues should not be forfeited due to the negligence of public officials.

Code (IRC) provides that the IRS may collect a tax assessment within ten years of the assessment in question.[3] In recent years, parties seeking to avoid purportedly fraudulent transfers made outside the typical four or six year lookback period generally provided for under state law have argued that "applicable law," as used in Bankruptcy Code section 544(b), incorporates the IRC and estate representatives are therefore entitled to utilize the ten-year lookback period in the IRC.

In *Tops Holding*, the Litigation Trustee's fraudulent transfer claims were timely with respect to the Dividend Payments made in 2012 and 2013: *i.e.*, Dividend Payments in those years were within the applicable six-year lookback period, but untimely with respect to the Dividend Payments made in 2009 and 2010. To defeat the statute of limitations defenses, the Litigation Trustee asserted in the complaint that "[u]nder Section 544(b) of the Bankruptcy Code, the Trustee may avoid any transfer . . . that is voidable under applicable non-bankruptcy law by any creditor holding an unsecured, allowable claim [and that] [c]reditors of Tops exist who could avoid the 2009 [and 2010] Dividend[s] under applicable law, including the Internal Revenue Service."

Judge Drain held that the estate is afforded the ten-year lookback period when bringing fraudulent transfer claims under the DCL through Bankruptcy Code section 544(b) where the IRS is an unsecured creditor of the debtor's estate and was a creditor at the time of the targeted transaction. In such instances, the IRS's claim held at the time of the bankruptcy filing need not be identical to the one held at the time of the purportedly fraudulent transfer.[4] Since the IRS is typically a creditor of many corporate entities, this ruling has broad ramifications. Even where the IRS is not a creditor, *Tops Holding*'s reasoning paves the way for estate representatives to utilize the longer lookback period afforded to other federal governmental departments that may be creditors of a debtor.[5] However, in order to proceed on a constructive fraudulent transfer claim, the plaintiff will need to show that the debtor was insolvent at the time of the relevant transaction, which will presumably be a more difficult burden the longer that time has passed since the transaction. Yet the Litigation Trustee in *Tops Holding* was able to overcome this burden.[6]

[3] *See* 28 U.S.C. § 6502(a).

[4] *See Silverman v. Sound Around, Inc. (In re Allou Distribs.)*, 392 B.R. 24, 34 (Bankr. E.D.N.Y. 2008) (holding that to satisfy the standing requirements of Bankruptcy Code section 544(b), "a triggering creditor must be the same creditor on both the Transfer Date and the Petition Date, but need not hold the same claim at these two essential points in time.").

[5] For example, the Securities and Exchange Commission is entitled to a six-year lookback period under 28 U.S.C. §§ 2415(a) and 2416.

[6] The Court noted that the fact that a business actually survived for a considerable period of time after a challenged transfer is a factor that a court may consider in deciding whether the business was insolvent or had unreasonably low capital at the time of the transfer. However, the Court further noted, it is only one of many factors that may be relevant, it is not necessarily controlling, and courts should also consider the company's debt to equity ratio, its historical capital cushion, the need for working capital in the specific industry at issue, and all reasonably anticipated sources of operating funds, which may include new equity infusions, cash from operations, or cash from secured or unsecured loans over the relevant time period. The Court concluded that "unreasonably small capital" for purposes of analyzing whether a constructively fraudulent transfer occurred "is not limited to a train wreck that is imminent because the engineer has fallen asleep; it can also be found where a key support for a trestle has rotted, no one is performing maintenance, and eventually the bridge will collapse." *Tops Holding*, 2022 WL 6827457, at *18.

As noted, Judge Drain's decision follows the recent trend of bankruptcy courts, which have applied the IRS ten-year statute of limitations to fraudulent transfer claims.[7] Some courts, however, have reached the contrary result and held that trustees are not afforded the ability to step into the IRS's shoes to benefit from the ten-year look back period.[8]

Judge Drain Calls for Congress to Curtail the Safe Harbor Provision's Applicability

In *Tops Holding*, the investor defendants also argued that the Dividend Payments were exempt from avoidance under the Safe Harbor Provision because (a) they were transfers made in connection with a securities contract, *i.e.*, there were private notes offerings that were "securities contracts," and the Dividend Payments, funded by the proceeds from the notes offerings, were transfers "in connection with" those notes offerings and (b) the Dividend Payments were transfers by a "financial institution" because they were made by Tops through its bank to the investors' banks, which were acting as either Tops' or the investors' agents or custodians and were therefore the parties' "financial institutions."[9]

In analyzing whether the Dividend Payments were transfers "in connection with a securities contract," the Court rejected the notion that it should analyze the notes offerings and the Dividend Payments together as an "integrated transaction." Instead, the Court held that, even though the notes offerings were "securities contracts," it should not look beyond the specific transfer sought to be avoided by the Litigation Trustee in deciding whether such transfer was safe harbored.[10] Accordingly, the Court looked at the Dividend Payments in isolation and held that, since such payments were not payments to settle a "securities contract," they were not safe harbored transfers.

Judge Drain's ruling on this issue is significant in two respects. First, the rejection of the "integrated transaction" analysis in determining whether a transfer is "in connection with a securities contract" is arguably at odds with other decisions issued from within the Southern District of New York concerning the Safe Harbor Provision.[11] Second, albeit implicitly, the decision may be read by some to alter the statutory language of the Safe Harbor Provision, changing the requirement that a transfer be "in connection with a securities contract" to say that the transfer

[7] *See, e.g., Maxus Liquidating Trust v. YPF S.A. (In re Maxus Energy Corp.),* 641 B.R. 467, 545–546 (Bankr. D. Del. 2022); *Williamson v. Smith (In re Smith)*, Adv. Pro. No. 22-07002, 2022 WL 1814415, at *4–7 (Bankr. D. Kan. June 2, 2022); *In re Webster*, 629 B.R. 654 (Bankr. N.D. Ga. 2021).

[8] *See, e.g.*, *In re Mirant Corp.,* 675 F.3d 530 (5th Cir. 2012) (declining to afford the trustee use of the six-year lookback period provided for in the Fair Debt Collection Practice Act); *In re Vaughan*, 498 B.R. 297 (Bankr. D.N.M. 2013) (declining to afford the trustee use of the IRS ten-year lookback period).

[9] *See* 11 U.S.C. § 101(22)(A) (defining a "financial institution" as banks and the customers of such banks when the banks are acting as the customers' agents or custodians).

[10] *See Merit Mgmt. Group, LP v. FTI Consulting, Inc.*, 138 S. Ct. 883 (2018) ("*Merit*"). *Merit* directed lower courts to examine the "overarching transfer that the trustee seeks to avoid."

[11] *See In re Boston Generating LLC*, 617 B.R. 442 (Bankr. S.D.N.Y. 2020), *aff'd sub nom. Holliday v. Credit Suisse Sec. (USA) LLC*, No. 20 Civ. 5404, 2021 WL 4150523 (S.D.N.Y. Sep. 13, 2021); *SunEdison Litig. Trust v. Seller Note, LLC*, 620 B.R. 505 (Bankr. S.D.N.Y. 2020); *In re Nine West LBO Sec. Litig.*, 482 F. Supp.3d 187 (S.D.N.Y. 2020).

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must be "in completion of [or to finalize or to settle] a securities contract."

Moreover, the Court utilized a restrictive approach to interpret whether an entity qualifies as a "financial institution" as a result of being a "financial institution's" customer. The Court held that the investor defendants had not identified an agency or custody agreement between (a) a "financial institution" and (b) either Tops or the Investor Group. In arguing the presence of a custodial relationship, the investors produced flow of funds memoranda showing the flow of funds from one of the book-running managers into Tops' bank account and thereafter from Tops to one of the investors' bank accounts. The Court held, however, that this was insufficient and the flow of funds memoranda were merely evidence of a creditor-debtor relationship, rather than agent-principal.

Perhaps most significantly, and recognizing the differing interpretations of the Safe Harbor Provision, Judge Drain called on Congress to curtail the Safe Harbor Provision's application:

> As this is my last opinion before retiring from the bench, perhaps I can be indulged in asking, why Congress has put the courts to all this parsing and hair splitting over . . . [what qualifies as a safe harbored transaction]. After all, at issue here is a transaction whereby, after encumbering a privately held company's assets with privately issued debt, a handful of sophisticated private equity investors took massive dividends that, as asserted by the Complaint, left the pension plans of thousands of workers and hundreds of creditors holding the bag. Only the veracity of that last assertion – that is, whether Tops was insolvent or rendered insolvent by the dividends – not whether the dividends are safe harbored, should be at issue. **The avoidance of these dividends and the loans that funded them would have *no* effect on the public securities markets, the ostensible purpose for section 546(e)**. On the other hand, . . . [g]iven the importance of fraudulent transfer law in bankruptcy cases, Congress should act to restrict to public transactions its currently overly broad free pass in section 546(e) that has informed the playbook of private loan and equity participants to loot privately held companies to the detriment of their non-insider creditors with effective impunity.[12]

* * * * *

The defendants have appealed *Tops Holding* to the district court, so there will likely be further notable developments on these issues.

[12] *Tops Holding*, 2022 WL 6827457, at *30 (internal citations and quotations omitted) (emphasis in original).

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An Invitation from the AIRA Journal Editorial Board

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@bakertilly.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/journal. To inquire about placing an ad or press release in the *AIRA Journal* contact Cheryl Campbell, ccampbell@aira.org.


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HARNESSING THE POWER OF BIG DATA IN LITIGATION

JORGE GALLARDO-GARCÍA, BENJAMIN SCHER and DAVID BARTH
Bates White

With the digital transformation, the amount of data available in litigation matters has grown dramatically in scope and volume.

A data set containing a million records was considered significant just a decade ago. Now it is commonplace to have data sets with billions of records.

This increase is not surprising. Companies are collecting and analyzing all the data they can get their hands on. Vendors that track and sell data are seemingly everywhere. Government entities are making large public data sets available. This explosion of available data has affected litigation, production, and the parties involved in disputes.

Data—when analyzed correctly and explained effectively—have always provided a valuable way to find objective insights in litigation matters, answer key liability and damages questions, and support critical discovery efforts.

The growth in the volume, scope, and utility of available data is transforming the way data are analyzed, and it requires new technological tools. Those tools can be used to harness big data, pull insights from it, and ultimately help inform case strategy based on information and insights the data provide.

Simple tools like spreadsheets are not equipped to handle the volume of data now available in litigation matters. The need to derive insights from litigation data in a timely way has rendered even "large data tools" from years past suboptimal and often unworkable.

New tools, including Hadoop, Spark, Databricks, and high-performance computing, are now available to manage and analyze today's big data in litigation matters.[1] How do those tools change the approach to analyzing data for litigation?

Big Data Tools for Different Types of Data Processing

At their core, these new technologies take advantage of a concept known as parallel processing. Parallel processing did not start with the big data tools discussed here, but these new tools have taken it to unprecedented levels. The basic idea is that, rather than running a long process from start to finish linearly, the process is broken into multiple components that are then run simultaneously.

Imagine you have 1 billion transactional records of the sales of a product, and you want to see how each transaction price compares to a benchmark price. Using standard tools, the first record would be compared to the benchmark, then the second record would be compared to the benchmark, then the third, the fourth—linearly to the billionth. Not surprisingly, even on advanced servers, these types of processes can often take quite some time.

With big data tools that utilize parallel processing, the process can instead work as follows. First, a billion records are broken up, for example, into 100 groups of 10 million each. Then the comparison to the benchmark is run on each of the 100 groups simultaneously. Since the 100 groups are analyzed in parallel, the task can be accomplished roughly 100 times faster.

Instead of taking a couple of weeks, the analysis can be done in a couple of hours. In the context of tight litigation timelines, this time savings can be critical.

There are three key benefits of using big data tools in litigation matters.

More Analyses in the Same Amount of Time

Litigation is inherently deadline oriented. Big data technologies can accomplish analyses in a fraction of the time it would have taken without them.

Whether attempting to perform complex computations on large data sets prior to a report submission or evaluating large amounts of information prior to the close of discovery, big data tools may allow for the previously impossible to be accomplished within tight time frames.

Better-Informed Decisions

The time saved in processing data enables better insights and conclusions than are possible with more limited computing resources. If an analysis is done earlier, there is more time to think through the results, to run different scenarios, to identify different possibilities, and to adjust strategy.

Cost Efficiencies

By speeding up the analytical process, using big data tools can save money. The time gained in running the data can be used for other aspects of the case or just saved altogether by obtaining

[1] Hadoop is an open-source framework used to efficiently store and process large data sets ranging in size from gigabytes to petabytes of data; instead of using one large computer to store and process the data, Hadoop allows clustering multiple computers to analyze massive data sets in parallel more quickly. Spark is another open-source unified analytics engine for large-scale data processing that provides an interface for programming clusters with implicit data parallelism and fault tolerance. Databricks is a big data processing platform that provides a just-in-time cloud-based platform for big data processing.

similar answers but in less time. That is, more can be done in less time, or the same analysis can be done for less.

In other words, using big data tools can improve the quality of the work and the reliability of the analysis and can result in cost efficiencies.

But big data has also opened the door to other important considerations.

Points to Consider with Big Data

Deciding Whether to Use a New Data Tool

Big data tools are not self-aware. They cannot tell us if they should be used or not. For each situation, it's important to determine the best approach, given the problem and the available data. The matter may, in fact, dictate that analyzing a statistically representative sample of data is a better approach than using a new data tool.

For instance, in litigation over price-fixing with billions of transactional records of the sales of a product available, there may be two approaches for comparing them to a benchmark price. One option could be to use big data tools and calculate the difference for each of the billion records.

A different option is to draw a random sample from the billion records to perform the analysis. Big data tools make the choice easier in some cases: If the data are electronic and of uniform quality, and one has the means to use all the data, then using all the data is both feasible and efficient.

The resulting analysis will be more precise, more reliable, and even less expensive. Also, if there isn't a need to design, implement or interpret a sample, that can free up budget and allow more time to analyze the results in greater detail.

Sampling may be an appropriate solution if, for instance, the information is only available in handwritten notes in hard copies stored at various locations. In such instances, collecting all this information and converting it into a database could take a long time and be cost prohibitive.

For such a circumstance, a representative sample could be drawn, collected, analyzed and extrapolated to estimate the results for the full population. The key, of course, is to have a sample design that will be representative of the population and useful to answer the question at hand.

Sampling can be appropriate even when the data are entirely electronic. Although big data tools have increased the amount of data that can be analyzed, they are not limitless, and some data sets are too big even for these modern tools. In this case, one can use a sample of millions of observations instead of billions or trillions.

In some cases, data may be widely distributed and even when possessed by a small number of firms, enormously large, even by the standards of big data. In litigation matters involving credit card transactions or social media postings, there can be billions of records.

For example, in the U.S. in 2020 alone, there were 124 billion transactions on certain credit cards and debit cards[2] spread across 11 million merchants.[3] There were 1.93 billion daily average users of Facebook in December 2021.[4] If that number held throughout the year, and if each daily active user created on average five posts, comments or likes per day, there would have been 3.5 trillion such interactions in 2021.

It may not be practical to collect information on all card transactions or all Facebook interactions for analysis; but even when possible, the benefits of collecting, storing and analyzing all the data may be outweighed by the costs. The best approach in such situations could be to review data in a properly chosen sample.

Considering Nuances of the Data

No machine or technology can answer certain questions about data, such as how they were compiled and whether they are useful for a particular analytical question.

In many instances, a company may collect data as part of the normal course of business with one purpose in mind. Although the data can be very useful for that purpose, those data may need to be audited and supplemented to become useful to answer the question posed in litigation.

Or the data may not be relevant enough for the question at hand. Knowing what is in the data—and conversely knowing what is not in the data—is critical because not accounting for those factors can result in erroneous conclusions no matter how much data there is or what data tool is used.

For example, in False Claims Act litigation with Medicare and other health data, there may be concerns about publicly disclosing personally identifiable or protected health information. As a result, many health care databases mask or exclude infrequent events, such as medical diagnoses of a rare disease.

Then, for instance, not taking a rare medical condition into account for the analysis can cause the prevalence of certain conditions computed from the available data to be incorrect and misleading. The province of the data can determine how it affects the analysis.

Avoiding Distorted Results

Outliers and erroneous data values can bias conclusions and significantly skew results. With a small data set, potential outliers and apparent errors may be visually perused and individually evaluated in a relatively straightforward manner. However, with big data, outliers and apparent errors can easily number in the thousands or even millions.

For example, in a data set of 1 billion records, 1 million records would represent just 0.1% of the data. Visually perusing or individually evaluating 1 million records is likely not feasible, so

[2] Board of Governors of the Federal Reserve System, "Federal Research Payments Study," updated Jan. 14, 2022, www.federalreserve.gov/paymentsystems/december-2021-findings-from-the-federalreserve-payments-study.htm.

[3] Alexandria White, "99% of Merchants in the U.S. Who Accept Credit Cards Now Take American Express," CNBC, updated Oct. 19, 2021, www.cnbc.com/select/american-express-merchant-acceptance/.

[4] Meta Platforms, Inc., FY 2021 Form 10-K for year ending December 31, 2021 (filed February 3, 2022), 57, www.sec.gov/ix?doc=/Archives/edgar/data/1326801/000132680122000018/fb-20211231.htm.

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more sophisticated and complex procedures are necessary to properly evaluate such records.

With relatively small data sets—such as monthly pricing data spanning a few years—key points can be easily illustrated. A basic line chart showing the month-to-month change in prices may be sufficient to show trends or patterns.

In contrast, determining the key visual to identify and subsequently depict the pattern of interest is much more challenging when the data include millions of daily transactions across geographies, products and customer types. In such situations, all the relevant permutations of the available information need to be taken into account.

Conclusion

Modern technology can be used to harness the power of big data in litigation matters; what would have been unworkable just a few years ago today is readily achievable now. Attorneys need to make sure they understand what data should be collected and what the right tools are to analyze them for accurate and timely results.

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DEBT RESTRUCTURING INVOLVING CONTINGENT VALUE RIGHTS

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Introduction

In an increasingly challenging economic environment, many companies are restructuring their existing debt obligations. Some companies are presented with the opportunity to retire, or partially satisfy their outstanding debt obligation in exchange for a contingent value right (CVR). These CVRs are most often used in debt restructurings when parties have difficulty valuing the underlying business or assets to which the right is tied.

Where a debt instrument is retired in whole or in part for the issuance of a CVR, there may be cancellation of indebtedness income (CODI), the tax treatment of which is not entirely clear. Typically, CODI would be equal to the excess, if any, of the adjusted issue price of the retired debt over the fair market value of the CVR. As discussed below, given the inherent difficulty in valuing CVRs, this calculation can be challenging.

Contingent Value Rights

CVRs are generally understood to refer to cash payments that are contingent upon the occurrence of specified events, but they can also provide for payment in the form of stock or securities. CVRs can either be issued in the form of a non-assignable contract right or a tradeable instrument that can be sold on the open market. Traditionally, payment under a CVR is contingent upon completion of a defined milestone, such as: successful litigation, tax refunds, meeting financial performance metrics, or regulatory approval (*i.e.*, FDA approval).

The appropriate tax treatment of a CVR is somewhat unclear under the Tax Code; accordingly, a case-by-case analysis is usually in order. While there is no controlling authority on characterization, a CVR potentially could be treated as debt, property right, or equity for U.S. federal tax purposes.

While not always the case, CVRs generally do not bear stated interest, are non-transferable, and are not registered with the SEC. Moreover, CVRs typically do not provide liquidation rights, nor do they carry voting rights. As such, most CVRs would not appear properly characterized as stock or equity. Likewise, traditional CVRs arguably do not constitute debt under general federal tax principles, because there is no obligation to pay a sum certain at a fixed maturity date along with a percentage of interest. *See e.g., Gilbert v. Commissioner*, 248 F.2d 399, 402 (2d Cir. 1957). For these reasons, it would seem that traditional CVRs are most akin to that of a contractual property right (as opposed to debt or equity).

Cancellation of Debt

As mentioned above, in general, where a debt is retired in exchange for new debt, equity, or property (or a mix) and the adjusted issue price of the debt exchanged exceeds the issue price or value of what is received, there is CODI. CODI is either currently recognized or is subject to exclusion, for example, under the bankruptcy or insolvency exclusions set forth in section 108 of the Internal Revenue Code. To the extent an exclusion applies, the debtor entity generally must reduce its tax attributes (which may include tax basis in assets) in the order and amount specified in section 108(b).

<u>Example:</u> A solvent Debtor Corporation has $100x of debt outstanding with Creditor. Debtor then retires the debt with Creditor for a new debt instrument with an issue price of $60x. Thus, Debtor has CODI of $40x.

Exchange for CVR

The federal tax treatment of an exchange of debt for a CVR is somewhat more complex. Generally, taxpayers can report their debt exchange transactions using the closed transaction method, or in rare and unusual circumstances, the open transaction method. Using the closed transaction method, the taxpayer would take CODI into account in the tax year the exchange took place. Whereas, using the open transaction method, the taxpayer would take CODI into account in the tax year the CVR payments were actually made.

<u>Example</u>: A solvent Debtor Corporation has $100x of debt outstanding with Creditor. In Year 1, Debtor retires the $100x of debt with Creditor in exchange for a CVR, which the parties valued at $40x at the time of the exchange. In Year 3, under the terms of the CVR, it actually pays out $50x and the CVR is extinguished.

On its face, and based on the valuation, Debtor would appear to have $60x CODI in Year 1 (the difference between the amount of the debt and the apparent fair market value of the CVR upon the exchange). Assuming Debtor reports it as such, what then happens when the CVR pays out the $50x in Year 3 – that is, what happens when it pays out $10X more than what the CVR was initially valued at (arguably overstating CODI in Year 1)?

One approach, under the closed transaction method, might be to apply the “relation back” doctrine of *Arrowsmith*. *See Arrowsmith v. Commissioner*, 344 U.S. 6 (1952). Under this approach, viewing the underlying debt as having initially been written down to $40x, would generally mean that the eventual retirement of the debt for $50x would be considered a repurchase premium and potentially generate a $10x interest deduction under Treas. Reg. Sec. 1.162-7(c).

On the other hand, some might take the view that open-transaction reporting is justified, due to the inherent difficulty of pinpointing a value for the CVR in Year 1. In such a case, no CODI would be reported in Year 1. Instead, the CODI calculation would take place in Year 3, when the CVR is ultimately paid out, resulting in $50x of CODI.

Ultimately, open-transaction reporting may benefit or hurt a taxpayer depending upon their solvency or insolvency as of the CODI event. Notably, however, Treasury and IRS generally frown upon open transaction reporting, limiting it to "rare and unusual circumstances." *See* Treas. Reg. Sec. 1.1001-1(g)(2)(ii). Therefore, parties probably should be ready for a challenge if they decide to apply the open transaction method.

Conclusion

While there are no definitive answers, when dealing with CVRs in the context of potential debt cancellation, taxpayers need to understand the potential tax impacts of these arrangements. As the law is currently unsettled, taxpayers may have some flexibility in choosing an approach that may be beneficial to them.

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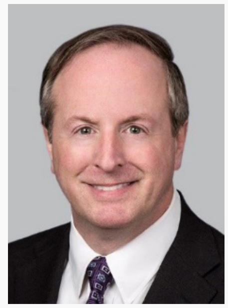

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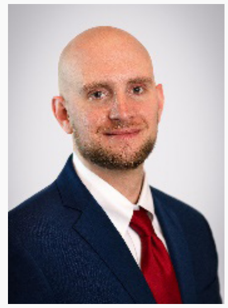

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WHEN IS CRYPTO CUSTOMER PROPERTY? A Cryptographic Analysis

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The devastating effects of the 2008 Great Recession on economic output, employment, household wealth and homeownership were a principal driver for the development of a technology "that's fully peer-to-peer, with no trusted third party."[1] This concept caught on in an environment where public sentiment assigned much of the economic devastation to the centralized nature (banks, investment banks, central banks, regulators) of our financial system and the resulting exposure to lapses in judgment of those in charge of such a centralized system. Indeed, an invention that promised financial decentralization sounded like an appealing innovation to avoid another 4-sigma event with its epicenter in the financial system.

While the promise of decentralization materialized on the supply side of many cryptocurrencies (supply became generally algorithm-driven and decentralized),[2] it fell (quite substantially) short in the transactional realm in which both fiat and crypto currencies spend their lives after issuance. In fact, we will see that several practical factors coalesced to make the crypto system more centralized and riskier than the traditional regulated financial architecture.

Three years ago, in the wake of the first insolvencies of blockchain firms, I wrote an article[3] focused on two sets of unique unknowns facing any such insolvencies, namely:

1) Will crypto custodians qualify for reorganization under Chapter 11 (*i.e.*, they will not be deemed to have been required to register as securities firms, banks, or commodities brokers, or any other business ineligible for Chapter 11 reorganization)? No bankruptcy court having presided over any of the substantial cases filed in 2022 ruled that the filing business was ineligible for Chapter 11 reorganization or that the insolvency should be governed by an ad-hoc regime; and

2) What type of assets are cryptocurrencies? The answer is asset-specific and has not been settled. While some (albeit very few) cryptocurrencies meet the formal definition of currency (means of payment, unit of account, store of value), others behave more like securities, especially in the cases where businesses finance themselves through the issuance of "coins." A third broad category encompasses "utility tokens," which can be used to pay for goods or services provided, generally, by the issuer.

While three years ago my questions were interesting, and maybe even prescient, they failed to address the elephant in the room: **are an insolvent's blockchain exchange assets the property of their customers or of the bankruptcy estate?**[4] Part of the reason I failed to address the nature of the relationship between a crypto exchange and its customers is that exchanges were not something that were contemplated in the cryptocurrency universe, since the original value proposition for cryptocurrencies was their decentralized nature. Yet without exchanges, cryptocurrency miners cannot readily convert their mining rewards, which are paid in cryptocurrency, into fiat currency, which they must do to cover their capital and operating expenditures.

Also, cryptocurrency investors have been drawn to transact through exchanges for several reasons, including transactional ease, avoidance of fees for transactions between wallets, access to additional income-generating products (*e.g.*, lending and staking ventures), and concerns about losing their credentials. Crypto exchanges address each of these concerns by offering hosted wallets that put the customer's private keys in the custody of the exchange.[5] **The nature of the assignment of the private keys from customer to exchange is a key factor in determining the nature of the relationship between a customer and their insolvent crypto exchange**.

To deliver all that utility to the crypto investor, a crypto exchange needs to be a lot more than just a trading venue. To be sure, crypto exchanges do function at least in part as centralized marketplaces by matching buyers and sellers with each other based on their bids and asks without the buyers ever having to know the sellers or vice-versa.[6] In addition to allowing their customers to contract their trades, crypto exchanges also facilitate the execution of those trades.[7] Finally, crypto exchanges layer on a clearing function by accepting and processing the

[1] Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System," https://bitcoin.org/bitcoin.pdf. Accessed January 2023.

[2] For example, BTC are created each time a user discovers a new block. The rate of block creation is adjusted every 2016 blocks to aim for a constant two-week adjustment period (equivalent to 6 per hour). The number of BTC generated per block is set to decrease geometrically, with a 50% reduction every 210,000 blocks, or approximately four years. The result is that the number of bitcoins in existence will not exceed slightly less than 21 million.

[3] Carlos A. Abadi, "Q: What Happens When a Blockchain Company Fails in the US? A: A Nightmare," October 20, 2019, https://decisionboundaries.com/q-what-happens-when-a-blockchain-company-fails-in-the-us-a-a-nightmare-2/.

[4] My two-prong analysis focused on the nature of cryptocurrencies and the availability of Chapter 11 reorganization for its custodians had missed this critical question in my 2019 article.

[5] In fact, holding crypto in one's unhosted wallet strengthens property rights over the assets but is as transactionally awkward as holding cash in a safe deposit box.

[6] In this sense, crypto exchanges function much like NASDAQ, the OTC government and corporate bond markets, and other regulated exchanges that allow customers to contract trades.

[7] In this respect, crypto exchanges layer the function of a broker dealer on top of that of a trading venue.

actual payments for the transactions contracted for on their matching platform and executed on the customers' behalf. While the matching, execution, and clearing functions are regulated in the context of traditional financial services, crypto exchanges perform all three functions unburdened by any regulation except for AML compliance.[8,9] The net effect is that ***crypto exchanges operate as unregulated securities or commodities brokerages that hold customer funds***.

Thus unconstrained, crypto exchanges have every incentive (and indeed, in many cases, the contractual right) to transfer the customers' cryptocurrency to a single omnibus account for which the crypto exchange alone holds private key, with the customer's interest then tracked solely on the exchange's books and records, rather than on the blockchain.[10] From the perspective of miners who validate blockchain transactions, the exchange is fully within its rights to use its customers' private keys to trade their crypto assets: an individual is authorized to transact a unit of cryptocurrency if (and only if) they can present a cryptographic proof that they possess the corresponding private key. That is, by giving up their private keys, an exchange's customers effectively relinquish ownership of their assets. Any limits on the exchange's rights to transact customers' cryptocurrency must be explicitly established in a contract between customers and the exchange.

Therefore, the crypto paradox is that an asset that was invented in part to eliminate the credit risk inherent to the legacy financial system ended up amplifying that credit risk by relying on unregulated intermediaries that aggregate the functions of securities exchanges, broker dealers and clearing firms without any of their inherent protections (such as net capital rules and customer protection rules). Indeed, unburdened by regulation, crypto exchanges have a serious moral hazard problem: they have every incentive to engage in risky behavior because the (lawful) commingling of funds affords them the upside from their risky ventures, while the downside is externalized on their customers.[11]

The most significant novel issue to have been recently adjudicated was Judge Martin Glenn's January 4, 2022, decision[12] that customer deposits in Celsius' Earn Program[13] constituted property of the bankruptcy estate and not customer property. In reaching this decision, the Court determined that the terms of use to which customers agreed when opening Earn accounts constituted a binding contract between customers and Celsius. Because customers agreed in those terms of use that they were transferring ownership of cryptocurrency assets in the Earn accounts to Celsius, when Celsius filed for chapter 11, those assets became property of the bankruptcy estate.

But, in my view, the most interesting decisions associated with insolvencies of crypto exchanges are going to be those dealing with any parallel criminal cases.

In fact, while the lack of consumer protections in cryptocurrency markets is strikingly at odds with regulations in other markets, it is surprisingly well-aligned with the overall ethos of decentralized finance. Bitcoin and its progeny are built upon a model in which blockchain users have no need to *trust* that regulators will behave faithfully – instead, users have the ability (but also the responsibility) to *verify* the validity of transactions on their own. This explains why the first crypto exchanges (just like the mining ventures of the Wild West) could have emerged even without accompanying consumer protection laws. The lack of consumer protection regulation is a feature, not a bug of the crypto ecosystem. This "Don't trust, verify" ethos should also inform the law about purportedly fraudulent representations.

In fact, the blockchain offered its adopters an environment where they are protected from deletion, tampering, and revision and where every process, every task, and every payment contain a digital record and signature that can be identified, validated, stored, and shared. This environment renders trust redundant, and intermediaries like lawyers, brokers, and bankers no longer necessary. Most significantly, the blockchain negates (as was its original post-2008 Great Recession aim) the need for trusted intermediaries (including crypto exchanges) and reduces any representations made by such redundant intermediaries to the level of commercial puffery.

In particular, SBF's indictment[14] was filed with studied lack of specificity but the allegation that SBF "misappropriate[d] billions of dollars of customer funds deposited with FTX, the international cryptocurrency exchange founded by [SBF], and

[8] Because they have custody of customer assets, securities laws and regulations require clearing firms to maintain higher levels of net capital than pure execution firms and, critically, the segregation of customer funds and securities in their custody from their own.

[9] In the absence of explicit customer protections (*e.g.*, customer protection rule, net capital rule), we have implicitly been protecting the broad investing public by barring the legacy financial system from the crypto space. The result is that, while investors in crypto enjoy little to no protection, the traditional (and bigger by orders of magnitude) financial markets (and their customers) are shielded from losses in the crypto space.

[10] Additionally, similarly to the regulated securities industry, exchanges acquire property rights over crypto assets hypothecated pursuant to leverage and staking products.

[11] Crypto investors are protected by anti-fraud statutes only insofar as fraud happens. However, given the lack of regulation, crypto exchanges and their principals need not rely on fraud to fund risky investments with what crypto investors reflexively perceive as their property. Exchange-friendly and/or ambiguous terms of service are often enough to lawfully shift investment risk from the exchanges to customers.

[12] *Memorandum Opinion and Order Regarding Ownership of Earn Account Assets, In re Celsius Network LLC*, Case No 22-10964(MG) (Bankr. S.D.N.Y. Jan. 4, 2022) [ECF No. 1822].

[13] Celsius's flagship "Earn Program" enabled customers to deposit crypto assets in an online account, which Celsius would then intermingle with other customers' assets and collectively deploy to generate revenue.

[14] Sam Bankman-Fried ("SBF") is the former CEO of FTX.com was indicted in December 2022 on charges including conspiracy to commit wire fraud, wire fraud, conspiracy to commit commodities fraud, conspiracy to commit securities fraud.

Continued from p.17

misled investors and lenders to FTX and to Alameda Research, the cryptocurrency hedge fund also founded by [SBF]"[15] appears challenging to prove in the context of:

1) The crypto investing public's systematic rejection of trusted intermediaries as redundant, if not harmful;

2) The voluntary contracting of hosted wallets by FTX's customers and their conveyance of private keys to FTX; and

3) A specific representation/disclaimer concerning the comingling of accounts.[16]

To make crypto exchange prosecutions such as the one targeting SBF more challenging, the only property rights crypto investors can conceivably hold are their private keys. Should those private keys be conveyed to a crypto exchange in return for transaction facilitation, improved economics, financial leverage, or other utility, the crypto exchange customer holds a mere contract right and not a property right and fraud charges associated with the use of the cryptocurrency for the benefit of the crypto exchange and its principals become as challenging to prove as a constructive trust on those assets in bankruptcy.

[15] DOJ, U.S. Attorney's Office SDNY, *Press Release*, Dec. 13, 2022, https://www.justice.gov/usao-sdny/pr/united-states-attorney-announces-charges-against-ftx-founder-samuel-bankman-fried.

[16] "Your balances in your FTX.US Account are not segregated, and cryptocurrency or cash are held in shared addresses or accounts, as applicable" –FTX.US TOS, 05/20/2020.

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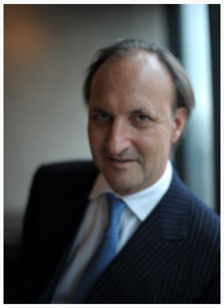

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A MISAPPLICATION OF THE VENTURE CAPITAL METHOD

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Province

A recent valuation of the common stock of an early-stage Artificial Intelligence (AI) venture for purposes of Section 409(A) compliance[1] "concluded" and used a 23% cost of capital (*i.e.*, discount rate). As the basis for the concluded 23% cost of capital, the valuation team proffered a menu of discount rates that venture capital (VC) investors apply based on an entity's stage of development. These discount rates ranged from 50% to 100% for a Start-up entity, from 40% to 60% for an Early-Development entity, from 30% to 50% for an Expansion-stage entity, and from 20% to 35% for a Bridge / pre-IPO stage entity. The authors of the 409(A) valuation failed to provide support, however, for the assumptions underlying their concluded cost of capital other than by general reference to a Harvard Business School Background Note on the "venture capital method written by Sahlman and Scherlis in 1987."[2]

The Venture Capital Method Revisited

The Venture Capital Method is "a method for valuing high-risk, long-term investments such as those confronting venture capitalists."[3] The method entails forecasting a future value (*e.g.* a terminal value five years out) and discounting that terminal value back to the present by applying a high discount rate (*e.g.*, 50%).[4]

The VC method entails the following steps:

1) Project the entity's net income for some terminal year, say five years from the present. "The estimate of net income is typically based on a "success scenario," that is, one in which the company attains its sales and margin projections."[5]
2) Determine a Price-to-Earnings ratio (P/E ratio) appropriate for a company that has achieved the measure of success implicit in the forecasted income. Often, this P/E ratio is estimated by analyzing current multiples for companies with similar economic characteristics (*e.g.*, size, profitability, growth rate, capital intensity, risk).[6]
3) Calculate the company's projected terminal value ("TV") as the product of the projected net income and the estimated P/E ratio.
4) Convert the company's TV to present value ("PV")"by applying a very high discount rate, typically between 35% and 80% per year."[7]
5) Calculate the percentage ownership that a venture capitalist should demand if asked to invest in the company today.[8]

A variation of the VC method – the First Chicago Method – considers not only the projected "success scenario," but also a sideways scenario and a failure scenario. It assigns probabilities to each of these outcomes and uses the expected (probability-weighted) net income for the terminal period. Since the First Chicago Method adjusts for net income risk in the terminal year, it would be redundant to penalize it again by employing a high discount rate such as the 35% to 80% per year discount rates used by VC investors.[9]

Why Do VC Investors Apply High Discount Rates in Valuing Target Investments?

Venture capital investors apply discount rates ranging from 20% to 70% to assess contemplated investments at various stages of venture's development.[10] These discount rates reflect not only the riskiness of investing in an earlier stage of a venture, but also adjust for the level of services typically provided by VC Investors to a venture in a specific stage of development. Specifically, in the ***seed-financing stage***, VC investors provide business advice, and often even facilities for the entrepreneurs. VC investors apply a discount rate of over 80% to such early-stage ventures.[11] Investors in the ***startup-financing*** stage who frequently assist

[1] The US Congress passed the American Jobs Creation Act creating Section 409A of the Internal Revenue Code (Section 409A) in 2004 in response to a perceived abuse of deferred compensation arrangements. The text of 26 U.S. Code § 409A - *Inclusion in gross income of deferred compensation under nonqualified deferred compensation plans*, is available at https://www.law.cornell.edu/uscode/text/26/409A. A stock option grant that is "inadvertently granted with an exercise price that is less than the grant date fair market value (FMV) likely will fail to comply with Section 409A." DLA Piper, "Section 409A Valuations." Available at https://www.dlapiperaccelerate.com/knowledge/2020/section-409a-valuations.html. Accessed January 2023.

[2] William A. Sahlman and Daniel R. Scherlis, "A Method for Valuing High-Risk, Long-Term Investments: The 'Venture Capital Method,'" Harvard Business School Background Note 288-006, 1987.

[3] Sahlman and Scherlis (1987).

[4] *Ibid*.

[5] William A. Sahlman, "A Method for Valuing High-Risk, Long-Term Investments: The 'Venture Capital Method,'" Harvard Business School Background Note 288-006, revised Oct. 1, 2009, 1.

[6] Sahlman (2009), 1.

[7] *Ibid*.

[8] Sahlman (2009), 1. "If that total [present] value is $4 million, to illustrate, and a venture capitalist is being asked to invest $2 million, then he or she will demand 50% of the value of the company, or one-half of the shares."

[9] Sahlman (2009), Appendix 3 and 48-50.

[10] Sahlman (2009), 6-7. Sahlman also discusses "Restart Financing," also known as Emergency or Sustaining financing. Such financing is raised for a troubled firm typically at a price significantly below that of the previous round. As a result, previous investors that do not participate in the restart financing are diluted of their ownership in the venture (Sahlman (2009), 7).

[11] Sahlman (2009), 6-7.

management to recruit key personnel, to establish sound management practices or help with access to suppliers, bankers and potential customers, apply a 50% to 70% discount rate.[12]

First-stage VC investors monitor headcount and ensure staffing levels correspond to attainable sales levels. They become more actively involved as problems arise in production or sales and are prepared to replace key managers as necessary, including filling in key positions themselves while searching for new managers. Thus, VC investors apply a 40% to 60% discount rate when analyzing potential first-stage-financing ventures.[13] ***Second-stage*** investors do not expect to become involved in problem solving as often as earlier-stage investors. Investors in this stage monitor performance closely by comparison to a business plan. The discount rate they apply to second-stage ventures is 30% to 50%.[14] Investors in the ***bridge-financing*** stage are typically passive investors who apply a 20% to 35% discount rate to assess contemplated investments.[15]

Note that the 20% to 70% discount rates discussed above are *ex-ante* rates applied by VC investors. The *ex-post* rates or the annual nominal returns realized on venture capital investments average to 13.9% based on a study of deals from 1986 to 2002.[16] Why do VC investors continue to apply the same high (20% to 70%) *ex ante* rates when their *ex post* realized rates are much lower?

To explain the high discount rates VC investors use, we could decompose total risk into systematic (*i.e*. market-related) and non-systematic (or non-market risk). The uncertainty of whether a new technology, product or service offering will work or can be commercialized is one example of the high non-systematic risks VC investors face. Since unsystematic risk can be diversified away, investors can expect no extra return for bearing unsystematic risk.[17] While the systematic risk of a new venture is high, the systematic risk alone cannot be used to justify very high discount rates.[18] Similarly, an illiquidity premium alone cannot justify the 50-80% discount rates applied by venture capitalists.[19]

Another explanation is that VC investors apply higher hurdle rates to compensate the VC general partners who add value and services to the target venture. "In the case of the typical venture capital firm, the compensation takes the form of a 20% override on the portfolio given to the general partners. Holding all other things constant, the return required on any given investment must be grossed up to reflect the compensation to the venture capital managers. Thus, if the required return on the investment were 20%, then the venture capital fund with a 20% override would have to demand 25% in order to have the limited partners attain their required 20% net return."[20]

To recap, the high systematic risk faced by the VC investor, the little opportunity to liquidate the holdings for an extended period of time, and the value-added supplied by the VC general partners in addition to the capital they invest, help to explain the high average long-term VC portfolio required rate of return. However, there still remains a wide gap between the average long-term venture capital portfolio return of 13.9% and the usual discount rate, generally 50%, applied to a first-round investment.[21]

Yet another explanation for the wide gap between the discount rates applied *ex-ante* and the *ex-post* returns VC investors realize is the expectation-adjustment or the "cash flow adjustment":

> If the VC, who expects a 27% return, applies a 50% rate in order to derive the appropriate ownership, he is implicitly asserting that the forecasted terminal value is not the terminal value he really expects. Since the VC knows what his own investment is, if he is applying a higher than expected discount rate, he must be expecting the actual terminal value to be lower than forecasted.[22]

Furthermore, another explanation for the higher discount rates VC investors apply *ex-ante* could be the VC investors' position of greater bargaining power.

> VCs probably do not apply the discount rates they use based on careful historical analysis of distributions of returns…The successful venture capitalists are those who have demanded rates high enough to compensate for a

[12] *Ibid.*

[13] *Ibid.*

[14] *Ibid.*

[15] Sahlman (2009), 7. "Bridge Financing is intended to carry a company until its Initial Public Offering ("IPO")."

[16] *See* Ibbotson Associates, VentureXpert, Datastream, and COMEX data. Summarized in Sahlman (2009), 7.

[17] Sahlman (2009), 7.

[18] Sahlman applies the capital asset pricing model ("CAPM") to represent the stock's expected return ("ER") as:

*ER= Risk-free rate + Beta * Market-Risk Premium*

Then a 50% expected rate of return (as used by VC investors), a 4% risk-free rate, and an estimated market risk premium of 6%, would yield a Beta = 7.67x.

(Note that solving the ER equation above for Beta, yields: Beta = (Expected Return – Risk-free rate) / (Market Risk Premium) = (50% - 4%) / 6% = 7.667%). Sahlman also observes that "among S&P 500 stocks, only 1 had a beta over 4.0 and only 10 had a beta between 3.0 and 4.0. Even if the correct beta estimate were 4.0, then the required rate of return would be 28%, not 50%." *See* Sahlman (2009), 10 and Exhibits 5, 6, and 7.

[19] "There are many potential investors for whom illiquidity, per se, is not a major issue. A good example is a pension fund, which can afford to invest in projects that have long payback periods and are illiquid before harvest. If a very large discount were applied to illiquid investments, then investors like pension funds would increase the allocation of assets to such opportunities, driving up the prices paid and lowering the discount. This process of market equilibration will likely result in justifiable liquidity premiums that are not nearly large enough to justify 50-80% discount rates." *See* Sahlman (2009), 10-11.

[20] "The extra return required or expected to compensate for value added need not necessarily bear a direct relationship to the size of the equity override. This is so because in certain cases, the value added may be very large and in other cases small, regardless of the overall size of the equity override." *See* Sahlman, (2009), 10-11.

[21] *See* Ibbotson Associates, VentureXpert, Datastream, and COMEX data, summarized in Sahlman (2009), 7. *Also see* Sahlman (2009), 11-12.

[22] Sahlman (2009), 12. Mathematically and for the general case with no interim returns and a Terminal Value ("TV") N-years out, the present value (or the VC's initial investment) equals:

PV = Forecasted TV / [(1+VC Discount Rate)^N] =Expected TV / [(1+VC Expected Rate of Return)^N]

Then the ratio Expected to Forecasted TV can be expressed as:

Expected TV / Forecasted TV = [(1+VC Expected Rate of Return)^N] / [(1+VC Discount Rate)^N]

To illustrate, a VC expecting a 27% rate of return on an investment with no intermediate returns and a terminal value in year five, who applies a 50% discount rate, expects terminal value that is less than half the forecasted TV.

PV = Forecasted TV / (1+50%)^5 = Expected TV / (1+27%)^5

which can be expressed as:

Expected TV / Forecasted TV = [(1+27%)^5] / [(1+50%)^5]

Expected TV / Forecasted TV = 3.303837 / 7.59375 = 0.435073

*Expected TV = 0.435073 * Forecasted TV (i.e., Expected TV is less than half the Forecasted TV) or vice versa*

*Forecasted TV = Expected TV / 0.435073 = Expected TV * 2.298464 (i.e., forecasted TV is more than twice the expected TV).*

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venture's likely performance shortfall relative to forecast, but not so high as to force the managers of too many potential investments to seek alternate funding.[23]

While the explanations or factors discussed above provide rationale as to why VCs use high discount rates in valuing their target investments, it is not possible to segregate the incremental effect of each explanation in the discount rate a VC investor chose to apply. Thus, using a menu of discount rates, historically used by VC investors, in a valuation engagement and without analyzing the specific factors at play in that valuation, could subject that valuation to measurement errors and biases such as high systematic risk faced by the VC investor, little opportunity to liquidate the holdings for an extended period of time, value-added supplied by the VC general partners, VC's expectation adjustment for the probability that forecasted revenue and cash flows will not materialize to their fullest expectation, and compensation for the VC general partners built into the discount rate.

Possible Applications and Misuses of the Venture Capital Method

Under the right set of conditions, the VC method could offer an alternative method[24] for determining the cost of equity to be used in the valuation of a high-risk long-term investment, such as a start-up or a first-stage or second stage privately held company. Those conditions are:

- First, the VC method assumes that the discount rates VC investors would apply are known or knowable. This condition is hard to satisfy unless data available in the specific valuation attests to the VC's required rate of return for their investment in that specific target-valuation entity.
- Second, substituting the VC's discount rate for the cost of equity (in the weighted average cost of capital of the target-valuation entity) implicitly assumes that all equity investors have equal level of active involvement in the management of the enterprise and have homogeneous assessments of the entity's expected outcomes such as success, sideways or failure realizations. This second condition – equal participation in the management of the venture and homogeneous expectations of the venture's cash flows and necessary probability adjustments thereto – could be satisfied by using a blended rate of the discount rates used by VC investors in prior stages of the venture's financing. Nevertheless, it might still be challenging to adjust the discount rates from previous rounds of financings for the various levels of involvement in the management of the entity by various earlier groups of VC investors in the target entity.

In light of the above strict conditions for applying the VC method, simply referencing a menu of discount rates VC investors used historically on other target ventures appears inadequate. The valuation professional should analyze how specific factors – such as the systematic risk faced by the VC investor, the investment's liquidity, the level of value-added supplied by the VC general partners, the VC's expectation adjustment for the probability that forecasted revenue and cash flows will not materialize to their fullest expectation, and compensation for the VC general partners built into the discount rate – affect the specific target-valuation entity riskiness and the corresponding discount rate. Only after such analysis and appropriate adjustments, using VC method discount rates could be appropriate.

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23 Sahlman (2009), 12.

24 Note that due to the uniqueness of the product or service offering, the early-stages venture might have little to no direct publicly traded comparable companies that could be used to calibrate its cost of capital or Price-Earnings Ratios.

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WHAT LEGAL COUNSEL NEED TO KNOW ABOUT BANKRUPTCY-RELATED PROPERTY APPRAISAL BEST PRACTICES

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Introduction

There is a debate as to whether the U.S. economy has entered—or will enter—a recession. In any event, many industrial and commercial entities are experiencing the financial impact of higher interest rates on business debt, ongoing supply chain disruptions, continuing labor shortages, and inflationary price increases related to both materials and supplies. For all of these reasons, many business entity managements are considering the consequences of a bankruptcy filing, particularly of a Chapter 11 reorganization filing. The typical expectation of these management deliberations is that the Chapter 11 filing would allow the entity to emerge from the bankruptcy proceeding with a reorganized capital structure and lower-cost operating structure.

Legal counsel understand that property appraisals are a common element in many bankruptcy proceedings. Therefore, this may be an appropriate time to consider a review of bankruptcy-related property appraisal best practices.

There are many reasons why legal counsel would retain—and work with—an appraiser to value debtor entity property within a bankruptcy environment. While the focus of this discussion is on property appraisal, there are also many reasons why counsel would retain—and work with—an appraiser to develop a property damages analysis or a property transfer price analysis within a bankruptcy environment.

Before the appraiser is retained, the party-in-interest to the bankruptcy and that party's legal counsel should carefully define the property appraisal assignment. Based on that assignment definition, the appraiser, the client, and the counsel can all agree on the objectives and the scope of the property appraisal.

This discussion summarizes what legal counsel need to know about the generally accepted property appraisal approaches and methods that appraisers typically consider in a bankruptcy-related assignment. This discussion also summarizes what legal counsel need to know about the property appraisal synthesis and conclusion process.

Due to the litigious nature of a bankruptcy proceeding, bankruptcy-related property appraisals are often subject to a rigorous contrarian review. Therefore, this discussion considers the best practices related to the attributes of an effective (*i.e.*, persuasive) bankruptcy-related property appraisal report.

A Property Appraisal

First, let's define the term "property" within the context of this discussion. Second, let's define the term "appraisal" within the context of this discussion.

For purposes of this discussion, let's define the term "property" within a bankruptcy context. Unfortunately, the U.S. Bankruptcy Code does not define either the term "property" or the term "asset." For purposes of this discussion, "property" is a legal term and "asset" is an accounting term. In general conversation, and even in appraisal-related conversation, these two terms are often used as synonyms. However, counsel understand that they do not mean exactly the same thing. Not all types of property are considered to be assets. And, not all types of assets are considered to be property.

Black's Law Dictionary defines property as follows:

1. Collectively, the rights in a valued resource such as land, chattel, or an intangible. It is common to describe property as a "bundle of rights." These rights include the rights to possess and use, the right to exclude, and the right to transfer.
2. Any external thing over which the rights of possession, use, and enjoyment are exercised.[1]

Typically, in order for something to be considered property, there should be an identified bundle of legal rights (including the legal right to transfer) associated with it.

While the term property has a legal definition, the term "assets" has an accounting definition. The term assets is generally defined by reference to the Financial Accounting Standards Board Statement of Concepts No. 8, *Conceptual Concepts for Financial Reporting* ("CON8").

According to CON8, "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." CON8 also states, "An asset is a present right of an entity to an economic benefit." In addition, CON8 continues as follows:

> An asset has the following two essential characteristics:
>
> (a) It is a present right.
>
> (b) The right is to an economic benefit.

Both the legal definition of property and the accounting definition of assets focus on the concept of a bundle of rights. The result of something being considered to be property is

[1] *Black's Law Dictionary*, 10th edition (Thomson Reuters, 2014).

that the property rights can be legally protected. The result of something being considered to be an asset is that it is recognized on an entity's balance sheet prepared in accordance with U.S. generally accepted accounting principles ("GAAP").

However, not all legally protected property is recognized on a GAAP balance sheet. And, not all assets recorded on a GAAP balance sheet are legally protected property.

This discussion focuses on the concept of property within a bankruptcy context. However, this discussion recognizes that (rightly or wrongly) the term assets is frequently used within the bankruptcy context.

This discussion will adopt the definition of "appraisal" provided in the *Uniform Standards of Professional Appraisal Practice* ("USPAP"). USPAP defines appraisal as, "(noun) the act or process of developing an opinion of value; an opinion of value; (adjective) of or pertaining to appraising and related functions such as appraisal practice or appraisal services."[2]

This USPAP definition of the term "appraisal" is applicable to most bankruptcy-related issues. Unfortunately, the U.S. Bankruptcy Code does not provide a definition of the term "value"—or of any particular standard of value. In other words, the U.S. Bankruptcy Code does not define fair value, fair market value, market value, or any other standard (or definition) of value. And, the Bankruptcy Code does not inform us as to which standard of value is relevant to which type of bankruptcy question.

Types of Property

This discussion is generally applicable to most categories of debtor entity property that may become an issue in a bankruptcy proceeding. Specifically, this discussion encompasses the following categories of debtor entity property:

1. Real estate and real property
2. Tangible personal property
3. Intangible personal property

For purposes of this discussion, the real estate property category includes the tangible elements of land and the structures affixed to land, including, for example, the following:

1. Land
2. Land improvements
3. Buildings and building components

For purposes of this discussion, the real property category includes the intangible elements of real estate, including, for example, the following:

1. Lessor and lessee interests
2. Easements and rights of way
3. Air, water, and subsurface rights

For purposes of this discussion, tangible personal property includes, for example, the following property categories:

1. Office furniture and fixtures
2. Manufacturing machinery and equipment
3. Processing machinery and equipment
4. Trucks and automobiles
5. Computers and information technology equipment

For purposes of this discussion, intangible personal property includes, for example, the following property categories:

1. Identifiable intangible assets
2. Intellectual property
3. Personal and institutional (business) goodwill

Counsel understand that the U.S. Bankruptcy Code does not include trademarks or trade names within its definition of intellectual property. However, for purposes of this discussion, the term intellectual property is intended to include all of the following categories: trademarks and trade names, patents, copyrights, and trade secrets.

Unless specifically noted, most of the following discussion applies to each of the above-listed categories of debtor entity property.

The Bankruptcy Appraisal Assignment

A statement of the purpose and the objective of the appraisal is a best practice at the outset of any bankruptcy-related appraisal assignment.

Such a statement requires the appraiser, the client, and legal counsel to carefully think through all of the so-called elements of the valuation assignment. Such a statement also mitigates the possibility of any misunderstandings about the bankruptcy-related appraisal assignment.

Whether tangible property or intangible property is the subject of the appraisal, it is a best practice to consider all of the elements of the assignment. When parties need to know the value of property that is either owned by or operated by a debtor entity, the party-in-interest to the bankruptcy—and that party's counsel—should carefully define the elements of the appraisal.

Bankruptcy law seeks to preserve the on-going value of—and to maximize the economic stake of—the creditors to the debtor entity. Typically, in the bankruptcy proceeding, contracts, leases, and licenses can be assumed, rejected, or assigned. This fact may complicate the appraisal when the debtor in possession ("DIP") is either a property lessor/licensor or a property lessee/licensee.

For example, let's assume that the debtor entity is an intangible property licensor and that the license may be assignable by the bankruptcy estate to the licensor's competitor. In that case, the appraiser may have to consider whether the intangible property appraisal should be based on the expectation that the licensor is required to continue to support (*e.g.*, make improvements to) the intangible property (even if it is in the hands of a competitor).

Defining the assignment is a first best practice in the property appraisal process. This definition may influence many of the appraiser's considerations and procedures. The assignment definition may influence many of the decisions to be made in the appraisal. The time spent by the appraiser, the client, and the legal counsel to define the purpose and the objective of the appraisal assignment is time well spent.

There are many possible clients for a bankruptcy-related appraisal assignment. This is because there are typically many parties-in-

[2] 2020-2022 *Uniform Standards of Professional Appraisal Practice* (The Appraisal Foundation, 2022).

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interest to a commercial bankruptcy. These various parties may include the debtor entity, the debtor entity directors, a court-appointed bankruptcy trustee, the individual secured creditors, a secured creditors committee, an unsecured creditors committee, the individual contract counterparties (*e.g.*, a labor union), and the debtor entity equity holders.

Each of these parties may have an interest in some valuation (or damages or transfer price) aspect of the commercial bankruptcy proceeding.

Regardless of who the client is, the appraisal assignment is typically provided by the client's counsel to the appraiser. The appraisal assignment should describe the objective of the appraisal by considering these elements of the appraisal:

1. Definition of the subject property
2. Description of the ownership characteristics subject to appraisal
3. Decision of the appropriate bundle of legal rights
4. Decision of the appropriate standard of value
5. Decision of the appropriate premise of value
6. Specification of the "as of" valuation date

Before these elements are defined, the purpose of the appraisal assignment should be agreed to. That is, the elements of the appraisal assignment may also be influenced by the stated purpose of the appraisal. The purpose of the appraisal assignment should describe:

1. why the property appraisal is being prepared; and
2. who may (and may not) rely on the property value conclusions.

The Bankruptcy Appraisal Purpose

There are many reasons why counsel may retain an appraiser to value the debtor entity property within a bankruptcy context. For this purpose, the subject property can include both:

1. the property owned by the debtor entity; and
2. the property operated by the debtor entity (including inbound and outbound leases and licenses).

The property could serve as collateral for either the debtor entity's pre-bankruptcy financing or the DIP financing. A debtor property sale or license could serve to generate needed cash flow to the financially troubled DIP.

Counsel may ask the appraiser to opine on the fairness of the consideration or terms of a property sale, lease, or license. Counsel may ask the appraiser to opine on the impact of an assignment or a rejection of a lease or a license. Counsel may ask the appraiser to assess this transactional fairness to the creditors or to other parties-in-interest.

The property value often affects the debtor entity solvency (or insolvency) at various dates prior to the bankruptcy filing.

These debtor entity solvency issues become relevant with regard to allegations of fraudulent conveyance or preference payments. Such solvency issues also may be relevant when the pre-filing debtor entity is operating within the so-called zone of insolvency.

The debtor entity property commercialization potential (or the associated spin-off opportunities) could affect the reasonableness of a proposed plan of reorganization. And, the fair value of the property may be recognized in the fresh start accounting when the reorganized debtor entity emerges from bankruptcy.

Under GAAP, the fresh start accounting fair value measurement guidance is provided in the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 852.

Legal counsel are often involved in the bankruptcy-related property appraisal. This is because counsel are involved in assisting the party-in-interest client in structuring transactions, complying with taxation and accounting requirements, negotiating and arranging financings, litigating claims, and defending and commercializing the debtor entity property.

Within a bankruptcy context, counsel may become involved in the process of:

1. identifying the debtor entity property;
2. performing the related due diligence procedures;
3. interviewing and selecting the appropriate appraiser;
4. defining the appraiser's assignment;
5. helping to assemble valuation-related data and documents;
6. providing legal instructions to the appraiser;
7. reviewing and challenging the property appraisal work product;
8. interpreting and relying on the property appraisal report; and
9. defending the appraiser—and the value conclusions—during any administrative, regulatory, or judicial proceeding.

The appraiser may sometimes value the debtor entity property in a bankruptcy proceeding without advice from, or assistance by, legal counsel. However, due to the special nature of the bankruptcy-related engagement, the appraiser and counsel will often work closely in several phases of the bankruptcy-related appraisal.

The following list summarizes some of the many reasons why an appraiser may be retained to value debtor entity property in a bankruptcy environment. Such assignments may come directly from a party-in-interest to the bankruptcy. However, such assignments typically come from counsel to one of the parties.

1. Transaction pricing and structuring
    - Pricing the sale of a DIP's individual property or of a portfolio of two or more properties
    - Pricing the license of the DIP's individual property or of a portfolio of two or more properties
    - Valuing the equity allocations in a DIP joint venture when one or more parties contributes property
    - Valuing the property distributions in a debtor entity liquidation when one or more parties receives distributed properties

- Transferring a property between a parent company's subsidiaries (when one subsidiary has filed for bankruptcy protection and another subsidiary has not filed for bankruptcy protection)

2. Financings collateralization and securitization
   - Use of the property as collateral for cash-flow-based or asset-based pre-bankruptcy debt financings
   - Sale/leaseback financing of the (pre-bankruptcy) debtor entity property
3. Taxation planning and compliance
   - Effect of the property value on the Internal Revenue Code Section 382 limitation on the debtor entity's use of a net operating loss
   - Effect of the property value on the Section 108 discharge of indebtedness income exclusion related to the debtor entity amount of insolvency
4. Adequate consideration for DIP transactions
   - Use of debtor entity property as collateral for a secured creditor's position
   - Use of debtor entity property as collateral for a new secured financing for the DIP
   - Fairness of the sale or lease of property as a DIP cash generation spin-off opportunity
   - Use of the property in the assessment of the debtor entity's solvency or insolvency with respect to alleged fraudulent transfers and preference actions
   - Impact of the debtor entity property on the reasonableness of a proposed plan the reorganization
5. Financial accounting and fair value measurement
   - The impairment testing and fair value measurement of the debtor entity's tangible property, intangible property, and goodwill
   - Post-bankruptcy fresh start accounting for the tangible assets and intangible assets of the reorganized debtor entity emerging from bankruptcy
6. Debtor entity strategic planning and management information
   - Formation of a DIP property joint venture, joint development agreement, or joint commercialization agreement
   - Negotiation of a DIP inbound or outbound property use, development, commercialization, or exploitation agreement, lease, or license
   - Identification and negotiation of a DIP property license, spin-off, joint venture, and other commercialization opportunity
7. Other bankruptcy considerations
   - Prosecution or defense of secured creditor claims that the debtor entity property collateral had "inconsequential value"
   - Assessment of the impact on the DIP's decision to reject property inbound/outbound lease or license agreements
   - Assessment of the impact on a counterparty of the DIP's decision to reject property inbound/outbound lease or license agreements

Defining the purpose of the assignment may influence the form or the format of the property appraisal work product. The appraisal report can be oral, written, or a combination of the two. The appraisal report should be prepared for a specified purpose and for a specified audience.

The property appraisal should consider all of the appraisal approaches and methods that are relevant for the intended audience. And, the appraisal report should include all of the information appropriate to the intended audience.

The assignment should describe the purpose of the appraisal. And, that assignment purpose should consider the following elements of the appraisal:

1. How will the property appraisal be used?
2. Who will rely on (or receive a copy of) the appraisal report?
3. What form and format of appraisal report is appropriate?
4. Are there any legal instructions (*e.g.*, specific statutory definitions, judicial precedent, or reporting requirements) that the appraiser should consider?

In addition to understanding the reason for developing the property appraisal, it is a best practice for the appraiser to understand exactly what the appraisal objective is. The client or the counsel should specifically define which of the following opinions the appraiser is being asked to render:

1. Estimate a value (as specifically defined) for the debtor entity property
2. Measure lost profits or some other damages measurement related to a tort or breach of contract related to the debtor entity property
3. Conclude an arm's-length price for the intercompany transfer of the property
4. Estimate a fair lease or license agreement royalty rate between independent arm's-length parties
5. Conclude the fairness of a property sale, lease, license, or other transfer transaction from a financial perspective
6. Estimate the debtor entity property's useful economic life ("UEL")

The Bankruptcy Appraisal Objective

The first element of the appraisal objective is a definition of the debtor entity property. That definition should specify exactly what property is the subject of the appraisal.

This definition should describe all of the tangible property and intangible property that are included as the subject of the appraisal.

In a bankruptcy-related environment, there may be uncertainty—or controversy—as to exactly what bundle of property—and property rights—should be included with (or excluded from) the assemblage of property that is the objective of the appraisal.

For example, in the property appraisal, there may also be controversy as to whether to include future access to the future assets that are not yet in place as of the valuation date.

The second element of the appraisal objective is a description of the ownership characteristics of the property rights, including any lease, license, or contract in effect.

When a debtor entity operates within the so-called zone of insolvency, that condition may undermine the incentives for the debtor to (1) lease or license any property and (2) make investments to exploit any lease or license agreements that have already been entered into.

When a bankruptcy petition is filed and the bankruptcy stay has been entered, the debtor (either as property licensor/lessor or as property licensee/lessee) cannot pursue a breach of contract action without authorization from the bankruptcy court.

If there is a lease, license, or other agreement associated with the debtor's property, then the appraiser should be made aware of all relevant contract terms, such as the following:

1. Licensor/licensee responsibility contract terms
    - Legal protection requirements
    - Maintenance expenditures
    - Development expenditures
    - Licenses, permits, or other regulatory approvals
2. Other contract terms
    - Minimum use, production, or sales
    - Minimum marketing or commercialization expense
    - Property development payments, completion payments
    - Party responsible to obtain the required approvals
    - Milestone lease or license payments

The third element of the appraisal objective is a description of the bundle of legal rights. The assignment should specify which of the following (or which other) bundles of rights should be included in the appraisal:

1. Fee simple interest
2. Term/reversion interest
3. Licensor/licensee interest
4. Lessor/lessee interest
5. Territory (domestic/international) interest
6. Product line/industry interest
7. Sublease or sublicense rights
8. Development rights
9. Commercialization/exploitation rights

The fourth element of the appraisal objective is the standard (or the definition) of value. The standard of value typically relates to the question: Value to whom? Different standards of value often correspond to different reasons to conduct the appraisal.

The standard of value may be determined by a statutory, judicial, regulatory, or administrative requirement. Therefore, the client—or legal counsel—should instruct the appraiser as to the appropriate standard of value.

Some of the alternative standards of value that may be concluded in a debtor entity property appraisal include the following:

1. Fair value
2. Fair market value
3. Market value
4. Use value
5. User value
6. Owner value
7. Investment value
8. Acquisition value

The fifth element of the appraisal objective is the premise of value. The premise of value considers the assumed set of transactional circumstances under which the property transfer (*i.e.*, sale, lease, or license) will take place.

Some of the alternative premises of value that may be applied in a debtor entity property appraisal include the following:

1. Value in continued use
2. Value in place (but not in use)
3. Value in exchange—orderly disposition basis
4. Value in exchange—voluntary liquidation basis
5. Value in exchange—involuntary liquidation basis

The selected premise of value is typically an assignment instruction from the client (or counsel) to the appraiser. If the client—or counsel—does not instruct the appraiser as to the appropriate premise of value, then the appraiser may select the premise of value that concludes the highest and best use ("HABU") for the debtor entity property.

The tests for HABU are based on an analysis of what is physically possible, legally permissible, financially feasible, and maximally productive with regard to the subject property.

In selecting the appropriate HABU of the subject property, the appraiser may consider the following alternatives:

1. Current owner/operator HABU
2. New owner/operator (*i.e.*, market participant) HABU
3. Licensor/lessor and licensee/lessee HABU

The sixth element of the appraisal objective is the valuation date. The client (or legal counsel) will instruct the appraiser as to the appropriate "as of" date on which to conclude the defined value.

The date, or dates, as of which the property is valued may be important to the value conclusion. This is because circumstances can cause values to vary materially from one date to another, and the valuation date directly influences data available for the appraisal.

Many internal and external factors can influence property value. A sudden change in the debtor entity earnings, especially if unanticipated, can have a material effect on value. Also, the property value can vary with the debtor entity's cost of capital, a factor that can vary over time. Major events, such as the signing or the termination of a lease/license agreement, can also impact the property value.

In order to serve the information needs of the client, the appraiser should have a clear understanding of the assignment. In a bankruptcy-related assignment, counsel is typically responsible for ensuring that the appraiser develops that understanding.

Appraisal Data Gathering and Due Diligence Procedures

Before selecting and applying any of the generally accepted property appraisal approaches, methods, and procedures, the appraiser performs due diligence with respect to the debtor entity property.

Counsel may participate in this due diligence process. In particular, such counsel participation may occur if the appraisal relates to a property transaction, financing, or litigation.

These due diligence procedures relate to identifying and obtaining information for the property appraisal. The appraiser's due diligence process is a supplement to—and not a substitute for—counsel's legal due diligence process.

First, the appraiser typically gathers and analyzes information related to the current owner/operator (*i.e.*, the debtor entity). The information typically relates to the property's historical development and current use.

Such information may include the following:

1. Owner/operator historical and prospective financial statements
2. Owner/operator historical and prospective development/maintenance costs
3. Current and expected owner/operator resource/capacity constraints
4. Description and estimate of the property's economic benefits to the current owner/operator
   - Associated revenue increase (*e.g.*, related product unit price/volume, market size/position)
   - Associated expense decrease (*e.g.*, expense related to product returns, cost of goods sold; selling, general, and administrative, R&D)
   - Associated investment decrease (*e.g.*, inventory, capital expenditures)
   - Associated risk decrease (*e.g.*, the existence of a property lease, license, or other contract, decrease in the cost of capital components)

The appraiser may consider the property's market potential outside of the debtor entity. For example, the appraiser may consider the following factors from the perspective of an alternative (*e.g.*, hypothetical willing buyer/willing lessee or licensee) owner/operator:

1. Change in the market definition or in the market size for an alternative owner/user
2. Change in alternative/competitive uses for an alternative owner/user
3. The property's ability to create inbound/outbound lease or license opportunities to an alternative owner/user
4. Whether the debtor entity can operate the property and also outbound lease or license the property (in different products, different markets, different territories, etc.)

The appraiser may also review and challenge any debtor-prepared financial projections and any debtor-prepared measurements of the property's economic benefits. The appraiser may test such financial projections and economic benefit measurements against industry, guideline company, and other benchmark comparisons.

For example, the appraiser may perform the following comparative benchmark analyses:

1. Compare prior debtor entity projections to prior debtor entity actual results of operations
2. Compare current debtor management projections to the debtor's current capacity constraints
3. Compare current debtor management projections to the current total market size
4. Consider published industry average comparable profit margin data
5. Consider selected guideline publicly traded company profit margin data
6. Consider the quality and the quantity of available guideline or comparable property lease or license data
7. Perform a debtor property UEL analysis, with consideration to the following:
   - Physical life
   - Legal/statutory life
   - Contract/license life
   - Technology obsolescence life
   - Economic obsolescence life
   - Lives (*i.e.*, ages) of any prior generations of the subject property
   - Position of the subject property in its life cycle

In addition to comparing the debtor entity's historical and projected results of operations to those of selected guideline public companies (described below), the appraiser may compare the debtor entity results of operations to published industry data sources.

Generally Accepted Property Appraisal Approaches and Methods

The three generally accepted property appraisal approaches are the cost approach, the market approach, and the income approach. These appraisal approaches apply generally to real estate, to tangible personal property, and to intangible personal property.

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Appraisers typically consider, and attempt to apply, all three generally accepted property appraisal approaches in each debtor entity property appraisal. Practically, however, many industrial or commercial property appraisals are based primarily on the application of one or two of the property appraisal approaches.

For each property appraisal, the appraiser selects the generally accepted approach (or approaches):

1. for which there is the greatest quantity and quality of available data,
2. for which the appraiser can perform the most comprehensive due diligence procedures,
3. that best reflect the actual transactional negotiations of market participants in that industry,
4. that best fit the characteristics (e.g., use, age, etc.) of the debtor entity property, and
5. that are most consistent with the professional experience and informed judgment of the appraiser.

Within each property appraisal approach, there are several appraisal methods that the appraiser can select and apply. And, within each method, there are numerous appraisal procedures that the appraiser can perform. Appraisal procedures are performed within a method to conclude a value indication. The appraiser may perform two or three appraisal methods within a single appraisal approach.

For example, the appraiser may develop two different income approach appraisal methods and reconcile the two value indications in order to conclude a single income approach value indication.

The appraiser reconciles the various value indications (if more than one approach is applied). This synthesis of the various value indications results in a final value conclusion for the debtor entity property.

All of the cost approach appraisal methods are based on the principle of substitution. That is, the value of the actual property is influenced by the cost to create a substitute property.

All cost approach appraisal methods apply a comprehensive definition of cost, including consideration of an opportunity cost component during the property development stage. In addition, the cost of the substitute property should be reduced (or depreciated) in order to make the substitute property comparable to the actual property.

All market approach appraisal methods are based on the principles of (1) efficient markets and (2) supply and demand. That is, the value of the debtor entity property may be estimated by reference to prices paid in the marketplace for the arm's-length sale, lease, or license of comparable (or guideline) property. Comparable sale data are analyzed in order to extract pricing multiples or other metrics that can be applied to the debtor entity property.

All income approach appraisal methods are based on the principle of anticipation. That is, the value of any income-producing property is the present value of the income that the owner/operator expects to receive from owning or operating that property. All income approach methods involve a projection of some measure of owner/operator income over the property's expected UEL.

Such income measures may relate to:

1. the income earned from operating the property in the owner/operator business enterprise and/or
2. the income earned from leasing or licensing the property from the owner/licensor to an operator lessor/license that will pay a lease payment or a royalty (or some other fee) for the use of the property.

This income projection is converted to a present value by the use of a risk-adjusted present value discount rate (or an annuity direct capitalization rate).

Cost approach appraisal methods may be particularly applicable to the valuation of a recently developed debtor entity property. In the case of relatively new property, the debtor entity development cost and effort development data may be available (or may be subject to accurate estimation).

In addition, cost approach appraisal methods may be applicable to the appraisal of in-process property, special purpose property, or noncommercialized property.

In all cases, the counsel should understand that the debtor entity property value is not derived from the cost measure alone. Rather, the property value is derived from the cost measure (however defined) less appropriate allowances for all forms of depreciation and obsolescence.

Market approach appraisal methods may be applicable when there are a sufficient quantity of comparable (almost identical) or guideline (similar from an investment risk and expected return perspective) property transaction data. These transactions may relate to either sale, lease, or license transactions.

The appraiser attempts to extract market-derived valuation pricing indications (*e.g.*, pricing multiples or other metrics) from these comparable transaction data to apply to the corresponding metrics of the subject property.

Income approach appraisal methods may be applicable in situations where the debtor entity property is used to generate a measurable amount of income. This income can either be:

1. operating income (when the property is used in the owner's business operations) or
2. ownership income (when the property is leased or licensed from the owner/licensor to an operator/licensee) to produce rental or royalty income.

Income approach appraisal methods may be applied when the owner/operator has elected to not currently commercialize the property. An example may be when this forbearance of use is for the purpose of protecting the income that is produced by the owner/operator's other property.

For Further Reference

The following discussion summarizes the generally accepted property appraisal approaches and methods. This discussion is intended to be general and to apply to all debtor entity property categories.

There are both professional literature and valuation professional organization ("VPO") promulgated standards related to the appraisal of the individual categories of debtor entity property.

For example, for a more comprehensive discussion of real estate appraisal approaches, methods, and procedures, counsel are referred to *The Appraisal of Real Estate*, 15th edition, published by the Appraisal Institute in 2020.

For a more comprehensive discussion of tangible personal property appraisal approaches, methods, and procedures, counsel are referred to *Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets*, 4th edition, published by the American Society of Appraisers in 2020.

And, for a more comprehensive discussion of intangible personal property appraisal approaches, methods, and procedures, counsel are referred to *Guide to Intangible Asset Valuation*, revised edition, published by the American Institute of Certified Public Accountants in 2014.

Cost Approach Appraisal Methods

There are several generally accepted property appraisal methods within the cost approach. Each of the appraisal methods applies a particular definition of cost.

These definitions of cost include the following:

1. Reproduction cost new ("RPCN")
2. Replacement cost new ("RCN")
3. Historical cost or original cost ("HC" or "OC")

RPCN is the total cost, at current prices, to develop an exact duplicate of the actual property. RCN is the total cost, at current prices, to develop an asset having the same functionality or utility as the actual property.

Functionality is an engineering concept that means the ability of the property to perform the task for which it was designed. Utility is an economics concept that means the ability of the property to provide an equivalent amount of satisfaction.

Historical cost is less frequently applied in cost approach property appraisals. However, it is sometimes applied in the development of unit principle property appraisals developed for property tax purposes. And historical cost is sometimes applied in the appraisal of public utility or other regulated-industry property. Historical cost considers the cost of the subject property when it was purchased, constructed, or developed by the first owner.

In contrast, original cost considers the cost of the subject property when it was purchased, constructed, or developed by the current property owner. Historical cost considers the price paid by the very first property owner—when the property was first placed in service. Original cost considers the price paid by the current owner to the previous property owner. In a business combination (*e.g.*, a merger or acquisition transaction), the original cost may be influenced by the transaction purchase price allocation.

There are other cost definitions that may be applicable to a cost approach property appraisal. Some appraisers consider a measure of cost avoidance as a cost approach appraisal method. This appraisal method quantifies either historical or prospective costs that are avoided because the debtor entity actually owns (and does not have to lease or license) its own property.

Some appraisers consider historical cost or trended historical cost as a cost measure. In the trended historical cost method, historical development costs are identified and trended to the valuation date by an inflation-based index factor.

Regardless of the specific cost definition applied, all cost approach appraisal methods include a comprehensive definition of cost. The cost measurement (whether RCN, RPCN, or some other cost measure) typically include the following four cost components:

1. Direct costs (*e.g.*, materials)
2. Indirect costs (*e.g.*, engineering and design labor)
3. The property developer's profit (on the direct cost and indirect cost investment)
4. An opportunity cost/entrepreneurial incentive (to motivate the property development process)

The property construction or development material, labor, and overhead costs may be easy to identify and quantify. The developer's profit may be estimated using several procedures. It is often estimated as a percentage profit margin on the developer's investment in the material, labor, and overhead costs.

The entrepreneurial incentive may be measured as the lost profits during the replacement property development period. Alternatively, entrepreneurial incentive is sometimes measured as a fair rate of return on investment during the duration of the property development process.

For example, let's assume it would take two years to develop a replacement property. If the buyer buys the seller's actual property, then that buyer can start earning income (either operating income or license income) immediately.

To illustrate the concept of entrepreneurial incentive, let's consider the development (or replacement) of a property. If the property buyer "builds" its own hypothetical replacement property, then that buyer will not earn any income (operating income or license) during the two-year development period.

The two years of lost profits during the hypothetical property development period represents the opportunity cost (to the buyer) of developing a new replacement property—compared to buying the debtor entity's actual property.

All four cost components—that is, direct costs, indirect costs, developer's profit, and entrepreneurial incentive (or opportunity cost)—should be considered in the cost approach analysis. While the cost approach is a different set of analyses from the income approach, there are economic analyses included in the cost approach.

These cost approach economic analyses provide indications of both:

1. the appropriate levels of opportunity cost (if any) and
2. the appropriate amount of economic obsolescence (if any).

The current cost metric (however measured) should be adjusted for losses in value due to:

1. physical deterioration,

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2. functional obsolescence, and
3. external obsolescence.

Physical deterioration is the reduction in property value due to physical wear and tear. It is unlikely that an intangible property will experience physical deterioration. Nonetheless, this type of appraisal depreciation should be considered in every property appraisal.

Functional obsolescence is the reduction in property value due to the property's inability to perform the function (or yield the periodic utility) for which it was originally designed. The technological component of functional obsolescence is a decrease in value due to improvements in technology that make the actual property less than the ideal replacement for itself.

External obsolescence relates to a decrease in property value due to influences external to (or outside of) the subject property. There is a locational obsolescence component of external obsolescence that typically affects real estate only. The economic obsolescence component of external obsolescence is a reduction in property value due to the effects, events, or conditions that are external to—and not controlled by—the property's current use or condition.

The impact of economic obsolescence is typically beyond the control of the debtor entity.

In any cost approach analysis, the appraiser typically estimates the amounts (if any) of the property physical deterioration, functional obsolescence, and economic obsolescence. In this estimation, the appraiser typically considers the property's actual age—and its expected UEL.

Appraisers sometimes apply the following cost approach formula to quantify RCN: RPCN – curable functional obsolescence = RCN.

To estimate the debtor entity property value, appraisers often apply the following cost approach formula: RCN – physical deterioration – economic obsolescence – incurable functional obsolescence = property value.

In summary, in the application of the cost approach to value debtor entity property within a bankruptcy context, the appraiser — and the legal counsel — should recognize the following misconceptions regarding the cost approach:

1. The cost approach value indication does not equal accounting net book value (and the cost approach does not include the so-called "net book value" method).
2. The cost approach to property appraisal is not the same as the asset-based approach to business valuation.
3. The cost approach only considers future costs. That is, the cost approach considers the costs that would be measured on the valuation date to replace or reproduce the subject property. The cost approach is not a backward-looking analysis.
4. The so-called cost savings method is an income approach appraisal method, not a cost approach appraisal method.
5. The cost approach considers capitalizable expenditures, and not current period expenses.
6. The cost approach should consider an opportunity cost component (as part of the entrepreneurial incentive cost component).
7. The cost approach should consider all forms of obsolescence.
8. The cost approach typically does not consider any income tax considerations. That is, the cost approach is a tax-neutral analysis.

Market Approach Appraisal Methods

Appraisers often attempt to apply market approach appraisal methods first in the debtor entity property appraisal process. This is because the market—that is, the economic environment where arm's-length transactions between unrelated market participants occur—often provides the best indicator of value.

However, the market approach will only provide meaningful valuation pricing evidence when the actual (*i.e.*, the debtor's) property is sufficiently similar to the guideline properties that are transacting (by sale, lease, or license) in the marketplace. In that case, the guideline transaction (sale or license) prices may provide market-derived evidence of the expected price for the debtor entity's property.

The generally accepted market approach property appraisal methods include the following:

1. The comparable transaction (or comparable sales) method (principally applied to debtor tangible property)
2. The relief from royalty method (principally applied to debtor intangible property)

In the comparable transaction appraisal method, the appraiser searches for arm's-length sales, leases, or licenses of either comparable or guideline property.

In the relief from royalty ("RFR") appraisal method, the appraiser recognizes that the debtor entity in fact owns the subject intangible property. However, the appraiser assumes that, if the debtor entity did not own the intangible property, then the debtor would have to inbound license the use of that property from a third-party licensor.

Therefore, because the debtor does actually own the actual property, the debtor is "relieved" from having to pay a royalty payment on the inbound license of the property. The appraiser values the subject intangible property as the present value of the license royalty payment that the debtor entity is "relieved" from paying.

In the application of the comparable transaction method, the appraiser often relies on comparable or guideline sale transactions related to real estate or tangible personal property. This is because third-party sales of tangible property are more typical than third-party sales of intangible property.

In the comparable transaction method, first, the appraiser researches the appropriate exchange markets to obtain information about sale transactions, involving either guideline (*i.e.*, similar from an investment risk and expected return perspective) or comparable (*i.e.*, almost identical) property that may be compared to the debtor entity property.

AIRA
Distinguished Fellows Program

The AIRA Distinguished Fellows Program was created by AIRA's Board of Directors to recognize significant contributions to the art and science of corporate restructuring.

Purpose of Distinguished Fellows Program

- To provide a senior-level status that recognizes AIRA member achievements and contributions to the field of corporate restructuring and to AIRA.
- To distinguish AIRA members who exemplify the highest level of excellence in professional practice and whose contributions have left a significant positive legacy to the profession and the organization.

Nomination Process

Elevation to the status of AIRA Distinguished Fellow is by invitation only through a nominating process which includes:

- Submission of completed forms by any AIRA member, and
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- Be an AIRA member in good standing for at least 10 years, and
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Some of the comparison attributes may include characteristics such as the property type, the property use, the industry in which the property operates, the date of sale, and so on.

Second, the appraiser typically verifies the transactional information by confirming that (1) the transactional data are factually accurate and (2) the sale exchange transactions actually reflect arm's-length market considerations.

If the guideline sale or license transaction was not at arm's-length market conditions, then adjustments to the transactional data may be necessary.

This verification procedure may also elicit additional information about the current market conditions related to the potential sale of the actual debtor entity property.

Third, the appraiser typically selects relevant units of comparison (*e.g.*, income pricing multiples or dollars per unit—such as "per horsepower" or "per square foot"). And, the appraiser develops a comparative analysis for each selected unit of comparison.

Fourth, the appraiser compares the selected guideline or comparable property sale, lease, or license transactions with the debtor entity's actual property, using the selected elements of comparison.

Then, the appraiser adjusts the sale price of each guideline transaction for any differences between (1) the guideline property and (2) the actual property. If such comparative adjustments cannot be measured, then the appraiser may eliminate the sale transaction as a guideline for future appraisal consideration.

Fifth, the appraiser selects pricing metrics to apply to the actual property based on the range of pricing metrics indicated from the guideline or comparable transactions.

The appraiser may select pricing multiples at the low end, midpoint, or high end of the range of pricing metrics indicated by the transactional sale data. The appraiser selects the subject-specific pricing metrics based on the appraiser's comparison of the actual property to the guideline property.

Sixth, the appraiser applies the selected subject-specific pricing metrics to the debtor entity's financial or operational fundamentals (*e.g.*, revenue, income, amount of motor horsepower, amount of building square feet, etc.). This procedure typically results in several market-derived value indications for the debtor entity's property.

Seventh, the appraiser reconciles the various value indications produced from the analysis of the guideline sale transactions into a single market approach value indication. In this final reconciliation procedure, the appraiser summarizes and reviews (1) the transactional data and (2) the quantitative analyses (*i.e.*, various pricing multiples) that resulted in each value indication.

Finally, the appraiser resolves these multiple value indications into a single market approach value indication.

The appraiser may confer with the debtor entity management to explore whether the debtor itself has entered into any property sale agreements. These debtor entity agreements may relate to sales of operating property or surplus property—either before or during the bankruptcy proceedings.

The RFR method also relies on arm's-length transactional data—in this case, the inbound or outbound license of comparable or guideline intangible property. Some appraisers consider the RFR method to be an income approach appraisal method. This is because a projected royalty expense savings is capitalized in order to reach a value indication.

Other appraisers consider the RFR method to be a cost approach appraisal method. This is because the "cost" of the royalty (*i.e.*, the expense of the license payment) is avoided because rights associated with the intangible property is owned by the debtor owner/operator.

However, this intangible property appraisal method is typically considered to be a market approach method. This is because the RFR method relies on market-derived, empirical transaction data.

In applying the RFR method, the appraiser assumes that the debtor entity does not own the actual intangible property. Without this ownership, the debtor entity would have to license the intangible property from a hypothetical licensor.

So the debtor entity becomes a hypothetical licensee that licenses the intangible property from a hypothetical third-party licensor. In that scenario, the debtor entity or licensee would have to pay a royalty payment to the hypothetical owner or licensor. The royalty payment would be for a use license to use the intangible property in the debtor's business operations.

In reality, the debtor entity does own the intangible property. Because of that ownership, the debtor entity avoids the cost of having to pay a use license royalty payment to a third-party licensor. Therefore, the debtor's intangible property can be valued by reference to this hypothetical royalty payment that the debtor is relieved from making.

The hypothetical royalty payment is often calculated as a market-derived royalty rate multiplied by the debtor entity's revenue. So the application of this appraisal method requires (1) an analysis of comparable property license royalty rates and (2) a projection of the debtor entity revenue related to the use of the actual intangible property.

In this method, the revenue expected to be generated by the intangible property (from all sources) during its UEL is multiplied by the selected royalty rate. The product of the multiplication is a projection of the royalty expense that the owner/operator is relieved from paying because of its ownership of that intangible property.

This projected royalty expense is capitalized over the intangible property's UEL. The result of this capitalization process is the intangible property value indication.

Although the projected royalty expense is typically based on a royalty rate multiplied by the debtor entity's revenue, it could also be based on a royalty rate multiplied by gross profit, net income, number of units produced, number of units sold, or some other owner/operator metric.

The royalty expense should be the amount of the net royalty expense that the debtor entity is relieved from paying. Therefore, if the debtor entity would have to pay for any intangible property development, maintenance, promotion, or legal protection expenses (as part of its licenses agreement), then these expenses should be subtracted from the royalty expense projection.

The objective of the analysis is to measure the net benefit to the debtor from not having to inbound license the intangible property. So when analyzing the transactional data, the appraiser should consider which party would be responsible for these intangible property maintenance expenses: the actual owner or licensee or the hypothetical owner or licensor.

In the application of the RFR method, the appraiser typically performs the following procedures:

1. Select and document the criteria to be used for selecting the comparable license agreements; such criteria could include the type of intangible property, the type of owner/operator, the type of industry in which the property is used, the size of the market in which the property is used, and the dates and terms of the license agreements.
2. Assess the terms of each selected intangible license agreement with consideration of:
    - the description of the bundle of legal rights for the licensed comparable property,
    - the description of any maintenance or other expenditures required for the comparable property (for example, product development, advertising, product promotion, or legal protection),
    - the effective date of the comparable license agreement,
    - the termination date of the comparable license agreement, and
    - the degree of exclusivity of the comparable license agreement.
3. Assess the current status of the industry and the associated relevant market and prospective trends.
4. Estimate an appropriate market-derived capitalization rate for the royalty expense projection; the capitalization rate considers the risk of the royalty expense avoidance projection and the UEL of the intangible property.
5. Apply the market-derived capitalization rate to the royalty expense avoidance projection in order to conclude a value indication.

The RFR method has particular application for the type of intangible property that is typically licensed between licensors and licensees. This appraisal method is also applicable when there are a sufficient number of comparable license agreements related to sufficiently similar intangible property.

The RFR method may be especially applicable when the intended standard of value is fair value or fair market value. That is because this appraisal method is based on actual arm's-length transactions (licenses) between independent parties.

It may be applicable when the appraiser has access to the debtor's financial projections, especially debtor revenue projections. It may also be applicable when the appraiser has developed an estimate of the intangible property's UEL.

The RFR method may be less applicable in the following circumstances:

- In the analysis of intangible property that is not typically licensed between a licensor and a licensee
- When there is not a sufficient quantity of comparable license agreements or if the licensed intangible property is not sufficiently similar to the actual intangible property
- When the appraiser does not have access to the debtor's financial projections or cannot estimate the subject intangible property's UEL
- When the appraiser does not have sufficient information about which comparable transaction party (licensor or licenses) is responsible for the intangible property maintenance and protection expenses

Income Approach Appraisal Methods

In the application of the income approach, value is estimated as the present value of the future income from the ownership/operation of the debtor entity's property.

The present value calculation has three principal components:

1. An estimate of the duration of the income projection period, typically measured as the debtor property's UEL
2. An estimate of the property–related income for each period in the UEL projection, typically measured as either (a) owner income (*e.g.*, lease rent or license royalty income), (b) operator income (*e.g.*, some portion of the total business enterprise income), or (c) both
3. An estimate of the appropriate present value discount rate or direct capitalization rate, typically measured as the required rate of return on an investment in the debtor's property

For purposes of the income approach, the property UEL relates to the period of time over which the debtor entity expects to receive the income metric related to the subject property:

1. lease,
2. license,
3. operational use, or
4. forbearance of operational use.

In addition to the term (or duration) of the UEL, the appraiser may also be interested in the shape of the UEL curve. That is, the appraiser may be interested in the annual rate of decay of the debtor property's expected future income.

For purposes of the income approach analysis, many different income measures may be relevant. If properly applied, these different income measures can all be applied in the income approach analysis to conclude a value indication.

Some of the different income measures that may be applied in the income approach analysis include the following:

1. Gross or net revenue
2. Gross income (or gross profit)

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3. Net operating income
4. Net income before tax
5. Net income after tax
6. Operating cash flow
7. Net cash flow
8. Incremental income
9. Differential income
10. Rent or royalty income
11. Excess earnings income
12. Several others

Because there are different income measures that may be applied in the income approach, it is important for the capitalization rate (either the present value discount rate or the direct capitalization rate) to be derived on a basis consistent with the level of income measure applied in the appraisals.

Regardless of the measure of income considered in the income approach, there are several categories of appraisal methods that may be applied to value the debtor entity's property:

1. Appraisal methods that quantify an incremental level of property income—that is, the debtor entity may expect a greater level of revenue (however measured) by owning/operating the property as compared to not owning/operating the property.

   Alternatively, the debtor entity may expect a lower level of costs—such as capital costs, investment costs, or operating costs (expenses)—by owning/operating the property as compared to not owning/operating the property.

2. Appraisal methods that estimate the present value of actual or hypothetical lease or rent license royalty income—that is, these methods estimate the amount of actual or hypothetical lease or royalty income that the entity company (as licensor) would generate from the outbound license of the use of the subject property.

3. Appraisal methods that estimate a residual measure of property income—that is, these methods typically start with the debtor entity overall business enterprise income. Next, the appraiser identifies all of the tangible property and routine intangible property (other than the subject property) that are used in the debtor entity's overall business.

   These other properties are typically called "contributory assets." The appraiser then multiplies a fair rate of return times the value of each of the contributory assets. The product of this multiplication is the fair return on all of the contributory assets.

   The appraiser then subtracts the fair return on the contributory assets from the debtor business enterprise total income. This residual (or excess) income is the income related to the subject property.

4. Appraisal methods that rely on a so-called profit split—that is, these methods typically also start with the debtor entity's business enterprise total income.

   Typically applied to the appraisal of intangible property, the appraiser then allocates or "splits" this total income between (a) the entity's tangible property and routine intangible property and (b) the subject property.

   The profit split percent (*e.g.*, 20%, 25%, etc.) to the subject property is typically based on the appraiser's functional analysis of the debtor entity's business operations. This functional analysis identifies the relative importance of:

   a) the subject property and
   b) the routine (or contributory) assets—to the production of the debtor entity's business total income.

5. Appraisal methods that quantify comparative income—that is, these methods compare the debtor entity's income to a benchmark measure of income that, presumably, does not benefit from the use of the subject property.

   Such benchmark income measures typically include (a) the debtor entity's income before the subject property development, (b) industry average income levels, or (c) selected guideline publicly traded company income levels.

   One typical measure of income for these comparative analyses is the EBIT margin.

   When publicly traded companies are used as the comparative income benchmark, the method is sometimes called the comparable profit margin method.

All of these income approach property appraisal methods can be applied using either:

1. the direct capitalization procedure or
2. the yield capitalization procedure.

In the direct capitalization procedure, the appraiser:

1. estimates a normalized income measure for one future period (typically, one year) and
2. divides that income measure by an appropriate investment rate of return.

The appropriate investment rate of return is called the direct capitalization rate. The direct capitalization rate may be derived for:

1. a perpetuity time period or
2. a specified finite time period.

This selection of the capitalization period depends on the appraiser's estimate of the subject property's expected UEL.

Typically, the appraiser concludes that the subject property has a finite expected UEL. In that case, the appraiser may use the yield capitalization procedure. Or, the appraiser may use the direct capitalization procedure with a limited life direct capitalization rate.

Mathematically, the limited life capitalization rate is typically based on a present value of annuity factor ("PVAF") for the subject property's expected UEL.

In the yield capitalization procedure, the appraiser projects the appropriate income measure for several future time periods. The discrete time period is typically based on the subject property's expected UEL. This income projection is converted into a present value by the use of a present value discount rate.

The present value discount rate is the investor's required rate of return—or yield capitalization rate—over the expected term of the income projection.

The result of either the direct capitalization procedure or the yield capitalization procedure is the income approach value indication for the debtor entity's property.

Valuation Synthesis and Conclusion

In the valuation synthesis and conclusion, the appraiser considers the following question: Does the selected property appraisal approach(es) and method(s) accomplish the appraiser's assignment?

That is, does the selected approach and the selected method actually quantify the intended objective of the debtor entity property analysis, such as:

- a defined value,
- a transaction price,
- a third-party license rate,
- an arm's-length intercompany transfer price,
- a damages measurement,
- a property bundle exchange ratio, or
- an opinion on the property transaction fairness.

With regard to a bankruptcy-related analysis, the appraiser also considers if the selected appraisal approach and method analyzes the appropriate property bundle of legal rights. The appraiser also considers if there were sufficient empirical data available to perform the selected appraisal approach and method.

The valuation synthesis considers if there were sufficient data available to make the appraiser comfortable with the analysis conclusion. The appraiser may also consider if the selected approach and method will be understandable to the intended audience for the property appraisal.

The appraiser also considers which appraisal approaches and methods deserve the greatest consideration with respect to the subject property's expected UEL. The subject property's expected UEL is an important consideration in each appraisal approach.

In the income approach, the expected UEL affects the projection period for the property income subject to either yield capitalization or direct capitalization.

In the cost approach, the expected UEL affects the total amount of obsolescence, if any, from the estimated cost measure—whether that be the property reproduction cost new or the property replacement cost new.

In the market approach, the expected UEL affects the selection, rejection, and/or adjustment of the comparable or guideline sale, lease, or license transactional data.

The following factors influence the appraiser's consideration of the debtor property's expected UEL:

- Physical factors
- Legal factors
- Contractual factors
- Functional factors
- Technological factors
- Economic factors
- Analytical factors

Each of these factors is normally considered in the appraiser's UEL estimation. Typically, the life factor that indicates the shortest UEL conclusion deserves the primary consideration in the bankruptcy-related valuation synthesis and conclusion.

Ultimately, the appraiser applies professional judgment to weigh the various appraisal approach and method value indications in order to reach a final value conclusion.

The appraiser's weighting of the value indications (whether quantitative or qualitative) is based on:

- the appraiser's confidence in the quantity and quality of available data,
- the appraiser's level of due diligence performed on those data,
- the relevance of the appraisal method to the debtor entity property's life cycle stage and degree of marketability, and
- the degree of variation in the range of the value indications.

Based on the valuation synthesis, the final value conclusion regarding the debtor entity property can be (1) a point estimate (which is typical for fair market value valuations) or (2) a value range (which is typical for transaction negotiations or proposed license/lease/sale transaction fairness opinions).

Attributes of an Effective Bankruptcy Appraisal Report

Counsel should understand that there are numerous objectives for any property appraisal report that is prepared within a bankruptcy environment.

First, the appraiser wants to persuade the appraisal report reader (whether the reader is a potential transaction participant, the DIP management, a creditor, counsel for any party, a judge or other finder of fact, etc.).

And, second, the appraiser wants to defend the property value conclusion.

In order to accomplish these objectives, the content and the format of the property appraisal report should demonstrate that the appraiser:

1. understood the specific property appraisal assignment;
2. understood the debtor entity's property and the subject property's bundle of legal rights;

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3. collected sufficient debtor entity financial and operational data;
4. collected sufficient debtor entity industry, market, and competitive data;
5. documented the specific property's economic benefits to the debtor entity;
6. performed adequate due diligence procedures related to all available data;
7. selected and applied all applicable income approach, market approach, and cost approach appraisal methods; and
8. reconciled all value indications into a final value conclusion.

The final procedure in the entire bankruptcy-related analysis is for the appraiser to defend the value conclusion in a replicable and well-documented property appraisal report.

The written property appraisal report will typically:

- explain the debtor entity property appraisal assignment,
- describe the debtor entity subject property and the subject bundle of legal rights,
- explain the selection of (and the rejection of) all generally accepted property appraisal approaches and methods,
- explain the selection and the application of all specific appraisal procedures,
- describe the appraiser's data gathering and due diligence procedures,
- list all documents and data considered by the appraiser,
- include copies of all documents that were specifically relied on by the appraiser,
- summarize all of the qualitative appraisal analyses developed,
- include schedules and exhibits documenting all of the quantitative appraisal analyses developed,
- avoid any unexplained or unsourced appraisal variables or appraisal assumptions, and
- allow the appraisal report reader to be able to replicate all of the appraisal analyses developed.

In order to encourage the reader's acceptance of the appraisal report conclusion, the appraisal report should be:

- clear, convincing, and cogent;
- well-organized, well-written, and well-presented; and
- free of grammatical, punctuation, spelling, and mathematical errors.

In summary, the effective (*i.e.*, persuasive) debtor entity property appraisal report will tell a narrative story that:

1. defines the appraiser's assignment;
2. describes the appraiser's data gathering and due diligence procedures;
3. justifies the appraiser's selection of the generally accepted property appraisal approaches, methods, and procedures;
4. explains how the appraiser developed the valuation synthesis and reached the final value conclusion; and
5. defends the appraiser's property value conclusion.

Summary and Conclusion

Due to higher interest rates, continuing supply chain disruptions, ongoing labor shortages, and price inflation related to materials, supplies, and labor inputs, some company managements are considering the costs and the benefits of a Chapter 11 bankruptcy filing. Often, the company management expectation of such a Chapter 11 filing is that the reorganized entity will emerge from bankruptcy protection with a lower-cost capital structure and a lower-cost operating expense structure.

Counsel know that a property appraisal is a typical element in many industrial or commercial company bankruptcy proceedings. Accordingly, a discussion of what counsel needs to know about best practices with regard to bankruptcy-related property appraisal is timely.

This discussion considered the various types of debtor entity property analyses that an appraiser may be retained to develop within a bankruptcy environment. For purposes of this discussion, the term property includes the debtor entity's real estate and real property, tangible personal property, and intangible personal property.

For all debtor entity property appraisals, counsel should understand that it is a best practice for appraisers to consider all of the generally accepted property appraisal approaches—including the cost approach, the market approach, and the income approach.

Each of these property appraisal approaches has the same objective: to arrive at a defined value indication for the debtor entity's property.

Within each of the generally accepted appraisal approaches, there are generally accepted appraisal methods and procedures that may be appropriate for the particular debtor entity property appraisal assignment.

Counsel should understand that, as a best practice, the appraiser's selection of the specific appraisal approaches, methods, and procedures for the debtor entity's property is based on:

1. the particular characteristics of the debtor entity property,
2. the specific bundle of legal rights subject to appraisal,
3. the quantity and the quality of available data,
4. the appraiser's ability to perform sufficient due diligence related to that data,
5. the purpose and the objective of the specific appraisal, and
6. the relevant professional experience and the informed judgment of the individual appraiser.
7. The final value conclusion is typically based on the appraiser's synthesis of the value indications from each applicable property appraisal approach and method.

The generally accepted appraisal approaches, methods, and procedures summarized in this discussion are generally relevant to bankruptcy-related property appraisals performed for transaction, financing, strategic planning, taxation, accounting, litigation, and other purposes.

Accordingly, counsel should understand that it is a best practice for both the party-in-interest and counsel to the bankruptcy proceeding to be familiar with the generally accepted property appraisal approaches and procedures for purposes of:

1. selecting the appropriate appraiser,
2. relying on the appraiser's value conclusion, and
3. defending the appraiser's value opinion and appraisal report.

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ARGENTINA'S LATEST TANGO (OR TANGLE) WITH THE IMF: THE DEAL THAT ALMOST WASN'T[1]

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Note: The original version of this article was completed as of mid-May 2022, and therefore speaks of developments as of that date unless otherwise noted.

Argentina and the International Monetary Fund (IMF) recently reached final agreement on a new arrangement for Argentina that would enable Argentina to avoid falling into arrears on the IMF's 2018 loan to Argentina ("2018 IMF loan"). However, this outcome was reached only after Argentina and the IMF had engaged in a protracted negotiation process that went on for eighteen months or longer, concluding at the last minute before a late March 2022 deadline. This article discusses some of the twists and turns in that process and identifies various substantive policy differences between Argentina and the IMF as well as political considerations that contributed to the challenges encountered in the negotiation process. The article concludes with some general observations as to the broader significance of the new IMF program and, in particular, whether it signifies a new direction for future IMF programs for indebted sovereigns or represents only a superficial attempt to address deep-seated economic problems that have faced Argentina for many years.

Background of the IMF's 2018 Loan to Argentina

In March 2022, Argentina and the IMF had been engaged in negotiations for over a year and a half to refinance a loan that the IMF had made to Argentina in 2018.[2] They needed to come to an agreement by late March 2022, otherwise, Argentina, having virtually depleted its foreign exchange reserves, would have been unable to make debt service payments of nearly $3 billion then due to the IMF and thus would have fallen into arrears on the 2018 IMF loan.

Yet, despite all of the lead time that the two parties had in which to reach an agreement on the terms of a new loan and a related new IMF program for Argentina, the IMF and Argentina just barely made it across the finish line in time to avoid a nonpayment by Argentina on the 2018 IMF loan. Indeed, it was only on March 25, 2022, that the final step in the process was taken when IMF's Executive Board approved the new arrangement with Argentina.

The IMF's 2018 loan to Argentina was not just any ordinary loan from the IMF. Rather, with a final IMF authorization for the loan in the amount of $57 billion, it was the largest loan authorization in IMF history at that time. Ultimately, the IMF ended up disbursing $45 billion of funds under the 2018 loan facility before the new administration of President Alberto Fernández effectively cancelled the facility in July 2020. (The Fernández administration had been very critical of the prior government of President Mauricio Macri for entering into the 2018 IMF loan in the first place and believed that the loan was used largely to finance capital flight from Argentina and to repay foreign bondholders.)

In 2018, when the IMF originally approved the loan to Argentina, the authorization was subject to some criticism and opposed in certain quarters due to concerns over the sheer size of the loan, especially in view of the size of the loan relative to IMF's country quota for Argentina.[3] The ratio of the loan's size to Argentina's country quota was extremely high, even by the standards of the IMF's exceptional access policy, which was the only way Argentina would have had access to such a large IMF facility.

The IMF's exceptional access policy provides a sovereign access to IMF financing when the ratio of the proposed loan's size relative to the sovereign's country quota exceeds certain normal lending limits established by the IMF. Application of the exceptional access policy is subject to satisfaction of specific criteria.[4]

Some observers have questioned whether the 2018 IMF loan authorization even satisfied all of the exceptional access criteria

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[2] In fact, Argentina first initiated a request for a new IMF program in an August 26, 2020, letter from its Minister of Economy and Central Bank president following Argentina's agreement with its foreign bondholders on the restructuring of $65 billion of foreign bondholder debt. Furthermore, the IMF and Argentina had been engaged in general informal consultations on the matter for months before the August 2020 letter.

[3] The IMF explains country quotas as follows: "An individual member country's quota broadly reflects its relative position in the world economy. Quotas are denominated in Special Drawing Rights (SDRs), the IMF's unit of account." IMF, "IMF Quotas," available at https://www.imf.org/en/ About/Factsheets/Sheets/2016/07/14/12/21/IMF-Quotas (last visited on May 12, 2022).

[4] The four specific exceptional access criteria, as updated by the IMF Executive Board in 2016, are as follows: 1) "The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or capital account resulting in a need for Fund financing that cannot be met within the normal limits;" 2) [various specific scenarios related to debt sustainability (or lack thereof) and high probability or not of such debt sustainability]; 3) "The member has prospects of gaining or regaining access to private capital markets within a timeframe and on a scale that would enable the member to meet its obligations falling due to the Fund;" and 4) "The policy program of the member provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.' IMF, "Ex-Post Evaluation of Exceptional Access Under the 2018 Stand-By Arrangement," December 2021, 47; available at https://www.imf.org/en/Publications/CR/Issues/2021/12/22/Argentina-Ex-Post-Evaluation-of-Exceptional-Access-Under-the-2018-Stand-By-Arrangement-511289 (last visited on May 12, 2022).

that would have been required.[5] In fact, whereas the IMF's lending limits under the exceptional access policy would have been 145% of the country quota for any twelve-month period and cumulatively 435% of country quota (net of repayments) over the length of the program, the 2018 IMF loan to Argentina was 1,227% of its country quota.[6] In other words, Argentina's 2018 IMF loan size was almost three times greater than the normal cumulative limit of 435% of country quota.

The IMF made the 2018 loan to Argentina under the government led by then-President Mauricio Macri at a time when Argentina was facing serious economic difficulties, including in particular a major run on its national currency, the Argentine peso. The loan was in the form of a three-year IMF Standby Arrangement (SBA) and was intended to help the Argentine economy stabilize in the face of currency-related and other economic pressures. The loan came with some limited IMF conditionality, including the condition that the Argentine government should ensure that it preserved the operational and institutional independence of the Argentine central bank.

The 2018 IMF loan to Argentina was reportedly strongly backed by the Trump administration and, given the US government's outsized voting power at the IMF, such support from the US government would have been considered crucial to the IMF's eventual approval of the 2018 loan. Some observers have suggested that the Trump administration's support for the loan stemmed from a personal and/or business relationship that the former US president had with Mauricio Macri when they were both in the business world prior to their entering politics.

Alas, the 2018 IMF loan and program quickly went off track and the economy of Argentina continued to deteriorate significantly in the first year of the program. As will be discussed further in Part Two, the 2018 loan and program for Argentina eventually came in for very harsh criticism from outside observers as well as from the IMF itself.[7]

Arranging a New IMF Facility to Refinance the 2018 Loan

Basically, in the recent negotiations with the IMF, Argentina was seeking to refinance its outstanding debt under the 2018 loan, and in refinancing the debt, it would also be in effect rescheduling the loan as the maturity dates on the new loan would have pushed out the maturity dates on the old loan. The 2018 loan was made under an IMF Standby Arrangement (SBA) between Argentina and the IMF. An SBA, which is considered "the [IMF's] workhorse lending instrument for emerging and advanced market economies,"[8] is an arrangement that is designed to help a sovereign address actual or potential external financing needs. The duration of an IMF program under an SBA is flexible and typically covers a period of 12–24 months but no more than 36 months; also, the repayment period is within 3½ to 5 years of initial disbursement.[9] In principle, SBAs are not supposed to be heavy on conditionality; *i.e.*, conditions involving required changes in policy in order for the country to achieve the desired adjustment.

It quickly became evident to the new administration of President Alberto Fernandez, which came into office in December 2019, that Argentina would not be able to repay the remaining balances on the IMF's 2018 loan. Argentina was due to pay the IMF approximately $38 billion in 2022 and 2023, but it was clear that would not be possible in view of Argentina's meager and dwindling net foreign exchange reserves as well as the other serious economic woes that Argentina was then experiencing, including, among others, very high inflation and a long-running recession (in existence even before the onset of the COVID-19 pandemic).

Argentina was therefore seeking to substitute a longer-term IMF loan facility—called an "Extended Fund Facility" or "EFF"—for the existing Standby Arrangement (SBA). According to the IMF, an EFF provides for a longer repayment period than an SBA of the type Argentina had in connection with the 2018 IMF loan; however, an EFF requires greater conditionality (involving macroeconomic and structural policy modifications or adjustments) than an SBA. As explained by the IMF, an EFF is designed to assist countries that face "serious medium-term balance of payments problems because of structural weaknesses that require time to address."[10]

For Argentina, an EFF would be an attractive option for replacing the SBA since an EFF provided for a much longer repayment period (up to ten years) than an SBA, as mentioned above.[11] With its longer repayment period, a new loan under an EFF would provide Argentina with much-needed breathing space so that it would not face the type of near-term payment pressures it was facing under the 2018 IMF loan, especially in light of the large debt service payments scheduled for both 2022 and 2023.

[5] *See, e.g.*, Willem H. Buiter, "An Argentinean Haircut for the IMF," Project Syndicate, February 16, 2022. Buiter argues that the 2018 loan authorization did not satisfy the second and third criteria of the IMF's four exceptional access criteria. Specifically, Buiter stated (commenting on the second and third of the four exceptional access criteria), "In mid-2018, the IMF characterized Argentina's public debt as sustainable but not with high probability, even though the debt was clearly unsustainable and ought to have been restructured as a precondition for IMF funding. Nor had Argentina satisfied [the third exceptional access criteria]. It had no prospect of gaining or regaining sufficient access to private capital markets in 2018, and it still doesn't today."

[6] During the eurozone crisis, the IMF provided financing support for Greece, among other eurozone sovereigns, and in its 2010 Standby Arrangement (SBA) and 2012 Extended Fund Facility (EFF) for Greece (both authorized under the IMF's exceptional access policy), the relevant ratios of such facilities relative to Greece's country quota at the time were 1,592% and 2,159%, respectively. IMF, "Ex Post Evaluation of Exceptional Access Under the 2012 Arrangement," February 2017, available at https://www.imf.org/en/Publications/CR/Issues/2017/02/07/Greece-Ex-Post-Evaluation-of-Exceptional-Access-Under-the-2012-Extended-Arrangement-Press-44636 (last visited on May 12, 2022).

[7] IMF Press Release, "IMF Executive Board Discusses the Ex-Post Evaluation of Argentina's Exceptional Access Under the 2018 Stand-By Arrangement," December 22, 2021, available at https://www.imf.org/en/News/Articles/2021/12/22/pr21401-argentina (last visited on May 10, 2022).

[8] IMF, Factsheet, "IMF Stand-By Arrangement (SBA)," October 7, 2021, available at https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/20/33/Stand-By-Arrangement (last visited on May 12, 2022).

[9] *Ibid*.

[10] IMF, Factsheet, "IMF Extended Fund Facility (EFF)," May 19, 2021, available at https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/20/56/Extended-Fund-Facility (last visited on May 11, 2022).

[11] *Supra* note 8.

Continued from p.41

An EFF would also provide Argentina with ample time to get its house in order from a macroeconomic and structural standpoint.

As will be explained in greater detail below, Argentina and the IMF engaged in a very long and drawn-out negotiation process but ultimately came to an agreement on the terms of the new EFF. The broad outline of the terms of the EFF was first set forth in a preliminary agreement announced on January 28, 2022, and was spelled out with much greater specificity in a staff-level agreement on March 3, 2022. Ultimately, these agreements between Argentina and the IMF culminated in approval of the new IMF program and loan by both houses of the National Congress of Argentina in mid-March (as required by Argentine law) and by the IMF Executive Board on March 25, 2022.

The Extended Fund Facility approved by the IMF Executive Board provided for a loan facility of $44 billion (representing approximately 1000% of Argentina's country quota). The facility matures in ten years, provides for a 4-year grace period on principal payments, and authorizes an immediate disbursement to Argentina of $9.6 billion.[12] This early disbursement of IMF funding, or "frontloading," was considered critical so that Argentina would be able to make the debt service payments under the 2018 loan that were falling due in late March 2022, as well as in the subsequent months, given the heavy debt service payments that would fall due in the remainder of 2022. According to an IMF Staff Report, this frontloading of disbursements was also designed to help build up Argentina's foreign exchange reserves.[13]

On the non-financing side, the Extended Fund Facility provides for a thirty-month program between Argentina and the IMF to focus on reducing Argentina's very high inflation, strengthening the country's balance of payments, and "improv[ing] Argentina's public finances to strengthen debt sustainability by reducing primary fiscal deficits, while improving the targeting of spending and addressing deep infrastructure gaps."[14]

The IMF has emphasized the point that the program is based on a multi-pronged strategy to reduce inflation, and a key element of that strategy involves a gradual reduction in the level of central bank financing (or monetizing) of Argentina's fiscal deficit (*i.e.*, a situation where the central bank prints money to finance the country's fiscal deficits) and the execution of a monetary policy that will bring about positive real interest rates in Argentina. The IMF has also stressed that the program is intended to allow Argentina to make important infrastructure investments as well as address spending on pressing social issues, such as the very high level of poverty that exists in Argentina.

[12] Government of Argentina, Ministry of Economy, "The Argentine Government Reached a Staff-level Agreement with the International Monetary Fund and the Bill Will Be Sent to the National Congress," Press Release, March 4, 2022, available at https://www.economia.gob.ar/en/the-argentine-government-reached-a-staff-level-agreement-with-the-international-monetary-fund-and-the-bill-will-be-sent-to-the-national-congress/ (last visited on May 16, 2022). The Press Release indicates "[t]he repayment period of each disbursement is 10 years, with a grace period of 4 and a half years, which implies paying the debt from 2026 to 2034."

[13] IMF, "Staff Report for 2022 Article IV Consultation and Request for an Extended Arrangement Under the Extended Fund Facility," March 10, 2022, available at https://www.imf.org/en/Publications/CR/Issues/2022/03/25/Argentina-Staff-Report-for-2022-Article-IV-Consultation-and-request-for-an-Extended-515742 (last visited on May 12, 2022).

[14] *Ibid.*

A central part of the new IMF program relates to so-called fiscal consolidation matters and envisions Argentina gradually eliminating its primary fiscal deficit over a period of four years. Specifically, the targets for the primary fiscal deficit expressed as a percentage of GDP are as follows: 2.5% in 2022, 1.9% in 2023, 0.9% in 2024, and 0% in 2025.[15] In 2021, it is estimated the primary fiscal deficit was 3.0% of GDP. Thus, the speed and degree of fiscal consolidation under the new IMF program might be considered fairly gradual: more in line with what Argentina was willing to live with than with what it was thought the IMF would like to have seen early on in the negotiations. Argentina originally did not want to reach the 0% level until 2027, instead of 2025 as in the final agreement.

On the politically sensitive matter of proposed reductions in fuel subsidies—a critical issue for many (especially poorer) Argentineans—the program calls for a reduction of such subsidies by 0.6% of GDP. This represents a fairly significant subsidy decrease; however, the IMF argues the reduction in fuel subsidies will be handled in a "progressive manner so that the lower income segments of the population would be more protected, and those with a higher payment capacity would have their subsidies eliminated."[16] It remains, of course, to be seen whether and how this notion of progressivity will work out in practice.[17]

Another hot-button issue in the negotiations between Argentina and the IMF concerned pensions. The IMF has been critical of Argentina's pension system as covering too many retirees and being too generous and too costly, whereas the Fernández administration vowed to leave pensions untouched by any new IMF program. This was considered to be a crucial political issue for the Peronist base supporting the Fernández administration.

In the final analysis, when the details of the staff-level agreement between Argentina and the IMF were released, it seemed Argentina had largely succeeded in forestalling any major substantive changes in its pension system. In its Memorandum of Economic and Financial Policies dated March 3, 2022, Argentina simply committed to undertake a study to be completed by December 2022, "outlining options and recommendations to strengthen the equity and sustainability of our long-term pension system…"[18] Separately, Argentina said that it would seek to "protect the real income of pensioners and public sector workers" by seeking to "rationalize" certain other public spending.[19]

[15] IMF, "IMF and Argentine Authorities Staff-Level Agreement on an Extended Fund Facility (EFF)," transcript of IMF Virtual Press Briefing, March 3, 2022, available at https://www.imf.org/en/News/Articles/2022/03/04/tr03032022-argentina-transcript-press-briefing- staff-level-agreement-on-eff (last visited on May 12, 2022).

[16] Eliana Raszewski, Jorge Otaola, and David Lawder, "Argentina Agrees $45 Bln IMF Debt Deal That Targets Energy Subsidies," Reuters, March 3, 2022, https://jp.reuters.com/article/argentina-imf-idUKL2N2V60XS.

[17] Observers have commented that in the wake of the war in Ukraine, it may be more difficult for the new IMF program to remain on track with planned reductions in fuel subsidies, since Argentineans may need continued subsidy protection against recently elevated global energy prices.

[18] Republic of Argentina, "Memorandum of Economic and Financial Policies (accompanying Argentina's Letter of Intent addressed to the IMF)," *IMF*, March 3, 2022, 9-10.

[19] *Ibid*.

As will be discussed in the conclusion of this article, when the new Extended Fund Facility was finally approved in late March 2022, the IMF—from its Executive Board to its Managing Director to its staff—all flagged the high-risk nature of the new EFF, particularly in view of the economic fallout from the then-recently initiated war in Ukraine (which had only begun a month prior to the IMF's final approval of the EFF). But the risk also flowed from the general social and political dynamics in Argentina relative to IMF programs; or what a recent IMF staff report referred to, in very straightforward terms, as "*open hostility* from some quarters [in Argentina] towards the Fund from its long engagement in Argentina" (emphasis added).[20]

The Mountain of Legacy Debt and Economic Woes Facing The New Fernández Government

When the new government of President Alberto Fernández came into power in Argentina in December 2019 (with Fernández having defeated Macri in the October 2019 presidential election), it was clear that Argentina would not be able to repay the 2018 IMF loan on its original terms (nor would it be able to repay its sizeable foreign bond debt on its original terms). The Argentine economy was in a fairly dismal state with inflation soaring above 50% and a poverty rate of approximately 40%, and with Argentina possessing dwindling foreign exchange reserves.

Thus, faced with approximately $65 billion in debt owed to foreign bondholders and approximately $45 billion in debt owed to the IMF, an immediate priority of the new Fernández administration was to renegotiate all of its outstanding foreign debt since the debt was widely considered to be unsustainable. A significant portion of the debt—approximately $40 billion or so of the approximately $65 billion of total outstanding foreign bond debt (plus the $45 in outstanding IMF debt)—had been incurred during the time the Macri administration was in office from 2015-2019.[21]

In fact, Argentina's debt-to-GDP ratio, often looked to as a shorthand way of gauging a country's debt sustainability, had increased substantially over the length of the Macri administration. Argentina's debt-to-GDP ratio in 2015 was approximately 52.56%, while in 2019 the ratio was approximately 88.84%.[22]

Under the Macri government, Argentina had ready access to the capital markets, particularly in view of the fact that investors at the time were searching for yield on their investments in the then prevailing low interest rate environment globally. Indeed, Argentina was even able to sell so-called century bonds—*i.e.*, bonds with a maturity of one hundred years—and, indeed, the issuance of such century bonds was oversubscribed by investors. The Macri government was able to issue so much debt because Macri was essentially considered a "darling" of the international financial markets given his putatively "market-friendly" or "market-oriented" economic policies.

The financial markets appeared to prefer those policies compared to the more populist economic policies that had been pursued by the prior Argentine government under President Cristina Fernández de Kirchner who served as president from 2007-2015. Fernández de Kirchner, of course, had (in)famously clashed in a long and bitter struggle with holdouts from Argentina's sovereign debt restructurings that followed Argentina's 2001 default, and for many investors Fernández de Kirchner was considered a pariah in the international financial markets. (Her husband, Néstor Kirchner, had served as Argentina's president from 2003-2007.)

Nonetheless, when it was time to pay the piper on the huge mountain of debt that had largely been incurred during the Macri administration, it fell to the new Argentine government of President Alberto Fernández to address that challenge. The first step in this process was for the new Argentine government to renegotiate its foreign bondholder debt. There were six months or more of tortuous and fairly contentious negotiations between Argentina and its foreign bondholders, and at least at a few points the negotiations threatened to go off the rails. Yet, Argentina was finally able to reach a deal with its foreign bondholders in August 2019 to restructure its outstanding foreign bond debt.[23]

While Argentina certainly did not achieve all of its objectives in the restructuring of its foreign bondholder debt, it was able to obtain a substantial principal reduction (or haircut) on the outstanding debt, amounting to a face value reduction of approximately 45 cents on the dollar. Importantly, Argentina also achieved considerable cash flow relief on its bond debt over a ten-year period, and this was attributable, among other things, to a grace period of a few years on then-upcoming principal payments post-restructuring[24] as well as a reduction of average interest rates on the restructured debt.

Coming off its successful restructuring with its foreign bondholders in August 2019, Argentina seemed to have certainly more than enough time to be able to renegotiate or refinance its 2018 IMF loan. Argentina had debt service payments of approximately $19 billion due in both 2022 and 2023, with very limited debt service payments due in 2021. In 2022, Argentina would not have any relatively major debt service payments on the IMF loan until late March 2022 when it would need to repay the IMF approximately $3 billion.

Thus, late March 2022 became the de facto deadline for Argentina and the IMF to reach a deal on a new "arrangement" (in IMF parlance) since Argentina would use a new loan from the IMF to refinance its existing IMF loan. (It should be noted that in the course of its relations with the IMF, Argentina has, remarkably,

[20] *Supra* note 13, 33.

[21] *See* Brad Setser, "The State of Argentina's Debt Restructuring …" Council on Foreign Relations, Follow the Money blog post, June 24, 2020, available at https://www.cfr.org/blog/state-argentinas-debt-restructuring (last visited on May 17, 2022).

[22] Federal Reserve Bank of St. Louis (Federal Reserve Economic Data), "General Gross Government Debt for Argentina," available at https://fred. stlouisfed.org/series/GGGDTAARA188N (last visited on May 17, 2022). Note that the dates for the debt-to-GDP ratios cited in the text above do not correspond to the precise dates that the Macri administration was in office but rather are figures for 2015 as a whole and 2019 as a whole.

[23] For a discussion of Argentina's negotiations to restructure its foreign bond debt, *see, e.g.*, Steven T. Kargman, "Argentina's Quest for the Moral High Ground in Its Recent Restructuring," Global Restructuring Review, September 14-17, 2020. The four-part series of articles was featured in the Harvard Law School Bankruptcy Roundtable (November 10, 2020) and the Oxford Business Law Blog (January 22, 2021).

[24] *See, e.g.*, Steven T. Kargman, "Argentina's Quest for the Moral High Ground," September 2020.

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entered into twenty-one arrangements with the IMF beginning in 1958, and thus any such new arrangement would have become Argentina's 22nd arrangement with the IMF.)

Argentina's situation in relation to the IMF was also intertwined with Argentina's situation vis-à-vis the Paris Club of bilateral creditors.[25] In May 2021, Argentina owed the Paris Club creditors debt service payments in the amount of approximately $2.4 billion, but Argentina could not make those payments by the scheduled payment date. That failure to pay, if it had not been cured during a two-month grace period (*i.e.*, by July 2021), would have matured into a payment default to the Paris Club creditors.

However, in June 2021, the Paris Club effectively granted Argentina a roughly one-year reprieve on the bulk of the missed $2.4 billion in debt service payments. The Paris Club gave Argentina until March 2022 to make the missed debt service payments, and the Paris Club also targeted March 2022 as a date by which Argentina should come to a new agreement with the IMF.

Thus, particularly in light of the debt service payments due to the IMF at that time, late March 2022 was seen as the outside deadline for Argentina and the IMF to reach a deal which would refinance or reschedule the IMF's 2018 loan to Argentina. But at the time the deal with foreign bondholders was reached in August 2020, few observers might have expected that the negotiations between Argentina and the IMF would spill over into 2022, much less drag on until a de facto deadline of late March 2022. Instead, the general expectation might have been that Argentina and the IMF would most likely be able to reach some type of a deal by sometime in 2021 at the latest.

Limited Progress in Protracted Negotiations

Yet, as 2021 turned into 2022, it was far from certain that Argentina and the IMF would make it across the finish line with a new deal by late March 2022. Specifically, by the beginning of 2022, Argentina and the IMF had not even achieved a basic agreement on the outlines of a deal. It was only in late January (January 28, 2022, to be precise) that Argentina and the IMF issued separate statements announcing the bare-bones details of a potential deal, or what might be considered a preliminary agreement or preliminary understanding, between the two parties. (It should be noted that in January 2022, Argentina began to see a major surge in COVID-19 cases related to the omicron variant, introducing another element of uncertainty to Argentina's outlook.)

The preliminary agreement of January 28, though, was just that—*i.e.*, preliminary—and there remained a number of important procedural steps that still needed to be taken by late March by both Argentina and the IMF in order for a definitive, approved deal to be in place by that time. In the IMF loan authorization process, a so-called staff-level agreement between the sovereign and the IMF is considered a crucial milestone in that process, as the staff-level agreement provides a detailed roadmap of the key

features of the prospective deal between the parties and serves as a basis for developing the definitive documentation of a new IMF arrangement.

Yet, it was not until March 3, 2022, that the IMF and Argentina announced that they had reached a staff-level agreement. With that announcement, Argentina submitted a Letter of Intent (which constitutes the sovereign's formal request for IMF support) accompanied by a Memorandum of Economic and Financial Policies as well as a Technical Memorandum of Understanding. The latter two documents set forth in detail the policy initiatives that the Argentine government commits to undertake as part of the new IMF program and the financial and economic assumptions underpinning the program.[26]

Even at this stage, there were several major hoops for the parties to jump through by late March 2022. On the IMF side, the proposed new arrangement would need to be reviewed by the IMF staff (including, in particular, by the IMF's Western Hemisphere Department), and then it would ultimately require the approval of the IMF Executive Board. Generally speaking, this type of IMF review and approval process does not happen overnight; but in this case, it needed to be undertaken on an expedited timetable, in view of the late March deadline for reaching a new deal.

On the Argentine side, a new law in Argentina required that any new deal with the IMF would need to be approved by both houses of the Argentine Congress, namely its Senate and Chamber of Deputies. Crucially, though, the approvals by the Argentine Congress and the IMF Executive Board were far from a foregone conclusion, especially in light of the short period of time that remained before the late March deadline for reaching a new deal as well as the political/policy sensitivities related to the approvals in Argentina and at the IMF.

Not surprisingly, given the twists and turns the process had already taken, last-minute complications arose that clouded prospects for a quick or easy approval of the proposed new arrangement. For the IMF, the proposed new arrangement would have to be considered against the backdrop of the state of the global economy at the time, since global economic developments might well affect the outlook for the Argentine economy and thus the prospects for the viability and/or success of any new IMF program with Argentina. And, as the whole world is now keenly aware, on February 24, 2022, just days before the staff-level agreement

[25] Editor's note: The "Paris Club" of creditors refers to a group of mostly Western creditor countries that grew from a 1956 meeting in which Argentina agreed to meet its public creditors in Paris. *Club de Paris* currently defines itself as "an informal group of official creditors whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor countries," https://clubdeparis.org/.

[26] *Supra* note 18.

between Argentina and the IMF was announced, Russia invaded Ukraine. Within a matter of days, Russia's invasion of Ukraine sent shock waves through the global economy and introduced a whole new array of uncertainty, unpredictability, and risk (mostly on the downside) into the outlook for the global economy.

Inevitably, before it could move to a final approval of the proposed new arrangement, the IMF would have to step back and assess the likely impact of the war in Ukraine on the global economy given the likely spillover effects on economies around the globe, including the Argentine economy. In fact, the IMF seemed to temporarily slow its final decision-making process. As stated by Gerry Rice, IMF Director of Communications, on March 19, 2022: *"To allow time to take account of the fast-changing global environment—including the war in Ukraine*—the IMF Executive Board will meet to discuss Argentina's request for an IMF-supported program on Friday, March 25, 2023" (emphasis added).[27]

It was thus only at virtually the last minute, on March 25, that the last step in the process, namely approval of the deal by the IMF Executive Board, was announced. But this slippage in the date of IMF approval until March 25 meant that Argentina would not have had the funds to make its debt service payments due on March 21 and March 22 since Argentina, in view of its depleted foreign exchange reserves, was presumably counting on the proceeds of the new IMF loan to be able to make the two debt service payments that fell due in late March.

Argentina basically had to finesse this problem by in effect combining the payments due on March 21 and March 22 into one payment that would be due by March 31, and IMF rules apparently permitted this maneuver.[28] By the new payment date of March 31, Argentina would then have at its disposal part of the proceeds of the new IMF loan approved on March 25, and such loan proceeds could then be applied to make those two payments that originally fell on March 21 and March 22.

As a practical matter, this was made possible because the $44 billion Extended Fund Facility (EFF) approved by the IMF Executive Board on May 25 was front-loaded to provide for the immediate disbursement of approximately $9.6 billion in funds. In other words, the amount of immediately disbursed funds would be more than enough to allow Argentina to pay off the approximately $3 billion that it owed the IMF in late March while also providing a cushion for other debt service payments that would be forthcoming in the remainder of 2022.

Earlier Shared Interests of Argentina and the IMF in Reaching a New Deal ?

The question arises: How and why did the process of renegotiation of the IMF's 2018 loan to Argentina become such a protracted and problematic process? After all, as will be explained more fully below, ex ante one might have thought that Argentina and the IMF would presumably have had a shared interest in reaching a deal on a new arrangement in a relatively timely manner and thereby avoiding a non-payment by Argentina on the 2018 IMF loan. Yet, as will be discussed below, ex post one can see that there were myriad reasons that the process of renegotiating the 2018 loan dragged on over such an extended period of time without the parties being able to reach any final, definitive resolution. Thus, with the benefit of hindsight, one might say that this result was an overdetermined outcome, as social scientists would put it.

The presumed mutuality of interest between Argentina and the IMF in reaching a deal stemmed from the fact that fundamentally neither the interests of Argentina nor the interests of the IMF would have been served by Argentina's nonpayment on the IMF's 2018 loan which would have been the result of a failure by the parties to reach such a deal by late March 2022 to refinance or reschedule the IMF's then-outstanding loan to Argentina.

During the period that the Fernández administration was negotiating with the IMF, the Argentine economy was in fairly dire straits. Although Argentina had finally emerged from a recession that lasted roughly three years, inflation was still running in the range of 40-50%, its foreign exchange reserves had dwindled to a mere few billion dollars if not less, the poverty rate among the Argentine population was roughly 40%, and the value of the Argentine peso had continued to depreciate considerably.

Under such circumstances, Argentina would need fresh capital, most likely from foreign sources, to dig itself out of its deep economic hole, and a nonpayment on the 2018 loan would have been a huge setback for Argentina on that front. For some time, Argentina had found itself effectively locked out of the private capital markets as a result of defaulting on its foreign bond debt in May 2020, a record ninth sovereign debt default for Argentina since the time it became an independent state in 1816. Further, as a practical matter, in the last couple of years the average yields on its outstanding debt had spiked to very elevated levels, and at such levels it would not be affordable or sustainable for Argentina to issue new debt.

A nonpayment by Argentina on the 2018 IMF loan would have had broader consequences for Argentina: It would have meant that Argentina would find itself prevented from tapping into financing from the other major multilateral institutions, such as the World Bank and the Inter-American Development Bank, among others. That would have been a serious blow to Argentina as such multilateral institutions are seen as important and reliable long-term sources of financing for emerging and developing economies such as Argentina.

Thus, having already lost access to the private capital markets and with access likely to be cut off from the multilateral institutions upon a potential nonpayment of the 2018 IMF loan, Argentina would essentially have found itself in an economic straitjacket (unless it was able to arrange financing from some other, as-yet-untapped deep pocket, whether that might be China or some other funding source). Again, the prospect of a lack of financing options should have provided Argentina with a strong incentive

[27] Gerry Rice, "Statement by the IMF Spokesperson on Argentina," IMF Press Release No 21/11, March 19, 2022.

[28] *Ibid*. As explained by IMF spokesperson Gerry Rice on March 19, 2022, "I can also confirm that the authorities have informed the IMF that they will combine Argentina's March repayment obligations due on March 21 and March 22 into a single repurchase before March 31, 2022...Under [an IMF] Board Decision adopted in the late 1970s, *members have the right to bundle together multiple repurchases (principal payments) falling due in a calendar month*" (emphasis added).

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to reach a timely agreement with the IMF on the terms of a refinancing or rescheduling of the IMF's 2018 loan.

From the IMF's standpoint, it, too, would probably have preferred to avoid a nonpayment on the 2018 loan to Argentina because a nonpayment on its largest-ever loan would have been a major embarrassment for the institution. Such a nonpayment might also have invited heightened scrutiny of whether the 2018 loan to Argentina had been imprudent in the first place. Indeed, in late December 2021, the IMF itself released a report that was sharply critical of the 2018 loan.[29]

In that IMF report known as an "ex post evaluation" (EPE) which is required by the IMF in cases of IMF lending above normal limits, the 2018 arrangement with Argentina was essentially declared a program failure. As the report stated, "*the program did not deliver on its objectives, despite significant modification of economic policies*" (emphasis added). Specifically, the report noted that the program "did not fulfil the objectives of restoring confidence in fiscal and external viability while fostering economic growth."

Or as the Executive Directors of the IMF put it, the 2018 program "did not deliver on its objectives of restoring market confidence, bringing down external and fiscal imbalances, reducing inflation, and protecting the most vulnerable segments of the population." However, the EPE report itself, as well as an assessment of the report by the IMF's Executive Board, appeared to assign a fair amount of the blame for the program's failure to the Argentine government (then under the leadership of President Mauricio Macri) for, among things, its unwillingness to undertake a debt restructuring with its private creditors or to impose capital controls.

Separately, given the attention that has been focused on the fate of the 2018 IMF loan to Argentina, it would not be surprising if at some point the IMF's own internal review organ, the Independent Evaluation Office (IEO), would be prompted to conduct a searching post-mortem of the 2018 loan. The IEO has conducted such reviews in other high-profile, problematic IMF lending programs from the past, including for example the IMF's involvement in Argentina from 1990-2001 (which was the subject of a 2004 IEO report).[30]

[29] Earlier, in September 2021, the European Central Bank (ECB) issued a report on sovereign debt restructuring, and in an annex to that report, the ECB raised pointed (and even troubling) questions about the IMF's 2018 loan to Argentina, *See* European Central Bank, "The IMF's Role in Sovereign Debt Restructurings," Occasional Paper Series No. 262, September 2021, Annex A.2 ("Argentina 2018-19. Exceptional Access Criteria and Financing Assurances"), 51-52.

[30] The IMF's Independent Evaluation Office also produced a report in 2003 concerning the IMF's involvement in Indonesia, Korea, and Brazil in connection with the financial crises in those countries in the late 1990s. Separately, it should be noted that, in the IMF's Executive Board comments on the December 2021 ex post evaluation concerning the IMF's 2018 loan to Argentina the Directors adverted to the possibility of a future report to be undertaken by the Independent Evaluation Office. Upon the release of the ex post evaluation (EPE) in December 2021, it was noted that many executive directors of the IMF "*considered that an evaluation of the 2018 [standby agreement with Argentina] by the Independent Evaluation Office* could complement the EPE findings" (emphasis added). IMF Press Release, "IMF Executive Board Discusses the Ex-Post Evaluation of Argentina's Exceptional Access Under the 2018 Stand-By Arrangement," available at https://www.imf.org/en/News/Articles/2021/12/22/pr21401-argentina (last visited on May 10, 2022).

Delay and Discord in Reaching a New Deal: Policy and Political Factors

Nonetheless, even though Argentina and the IMF may have had a shared interest in reaching a new deal in a timely fashion (or at least without cutting it too close to the late March 2022 deadline), there were both substantive policy reasons, as well as political reasons, which contributed to the situation in which they were unable to do so.

Major Policy Differences Between Argentina and the IMF

With respect to substantive policy matters, at least until January 28, 2022, when Argentina and the IMF made their separate announcements indicating some preliminary understandings in their ongoing discussions, it appeared that Argentina and the IMF remained sharply divided on some very fundamental issues. Most prominently, the parties had profound differences on the so-called "fiscal path" (*i.e.*, the degree and speed of any "fiscal consolidation,"[31] or, particularly, the shrinking of Argentina's primary fiscal deficit) that the IMF would want to see anchor any new IMF program with Argentina and that Argentina would be willing to live with.

Essentially, in its pre-January 28 statements, the government of Argentine president Alberto Fernández expressed the belief that it could achieve the necessary fiscal consolidation by improving the collection of revenues such as taxes and by borrowing from multilateral institutions such as the World Bank. However, at least pre-January 28, the IMF was reportedly skeptical about whether Argentina was likely to be able to achieve the desired level of fiscal consolidation by those means alone.

The two sides also had significant differences over economic and budgetary projections. The IMF had argued that Argentina's projections had been overly optimistic or were otherwise not credible, including with respect to reducing the budget deficit and bringing down inflation.[32]

In effect, prior to January 28, the Argentine government appeared to want to limit to the greatest extent possible the degree of fiscal consolidation achieved by spending cuts (such as cuts in pensions) and subsidy reductions (particularly fuel subsidies). The Fernández administration believed that fiscal consolidation achieved by those means, and especially pursuing fiscal consolidation on a relatively compressed timetable as the IMF appeared to advocate, would lead to greater austerity and pain for the Argentine people, and the Fernández administration appeared firmly determined to avoid such an outcome.

The Argentine government also believed that such an approach would have adverse effects for the Argentine economy since, in the view of the government, it might choke off what it viewed as a nascent economic recovery that had been underway

[31] Fiscal consolidation is generally understood to mean something along the lines of "government policy intended to reduce deficits and the accumulation of debt." Glossary-Statistics Explained, Eurostat, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:Fiscal_consolidation (last visited on May 8, 2022).

[32] *See, e.g.*, Michael Stott and Lucinda Elliott, "Argentina Hardens Stance Against IMF as Debt Renegotiations Bog Down," *Financial Times*, October 30, 2021.

in Argentina following a lengthy recession, a point that was underscored in commentary from Nobel laureate in economics, Professor Joseph Stiglitz.[33] (Earlier, Stiglitz had been a very strong advocate for Argentina's positions in its negotiations in 2020 with its foreign bondholders and, in fact, had organized two open letters signed by scores of economists and other prominent academics in support of Argentina's positions (and critical of the bondholders' positions) in those negotiations.[34])

Ultimately, as noted in Part One, the degree and speed of fiscal consolidation reflected in the final form of the Extended Fund Facility approved by the IMF Executive Board in late March 2022, while not completely in line with what the Argentine government had been seeking, appears to be more in line with Argentina's position in the negotiations than with the IMF's position in the negotiations. Simply stated, the program seems to call for a somewhat gradual fiscal consolidation to be achieved over a period of a few years.

Furthermore, on a completely separate matter, Argentine government had sought to have the IMF eliminate its usual surcharge (ranging from two to three percentage points of the amount of the outstanding loan) on certain IMF loans that have been outstanding for a few years and which are disproportionately large to the country's IMF quota.[35] These surcharges are amounts due to the IMF above and beyond the normal interest charges due to the IMF. It was suggested if such surcharges were eliminated, that would have resulted in considerable savings for Argentina—perhaps amounting to a few billion dollars—given the huge balance that was then outstanding on the 2018 IMF loan to Argentina.

But in considering Argentina's request and similar requests from other emerging economies and developing countries (whose sovereign balance sheets came under considerable stress from expenditures they were forced to make to address the health and economic fallout from the COVID-19 pandemic), the IMF Executive board considered the matter last December and did not agree to end the surcharges. The IMF Executive Board, though, seemed to leave the door open to a further review of this matter at some point in the future when it could conduct "a comprehensive review…in the context of the [IMF's] overall financial outlook" as per a report in the *New York Times*.[36]

[33] Joseph E. Stiglitz, "Argentina's COVID Miracle," Project Syndicate, January 10, 2022. Certain other economists disputed the view expressed by Stiglitz that the Argentina was experiencing a relatively strong economic recovery. *See, e.g.*, Andres Velasco and Eduardo Levy Yeyati, "Argentina's Imaginary Miracle," Project Syndicate, January 21, 2022.

[34] For further discussion of Professor Stiglitz's singular role in Argentina's negotiations with its foreign bondholders in 2020, see Steven T. Kargman, "Argentina Quest for the Moral High Ground: The Professoriate Weighs In," Global Restructuring Review, September 16, 2020. In that four-part series in Global Restructuring Review, I discussed the role of the "three P's"—namely, the pandemic, the professoriate, and the Pope—in affecting the course of the negotiations with the foreign bondholders.

[35] For further discussion of the IMF surcharges and an interesting proposal for allowing sovereign borrowers to apply funds that would have been paid as surcharges to the IMF instead for the development of approved environmental projects, *see, e.g.*, Mitu Gulati, *et al*., "Letter to the Editor: A Novel Idea for Argentina & the IMF," *Americas Quarterly*, February 23, 2022.

[36] Patricia Cohen, "Critics Say IMF Loan Fees Hurting Nations in Desperate Need," *New York Times*, January 14, 2022.

Political Considerations Affecting the Parties

Furthermore, there were serious political constraints facing both Argentina and the IMF. The Fernández government in particular was walking a political tightrope in negotiating a new deal with the IMF. For one thing, the IMF has long been the *bête noire* of Argentine politics, with many Argentineans blaming the IMF for many of the economic and financial woes it has experienced over the years, including especially Argentina's 2001 sovereign debt default and the ensuing economic crisis. As a result, Argentina has often had a very acrimonious and antagonistic relationship with the IMF over many years.

Ironically or counterintuitively, when the left-of-center Fernández government came into office in late 2019, President Fernández seemed intent on forging a more constructive relationship with the IMF, and he and his team, including especially his Minister of Economy Martín Guzmán, appeared to work fairly cooperatively with the IMF in the next number of months. Indeed, during Argentina's negotiations with its foreign bondholders in the first half of 2020, IMF staff produced some debt sustainability analyses that seemed to bolster arguments that Argentina was making vis-à-vis its foreign bondholders, and this followed months of informal consultations between the Argentine government and the IMF.

One constant political constraint that Fernández faced from the outset was that his Peronist-based political coalition depended on the support of his vice president, Cristina Fernández de Kirchner, a leading figure in Peronist politics in Argentina and someone who arguably held more leftist views than Fernández. Fernández de Kirchner had long been an outspoken critic of the IMF's role in Argentina, and, in the context of Argentina's renegotiation of the 2018 IMF loan, she had taken the position at various points that the loan was illegitimate or illegal and should not be repaid.

This position was based largely on her view that the loan was used to finance capital flight from Argentina and therefore did not benefit Argentina or its people. In fact, there is not much disagreement among a broad range of parties that the proceeds of the 2018 IMF loan were used to finance capital flight as well as to pay down outstanding foreign debt obligations. However, there might well be some (and even sharp) disagreement in various quarters with Ms. Fernández de Kirchner's conclusion that the loan was illegal and did not need to be repaid.

Despite an earlier willingness to engage with the IMF and move the discussions forward, at a certain point as Argentina's discussions with the IMF progressed deeper into 2021, Fernández and his team appeared to want to slow down the process. They were apparently deeply concerned that any deal reached with the IMF might involve a fair amount of austerity being imposed on the Argentine people which would be politically unpopular with the Argentine body politic. The Fernández-led coalition seemed to be very sensitive to this political concern because Argentina would be holding important mid-term legislative elections in the latter part of 2021. Moreover, the political standing of the Fernández government was already somewhat precarious as there appeared to be widespread popular discontent with, among other things, the continuing high rate of inflation as well as elevated and troubling levels of poverty in Argentina.

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Fernández was undoubtedly very mindful of the street protests that took place in opposition to a deal with the IMF in the period, for example, following the announcement of the January 28, 2022 preliminary agreement, where the protesters seemed to be particularly concerned with respect to any austerity that a deal with the IMF might entail. According to news reports in Reuters and elsewhere, the protesters carried signs with statements such as "No to Paying the IMF" and "No to an IMF Deal."[37] (Later, as the legislation proposing the IMF deal was being debated in the Argentine Congress, some of the protesters resorted to violence and, for example, set fires and hurled various objects at the building housing the Argentine Congress,[38] and even Vice President Cristina Fernández de Kirchner's office in the Senate was damaged by protesters.[39])

As it turned out, the political coalition led by Fernández suffered a huge setback in the elections held in November 2021, and in fact the Peronists lost control of the Senate for the first time in decades. This weakened position of the Fernández-led coalition in the Congress gave rise to a concern that it was likely to be even more challenging for the Fernández administration to get an IMF program approved by the Congress given the emboldened position of the center-right political opposition in the wake of the election results from November 2021. (In December 2021, the opposition forces had led to the defeat of the Fernández administration's budget bill in the lower house of the Argentine Congress.[40])

To make matters even more challenging, Fernández has been presiding over a very fragile political coalition, and in moving too far in one direction or another in the negotiations with the IMF, he might have risked losing the support of partners in his coalition. This came into very sharp focus in the days immediately following the announcement on January 28, 2022, of a preliminary agreement between Argentina and the IMF when the leader of the most left-wing (or, as some would say, radical) faction of the Peronist coalition in the Chamber of Deputies, Maximo Kirchner, resigned his leadership position and announced his strong opposition to the preliminary agreement between Argentina and the IMF.[41,42] Notwithstanding Maximo Kirchner's opposition to the deal, his mother, Vice President Cristina Fernández de Kirchner, remained somewhat tight-lipped about whether or not she approved of the deal, but she was not so guarded in voicing her long-standing animus towards the IMF. She cited with approval the sentiments expressed by her late husband, former President Néstor Kirchner, regarding the IMF when he said that the IMF "always acted as a promotor and vehicle of policies which provoked poverty and pain for the Argentine people …"[43]

Further, particularly as he and his team were in the latter stages of negotiations with the IMF (including in the period following the mid-term losses that his coalition suffered in November 2021), Fernández appeared to have at least one eye firmly fixed on the upcoming presidential election that is currently scheduled to be held in October 2023 as he is expected to be a candidate for reelection. Again, he presumably did not want to agree to elements of any IMF program that would be politically unpopular in Argentina, and that is perhaps one reason why, for instance, the Fernández administration in its negotiations with the IMF dealt so gingerly with the issue of fuel subsidies given the potential political explosiveness of that issue. Some observers have also expressed the view that, with the 2023 presidential election in mind, Fernández and his team may be less than firmly committed in the coming year to implementing any parts of the new IMF program that would cause pain to the Argentine people and their pocketbooks.

Notwithstanding all of the daunting political challenges which it faced, the Fernández administration was finally able to get the deal with the IMF approved by both chambers of the Argentine Congress, and actually the votes in both chambers of the Argentine Congress were fairly overwhelming. On March 11, 2022 the lower house, the Chamber of Deputies, approved the deal by a vote of 202-37 (with thirteen abstentions), and on March 17, 2022 the Senate approved the deal by a vote of 56-13 (with three abstentions). In each case, much of the opposition in Congress to the deal apparently came from disaffected members of Fernández's own political coalition.

Apparently, one way that the deal won such widespread support in the Argentine Congress was that the Fernández administration agreed to narrow the scope of the bill being voted upon in the Congress. Specifically, the legislators were asked to vote upon approving the new IMF loan, but in effect they did not have to vote on endorsing the economic policies put forward by the Fernández administration that underlay the new IMF program with Argentina.[44] It seemed that a vote to endorse the underlying economic policies put forward by the Fernández administration would have been a bridge too far for many opposition legislators. It should be noted as well that many legislators were concerned that, if they did not vote in favor of the new loan from the IMF and as a result Argentina fell into arrears on the 2018 IMF loan,

[37] "No to an IMF Deal: Thousands Protest in Argentina Against Debt Deal," Reuters, February 8, 2022.

[38] "Argentina Anti-IMF Protestors Burn Tires, Hurl Rocks as Congress Debates Deal," Reuters, March 10, 2022.

[39] "Cristina Fernandez de Kirchner Hits Out at 'Paradoxical' Attack on Her Senate Office," *Buenos Aires Times*, March 11, 2022.

[40] *See, e.g.*, Patrick Gillespie and Jorgelina do Rosario, "Argentina Lower House Unexpectedly Rejects 2022 Budget Bill," Bloomberg, December 17, 2021.

[41] *See, e.g.*, Lucinda Elliott and Michael Stott, "Resignation of Peronist Leader Triggers Crisis Over Argentina's $44.5bn. IMF Deal," *Financial Times*, January 31, 2022.

[42] *Supra* note 39.

[43] *See, e.g.*, Lucinda Elliott, "Argentina's Congress Approves $45bn Debt Deal with IMF," *Financial Times*, March 11, 2022.

[44] Editorial, "IMF's Argentina Deal Needs Tougher Conditions," *Financial Times*, February 2, 2022.

that could result in serious adverse consequences for Argentina and its economy.

Needless to say, in considering the parameters of any new program with Argentina, the IMF had its own political challenges to deal with. On the one hand, the IMF could not afford to have another program with Argentina that ended in failure such as happened with the 2018 loan, and such a concern might possibly argue for the IMF pursuing a more lenient (*i.e.*, less austerity-focused) deal with Argentina so that the deal would face less resistance in Argentina. On the other hand, if the IMF went too "soft" on Argentina, it would open itself to criticism that it was dodging its responsibilities to help Argentina face up to the deep-seated structural problems facing the Argentine economy.

Indeed, when the preliminary agreement was first announced in late January, the IMF came in for some fairly strong criticism that it had essentially agreed to a toothless deal with Argentina, and this was sentiment was captured in an editorial in the *Financial Times* entitled "IMF's Argentina Deal Needs Tougher Conditions."[45] In response to such criticism, only days after the preliminary agreement of January 28, 2022 was announced, IMF Managing Director Kristina Georgieva felt compelled in a news conference to defend the merits of the deal outlined in the preliminary agreement, and she was insistent in pointing out that what was needed was a deal with Argentina that would enjoy broad political and social support (or so-called "buy-in") within Argentina, a lesson she said that the IMF had learned from its 2018 loan to Argentina and the related IMF program.

Finally, as noted above, the war in Ukraine became a last-minute wild card in the IMF's consideration of the new arrangement with Argentina. In the wake of the Ukraine invasion, one might imagine that the IMF did not want to further unsettle the financial markets, particularly the emerging economies, by failing to reach an agreement with Argentina. The IMF may have been concerned that if an important emerging economy such as Argentina fell into arrears on such a large IMF loan as the 2018 loan to Argentina, foreign investors might want to reexamine their exposures to other emerging market economies and, as a result, might consider heading for the exits in those markets (whether as a result of contagion or otherwise.)

Competing Perspectives on Whether the New IMF Program Is a Positive Step Forward

Even with the new IMF arrangement approved and in place after such a long and tortuous process of negotiations, neither Argentina nor the IMF can sit back and expect the new IMF program to be an automatic success. As the IMF explicitly recognized in its statements accompanying the March 25, 2022, announcement of the Executive Board's approval of the program, the new program carries significant implementation risks as well as risks from external factors such as the economic repercussions of the war in Ukraine.

As a statement from the IMF's Executive Board put it, "The Directors agreed that the program is *subject to exceptionally high risks*. They recognized Argentina's vulnerability of external shocks and implementation difficulties given the complex social and political situation [in Argentina]." (emphasis added.) In addition, the IMF Executive Board members also pointed out that "the *spillovers from the war in Ukraine are materializing* … Directors welcomed the [Argentine] authorities' agreement to bring forward the first review of the program and urged them to *recalibrate policies* …" (emphasis added.)[46]

Apart from the issue of whether or not the new IMF program will succeed, there is a sharp split of opinion among commentators as to whether the IMF, in approving a plan that was lighter on austerity and fiscal consolidation than typical IMF programs, had moved in the right direction or was setting a bad precedent. Professor Joseph Stiglitz, for one, hailed the new IMF program as potentially establishing a new paradigm for IMF programs going forward. In an article entitled "The IMF's Agreement with Argentina Could Be a Game Changer," Stiglitz and his co-author, economist Mark Weisbrodt, argued that the new program "*eschewed austerity*" and "*will allow the Argentine economy to grow* while the government continues its efforts to reduce poverty and gradually bring down inflation (emphasis added)."[47] The authors added that "[w]ith so many countries facing debt distress from the pandemic, the IMF will need to adopt similar changes to its policies elsewhere."[48]

A very different perspective critical of the new IMF program has been articulated by Alejandro Werner, who served as director of the IMF's Western Hemisphere Department from 2013 until he retired in August 2021. In essence, Werner has argued that the new IMF program does not demand enough from the Argentine government in terms of addressing many of the fundamental weaknesses of the Argentine economy; Werner, though, acknowledged the importance of avoiding a non-payment by Argentina on the IMF's 2018 loan. For example, Werner stated the following in the wake of the announcement on January 28, 2022, of the preliminary agreement between Argentina and the IMF: "The *macroeconomic policy targets of the program are very weak*, there is negligible strengthening of macroeconomic institutions, and a *structural reform agenda is completely absent*. In short, the current program implicitly accepts that solving Argentina's socioeconomic puzzle is impossible *[and settles] for the minimum conditions to avoid descending into the abyss* (emphasis added)."

These competing perspectives on the new IMF program mirror a more basic split in views on what fundamentally ails the Argentine economy. As a general matter, Stiglitz and his colleagues believe that the basic problem with past Argentine economic policy has been that it is too focused on belt-tightening

[45] The IMF's new program with Argentina was to be subject to quarterly reviews by the IMF, but it was agreed that, in light of the fragility of the global economic environment given the economic fallout from the then-new war in Ukraine, the first review under the program would take place two months after the start of the program rather than in the customary three months.

[46] Joseph E. Stiglitz and Mark Weisbrodt, "The IMF's Agreement with Argentina Could be a Game Changer" Project Syndicate, March 10, 2022.

[47] *Ibid*. See also Joseph E. Stiglitz, "Argentina and the IMF Turn Away from Austerity," *Foreign Policy*, February 1, 2022 ("The Argentine agreement [with the IMF] gives [developing countries and emerging markets stressed by high debt levels] hope that they can turn to the IMF without the Fund imposing detrimental austerity and other counterproductive conditionalities. Let's hope so.")

[48] Alejandro M. Werner, "Argentina and the IMF: A Never-Ending Story." *Americas Quarterly*, February 14, 2022.

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(or austerity) and not focused enough on promoting pro-growth, pro-investment policies. By contrast, those who look at these issues as Werner does believe that the basic problem of the Argentine economy is that Argentina has too expansive a welfare state and that Argentine government's spending on social welfare program represents too large a percentage of overall government spending.[49] As Werner has stated, "Central to explaining Argentina's equilibrium of low growth and financial instability is the size of the state."[50] In this view, a major objective of economic policy should be to shrink the size of Argentina's welfare state.

Conclusion

Nonetheless, in my view there is one important area of economic policy (beyond the basic split in views discussed above as to whether or not the new IMF program for Argentina represents progress in IMF program design) that seems to get short shrift in much of the policy debates about Argentina's economy: namely, the fundamental issue of the Argentine economy's ability to generate foreign exchange on a steady and reliable basis over time. In this regard, in formulating economic policy in the future, Argentine policymakers may well wish to consider which of Argentina's industries and sectors going forward could enjoy a comparative advantage in international markets and how the Argentine government could promote the growth of such industries and sectors, with a particular focus on those industries and sectors which have the potential to produce high value-added goods and services that will be in demand in international markets.

Argentina needs to consider developing an export strategy based on comparative advantage that can generate the quantum of foreign exchange that, for example, will be adequate to help finance debt service for any of Argentina's outstanding foreign debt (as well as help finance any shortfalls in government budgets). Otherwise, lacking such a reliable stream of foreign exchange earnings, Argentina may continue to face recurring debt crises with respect to its foreign debt in particular, as it has so often in recent decades (and, indeed, over its entire history as an independent nation). In addition, such an export strategy based on comparative advantage, if successful, might also generate well-paid jobs in the private sector, not a trivial matter in an economy where issues of unemployment are often a serious concern.

Argentine policymakers will have to give serious thought as to what high value-added Argentine-produced goods and services could enjoy a comparative advantage in international markets—*i.e.*, exports that go beyond Argentina's traditional leading exports of agricultural commodities such as wheat and soybeans. For example, Argentine policymakers might consider the experience of their neighboring country, Brazil, and specifically how several decades ago Brazil developed an aircraft industry virtually from scratch centered on the Brazilian company Embraer. Over time, Embraer has grown into one of the major manufacturers of aircraft in the world,[51] and it has become the source of thousands of well-paying jobs for Brazilians and is a major positive contributor to Brazil's balance-of-payments position.

To be sure, no two countries (or their respective cultures, histories and/or demographics) are exactly alike, and that certainly holds true for Argentina and Brazil; economic initiatives or policies that have worked effectively in one country are not necessarily easily replicable in another country; and a highly successful, internationally competitive company like Embraer cannot simply be conjured up out of thin air.[52] Nonetheless, Argentine policymakers could do worse than to consider whether there are any intrinsic strengths and resources present in Argentina today that Argentina could leverage into developing new industries of the future, much as Brazil did with Embraer many years ago. Apparently, at least judging by the emergence in Argentina in recent years of several unicorns, some strong high-tech talent already exists in Argentina. The question, though, is whether Argentina can develop major, large-scale companies of the type that can help drive the international competitiveness of the Argentine economy as a whole by producing high value-added exports (while crucially also providing valuable employment opportunities to large numbers of Argentineans).

In short, in the coming years, Argentina's debt problems will not simply disappear, regardless of whether the new IMF program for Argentina is successful or not. Rather, in the coming years, Argentina will need to develop a comprehensive, forward-looking economic strategy if it is ever to have a chance of having a sustainable debt burden over time. Otherwise, Argentina may continue to face the unwelcome prospect of recurring debt crises—something Argentina has endured for far too long over its history as an independent nation.

Update (as of mid-February 2023)

Since the original version of this article was first published last spring, there has been a dearth of positive news coming out of Argentina, apart from Argentina's spectacular victory at the World Cup in December, with its team led by football legend and national hero, Lionel Messi. Specifically, Argentina's economy in particular has continued to face deepening challenges on a number of fronts. While the Argentine economy did register economic growth of 5.2% in 2022 according to World Bank estimates[53] (but with slower growth of roughly 2% generally expected for 2023[54]), the Argentine economy has continued to suffer from a range of economic woes. These include sky-high inflation, a severely weakened national currency, a high poverty

[49] *Ibid*. ("Public expenditure is above 40% of GDP, one of the highest levels in the Americas, with a negligible investment component and there is no social agreement on how to fund it.")

[50] *Ibid.*

[51] Of course, Airbus and Boeing dominate the global aircraft manufacturing market, but Embraer has carved out a solid niche for itself in producing executive jets as well as civilian aircraft (especially regional jets) and defense aircraft.

[52] Among other things, the development of Embraer benefited from a number of key factors, among them the deep pool of engineering and particularly aeronautical engineering talent in Brazil (growing out of the well-respected engineering (including aeronautical engineering) programs in its universities) as well as the dedicated and strong financial support that Embraer received from Brazil's critically important national development bank, BNDES.

[53] World Bank, Global Economic Prospects (January 2023), Chapter 1, 4. As of Jan. 2023, IMF estimated GDP growth of 4.6% for Argentina in 2022.

[54] *Ibid*.

rate of over 40%,[55] and a relatively low level of net international foreign exchange reserves.

A high rate of inflation has been a chronic problem for the Argentine economy for many years and was one of the central areas of focus for the IMF in developing its March 2022 program with Argentina. Nonetheless, this problem was exacerbated in 2022 as inflation continued to rise sharply and reached 94.8% for the year (compared to a level of 50.9% in 2021), its highest level since 1991 when inflation hit 91%.[56] Furthermore, inflation is generally expected by Argentine private analysts to remain at an elevated level in 2023, possibly with a slight increase over the inflation rate for 2022.[57]

Argentina's extremely weak national currency, the Argentine peso, was another major area of focus for the IMF in the March 2022 program. Yet, over the course of 2022, the peso continued to depreciate significantly against the US dollar, losing 41.4% of its value against the dollar between January 2022 and December 2022,[58] and further depreciation of the peso is expected in 2023.[59]

Nonetheless, on a technical level, the IMF has assessed that overall, Argentina has been meeting the quantitative benchmarks and other commitments it made as part of its March 2022 program with the IMF (and where Argentina has not done so, such as in the imposition of certain types of capital controls, the IMF has granted waivers for non-observance). For instance, Argentina has reduced its primary fiscal deficit for 2022 to 2.6% of GDP (from 3.3% in 2021), against a target agreed upon with the IMF of 2.8% of GDP for 2022. In addition, the Argentine government has significantly reduced financing the deficit through the central bank printing money (or "monetizing the deficit"). Some observers, though, have underlined the fact that the Argentine government has basically resorted to financing its continuing budget deficit through the back door by issuing huge amounts of peso-denominated debt.[60]

The IMF has made all of its scheduled disbursements under the Extended Fund Facility (EFF), including a disbursement in December 2022 of $6 billion upon the completion of the IMF's third review under the EFF, with total disbursements as of December amounting to $23.5 billion.[61] Yet, while the IMF indicated it was satisfied with Argentina's progress in meeting the objectives specified in the EFF program and credited the Argentine government's economic team for achieving that progress, the IMF has also noted that the "situation remains fragile"[62] and that "[p]rogram risks remain elevated in the context of a less favorable external environment and ongoing policy implementation risks."[63]

Outside observers have also voiced major concerns about the performance of and prospects for the Argentine economy. For example, the credit rating agency Fitch has observed that "policy weaknesses continue to heighten economic vulnerabilities and undermine repayment capacity [on its outstanding debt], and a severe drought and looming elections compound these challenges in 2023."[64]

Finally, in the coming period, Argentina's debt profile could be fairly challenging: its local currency debt has a wall of maturities approaching in the coming months, and its restructured foreign bond debt begins amortizing in the next few years. The overriding question, then, is whether Argentina—which at the present time is still facing enormous economic challenges and which has presidential elections looming on the horizon in October 2023—will be in any better position in the coming years to service its outstanding debt than it was in the last few years, when it was forced to restructure both its foreign bond debt and local-law dollar debt as well as refinance its 2018 IMF loan. Only time will tell whether Argentina will be able to extricate itself from a seemingly endless cycle of debt distress, debt defaults, debt restructurings, and IMF arrangements.

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[55] *Buenos Aires Times*, "UCA Report Puts Argentina's Poverty Rate at 43.1%," December 6, 2022, https://www.batimes.com.ar/news/argentina/uca-reports-poverty-rates-have-reached-40-in-third-quarter-amid-political-transition.phtml.

[56] *Buenos Aires Times*, "Argentina Ended 2022 with 94.8% Inflation, Highest Rate in 32 Years," January 12, 2023, https://www.batimes.com.ar/news/economy/argentina-ended-2022-with-948-inflation-highest-rate-in-32-years.phtml.

[57] *Ibid*. Private analysts surveyed by Argentina's central bank of market expect the inflation rate to be 98.4 percent in 2023, which stands in sharp contrast to an inflation rate of 60 percent projected by the Argentine government.

[58] Sebastián Osorio Idárraga, "How Did Latin American Currencies Perform in 2022?" Bloomberg Linea, December 23, 2022, https://www.bloomberglinea.com/english/how-did-latin-american-currencies-perform-in-2022/.

[59] The value of the peso has continued on a further downward trajectory at the start of 2023. See Bitcoin.com, "Peso Loses Almost 12% of Its Value Against the Greenback During January; Inflation Expected to Rise Sharply," January 30, 2023, available at https://news.bitcoin.com/argentine-peso-loses-almost-12-against-the-greenback-during-january-inflation-projected-to-rise-sharply/ (last checked on February 16, 2023).

[60] Scott Squires, "Argentina Is Buckling Under Strain of US$174-Billion Debt Mountain," *Buenos Aires Times*, February 10, 2023. However, Argentina may encounter debt sustainability issues with respect to its outstanding peso-denominated debt in light of the extremely large stock of outstanding local currency debt and the approaching "wall" of maturities of such debt.

[61] International Monetary Fund (IMF), Press Release, "IMF Executive Board Completes Third Review of the Extended Arrangement Under the Extended Fund Facility for Argentina," December 12, 2022.

[62] IMF, "Argentina: Third Review Under the Extended Arrangement Under the Extended Fund Facility, Request for Waivers of Nonobservance of Performance Criteria, and Financing Assurances Review," December 12, 2022, 5.

[63] *Ibid*., 2.

[64] FitchRatings, "Argentina Avoids Default Event, but Faces Mounting Vulnerability," February 1, 2023. *See also* FitchRatings, "Fitch Downgrades Argentina to 'CCC-'; Removes from UCO," October 26, 2022.

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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 served formerly as Lead Attorney with the Export-Import Bank of the United States and as General Counsel of the New York State Financial Control Board. He has worked on numerous high-profile and complex restructuring and infrastructure project transactions in the emerging markets and has also advised multilateral institutions and national governments in developing countries and emerging markets on a wide range of financial and commercial matters.

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