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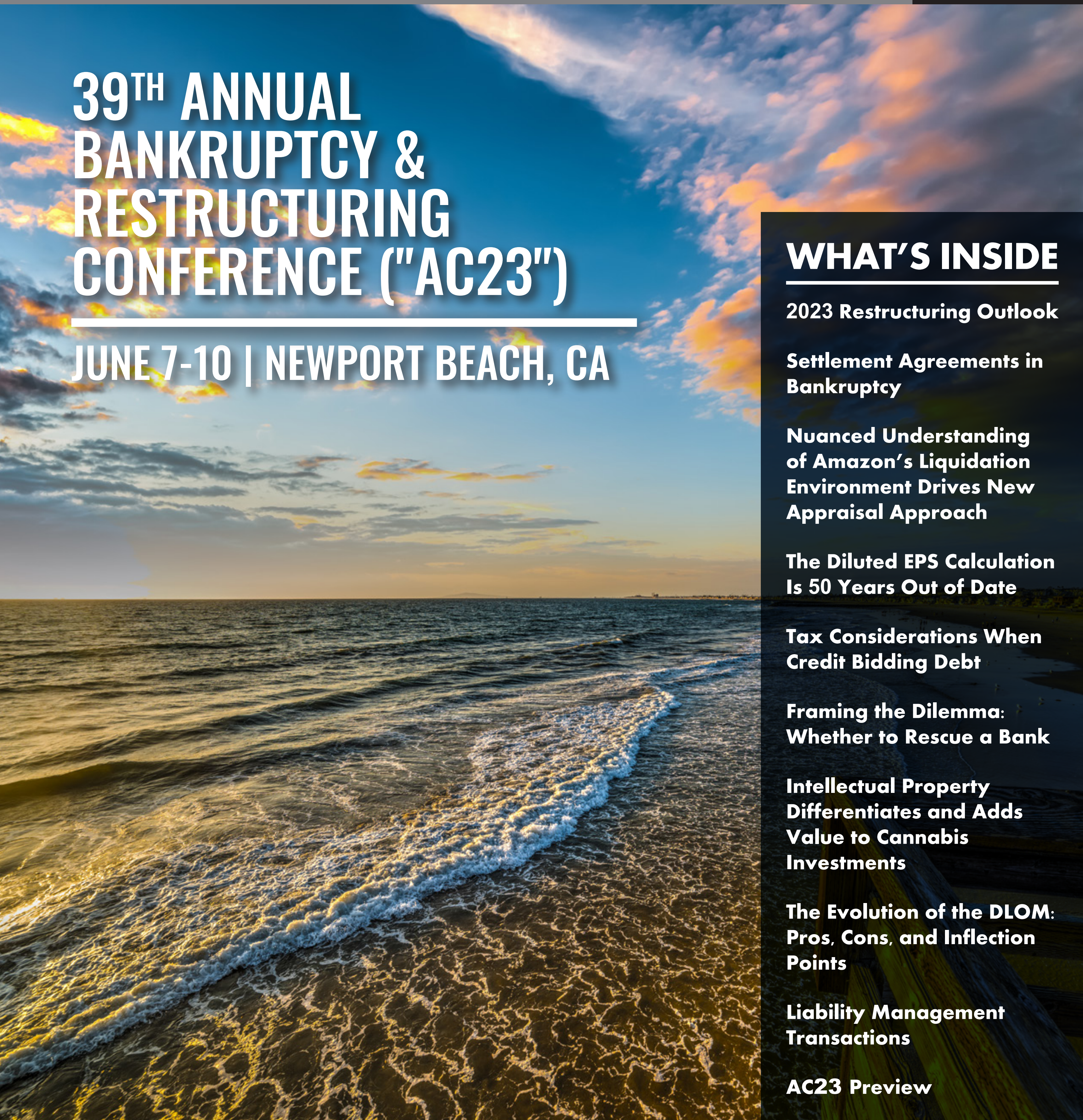

39TH ANNUAL BANKRUPTCY & RESTRUCTURING CONFERENCE ("AC23")

JUNE 7-10 | NEWPORT BEACH, CA

WHAT'S INSIDE

LEARN MORE ABOUT WHAT'S IN STORE FOR AC23, JUNE 7-10, 2023 - PREVIEW SECTION ON P.50!

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From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

VALCON 2023 just concluded in New Orleans, as I am drafting this letter. Valuation issues continue to be front and center in bankruptcy and restructuring cases, particularly in this time of emerging intangible valuation issues related to the increasingly important economics of crypto currencies, nonfungible tokens (NFTs), and digital matters in general. Recognizing the importance of these matters, on March 23, 2023, the FASB issued a proposed accounting standards update, "Accounting for and Disclosure of Crypto Assets." The comment period for the proposed standard ends on June 6, 2023.

In line with this emerging focus, valuation credentials are increasingly important to a professional's CV. AIRA will be conducting CDBV (Certification in Distressed Business Valuation) sessions later this summer. There is still plenty of time to sign up. Details are on the AIRA website.

In March, the Board voted to welcome three new board members: Katherine Catanese, from Foley and Lardner, Ira Herman, from Blank Rome, and Alexandra Mahnken, from Mahnken Consulting. All three of these new board members are recognized names for their involvement in AIRA events and programs, as well as their professional activities. Katie, Ira, and Alexa will begin their board terms at the annual meeting in June.

Also in March, the Board voted to recognize William A. Brandt, Jr., with AIRA's Emmanuel M. Katten award. Bill has devoted his career not only to advancing the turnaround, restructuring, and bankruptcy profession but to that intersection among the fields of business, civics, and politics. AIRA is pleased to recognize Bill for his many contributions.

Annually, AIRA, through the Grant Newton Educational Endowment Fund, provides a scholarship to an accounting student at Pepperdine University. This year's student is Zedekyah Teh (see page 57). In a thank you note to me, Zed stressed the importance of scholarships such as AIRA's for making it economically feasible for students to complete their education. The Endowment Fund is still building and depends on continued contributions from AIRA members. Please consider a contribution to the Endowment Fund in your annual giving.

Notes from Association President, David Payne, and President-Elect, Denise Lorenzo, follow.

Just a reminder, 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.

As you've come to expect, 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

Our 39th Annual Conference will take place at the Newport Beach VEA Marriott Resort & Spa beginning on Wednesday, June 7 and ending midday on Saturday, June 10th. On June 6-7, the AIRA Board of Directors will hold a one and one-half day long-range strategic planning session with Dynamic Change Solutions (DCS), our planning facilitator.

DCS has completed the Organizational Assessment phase by conducting an online membership survey and performing interviews with seven diverse Focus Groups. The luncheon presentation at the Preconference on June 7 will include a fireside chat discussing observations, insights and status of strategic challenges and opportunities among Louis Feldstein of DCS, Jennifer Meyerowitz, Chair of the AIRA Strategic Planning Committee, and AIRA's Executive Director, Jim Lukenda. The Annual Conference is a perfect opportunity for members to provide thoughts and insights into how AIRA can better serve you and your practice. Please take the opportunity to communicate your thoughts to Board members during the opening reception, excursions, breaks or at the annual dinner.

Denise Lorenzo—a Director at AlixPartners and AIRA Board member—will begin her 2024/25 term as AIRA's President at the conclusion of the Annual Conference. Denise and I have diverse backgrounds and experiences, but we share common values present in the AIRA organization. I look forward to serving with Denise as Chairman during the upcoming fiscal year. The reassessment and renewal of our organization has been set into motion during the 2023/24 year and Denise will lead us into the implementation phase in the upcoming year.

During early March 2023, AIRA began its newly activated membership in the Bankruptcy Diversity, Equity, Inclusion and Accessibility Consortium ("Consortium") which is comprised of ten professional organizations and the executive office of the UST. Leah Eisenberg, Eric Kerwood, Jim Lukenda and I will serve as AIRA representatives to the Consortium. As a member of the Consortium, AIRA will be one of the sponsors of the Emerging Leaders Reception at the National Conference of Bankruptcy Judges to be held this year in Austin, October 11-14, 2023.

— David Payne

A Letter from AIRA's Next President

DENISE LORENZO, CIRA
AlixPartners, LLP

On behalf of the AIRA Board, I want to thank outgoing President David Payne for his dedication and leadership to the organization. I am honored to serve the organization and to serve as successor to such a distinguished professional as David who has supported AIRA for several decades.

I have been an active AIRA board member for the last six years. For three of those years I served as Board Secretary. I serve on the Strategic Planning Committee and with the Board will lead the implementation of the strategic plan in the next year.

The upcoming year provides several AIRA events that will provide networking opportunities, reconnecting with industry professionals and in person continuing education:

- AIRA's 39th Annual Bankruptcy & Restructuring Conference, June 07-10, 2023, VEA Newport Beach, A Marriott Resort & Spa, Newport Beach, CA
- 10th Annual Energy Summit, date TBD, Dallas TX
- NCBJ Annual AIRA Breakfast Program, October 13, 2023, Austin, TX, "Valuation Conundrums," directed by Professor Jack Williams, CIRA, CDBV.
- 22nd Annual Advanced Restructuring and POR Conference, November 13, 2023, New York, NY

I look forward to continuing to work with David in his role as as Chairman and as President working with Executive Director, Jim Lukenda, and the Board starting with the annual meeting in Newport Beach, CA.

— Denise Lorenzo

2023 COURSES

CDBV

Part:	Dates:	Location:
1	Jun 05-06, 2023	Newport Beach, CA
2	Aug 07-11, 2023	Online
3	Aug 22-31, 2023	Online

More information on the CDBV program at www.aira.org/cdbv

2023 COURSES

CIRA

Part:	Dates:	Location:
3	May 23-31, 2023	Online
1	Jun 5-6, 2023	Newport Beach, CA
2	Jul 11-19, 2023	Online
3	Sep 05-13, 2023	Online
1	Oct 17-25, 2023	Online
2	Nov 08-16, 2023	Online
3	Dec 11-14, 2023	Online

More information and registration at www.aira.org

2023 RESTRUCTURING OUTLOOK

John Potter, Steven Fleming, and David Tyburski
PwC

The emergence of macroeconomic headwinds in the second half of 2022 may signal bankruptcy and restructuring activity for 2023. Rising interest rates, soaring inflation and a scale back of government support caused a slowdown in market activity and consumer demand in 2022. These disrupting forces have already impacted various companies with complex, global supply chains, high degrees of operating leverage, and inflexible pricing arrangements with customers.

As focus shifts toward capital preservation and cash flow efficiency, a challenging and higher-cost borrowing environment and decline in market liquidity are likely to fuel a broadly based increase in bankruptcies and financial and operational restructuring activity in the near term.

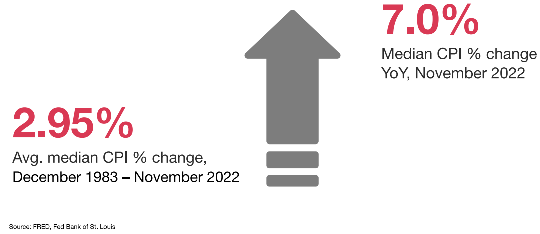
2022 in Review

Chapter 11 bankruptcies declined slightly in 2022 which had the lowest levels in more than a decade (Exhibit 1, left). That trend was less pronounced among larger companies where activity actually ticked up in the later months of 2022 (Exhibit 1, right).

Despite the reduced number of filings in 2022, the second half started to see a pickup relative to the same period in 2021, with December being the busiest month for filings all year(Exhibit 2). Based on the studies, this trend is expected to continue into 2023.Many factors contributed to this increase, including:

Interest rates—Higher interest rates were a result of the Fed's monetary tightening and the scaling back of stimulus programs (Exhibit 3). These changes in various instances created an unfavorable borrowing environment and may have a negative impact on consumer spending.

Inflation—Increased inflationary pressures were caused by continued supply chain disruptions, geopolitical unrest, rising wages and higher energy prices. These factors often increase financial stress for companies that are unable to pass along cost increases to customers or significantly improve their own cost structures. The following graphic is illustrative:



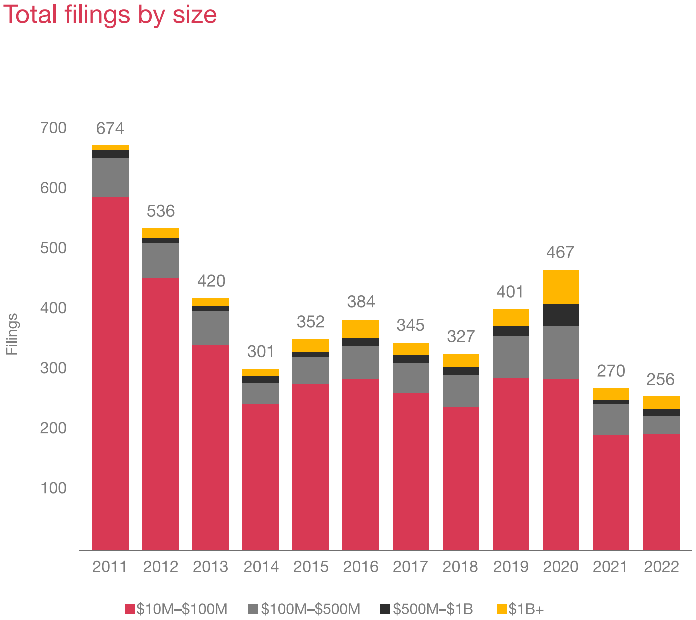
M&A activity—M&A activity returned to historic norms after a record year in 2021 (Exhibit 4).[1] Lower public-company valuations and a closed initial public offering (IPO) market are having a ripple effect on smaller public and private companies, making fundraising more challenging.[2]

[1] Detailed information available at https://www.pwc.com/us/en/services/consulting/deals/outlook.html.

[2] Detailed information available at https://www. pwc.com/us/en/services/consulting/deals/library/us-capitalmarkets outlook.html.

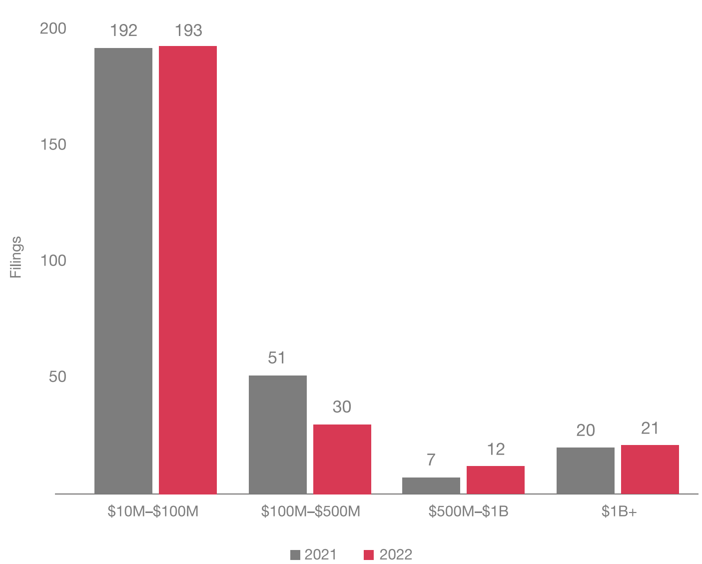
Exhibit 1: 2022 Filings by Size and by Total Liabilities

Total filings by size



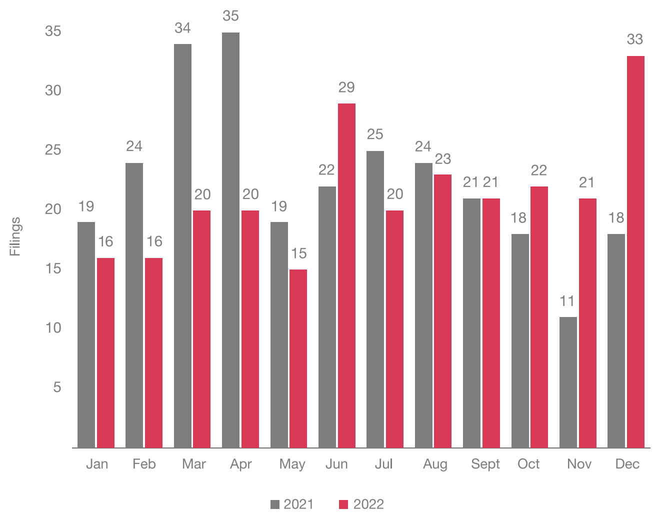
Source: Reorg Research, Debtwire, Capital IQ

Filings by total liabilities (2021 vs. 2022)



Source: Reorg Research, Debtwire, Capital IQ

Exhibit 2: Comparison of Filings by Month, 2021 vs. 2022



Source: Reorg Research, Debtwire, Capital IQ

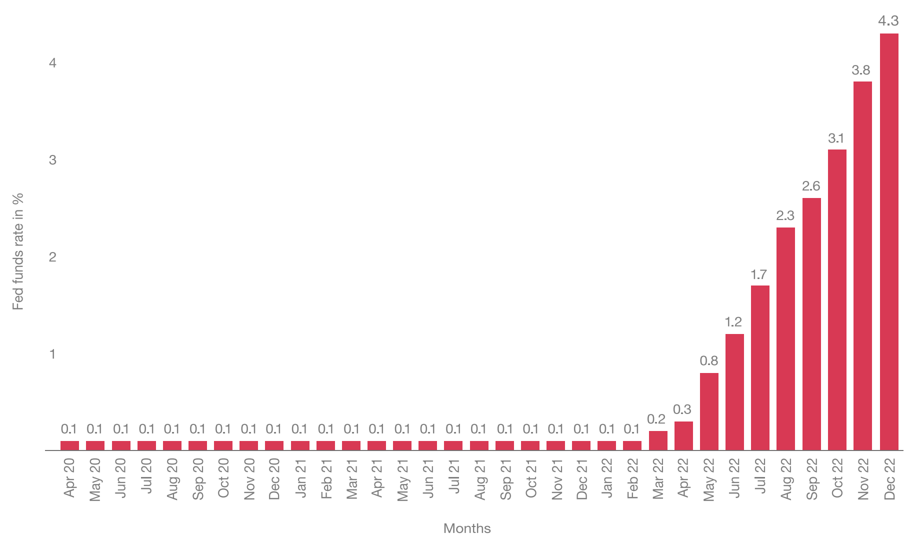
Credit market conditions—A tightening in credit markets, evidenced by leveraged loan and high-yield bond issuances decline 45% and 78% year-over-year, respectively, and yields have more than doubled as a result of the increased interest rate environment (Exhibit 5, p. 8). Moving into 2023, more challenging financial conditions will likely require that companies pay more to raise or refinance debt. For the less solvent, prohibitive funding costs or a shunning of risk can heighten focus on the implications of ratings downgrades and credit losses.

A Closer Look at the Sectors

While down from 2021 levels, the real estate, retail and consumer sectors again dominated restructuring activity in 2022, together accounting for 48% of Chapter 11 filings volume. Financial services had the most billion-dollar cases (Exhibit 6, p. 8).

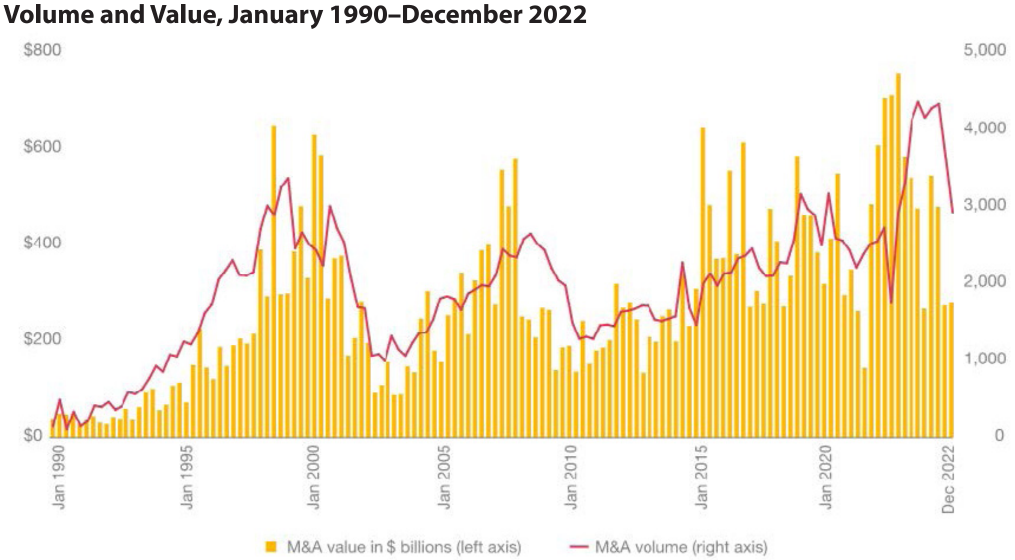
The pace of healthcare Chapter 11s picked up particularly in the latter half of 2022, potentially signaling more distress in the sector heading into 2023.

Exhibit 3: Federal Funds Effective Rate (not seasonally adjusted), April 2020 – December 2022



Source: Federal Reserve Economic Data (FRED), Fed Bank of St. Louis

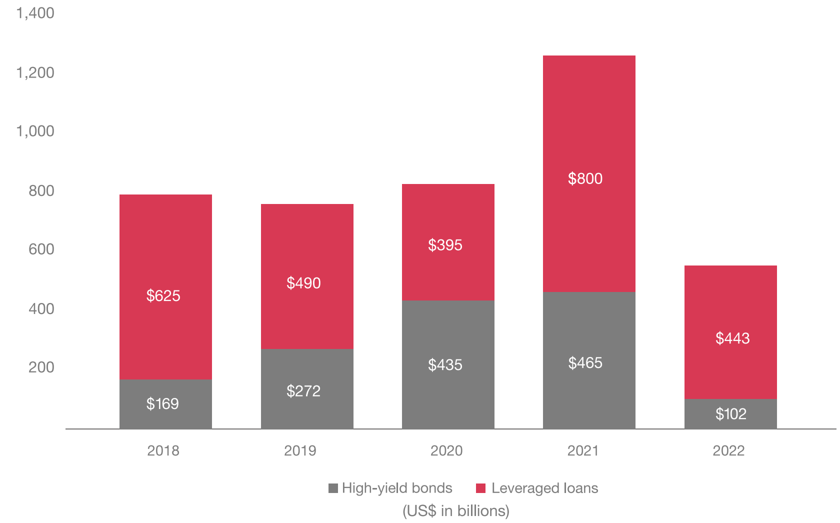
Exhibit 4: M&A Volume and Value, January 1990–December 2022



Source: PwC analysis of Refinitiv data as of Jan 3rd. 2023

Continued from p.7

Exhibit 5: High-Yield Bond and Leveraged Loan Issuance, 2018-2022



Source: Leveraged Commentary & Data

The financial services and healthcare sectors combined accounted for seven of the ten largest Chapter 11 filings in 2022. Taken as a whole, the top ten accounted for $82 billion in liabilities, up from last year's $32.5 billion. One reason for the increase: The top two 2022 filings comprise a combined $48 billion in liabilities.

2023 Outlook and Sectors to Watch

A number of macroeconomic factors emerged in 2022 that have resulted in various shifts in consumer behavior, unfavorable borrowing conditions and operational challenges due to rising costs. Market liquidity has declined and quieted M&A markets are forcing companies to realign their cost structures and focus on capital preservation and organic cash flow generation, according to PwC analysis of Refinitive, LCD and FRED data.

As these macroeconomic conditions persist into 2023, we can expect to see a sizable increase in restructuring activity as borrowers run out of levers to pull and lenders choose not to extend further accommodations.

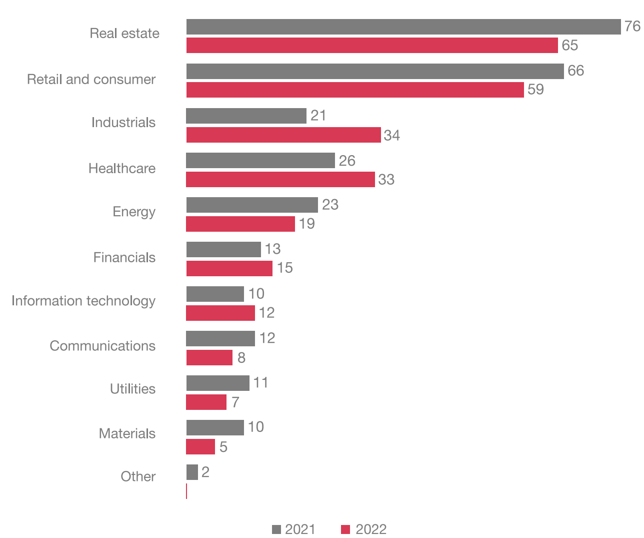
As 2023 unfolds, we are monitoring a number of sectors we think might face the heaviest challenges.

Automotive—The automotive industry may be in for a drastic technological disruption over the course of the next decade with the move toward electric vehicles (EV). Along with longer-term headwinds, auto suppliers also face near-term operational challenges related to the semiconductor chip shortage affecting light-vehicle production globally, margin contraction due to inflationary cost pressures and increased capital costs resulting from rising interest rates. Tier 1 suppliers in particular are facing the squeeze from original equipment manufacturers' (OEM) cost pressures, additional technical requirements, lack of accurate platform volume forecasts, shortage of labor, supply chain issues and increasing capital costs. OEM's have been generally reactive to distress within their tier 1 supplier base. To assure continuity of supply, car manufacturers have been providing pricing and liquidity accommodations only after their suppliers show critical financial distress. We expect this trend of reactive accommodations to continue into 2023 until some of the underlying macroeconomic triggers stabilize.

Consumer markets and retail—The sector is facing margin pressures from rising costs driven by inflation and inventory/ supply challenges along with declining consumer sentiment and spending on nonessential goods and services. While a return to normalized inventory levels and alleviation of supply chain backlogs can help improve margins, elasticity of price increases and the ability to pass them along to the end consumer remains unclear. Inflationary pressures from labor force shortages, rising commodity prices, and higher packaging and freight costs are likely to remain — which will likely continue to pressure profitability.

Crypto—We expect continuing restructuring activity throughout FY23. Crypto winter's hit to asset prices and the fall of certain large crypto natives have often undermined what every financial system depends on: trust. Until trust can be reestablished, digital assets will likely fail to reach their potential and won't likely offer profitable value to certain businesses.

Exhibit 6: Chapter 11 Filings by Industry, 2021 v. 2022



Source: Reorg Research, Debtwire, Capital IQ

Health services—As the temporary safety net measures of governmental support provided during the pandemic recede, healthcare organizations are confronting increased reliance on third-party systems and service providers, cost pressures and an increasingly complex, evolving regulatory environment. Supply chain issues and labor shortages are likely to challenge providers financially. For example, prices for personal protective equipment (PPE), infrastructure and staffing (such as nursing) have risen.[3] The senior care subsector is also likely to be challenged as the trend of seniors looking to home health and other alternatives versus traditional assisted living facilities continues from the fallout from the pandemic.

Industrials—Companies with complex, global supply chains and inflexible pricing arrangements will likely continue to face challenges in FY23. A persistent market environment of inflation, rising energy costs and heightened geopolitical risk can have an impact on a broad swath of companies as well as their available strategic options.

Pharmaceuticals and life sciences—The pharmaceuticals and life sciences industry faced a challenging year of record low IPOs, retrenchment of venture funding and falling share prices that are not expected to reverse in the near term. While desirable assets and promising sciences can continue to help attract investors and market premiums — and there will likely be winners and losers in M&A — higher risk sectors such as biotech with early-stage compounds will find fundraising opportunities more challenging. In the medtech sector, which just experienced one of its most difficult years in terms of capital market performance, some companies will likely be challenged as they deal with macro headwinds from supply chain uncertainty and the slower rate of medical device approvals by the Food and Drug Administration (FDA).

Real estate—In any period of economic uncertainty there are both real estate winners and losers. We expect that newly constructed and redeveloped assets will likely win out, while older and undeveloped assets experience headwinds. However, these headwinds repeatedly provide the impetus for innovative ways to help redefine and repurpose under-performing assets.

For instance, one developer recently pivoted a New York City residential project into a plan to build a convention and entertainment district. The ability of landlords to pivot in this way secures future relevance of their assets and can also help provide economic stimulus for tenants, including those operating within the hospitality and retail sectors. The early consideration of alternatives — such as redevelopment — can be key to helping real estate firms weather volatile market conditions.

3 https://www.pwc.com/us/en/industries/health-industries/library/behind-the-numbers.html.

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SETTLEMENT AGREEMENTS IN BANKRUPTCY[1]

Ira L. Herman
Blank Rome LLP

This practice note discusses settlement agreements and the various risks to the settling parties in a bankruptcy case. Settlement agreements, and the certainty that is supposed to be created by such agreements, are subject to several risks in the context of a bankruptcy filing by one of the settling parties.

First and foremost, there is the risk that the party against whom the claim has been asserted will obtain a release in exchange for a promise to pay (e.g., through a structured settlement) and then file for bankruptcy and discharge the payment obligation. Although this risk can be mitigated if the releasing party secures the payment obligation, the lien or security interest could be subject to claw back, as a preferential transfer, in the event the party that has granted the lien of security interest were to be in a bankruptcy case commenced within 90 days of the perfection of such lien or security interest. Even when a settlement payment is made up-front, in cash, there is a risk that the payment could be avoided as a preference or as a fraudulent transfer. Although these risks cannot be eliminated, they can be mitigated by careful drafting.

This practice note addresses settlement agreements in bankruptcy as follows:[2]

- The Discharge Risk
- Avoidance
- Bankruptcy Court Approval of Settlements
- Settlement Agreement Checklist

The Discharge Risk

When parties settle before a bankruptcy filing, the primary risk with respect to settlement agreements is that the party required to make one or more payments under the agreement in exchange for a release will obtain a discharge of its payment obligation. The recipient of the payments (*i.e.,* the releasing party) may then be in a situation in which it will not receive the full amount of the settlement and will not be able to successfully assert its original claim against the bankruptcy estate. This risk arises most frequently when the settlement is a structured settlement providing for payments over time.

As a practical matter, if the paying party is not financially sound, one way for the releasing party to counter this risk is to draft a settlement agreement that grants a security interest in collateral sufficient to cover the amount of the structured settlement. The security interest must then be perfected in accordance with applicable non-bankruptcy law. If the paying party later files for bankruptcy, the releasing party will have a secured claim against the estate and will then be paid in full (assuming the value of the collateral is sufficient to cover the amount of the claim). The releasor that secured a payment stream by taking collateral remains subject to the risk that the transfer of the collateral will be subject to attack as a preferential transfer.

If the underlying claim giving rise to the settlement would be a non-dischargeable obligation under Section 523(a) of the Bankruptcy Code (e.g*.,* for fraud), the releasing party should seek provisions in a settlement agreement that clearly state the basis for the agreement and thus preserve the non-dischargeable character of the claim—or, better yet, agree to the entry of a stipulated judgment. If, for example, the underlying claim is one based on fraud, willful and malicious injury, or defalcation in a fiduciary capacity (to name a few common categories of non-dischargeable debt), the settlement agreement can explicitly state the grounds of the debt being paid in language that tracks the elements of non-dischargeability under Section 523(a). Courts generally enforce post-petition settlement provisions setting forth the non-dischargeability of the debt in bankruptcy but hold that pre-petition waivers of dischargeability are unenforceable.[3]

A pre-petition stipulation as to the facts giving rise to the underlying claim may, however, be enforceable, particularly if it is entered by a court as part of a consent judgment.[4] The issue preclusive effect of such a stipulation is determined by applicable collateral estoppel law. A consent judgment in federal court does not have issue preclusive effect; the collateral estoppel effect of such a consent judgment in state court is determined pursuant to state law.[5] The stipulation must include a specific admission of the elements for one of the non-dischargeability grounds in Section 523 of the Bankruptcy Code. A bare assertion

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[2] For related content, see *Rule 9019 Settlement Agreements*, *Preferences*, *Fraudulent Conveyances versus Preference Actions and Fraudulent Transfers*. For clauses that can mitigate the risks discussed in this practice note, see *Settlement Agreement Clause(Bankruptcy Effect on Released Claims)*, *Settlement Agreement (Anticipating Fraudulent Transfer Challenges)*, and *Settlement Agreement (Anticipating Preferential Transfer Claims),* available at advance.lexis.com.

[3] See *Lichtenstein v. Barbanel*, 161 F. App'x 461, 468 (6th Cir. 2005); *Saler v. Saler (In re Saler)*, 205 B.R. 737 (Bankr. E.D. Pa. 1997).

[4] See *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) (determining that consent judgment proved that debt was non-dischargeable where parties stipulated to facts establishing the elements of Section 523(a)(4) and stating, "For public policy reasons, a debtor may not contract away the right to a discharge . . . [but] a debtor may stipulate to the underlying facts that the bankruptcy court must examine to determine whether a debt is dischargeable.").

[5] See *Bay Area Factors v. Calvert (In re Calvert)*, 105 F.3d 315, 317 (6th Cir. 1997) (holding that the collateral estoppel effect of a state court default judgment in a non-dischargeability action was based on applicable state law).

that a claim is based on "allegations of fraud," together with an agreement that the debt is non-dischargeable, is not sufficient without actual admissions of the facts.

Many settling defendants will be unwilling to stipulate that the settlement amount is based on non-dischargeable grounds because such a stipulation would amount to an admission, for example, of a fraud, defalcation, or willful and malicious injury. The releasing party may instead seek to include a provision that preserves its original claims, including the issue of non-dischargeability, in the event that a bankruptcy or other insolvency proceeding is filed and it does not receive or is not allowed to retain the full amount of the settlement payment.

If the releasing party fails to include provisions protecting the non-dischargeable character of the debt, the obligation may be transformed into a mere contractual obligation dischargeable in bankruptcy. This would be true particularly if the settlement involves the entry of a judgment converting an unliquidated claim into a fixed debt obligation, without a clarification that the claim is subject to non-dischargeability.[6]

Usually, however, a settlement agreement will not be interpreted as rendering the settlement obligation dischargeable. Following the Supreme Court's ruling in *Archer v. Warner*,[7] courts are required to look behind the settlement to the underlying cause of action to determine dischargeability as long as the terms of the settlement agreement do not direct otherwise. A releasing party should make sure that no language in the settlement agreement explicitly or implicitly renders the settlement obligation dischargeable. The paying party should bargain for a stipulation that the execution of a promissory note extinguishes the underlying cause of action and, if possible, that the debt created by the promissory note is dischargeable, thereby increasing the possibility that the settlement obligation will be dischargeable in the event of a bankruptcy filing.

Avoidance

Even when the settlement amount will be paid all at once, the party receiving the payment risks avoidance of the payment in bankruptcy, either as a fraudulent transfer or (more likely) as a preferential transfer. While it has been argued that the dismissal of litigated claims is "new value" and thereby excepted from preference risk under Section 547(c)(1) of the Bankruptcy Code, this reasoning is suspect at best and a settling plaintiff has to address the preference risk just as any creditor receiving payment on account of an antecedent debt within the preference avoidance period.[8] When the entire settlement amount is paid at once, the releasing party receives the entire amount agreed to under the settlement agreement. If, however, the payment is made less than 90 days before the paying party files for bankruptcy relief, the releasing party may be required to turn over the settlement payment to the estate since the amount received (the entirety of the settlement amount) is almost certainly greater than the amount that the releasing party would have received on account of its claim in a Chapter 7 distribution. Similarly, if the releasing party takes a security interest in the prospective debtor's property to secure a structured settlement, the security interest will likely be subject to avoidance as a preference if the other party files for bankruptcy less than 90 days after the perfection of the security interest.

As a practical matter, one way to mitigate this risk is to arrange for the payment (and/or the attachment and perfection of the security interest) to be made as soon as possible to lessen the likelihood that the paying party will need to file for bankruptcy within 90 days. Of course, if the settlement payment itself precipitates the filing, requiring an earlier payment may not help. If the payment of the settlement is likely to result in insolvency, the releasing party may choose to defer payment by 90 days while taking a security interest in noncash assets.

Although the security interest itself could be subject to avoidance as a preference for up to 90 days after perfection, both the security interest and subsequent payments will, after the 90-day window has passed, be protected from avoidance, since payments on a secured obligation are not avoidable preferences. Securing the obligations under the settlement agreement can therefore reduce the risk of avoidance of payments in a deferred or structured settlement.

With a structured settlement, if the paying party's debts are primarily commercial, the settlement payments may also be protected against avoidance if the total amount of the payments during any 90-day period falls below the threshold for an avoidance action set forth in Section 547(c)(9) of the Bankruptcy Code. This safe harbor is available only in the case of smaller settlements.

Additionally, if possible, the releasing party can require settlement payments to be made by a third party. If the funds used to pay the settlement would not have been property of a debtor's bankruptcy estate, the transfer should not be avoidable as a preference. Similarly, the settlement may be structured so that a third party lends money to the debtor to make the settlement payments. Such earmarked funds are not considered part of the bankruptcy estate, and the transfer of the funds is therefore not an avoidable preference. On the other hand, where the paying party has sufficient influence over another entity to make third-party payment or earmarking feasible, there may be a risk that the entities will be substantively consolidated in bankruptcy. In that event, the transfer would be of funds of the consolidated estate and would be subject to avoidance as a preference. Third-party payment should therefore be used in conjunction with other protective provisions.

Additionally, the releasing party may include in the settlement agreement a provision delaying the release of claims until 91 days after payment, the time at which the payment would be protected from avoidance, assuming that the debtor is not an insider of the releasing party (the insider preference reach back period is one year, rather than 90 days). This mechanism is often times referenced as a "springing release." To implement a springing release, the settlement agreement should say that the claim will not be reduced or released until 91 days have passed after the last payment without a bankruptcy filing. The settlement agreement should also include a provision acknowledging that

[6] See *Burtch v. Gannon (In re Cybersight LLC)*, No. 04-112, 2004 U.S. Dist. LEXIS 24426 (D. Del. Nov. 18, 2004).

[7] 538 U.S. 314 (2003).

[8] See *In re VasuFabrics Inc.*, 39 B.R. 513 (Bankr. S.D.N.Y 1984) (settlement payment is for antecedent debt, even if the payment is made before the settlement agreement is executed).

Continued from p.11

the full claim remains in effect for all defense purposes (e.g., to defend any claims brought by the debtor or creditors). Although it is possible that such a provision may be regarded as an ipso facto clause under Section 365(d) of the Bankruptcy Code, the provision likely could serve to protect the releasing party against a worst-case scenario in which the releasing party is required to return a settlement payment, while being simultaneously barred from asserting its claims against the debtor arising from the same transaction or occurrence.

See generally *I.T.T. Small Business Finance Corp. v. Frederique*[9] (provision in settlement agreement—that if debtor defaulted then creditor could proceed to collect the entire amount of judgment debt—was not an invalid "ipso facto" clause). In other words, the settlement agreement should be drafted so that the original claim does not immediately disappear on payment but survives until the retention of that payment is certain. While this is the logical and fair result of such an agreement, there is no guarantee that it will survive a bankruptcy challenge. Nevertheless, a carefully crafted settlement agreement can maximize the plaintiff's chances of being able to assert the full amount of its claim in the event of the defendant's bankruptcy.

Finally, another way to reduce the avoidance risk is to source the settlement payments from earmarked funds provided by a third party who effectively steps into the shoes of the debtor, so that there is no overall effect on the debtor's balance sheet—meaning no reduction in the net dollars available to the bankruptcy estate for use to satisfy creditor claims. For earmarking to be effective, the settling parties must adhere to specific guidelines: (1) the payor and the party that ends up in a bankruptcy case must agree that the new funds will be used specifically to pay the future debtor's antecedent debt and (2) the agreement must state that the future debtor does not have any control over the disposition of the earmarked funds. For an attempt to rely on the earmarking doctrine to be successful (1) the party receiving settlement funds should retain evidence that the agreement has been performed according to its terms and (2) the transaction should not negatively impact the debtor's balance sheet, for example, by replacing an unsecured obligation with a secured obligation.[10]

Bankruptcy Court Approval of Settlements

If the party asserting a claim files for bankruptcy relief, any settlement agreement will be subject to approval by a bankruptcy judge, who will determine if such settlement is fair to such debtor's estate and creditors. On motion by the debtor in possession or trustee, and after notice and a hearing, a court may approve a compromise or settlement. The court must decide whether "the compromise is fair, reasonable, and in the best interest of the estate." As the Third Circuit has noted, "[u]nder the 'fair and equitable' standard, [courts look] to the fairness of the settlement to the other persons, i.e., the parties who did not settle."[11] Furthermore, "[i]n the final analysis, the court does not have to be convinced that the settlement is the best possible compromise. Rather, the court must conclude that the settlement is within the reasonable range of litigation possibilities."[12] The debtors carry the burden of persuading the court that the compromise falls within the reasonable range of litigation possibilities.[13] Therefore, litigants must be aware of the very real possibility that their mutually agreed-upon settlement terms might be rejected by a bankruptcy court.

When considering the best interests of the estate, a bankruptcy court must "assess and balance the value of the claim that is being compromised against the value to the estate of the acceptance of the compromise proposal."[14] In striking this balance, courts typically should consider the following factors: (1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience, and delay necessarily attending it; and (4) the paramount interest of creditors.[15] For more information, see *Rule 9019 Settlement Agreements*.[16]

Settlement Agreement Checklist

A claimant (i.e., a potential creditor in a bankruptcy) should consider the following items when entering into a settlement agreement with a defendant (i.e., a potential bankruptcy debtor):

- Is claimant being paid in full upfront?
- Is the defendant (a potential debtor under the Bankruptcy Code) being released or are the claims being dismissed with prejudice 91 days after I am being paid in full?
- Is the defendant making the settlement payment or payments or is a third party making the payment or payments on behalf of the defendant?
- If claimant is not being paid in full upfront, is there any security for the payment obligations? If there is a security, answer the following questions:
    - Will claimant have a lien and/or security interest?
    - Will claimant have another form of payment security, such as a guaranty (possibly a bad-boy guaranty)?
    - Is the collateral being provided sufficient to cover the settlement obligation?
    - Has the lien or security interest securing the settlement payment been perfected?
    - If not, when will the recording of the interest take place?
- If claimant is releasing claims in exchange for a structured settlement, does claimant retain the right to seek a determination that the settlement obligation is non-dischargeable?

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9 *I.T.T. Small Business Finance Corp. v. Frederique*, 82 B.R. 4 (Bankr. E.D.N.Y. 1987).

10 For more information on preference liability, see *Preferences* and *Fraudulent Conveyances versus Preference Actions*. For information on fraudulent conveyances, see *Fraudulent Transfers* available at advance.lexis.com.

11 *Will v. Northwestern Univ. (In re Nutraquest, Inc.)*, 434 F.3d 639, 645 (3d Cir. 2006).

12 *In re World Health Alternatives, Inc.*, 344 B.R. 291, 296 (Bankr. D. Del. 2006); see also *In re Penn Cent. Transp. Co.*, 596 F.2d 1102, 1114 (3d Cir. 1979).

13 *In re A & C Properties*, 784 F.2d 1377, 1381 (9th Cir. 1986).

14 *Jeffrey v. Desmond*, 70 F.3d 183, 185 (1st Cir. 1995).

15 See *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424 (1968).

16 Available at advance.lexis.com.

- Is there a consent judgment with stipulated facts supporting an exception to discharge?
- Is there a provision stating that claimant shall maintain the right, in the event that a bankruptcy or other insolvency proceeding is filed by the defendant, to seek an exception to discharge if the settlement amount in question is not otherwise paid in full?

A defendant (i.e., a potential bankruptcy debtor) should consider the following items when entering into a settlement agreement with a claimant (i.e., a potential creditor in a bankruptcy):

- Has the settlement amount been negotiated with the understanding of the defendant's bargaining power to agree to bankruptcy protective provisions in favor of the claimant, in exchange for a lower settlement amount?
- Does the settlement agreement provide for a security interest or lien to secure the settlement? Are there any third-party guarantors of the settlement?
- Has claimant, as a potential debtor under the Bankruptcy Code, exposed itself to the risk that, despite the settlement, it could still be subject to an objection to discharge in a bankruptcy case?
- Is there a provision in the agreement which would support an argument that the settlement releases the defendant from an objection to a discharge in a bankruptcy case?
- Do the facts giving rise to the claim fall within an exception to discharge under Section 523(a) of the Bankruptcy Code?
- Does the settlement agreement provide for a lien or security interest to avoid litigation over dischargeability?

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NUANCED UNDERSTANDING OF AMAZON'S LIQUIDATION ENVIRONMENT DRIVES NEW APPRAISAL APPROACH

Ian Fredericks, Dominick Keefe, and Doug Jung
Hilco Global

As Amazon has grown to become the world's largest online marketplace, the need to offer financing solutions, and, consequently, a field exam and appraisal product has grown with it. For all existing and prospective Amazon sellers, securing financing has traditionally posed challenges, given the industry norm of ascribing zero value to inventory housed in Amazon's network. This was largely due to the lack of control associated with Amazon and the many rules it imposes upon its sellers. Together, the lack of control and many rules present a number of variables that create significant underwriting challenges for asset-based lenders and inexperienced liquidators. However, despite these challenges, the increased prevalence of Amazon sellers requires a different perspective that has been formed and consistently refined to keep pace with Amazon's changes.

Amazon accounts for nearly 40% of all US retail e-commerce sales, a larger share of the pie than Walmart, eBay, and Wayfair combined, and it adds nearly 4,000 new sellers to its platform daily. Approximately 22% of Amazon's total revenue is attributed to its more than 2 million third party sellers.

Third party sellers can leverage three different methods of selling: Fulfilled by Amazon (FBA), Fulfilled by Merchant (FBM), and Seller Fulfilled Prime (SFP). Under FBA, sellers send their inventory to Amazon-operated fulfillment centers, where Amazon then manages all picking, packing, shipping, customer service, refunds, and returns on behalf of the seller. All FBA sellers have the Prime badge. In contrast, FBM sellers list their products on the same Amazon marketplace but manage all storage, shipping, and customer support independently of Amazon and are ineligible for Prime. SFP is similar to FBM, though it allows sellers to deliver directly to domestic Prime members, so long as these sellers are able to adhere to the Prime standard, which includes free two-day delivery among other things.

Across all three selling programs, the seller retains title to the inventory: even when the inventory is physically sent to Amazon, the seller still owns it until sold. Importantly, these three programs are not mutually exclusive, and it is not uncommon for Amazon sellers to leverage multiple programs, adding an additional factor to the appraisal, field exam, and liquidation consideration.

Amazon Holds the Cards in a Liquidation

While Amazon allows liquidation of inventory through its website and even provides a variety of tools to assist in the sale of excess and underperforming inventory, the nature of the activity permitted on the marketplace is much different and more restrictive than the way traditional Going Out of Business (GOB) events are typically conducted.

During a traditional brick-and-mortar or e-commerce GOB event, for example, the ability to drive sales is greatly aided by the use of highly promotional language and messaging such as "EVERYTHING MUST GO" or "STORE CLOSING." Not only does Amazon prohibit this kind of language, but since it requires its sellers to adhere to their 30-day return and refund policy, for example, an "ALL SALES FINAL" strategy cannot be implemented as matter of procedure. This is in stark contrast to a typical retail liquidation where 100% sell-through of inventory is often assured.

The inability of Amazon's third-party sellers to fully control messaging and sales strategy on Amazon means that their inventory net orderly liquidation values (NOLVs) and liquidation recoveries are likely to come in lower than those of their traditional brick-and-mortar or eCommerce counterparts. Additionally, unlike these other, more familiar liquidation channels, Amazon has a comprehensive and relatively complex set of rules and policies that require careful attention and adherence. One mistake or issue, intentional or not, can cause a retailer to breach compliance and ultimately lose ability to sell through Amazon until the violation is resolved. Examples of these violations include pricing a product unfairly, providing an inaccurate product description, and aggressively discounting the same product on another website or marketplace but not Amazon.

The propensity for violations is understandably greater during the course of a liquidation. It is not uncommon for sellers to experience capacity limitations related to shipping and packing and ensuring on-time arrival of inventory to Amazon warehouses or customers. This is especially true during a bankruptcy, after a company has experienced financial difficulties, and during a liquidation when the goal is to sell through as much inventory as possible at the highest value possible. As inventory selection dwindles and discounting increases, albeit in much smaller increments on Amazon than other sales channels, it can be challenging to meet the shipping speeds and customer service requirements demanded by Amazon, especially for SFP sellers.

Furthermore, in the event of slippage, results can be negatively impacted; for example, if a seller's rating drops too low, they may have to discount further to win the "Buy Box" (also known as the "Featured Offer"). Simply put, winning the Buy Box means the customer is buying the seller's product when they click "Add to Cart" or "Buy Now."

Given these risks, it is imperative to monitor several key metrics before and during an Amazon liquidation, including, but not limited to Inventory Performance Index, Buy Box eligibility, inventory health (age, unit counts, etc.), sales history, product conditions, seller rating, inactive SKU counts, and more. Additionally, lenders need partners who have experience with the variables impacting these metrics—positively and negatively.

The Good News

Despite the many nuances, distinctions, and complex challenges associated with Amazon, lending to an Amazon seller and utilizing Amazon as a sales channel during liquidations are each viable options, when a proper understanding of risk and appropriate monitoring are both present.

Field Exams

Diligence unique to Amazon sellers would include analyzing key performance metrics, including return rates, and how the seller exploits Amazon metrics to optimize their sell through. Inventory reporting accuracy and timeliness should also be evaluated as well as compliance with Amazon's requirements. These and other Amazon seller specific procedures should be performed.

Appraisals

As mentioned previously, when Amazon is one channel through which a retailer sells its inventory, this inventory has historically been treated as ineligible and Amazon has been excluded as a recognized sales channel for underwriting purposes. Clearly, this approach to lending puts Amazon-centric sellers at a disadvantage. From our perspective, the many unique factors that impact NOLVs in the Amazon environment—including imposed fees, ratings, the restriction against aggressively marketing the urgency or finality of sales, the requirement to offer returns, and the potential of losing the right to sell at any point in time during or outside the course of a liquidation—demand a new way of approaching asset appraisals for these sellers that includes, among other things, a commitment to more frequent field exams and collateral updates. A specialized appraisal report that incorporates key metrics having a positive or negative impact on NOLVs and highlights variables to be monitored is critical for lenders.

Liquidations

Similarly, conducting liquidations that involve Amazon as a channel requires specialized knowledge and expertise. Each step must be well planned and coordinated to optimize the timing of efforts around Amazon's seasonally adjusted fee structure, navigating policies to minimize the chance of suspension, protecting Buy Box eligibility, and proactively developing a complementary disposition strategy to address the likelihood of less than 100% sell through, among others.

The Bottom Line

As with any other borrower, in order to make an asset-based loan to an Amazon seller, a lender must have confidence that its collateral—the inventory—can be effectively liquidated if necessary. In dealing with Amazon seller businesses, it will be critical to engage a liquidator with many years of retail inventory, field exam, appraisal and liquidation experience across retail and consumer goods businesses. The best liquidators for Amazon seller inventories will have developed innovative appraisal product and field exam approaches to effectively deal with Amazon-related seller liquidations, allowing them to plan and execute a successful liquidation.

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THE DILUTED EPS CALCULATION IS 50 YEARS OUT OF DATE

Steve Cooper

It will soon be the 50th anniversary of the publication of the Black-Scholes model for option valuation. The fair value of options has since been incorporated into several aspects of financial reporting. However, in the case of diluted earnings per share, the accounting still pre-dates Black-Scholes.

The treasury stock method for calculating diluted earnings per share only considers the intrinsic value of written equity options, such as warrants and employee stock options. We explain why this is a problem and the further reasons why the full economic value dilution resulting from these securities is not reflected in financial statements.

There is much to dislike about earnings per share, both as a measure of performance and, when part of a price earnings ratio, as a basis for equity valuation. The metric is both simplistic and complex in that it combines many different aspects of value in a single number. We have previously advocated that investors should focus on other performance metrics and valuation approaches, notably those based on enterprise value.[1] Nevertheless, as earnings per share is widely used by investors in practice, it is important that the accounting results in realistic metrics.

Basic EPS fails to allow for the 'cost' of written equity options.

Most investors quite rightly focus on diluted rather than basic EPS. The problem with basic EPS is it makes no allowance for the impact of written options (and other potentially dilutive securities such as convertible bonds) on the earnings attributable to the parent company common shareholders. While other non-common share equity interests, such as non-controlling interests, are factored into basic EPS through an attribution of profit to minority shareholders, there is no similar profit attribution or other recognition of the 'cost of capital' of written options. This is the omission that diluted EPS is designed to correct. However, in our view, the dilution adjustment calculated under both US GAAP and IFRS is incomplete.

The calculation of earnings per share has remained largely unchanged since the first US GAAP standard was issued over 50 years ago. Both current US GAAP and IFRS can trace their roots to APB 15 issued in 1969 by the AICPA (the US standard setter at the time). There have been some subsequent modifications to the detail, but much of this has been a reaction to other accounting developments, such as changes in the accounting for convertibles and the introduction of the expensing of share-based payments to employees; the fundamentals of basic or diluted EPS have not changed.

In this article we focus on the diluted EPS calculation and specifically the treasury stock method applied to written options (the most common source of dilution). The problem is that this calculation is based on the intrinsic value not fair value of equity options.

Accounting for diluted EPS pre-dates the Black-Scholes model for option valuation.

The treasury stock method predates the development of modern option pricing techniques. The well-known Black-Scholes option valuation model was first published in 1973, well after APB 15 was first applied. Therefore, it is no surprise that, when initially developed, the diluted EPS calculation did not reflect the fair value of options.

But 50 years later option valuation is well established, and fair value is widely used in other aspects of financial reporting, including the measurement of derivatives classified as assets and liabilities in the balance sheet, and in deriving the employment expense when options are granted to employees as part of stock-based compensation. Considering it is the fair value of equity options that creates economic dilution for common shareholders, we believe it is time to update the calculation of diluted EPS.

The Calculation of Diluted EPS

Diluted EPS adjusts for the additional shares that may be issued in circumstances that are not under the control of the company. Future share issues at the discretion of the company, including the potential future grant of options, are not included in diluted EPS.

Most diluted EPS effects arise from written call options. These may be stand-alone, such as share warrants or employee stock options, or could be options embedded in other securities such as convertible bonds. There are two methods for calculating diluted EPS: the treasury stock method applied to stand-alone options and the if-converted method applied to convertibles.[2] We do not discuss the if-converted method in this article; however, we believe that this approach also fails to fully capture economic value dilution.

In our view, the treasury stock method understates the dilutive effect of options, and therefore overstates diluted EPS. Indeed, we think there are three issues with the reported diluted share count that limits its relevance for investors:

[1] See our article, "Enterprise Value: Our Preference for Valuation Multiples," The Footnotes Analyst, November 28, 2019, https://www.footnotesanalyst.com/enterprise-value-multiples-preferred/.

[2] The accounting for convertible bonds under US GAAP, including the method for calculating diluted EPS, has recently been amended. For more about this topic, and why we believe US GAAP accounting does not faithfully reflect the true cost of convertible financing, see our article, "Convertible Accounting: New US GAAP Inflates Earnings," The Footnotes Analyst, May 26, 2021, https://www.footnotesanalyst.com/convertible-accounting-new-us-gaap-inflates-earnings/.

- The treasury stock method and its focus on intrinsic value.
- The adjustment for unrecognized stock-based compensation.
- The way that so-called 'anti-dilutive' securities are excluded from the calculation.

Treasury Stock Method—Intrinsic Value, Not Fair Value

Under the treasury stock method, the diluted share count is increased by the number of shares that could be issued if options are exercised, after adjusting for the shares that could be repurchased (*i.e.*, bought back as 'treasury stock') using the exercise proceeds, based on the average share price during the period.

For example, assume a company has issued 1,000 5-year share warrants, each entitling the holder to purchase 1 share at a price of $10. The average share price during the year was $12. The amount paid to the company if these options are exercised is 1,000 x $10 = $10,000. This could be used by the company to repurchase 10,000 / 12 = 833 shares. The net effect is that the share count would rise by 1,000 – 833 = 167 shares.

Dilution effect = shares issuable - shares issuable x exercise price / share price

Dilution effect = 1,000 – 1,000 x 10/12 = 167

The same result can also be obtained by dividing the intrinsic value[3] of the options by the stock price. The dilutive effect under the treasury stock method is the common stock equivalents of the intrinsic value of options – the number of common shares with the same value as the intrinsic value of the options.

Option intrinsic value = 1,000 x (12 – 10) = 2,000

Dilution effect = 2,000 / 12 = 167

This illustrates why we say that the treasury stock method only allows for the intrinsic value and not the fair value of outstanding options.

Out of the money options do not increase the diluted share count.

If the share price is below the exercise price, the above calculation would result in a negative value and the options would be regarded as anti-dilutive. However, because the options are out of the money, and exercise is unlikely, this reduction is ignored for diluted EPS purposes. The dilution effect is the higher of the above amount and zero, and diluted EPS can only ever be equal to, or lower than, basic EPS. The same result can be obtained by considering option intrinsic value. If the stock price is below the exercise price intrinsic value is zero and hence the common stock equivalents are also zero.

[3] The intrinsic value of a call option is the higher of zero and the share price less the exercise price. Sometimes the exercise price is discounted for the time value of money, but this does not apply to the intrinsic value used in diluted EPS.

The treasury stock method is based on an assumed exercise of options, but this entirely ignores the main benefit of options—the option time value.

The Treasury Stock Method Ignores Option Time Value

A holder of an equity call option benefits by being able to choose whether to exercise. If the stock price rises above the exercise price the option can be exercised and a gain realised. But if the stock price falls below the exercise price the holder can choose to not exercise and thus avoid a loss. This asymmetric payoff creates time value, which is what the Black-Scholes and other option valuation techniques are designed to measure. Of course, the holder must pay for this when buying the option (or providing employment services in return for receiving the option).

The asymmetric option payoff negatively impacts the common shareholders who have, in effect, written an option on part of their ownership of the company. In the same way that option holders benefit from optionality, the common shareholders have an equivalent cost.

Ignoring option time value creates misleading and illogical results.

Assume a company issues warrants that are 'at-the-money' with the exercise price equal to the share price. Intrinsic value is therefore zero and under the treasury stock method no dilution is reported (basic EPS = diluted EPS). Indeed, the transaction would be earnings enhancing considering that the proceeds from issuing the warrants can be invested or used to repay other financing. For example, the proceeds could be used to buyback common shares and produce an immediate increase in both basic and diluted EPS.

However, this EPS accretion is illogical and misleading. If warrants are issued at a fair price, there can be no positive effect on shareholder value. The gain to shareholders from raising (and investing) the cash is offset by giving up value through writing the option. Therefore, the increase in EPS does not reflect the economics.

The problem is that the treasury stock method of calculating the diluted share count fails to allow for the fair value of the options.

A Better Approach to Dilution—Fair Value Common Stock Equivalents

We think the diluted share count should reflect the fair value of outstanding options. The fair value can be converted into 'common stock equivalents' by simply dividing the aggregate option fair value by the share price (instead of the intrinsic value effectively used in the treasury stock method). This number of common stock equivalents is then added to the basic share count. The option value and stock price should either be an average for the period or the value at the balance sheet date, depending on whether the diluted share count is used for periodic (e.g., EPS) or balance sheet date statistics.

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Exhibit 1: Tesla Diluted Earnings Per Share Disclosures

The following table presents the reconciliation of basic to diluted weighted average shares used in computing net income per share of common stock attributable to common stockholders, as adjusted to give effect to the 2022 Stock Split (in millions):

	Year Ended December 31,		
	2022	2021	2020
Weighted average shares used in computing net income per share of common stock, basic	3,130	2,959	2,798
Add:			
Stock-based awards	310	292	198
Convertible senior notes	3	29	141
Warrants	32	106	112
Weighted average shares used in computing net income per share of common stock, diluted	3,475	3,386	3,249

Source: Tesla 2022 10K.

Returning to our 5-year share warrant example above (where the option exercise price was $10 and the share price $12), if the volatility of the stock is, for example, 70%, the option value calculated using the Black-Scholes model is about $7.60 per warrant. Applying our fair value common stock equivalent approach, we obtain the following dilution.

Fair value of warrants = 1,000 x 7.60 = $7,600

Dilution effect = common stock equivalents =

7,600 / 12 = 633

This effect is nearly 4x the dilution calculated using the treasury stock method.

Of course, the difference is magnified where options are close to being at-the-money, and we also chose a high stock volatility input. But not unrealistically high—70% is almost exactly the average volatility for Tesla over the last 3 years.

Tesla is a good example of a company where the dilutive effect of written options is material. In 2022 the diluted share count is 11% higher than the basic number of shares, with a commensurate difference between basic and diluted EPS. The dilutive effect in 2022 is lower than in the prior years, in part due to the lower stock price reducing the intrinsic value of the options (Exhibit 1).

In our view, because the treasury stock method omits consideration of the time value of the Tesla options, the dilution disclosed above under US GAAP is understated. The impact is difficult to determine—Tesla has high stock volatility which increases the option time value, but this is mitigated by many of the outstanding options being significantly in-the-money during 2022.

Nevertheless, while it is challenging, we think that investors should seek to identify the fair value of non-common share equity interests when material. These should be included in enterprise value for EV based analysis and used to estimate the appropriate diluted share count for the direct analysis of common shares.

The Unearned Compensation Adjustment

It is not just the treasury stock method that causes dilution to be understated. In our view, the adjustment to the exercise price for employee stock options is also problematic.

Unearned stock-based compensation increases the assumed 'treasury share buyback' and reduces apparent dilution.

When applying the treasury stock method to employee options and restricted stock units, the unearned employment expense is added to the exercise. This increases the assumed treasury share buyback and results in a lower diluted share count. The unearned employment expense arises where stock-based compensation (SBC) does not immediately vest, and employees must provide further employment services before being able to benefit from exercising their options or selling shares.

For example, suppose a company issued 100 employee stock options 1 year ago that had a fair value at the time of grant of $10 per option or $1,000 in total. If the vesting period is 4 years only $250 of the grant date value would have been recognised as an expense (and as a credit to shareholders' equity) in the previous year. The remaining $750 does not appear in the financial statements, although under US GAAP it is disclosed.

However, for EPS purposes, the employment expense related to past option grants that will be recognised in subsequent periods is added to the option exercise price—the employees must provide $750 worth of employment services (or $7.50 per option) as well as paying the strike price to exercise their options. If the exercise price is, say, $3 per option then the diluted share count adjustment would only be positive if the share price is above $10.50; the sum of the exercise price ($3) and the unrecognised employee stock-based compensation ($7.50).

The unearned compensation adjustment also affects the dilution for restricted stock units. In effect these have an exercise price of zero in cash terms, but the unearned component of the SBC expense is treated as a payment for these shares and therefore reduces the apparent dilutive effect.

We do not think the unearned compensation should be included in the exercise price. This is a pre-paid compensation expense and would be better reported as a prepayment asset with the full SBC issue recognised immediately and with no corresponding treasury stock method adjustment. The current approach unrealistically restricts EPS dilution, which is even further removed from the fair value of options that impacts equity investors.

Anti-Dilutive Securities Are Ignored

The diluted share count is only calculated and disclosed in the context of diluted earnings per share. The focus of the calculation is on the reduction of EPS if potentially issuable shares turn into actual issued shares. Consequently, any securities that are 'anti-dilutive'—those that would result in an increase in EPS—are ignored. Anti-dilution arises where the share price is below the exercise price and the net effect of applying the treasury stock method is therefore a reduction in shares. However, it can also happen if a company is loss making.

Share count dilution should not be ignored just because net income is negative.

If the treasury stock method results in an increase in diluted shares but the company is loss making, the effect is to reduce that loss per share, which is regarded as anti-dilutive. However, we think this is misleading—the diluted share count is still higher.

The extract below illustrates this issue: Aridis Pharmaceutical is loss making and has a negative basic EPS (Exhibit 2). As a result, the warrants and stock options it has issued are all anti-dilutive, even though at least some (those that are in the money) would have been dilutive had the company been profit making.

The potential future share issues total 5.5m shares compared with 12.3m currently in issue. There is therefore clearly a current economic dilutive effect due to the fair value of these options. If the company becomes profitable, there will be EPS dilution. However, the accounting does not quantify this—the 5.5m is not the result of applying the treasury stock method nor is there any disclosure of our favoured 'fair value common stock equivalent,' which makes the analysis of dilution for this company very difficult.

Adjusted (non-GAAP) diluted EPS may require a different diluted share count.

The effect we describe can be particularly misleading when companies present adjusted (non-GAAP or non-IFRS) EPS metrics. If, for example, the reported basic EPS is negative (and therefore potentially dilutive securities are anti-dilutive) the diluted and basic share count are the same. However, if the adjusted EPS is positive, and what was previously anti-dilutive now becomes dilutive, the diluted share count should be different from the share count used for GAAP EPS. Because there is no accounting standard that governs adjusted per share metrics, we cannot be confident that all companies reporting non-GAAP EPS use the correct share count.

In our view, investors would be better served if financial statements just contained a diluted share count measure (both an average for the period and a period end amount) calculated using the fair value approach we advocate. Investors can then determine how this is best used in their analysis.

Exhibit 2: Aridis Pharmaceutical

For the years ended December 31, 2021 and 2020, there is no difference in the number of shares used to compute basic and diluted net loss per share due to the Company's net loss position. The following tables presents the computation of the basic and diluted net loss per share (in thousands, except share and per share data):

	Year Ended December 31, 2021	Year Ended December 31, 2020
Numerator:		
Net loss available to common stockholders	$ (46,320)	$ (22,333)
Denominator:		
Weighted-average common shares outstanding used in computing net loss per share available to common stockholders, basic and diluted	12,291,600	9,168,744
Basic and diluted net loss per share	$ (3.77)	$ (2.44)

The following potentially dilutive securities were excluded from the computation of diluted net loss per share for the periods presented because including them would have been antidilutive:

	Year Ended December 31, 2021	Year Ended December 31, 2020
Stock options to purchase common stock	1,905,459	1,550,956
Common stock warrants	3,592,905	2,052,128
	5,498,364	3,603,084

Source: Aridis Pharmaceutical 2022 10K.

Continued from p.21

Enterprise Value Is a Better Approach

The problems with the diluted EPS calculation support our preference for an enterprise value-based approach to equity analysis and valuation. A market enterprise value used in EV multiples should include the fair value of equity options and convertibles. Because the dilutive effect is captured in the fair value of these other equity claims, the market capitalisation component of EV should be based on the basic (not diluted) number of shares. In an EV based analysis the inadequacies of the treasury stock method become irrelevant.

The same applies to an enterprise to equity bridge calculation. After computing a business value using, for example, an enterprise DCF model, deduct the fair value of all non-common stock claims, including the fair value of equity options, before dividing by the basic share count.

Lack of fair value disclosures also makes enterprise value based analysis difficult for investors.

We also think that the full fair value of outstanding employee stock options and restricted stock units should be included in EV, even though they are only partly reflected in the balance sheet. This is consistent with our comments above about how unearned stock-based compensation has the effect of understating the diluted share count.

The big problem for investors regarding enterprise value is that there is no requirement to disclose the fair value of outstanding equity options (including the bifurcated options embedded in convertibles reported under IFRS). We have previously advocated that this information should be a required disclosure. See our article "Enterprise to equity bridge—more fair value required." [4]

Is There Any Chance Diluted EPS Will Be Revised?

Don't hold your breath …

Last year the IASB completed its most recent consultation[5] about its agenda. During the next five years it intends to increase its focus on digital reporting, further support consistent application and improved understandability of IFRSs, and to commence work in some specific areas that may ultimately lead to new or revised standards.

Little sign that the standard setters will embrace the fair value approach for diluted EPS.

The IASB will start new projects on the accounting for intangibles and on the statement of cash flow, the shortcomings of which have been the subject of several our articles.[6] The IASB will also work with its new sister body, the ISSB,[7] on climate related risks and how these should be reflected in financial statements, and if resources allow, will start work on improving segment reporting and the accounting for pollutant pricing mechanisms.

All these initiatives are welcome. However, much to our disappointment, earnings per share barely featured in the latest IFRS agenda consultation, and there seems to be little chance of reform anytime soon.[8]

Insights for Investors

- The treasury stock method of calculating diluted earnings per share understates dilution by failing to consider the full fair value of outstanding options.
- Just allowing for the intrinsic value of options can result in a misleading increase in diluted EPS when options are issued, even though no value is created by simply raising finance in this way.
- The dilutive effect of stock-based compensation is reduced by including unrecognised compensation expense in the calculation of the assumed treasury stock buyback.
- The concept of securities being anti-dilutive is misleading. All options create dilution in value terms, even if not under the treasury stock method, and dilution should not be ignored for currently loss-making companies.
- The IFRS and US GAAP approach to dilutive EPS is long past its sell by date. Perhaps the 50th anniversary of the publication of the famous Black-Scholes model will persuade the standard setters to finally catch up.

ABOUT THE AUTHOR

Steve Cooper

Steve Cooper completed a 10-year term as a member of the IASB in 2017. After retiring as a board member, Steve continued his involvement with accounting standard setting as an advisor to the IASB and as a member of the ICAEW financial reporting committee. He also provides education and advisory services for investors and is the author of The Footnotes Analyst blog. Prior to joining the IASB, Steve was a Managing Director in the equities division of UBS. He led the valuation and accounting research team and was a member of the global investment recommendation committee. Steve's earlier career includes auditing, corporate finance, and education and training.

[4] "Enterprise to Equity Bridge—More Fair Value Required," The Footnotes Analyst, March 8, 2021, https://www.footnotesanalyst.com/enterprise-to-equity-bridge-more-fair-values-required/.

[5] More information about the IASB's third agenda consultation, including the conclusions and feedback documents, can be found on the IASB website at https://www.ifrs.org/projects/completed-projects/2022/2020-agenda-consultation/.

[6] "Enterprise to Equity Bridge—More Fair Value Required," The Footnotes Analyst, March 8, 2021, https://www.footnotesanalyst.com/enterprise-to-equity-bridge-more-fair-values-required/. For example, see our article "When Cash Flows Should Include Non-cash Flows," The Footnotes Analyst, last updated March 6, 2021, https://www.footnotesanalyst.com/some-cash-flow-measures-should-include-non-cash-flows/.

[7] The ISSB or International Sustainability Standards Board was established in 2022 to develop international standards for the disclosure of sustainability related information.

[8] Although there has been no proposal to embrace fair value for the diluted share count, some years ago the IASB had the clever idea to modify earnings attribution which, in effect, would have produced the same outcome. In the 'Financial instruments with characteristics of equity' discussion paper issued in June 2018, there was a proposal that part of profit and loss should be 'attributed' to outstanding options, based on the relative fair value of those options compared with the market capitalisation of common stock. This would deal with options in much the same manner as non-controlling interests in calculating basic earnings per share. The outcome in terms of earnings per share would be identical to what we propose in this article. Unfortunately, respondents to the discussion paper failed to see the merits of the approach and, although the IASB is still debating this subject, it seems unlikely there will be any change related to EPS or earnings attribution.

TAX CONSIDERATIONS WHEN CREDIT BIDDING DEBT

Nick Gruidl and Nate Meyers
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Introduction

The Federal Reserve's aggressive moves to combat inflation through continuous interest rate hikes coupled with the recent bank failures could lead the economy into recession, thus resulting in an influx of bankruptcies. If that occurs, we expect to see an uptick in Bankruptcy Code section 363 asset sales ("363 asset sales"), which are a common bankruptcy restructuring due to its relative simplicity over more traditional bankruptcies.

The section 363 asset sale process often involves the creditors credit bidding their debt to acquire the debtor's assets and is a common transaction for investors to ultimately acquire the debtor's business through an initial acquisition the debtor's distressed debt (i.e., "loan to own"). While a section 363 sale may result in a tax-deferred exchange, it generally results in a taxable exchange; as such, understanding the tax consequences to creditors is critical in avoiding phantom income.

Section 363 asset sales

To the extent that creditors are interested in acquiring the debtor's business, the section 363 process provides creditors with the right to "credit bid" their debt in the asset sale to provide some protection of their position. The creditors can bid an amount up to the full amount of the debt owed to them; however, in distressed acquisitions, an amount less than the full amount of the debt is typically bid. To the extent, they are the highest, or only bidder, the creditor will acquire the assets in exchange for their debt. In theory, a creditor would bid what they believed was the amount an unrelated party would pay for the debt, and to the extent more is bid, the creditor would likely receive that higher amount in satisfaction of their debt. Following the asset sale, the debtor will likely continue finalizing the bankruptcy process, resulting in a discharge of debt and ultimately liquidation or dissolution.

Generally, a section 363 asset sale is taxable under section 1001 where the purchaser takes a cost basis in the assets[1] (which could be different than the assets' basis to the debtor). The purchaser's cost basis equals the sum of any cash paid and the fair market value ("FMV") of any other consideration paid, plus the amount of the seller's liabilities assumed and the purchaser's transaction costs. As with any other taxable asset acquisition the seller's tax attributes (e.g., NOLs) do not carry over to the purchaser and the purchase price/adjusted grossed-up basis of the assets is determined and allocated pursuant to section 1060.

[1] I.R.C. section 1012.

Creditor Tax Considerations

Both the debtor company and creditor have tax consequences resulting from the section 363 sale process. The debtor would generally recognize either gain or loss on the sale, and/or cancellation of debt income ("CODI"). In limited circumstances, the section 363 sale could even represent a section 368(a)(1)(G) corporate reorganization, where the acquiring corporation created by the creditors to complete the acquisition is treated as a successor to the debtor company.[2]

For the creditors, the tax consequences relating to the section 363 sale can be significant and unexpected. Assuming the transaction is not a section 368(a)(1)(E) or (G) reorganization[3], the transaction is treated as if the creditors received the assets in exchange for their debt. To the extent that the FMV of the assets exceeds the creditors' basis in the debt, the creditors would recognize a gain on the sale.

A creditor's basis in the debt is often very close to the principal amount on the debt plus accrued interest but will often differ as a result of items such as original issue discount[4], deferred financing costs[5] and debt-for-debt exchanges resulting from significant modifications[6]. In addition, where the debt is acquired by the creditors on the open market at a discount (i.e., acquired for less than the face amount and accrued interest), the creditors' basis begins with what they paid for the debt, not the face amount.

Example 1:

Assume New Creditor (NC) acquires $300M of Debtor Corporation (DC) term loans from the original holder of the debt for $100M. NC acquired the debt at a substantial 66.66% discount, and NC has a basis in the debt of $100M.

The other component to the determination of gain or loss is the FMV of the property acquired. In a credit bid situation where no cash that changes hands it is not always clear whether the credit bid amount clearly reflects the FMV of the assets. Further, creditors generally do not have time to conduct a formal valuation before the credit bid occurs. Thankfully, the regulations under section 166 provide taxpayers some assistance.

[2] Note: whether the sale process represents a section 368(a)(1)(G) reorganization, or whether the CODI is excludable by the company, or its owners is beyond the scope of this article.
[3] Note: This assumption carries through the remainder of this article.
[4] Treas. Reg. Sec. 1.1273-1.
[5] Treas. Reg. Secs. 1.263(a)-5; 1.446-5.
[6] Treas. Reg. Sec. 1.1001-3(b).

Treas. Reg. Sec. 1.166-6(b)(2) provides that if the creditor acquires the mortgaged or pledged property, the FMV of the property is presumed to be the bid price. Either the IRS or the taxpayer may rebut this presumption by providing clear and convincing evidence that the actual FMV of the property was different than the bid price.[7]

NC acquires the assets of the debtor for a credit bid amount of $100M. NC was the highest bidder and bid an amount equal to what its basis was in the debt ($100M). Barring clear and convincing evidence to the contrary, the FMV would be assumed to equal the $100M credit bid, resulting in no gain or loss to NC on the asset acquisition.

So, in general, a creditor can look to the bid price as the FMV of the property so long as there is not clear and convincing evidence that the credit bid is not reasonable. What factors would a taxpayer or the IRS look to if arguing that a value of credit bid is appropriate? The court in *Community Bank*, as well as the IRS in Rev. Rul. 72-238, have provided a few items for consideration, particularly third-party valuations that differ materially from the credit bit amount.[8]

Example 2:

Same as the previous example but assume NC acquired the property with the $100M credit bid and then had a third-party valuation performed for financial statement reporting purposes that placed a value on the assets of $150M. Assume further that NC was a private equity fund that included the investment on their financial statement at a value of $150M. Does the valuation and financial reporting by NC provide clear and convincing evidence of a different value? The $50M value is a 50% increase over the $100M credit bid, but the credit bid process is an open process and the $100M was the highest bid. Further, the business being valued is now free of $300M of debt that encumbered the pre-petition business, so query whether a valuation after the transaction is a reasonable estimation of the value before the discharge. The answer is ultimately a facts and circumstances determination, but at minimum NC would want to document the reasoning and support for the fact that the credit bid is a reasonable estimation of the FMV of the property.

Summary

The credit bid process provided by a section 363 asset sale is often a streamlined approach to accomplish a business restructuring. However, the credit bid acquisition is generally a taxable exchange, so understanding the tax consequences of the exchange is an important part of the overall restructuring process. Creditors and debtors considering a section 363 bankruptcy process should consult a tax advisor.

[7] Treas. Reg. Sec. 1.166-6(b)(2); *See also*, *Community Bank v. Commissioner*, 62 T.C. 503, 506 (1974), *acq.*, 1975-1 C.B. 1, *aff'd*, 819 F.2d 940 (9th Cir. 1987); *Securities Mortgage Company v. Commissioner*, 58 T.C. 667 (1972) (taxpayer used an expert witness who provided a valuation of the property to establish that the FMV of foreclosed property was lower than the amount bid in the foreclosure sales transaction).

[8] Rev. Rul. 72-238, 1972-1 C.B. 65.

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FRAMING THE DILEMMA: WHETHER TO RESCUE A BANK

Robert F. Bruner
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In the financial turmoil this spring, the dilemma facing governments has been whether and how to intervene. When should a government simply let a financial institution fail as opposed to sending in cash to keep it alive? There is a traditional answer and a current-day answer: the difference says a great deal about how economic orthodoxy has shifted over the years.

The Traditional Banking View

Under the traditional view, the critical question is whether the troubled institution is merely out of cash (illiquid) or is unable to meet its liabilities even if all assets were converted to cash (insolvent). Conventional thinking at the turn of the twentieth century was that in a panic, illiquid institutions should be supported, and insolvent institutions should declare bankruptcy. The iconic expression of this was Walter Bagehot's *Lombard Street: A Description of the Money Market*, published in 1873.

In Bagehot's day, Lombard Street in London was the center of the international money market and the location of the Bank of England. Bagehot styled the book as a kind of primer for new professionals on Lombard Street. It was an extended argument in favor of a muscular central bank, one that would serve the liberal (and mercantile) policies of Britain and that would generally create the conditions for economic stability and advancement. An important responsibility of such a bank, he argued, was to fight financial crises by being a "lender of last resort" (LOLR).[1]

Bagehot's advice for such lenders was that in a financial crisis, the LOLR should lend freely to solvent borrowers upon good collateral and at a "penalty rate" of interest. Consider the three elements of Bagehot's instruction:

1. ***Lend freely:*** Illiquidity is a hallmark of financial crises. When depositors run and withdraw their savings from banks—both the healthy and distressed ones—banks call in loans. Credit, the lifeblood of commerce, stops flowing. By lending freely into the financial system, the LOLR supplies the short-term funding that banks need and thereby helps to quell runs and forestall the credit contraction that sparks a debt-deflation spiral.
2. ***Solvent borrowers upon good collateral:*** This is a "tough love" policy. To demand good collateral is to guard against losses by the LOLR. And it also means that the LOLR will really support only the solvent institutions and will necessarily allow insolvent ones to fail, preventing the persistence of "zombie banks" and the misallocation of resources they entail. It has been said that capitalism without bankruptcy is like Christianity without hell.[2] A world without the risk of failure fuels moral hazard.
3. ***At a penalty rate:*** Charging high rates of interest in a crisis may seem like extortion to stressed banks. But high rates may be useful. They discourage opportunists who would exploit the eagerness of the LOLR to lend freely and end the crisis. They discourage moral hazard by penalizing lenders who were too expansive. And they entice capital to come out of hoarding. Less-than-penalty rates might distort the efficient allocation of capital in an economy and/or fuel moral hazard.

In *The Panic of 1907: Heralding a New Era in Finance, Capitalism, and Democracy*, (2023, John Wiley & Sons), Sean Carr and I described the efforts of J.P. Morgan to quell the crisis. Though historical archives did not explicitly cite Bagehot's advice as Morgan's guiding principle, Morgan's behavior during the crisis was quite consistent with it. Under Bagehot's logic, Morgan would send auditors to scrutinize the books and assets of struggling institutions. If the auditors determined that the institution was solvent (that its assets exceeded its liabilities), then Morgan found the money to keep it afloat.

Early in the Panic of 1907, Morgan faced the dilemma of whether to fund a rescue of the Knickerbocker Trust Company, one of the largest in New York City. He sent his auditors over and they returned the next morning to say that it was not possible to tell whether Knickerbocker was solvent—they did not say that Knickerbocker was insolvent, but that they didn't have enough time to get all the facts before the institution would run out of cash. Perhaps relying on the opinion of other bankers who knew Knickerbocker better than he did, Morgan declined to assist the firm. Knickerbocker promptly closed its doors and handed the keys to the New York State Superintendent of Banks. Knickerbocker's failure greatly inflamed the fears of depositors and worsened the crisis. Thereafter, Morgan promptly responded to appeals for liquidity from troubled institutions.

Policies Adapt to Changing Conditions

Over the following century, orthodox thinking about financial rescues began to change, reflecting several developments.

- ***Increased complexity*****.** Banks and financial markets are complex institutions, which makes it difficult to know exactly what is going on. Complexity creates a host of information asymmetries among managers, regulators, depositors, long-term creditors, stockholders, and bank employees—each group has a different take on the bank's condition and communicates that at digital speed to others. The resulting information asymmetries spawn problematic behavior

[1] Bagehot did not invent the phrase "lender of last resort." In 1802, Henry Thornton published *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, in which he proposed that the Bank of England should be a backstop for the financial system. Bagehot's novel contribution was to suggest *how* the central bank should perform such a function.

[2] This statement has been attributed to Frank Borman, a former astronaut who became CEO of Eastern Airlines, a company that ultimately went bankrupt. He allegedly added, "But it is hard to see any Good News in that" (J. Madeleine Nash, Bruce Van Voorst, and Alexander L. Taylor III, "The Growing Bankruptcy Brigade," *Time*, October 18, 1982).

(such as runs) that arises from adverse selection[3] and moral hazard.[4]

- ***Greater connectivity***. Yet allowing some institutions to fail might worsen a crisis. The rescue of Continental Illinois Bank in 1984 was premised on the assertion that it was "too big to fail," that its failure would impoverish too many depositors. Then in 2008, the distress of Bear Stearns, Citigroup, and AIG Group sharpened that rationale to be "too *interconnected* to fail," meaning that the failure of any of those institutions would trigger the failure of too many others. Interconnections exist through transactional commitments among financial institutions, most importantly, in the funding markets by which banks lend or borrow cash to each other.
- ***Adaptability.*** The financial sector morphs over time, reflecting the embrace of financial innovations in markets, institutions, instruments, and processes. Like the generals who are always prepared to win the *previous* war, crisis-fighting playbooks tended to reflect the previous crisis. But modern financial innovations render previous playbooks obsolete. In the case of J.P. Morgan in 1907, and of Federal regulators in 2020 and 2023, we saw responses that were more *ad hoc* and experimental, reflecting adaptation of policies to conditions in real time.
- ***Possible market inefficiency.*** During a crisis, do market prices truly reflect the intrinsic value of financial assets? Prices driven by fear and fire sales of assets may severely understate fundamental values. This was an acute problem in the crisis of 2008, when some kinds of financial securities proved hard to value. A court case adjudicated during the Panic of 1857 (*Livingston v. Bank of New York*) established a precedent invalidating the closure of banks if they could not provide cash to depositors during a panic—this case was cited during the crisis of 2008 in the defense of banks seeking to avoid regulatory administration.
- ***Risk.*** The larger context will certainly influence the rescue decision. Is the nation at war? Is it facing a pandemic? The presence of existential crises will motivate a government to take dramatic steps to quell a financial crisis. It will focus on liquidity and rescues first, and solvency later. Demanding penalty interest rates might work against the goal of restoring liquidity to financial markets and institutions.
- ***Interests.*** This is the dark side of all bank rescues. Lurking in the background might be favoritism of the few at the expense of many. These few could include those led by cronies of the decision-makers—such was the allegation toward J.P. Morgan's rescues as asserted by Senator Robert La Follette in 1908 and Representative Charles Lindberg Sr. in 1911. These assertions led to Congressional hearings about the existence of a "money trust." Or a rescue could be motivated by the strategic interests of the country, a region, or an industry—examples would be the government takeover of seven bankrupt railroads in 1976 and Federal loan guarantees for the almost bankrupt Chrysler Corporation in 1980. The *real politique* of government rescues of businesses often comes down to who goes to bat for you and how big a bat is swung.

…and so on. A complete discussion would cover other factors beyond the scope of this article. But by now, you can see that the current-day decision to rescue a financial institution will be more contingent and less doctrinaire, and probably erring on the side of more rescues rather than fewer. Rescue policies today might be labeled "Bagehot Plus," meaning continued commitment to liquidity of the financial system ("lend freely"), but less about "penalty rates" and more about tailoring of crisis response aimed at restoring normal conditions quickly.

The larger point of this traditional-versus-modern comparison of rescue policies is that orthodox thinking about how best to quell financial crises has changed over time and will continue to do so. Traditional orthodoxy made sense when currencies were pegged to a gold standard, capital flowed slowly around the world, London was the undisputed hegemon of global finance, and citizens held low expectations for the intervention of national governments in financial crises. But times have changed. The dollar and other currencies float freely; capital moves among banks and across borders at the click of a few computer keys; news moves instantaneously; financial innovation has deepened vastly the interconnection among banks and countries; and the Fed in Washington and the New York financial community are dominant players in the world though lots of hungry competitors want their power and influence. Most importantly the citizens of developed economies expect their governments to restore financial stability, much as they maintain law and order on the streets.

A final point: this shift in orthodox thinking is not lost on people who worry about the vitality of democracy. The delegation of heightened powers to stabilize the financial system and commit large sums of taxpayer money without Congressional authority is attracting growing concern by critics on the right and left of the political spectrum. You should expect to see more debate over the authority of regulatory agencies.

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Bob Bruner is University Professor at the University of Virginia, Distinguished Professor of Business Administration, and Dean Emeritus of the Darden Graduate Business School, and Compton Visiting Professor in World Politics at UVA's Miller Center of Public Affairs. His publications include numerous books and articles, across a range of topics in finance and management. His recent work focuses on financial crises and includes the book written with Sean Carr, The Panic of 1907: Heralding a New Era in Finance, Capitalism, and Democracy (2023). Bruner holds the MBA and DBA degrees from Harvard University, and the BA from Yale University.

[3] Adverse selection arises if a better-informed party in a transaction can exploit information to the disadvantage of the less well-informed party. Think of buying a used car (the seller knows more about the condition of the car, possibly a "lemon") or selling health insurance (the buyer knows more about his or her health outlook). Concern about adverse selection may drive parties out of the market, thus diminishing liquidity and the ability of the market to clear. Also, adverse selection might drive quality goods out of the market because sellers of high-quality goods cannot obtain the prices they deserve. In finance, "Gresham's Law" (i.e., bad money drives out good money) is an example of adverse selection.

[4] In the case of moral hazard, a party to an agreement fails to act in good faith and shifts risk onto counterparties. For instance, debtors who believe that the government will always bail them out in a crisis may simply borrow more, ultimately shifting risk onto taxpayers.

INTELLECTUAL PROPERTY DIFFERENTIATES AND ADDS VALUE TO CANNABIS INVESTMENTS

Weston Anson and Evan Loker,
with contributions by Justin Anderson
CONSOR IP Experts

***The commoditization of cannabis requires companies to differentiate themselves through intellectual property (IP)—and to accurately value their IP**.*

To little surprise, the overall cannabis industry has been growing exceptionally fast over the past several years and, in fact, some reports say it has grown at a compound annual growth rate of 30.5% since 2018.[1] Yet, even with the industry growing at such a rapid rate, some companies have been able to differentiate themselves, experiencing even greater growth than the overall industry. This exceptional growth is not random, though; these companies have been able to distinguish themselves through their intellectual property and subsequent licensing programs.

The commoditization in the marijuana industry has led to many new forms of cannabis and cannabis products. Cannabis goods such as edibles, CBD products, oils, creams and many others are now available. This is an expected evolution in the cannabis business as has happened in other industries in the past: One can look at alcoholic beverages and vodka as an example, with the explosion of that product into multiple flavors and forms over the last two decades. Or, examine the tobacco industry over the last 50 years, with Marlboro growing from one simple red box to more than two dozen flavors and sizes, and even a combo of electric cigarettes and smokeless products available in countless markets. Commoditization of cannabis calls for creativity in the development of intellectual property.

Constant research and technical development are going into cultivation and processing of hemp, marijuana and other cannabis products. Growing, hydration, and lighting techniques and processes which improve the efficiency, quality and potency of the end product are in constant test format. As a result, numerous patented processes as well as a great amount of proprietary know-how and trade secrets are being created due to this research.

Branding Is Imperative and IP Licensing Is a Necessity

In the end, cannabis is still essentially an undifferentiated commodity product from the consumer's point of view. If competitive cannabis businesses want to create any amount of sustainable market share, they need to differentiate their products via branding, brand extension and licensing—and licensing not just of brands but all IP.

[1] IBIS World Report OD4141, "Medical & Recreational Marijuana Growing in the US," January 2023, https://www.ibisworld.com/industry-statistics/market-size/medical-recreational-marijuana-growing-united-states/.

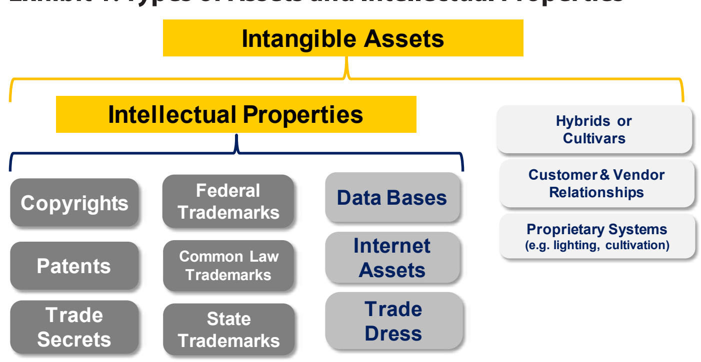
Let us look first at the issue facing the standard way of licensing national brands here in the U.S. The primary blockade to brand building for cannabis is the fact that you cannot register a federal trademark for cannabis but you can apply a Common Law Trademark on *cannabis product*. Constructing a ring of federal trademarks circling the Common Law Trademark in order to build a cannabis brand via licensing is a solution. This ring of Federal Trademarks often includes categories such as class 25 clothing, classes 9 and 16 for publishing and paper products, class 18 for leather goods, etc.; as well as registrations in service classes 35, 38, 41 and 44 covering various retail and service establishments as well as website and social media environments.

The core of this brand building is to have your Common Law Trademarks on your actual cannabis product, and then use Federal Trademarks duplicative of the Common Law Trademark licensed to third parties. Licensees can then manufacture products like apparel, smoking paraphernalia and leather goods, as well as offer services like health centers and social media sites. This is how to build brand value via licensing in the cannabis industry.

Licensing and Valuing Intellectual Property

In addition to trademarks and brands, how else can a company differentiate itself? One has to think about all of the company's intellectual property, not just its trademarks and brands. For example, Exhibit 1 looks at various types of assets and intellectual properties: there is a wide range of assets that can be developed internally and/or via licensing, ranging from trade secrets to copyrights and from trade dress to cultivars and various growing systems.

Exhibit 1: Types of Assets and Intellectual Properties



Continued from p.29

It is not only trademarks and brands that can be licensed by companies that are IP-based. Examples of various forms of licensing are shown in the following chart:

Licensing Method	Type of IP
Branding/Trademarks	Trademarks Trade Dress Graphics
Technology	Patents Trade Secrets
Process Licensing	Lab/Management Systems Technical Know-How
Genetics	Hybrids Cultivars

As you can see, we have broken this chart into four broad categories of licensing: branding/trademarks, technology, process licensing, and genetics. Within each of these categories, there are subsets ranging from management systems to hybrids and cultivars, and from patents and trade secrets to trademarks and trade dress.

How to Value IP and IP Licenses

Thinking about the overview above, the question becomes: What if we do have IP within the company? How do we identify it, and more importantly, how do we value it? For example, how do we value trade secrets as opposed to patents—or how do we value technical know-how, and how do we value complex systems that effectively run a lab testing facility. As we work through the second part of this article, we will look at the various techniques and methodologies that are used to value intellectual property as well as intangible assets. The table above which lists the various forms of cannabis licensing also is illustrative of the kind of intellectual property that can be found in many cannabis-based companies.

At the INCBA Law Institute we recently laid out some of the principles of building value for cannabis companies with their IP, and then discussed how best to quantify that value—in real world terms. In the balance of this article, we are going to look at the methodologies that are most accepted and are sometimes referred to as the Standard Valuation Methodologies. We will explore those methodologies in practice by looking at a case study of "Cannabis Corporation" in which a theoretical company has three bundles of assets that require valuation: a trademark/brand bundle, a patent bundle, and a trade secret/technical know-how bundle. In this case study, we will value the core IP within each bundle, as well as value what a single license agreement for each bundle would add to the company.

In the following exhibits and case study, you will note that we have a company whose total IP value is in the neighborhood of $36 million—which is substantial, considering that their annual revenues currently are in the $30 million range. A summary of Cannabis Corporation's IP and the methodologies employed for valuation are presented in Exhibit 2.

Cannabis Corporation Case Study

Cannabis Corporation, in our example laid out over the following pages, is illustrative of a relatively well-established company within the industry that has many products and lots of subsequent IP, and one whose licensing program is just getting started. The company is an Oregon based cannabis company that wants to license the IP within each bundle to companies in Colorado and California. In order to value the company's three bundles of IP, as well as the incremental value of a single license, we must first consider the different Standard Valuation Methodologies: the income approach, the market approach, the relief from royalty approach, and the cost approach.

The income approach calculates the present value of future income streams specifically attributable to the IP asset. This method utilizes forecasted financial results based on factors such as historical financial results, industry trends, and the competitive environment.

The market approach values IP by comparing the subject asset to available comparable transactions involving similar assets with similar uses. This provides a reasonable indication of value if an active market exists that can provide examples of recent arm's-length transactions, with adequate information regarding terms and conditions.

The relief from royalty approach is a hybrid between the income approach for its use of future cash flows, and the market approach for its use of comparable royalty rates. In the relief from royalty approach, a hypothetical situation is created to estimate what a business would hypothetically pay to license its IP assets in an arm's-length transaction. The value is then calculated as the present value of the avoided hypothetical royalty charges.

Finally, the historical cost to develop an asset is sometimes used to determine its value. However, the cost to develop IP is rarely representative of its ultimate value. This approach is less useful for IP used in products that have reached the market and generated revenues. Generally, the cost approach is better suited for the analysis of IP and products that have not yet been developed commercially. Alternatively, the cost approach may be used for products and services that could be re-created quickly using current or future costs. It reflects the cost a company could avoid by purchasing, rather than duplicating, a similar development effort.

We employ all four methodologies, in some form, to value the three IP bundles and licenses in our case study of Cannabis Corporation. To determine the value of most IP, we must calculate the present value of the hypothetical revenue or royalty streams

Exhibit 2: Cannabis Corporation IP Types and Valuation Methodology

Bundles/Types of IP	Valuation Methodology
Brand/Trademark	Income Approach
Patents	Relief from Royalty Approach
Trade Secret/Technical Know-How	Cost Approach

Exhibit 3: Valuation Assumptions for Case Study

Income Approach Assumptions	
Allocation of Revenue to Trademark/Brand Bundle	10.0%
Trademark Remaining Useful Life (in years)	10 years
Short-Term Growth Rate (2018-2022)	31.6%
Long-Term Growth Rate (2023 and beyond)	3.2%
Cannabis Corp. Historical EBIT Margin	16.6%
Discount Rate (Weighted Avg. Cost of Capital)	20.1%
Relief from Royalty Approach Assumptions	
Reasonable Royalty - Patent Bundle	15.0%
Patent Bundle - Remaining Useful Life (in years)	5
Short-Term Growth Rate (2018-2022)	31.6%
Discount Rate (Weighted Avg. Cost of Capital)	20.1%
Cost Approach Assumptions	
Annual Lic. Fee Based on Current Costs - T.S./Know-How Bundle	$35,000/month
Trade Secret/Know-How - Remaining Useful Life (in years)	5

generated in each case, and we accomplish this by conducting a discounted cash flow (DCF) analysis.

There are a handful of assumptions for each of the methodologies employed that we rely upon to conduct our DCF analyses, including growth rates, discount rates and remaining useful life of the IP, among others. Exhibit 3 presents a list of the assumptions for each valuation approach that we rely upon to calculate the value of the three bundles of IP and their respective licenses.

Valuing the Trademark/Brand Bundle

The first analysis that we will explore in detail is the trademark/brand bundle valuation. We are going to use the income approach to calculate the present value of the revenue generated by both the core IP and a single trademark/brand license.

The first step in our DCF analysis is to determine what amount of revenue Cannabis Corporation will generate in the future. We apply our short-term and long-term growth rates to Cannabis Corporation's most recent revenues and project them out ten years into the future. While trademarks essentially have an indefinite lifespan (think about how long Coca-Cola has been and will be around), for the purpose of this analysis we have limited our projections to only 10 years.

Next, we apply Cannabis Corporation's historical average earnings before interest and taxes (EBIT) margin to our projected revenues to calculate their annual free cash flows. Those future free cash flows needed to be discounted back to their present value, and we do this by applying a discount rate. We use the company's weighted average cost of capital (WACC) for our discount rate and apply it to each free cash flow period.

In our example, the total present value of Cannabis Corporation's free cash flows is over $50 million, but this is from the company's entire operations, not just from its trademark/brand bundle. We need to allocate or apportion a percentage of that total present value to the trademark/brand bundle—we accomplish this by using the market approach to calculate what the average allocation of value for this specific type of IP should be.

A prior study analyzed what public companies allocate to trademarks and trade names, and the average allocation among those companies was 10.0%. We apply that figure to the total present value of Cannabis Corporation's free cash flows to arrive at the value of the company's trademark/brand bundle. Exhibit 4 presents a summary of our trademark/brand bundle core IP analysis.

Exhibit 4: Summary of Trademark/Brand Bundle Core IP Analysis

Trademark/Brand Bundle Core IP Valuation - Income Approach					
		2018	**2019**	**...**	**2027**
Revenue		$30,000,000	$39,480,000		$105,409,542
		x	x		x
EBIT Margin		*16.6%*	*16.6%*		*16.6%*
		=	=		=
EBIT		**$4,980,000**	**$6,553,680**	**...**	**$17,497,984**
		x	x		x
Discount Factor@	*20.1%*	0.91	0.83		0.19
		=	=		=
Present Value of Free Cash Flow		**$4,544,172**	**$5,456,776**	**...**	**$3,365,474**

Total PV of Cash Flow	**$53,018,523**
Allocation of Value to Trademark/Brand Bundle	10%
Value of Cannabis Corp.'s Trademark/Brand Bundle	**$5,301,852**

Continued from p.31

Exhibit 5: Patent Bundle Core IP Valuation

Patent Bundle Core IP Valuation - Relief from Royalty Approach				
	2018	**2019**	**...**	**2022**
Revenue	$30,000,000	$39,480,000		$89,979,756
	x	x		x
Concluded Royalty Rate	*15.0%*	*15.0%*		*15.0%*
	=	=		=
Hypothetical Royalty Income	**$4,500,000**	**$5,922,000**	**...**	**$13,496,963**
	x	x		x
Discount Factor @ 20.1%	0.91	0.83		0.48
	=	=		=
Present Value of Royalty Income	**$4,106,180**	**$4,930,822**	...	**$6,486,937**
Value of Cannabis Corp.'s Patent Bundle	**$26,846,982**			

Valuing the Patent Bundle

The concluded royalty rate that we apply to our previously projected revenues represents the use of the market approach. For the Cannabis Corporation's patent bundle, we researched and identified license agreements that contained similar intangibles as those contained within Cannabis Corporation's patent bundle. We compiled the royalty rates from all of those agreements and calculated the average to use in our analysis. We applied the average to our projected revenues to calculate the company's hypothetical royalty income, and then discounted those back to a present value. Exhibit 5 presents a summary of our patent bundle core IP analysis.

Valuing the Trade Secret/Technical Know-How Bundle

To value Cannabis Corporation's trade secret/technical know-how bundle, we are going to employ the cost approach. This valuation methodology reflects the cost that a company could avoid by purchasing, rather than duplicating, a similar development effort. This approach is better suited for the analysis of intangible assets, processes, and products that have not yet been developed commercially. As shown in the table below, the IP within this bundle, and its annualized cost to the company, is comprised of software, facilities, data management, lab testing, and customer resource management.

Trade Secret/Know-How Valuation - Cost Approach	
	Annualized Cost
Software	$110,000
Facilities	$115,000
Data Management	$105,000
Lab Testing	$80,000
CRM	$40,000
Annual Trade Secret/Know-How Value	**$450,000**

Some additional assumptions or backstory for this valuation approach include the fact that Cannabis Corporation owns and licenses a completely integrated software-based facility management package. The annual trade secret/know-how value that the company will charge to license this IP is based on the time, labor, and other inputs necessary to maintain the system on an annual basis for the remainder of its useful life, which we have capped at five years. The actual valuation is very straightforward, even more so than the previous methods: we apply the annual IP value to the entirety of its useful life, and then discount those amounts back to a present value. Exhibit 6 on the next page presents a summary of our trade secret/technical know-how bundle core IP analysis.

Finally, Exhibit 7 also on the next page presents a summary of Cannabis Corporation's total core IP value.

Summary of Cannabis Corporation's Value

As we have seen in our valuation examples of Cannabis Corporation's different IP bundles, IP is a great way to differentiate a business from its competitors. As cannabis becomes legal in more and more states across the country, the product itself is becoming more of a commodity and this presents great opportunities within the industry. With these opportunities comes the need for cannabis companies and professionals to understand the IP involved in all facets of their business and how to value it properly.

Our case study highlights three critical things about valuing IP. First, the valuation context is critical, as is time. Different situations with different timing needs will greatly affect the final value of the IP. Second, multiple valuation approaches should be used to determine value, if possible. If two valuation approaches yield similar results, then we can be confident that the assumptions used, and the final IP value, will stand up well to scrutiny. And third, IP can have different values at the same time, depending on the context of value. An asset in bankruptcy will have a different value to the acquiror than the same asset in an acquisition by a competitor.

IP can have tremendous value and companies that understand how to value, monetize, and leverage their IP will succeed in differentiating themselves in an industry that is nearing the mature stage of its lifecycle. Especially as competition begins to force companies out of the market and into bankruptcy, it is of the utmost importance for owners and decision makers to protect their IP and ensure they are maximizing its value, thereby maximizing the total value of their companies. In bankruptcy, when companies are required to sell off their assets, IP is oftentimes sold at a fraction of its true value, therefore making it imperative for decision makers to value their IP prior to the start of the fire sale.

Exhibit 6: Trade Secret/Technical Know-How Core IP Valuation—Cost Approach

Trade Secret/Technical Know-How Core IP Valuation - Cost Approach					
		2018	**2019**	**...**	**2022**
Annual Trade Secret/Know-How Value		$450,000	$450,000		$450,000
		x	x		x
Discount Factor@	*20.1%*	0.91	0.83		0.48
		=	=		=
Present Value of Free Cash Flow		**$410,621**	**$374,688**	**...**	**$216,292**

Value of Cannabis Corp.'s Trade Secrect/Technical Know-How Bundle	**$1,573,347**

Exhibit 7: Cannabis Corp's IP Valuation Overview

Cannabis Corp.'s IP Valuation Overview	Core IP Value
Income Approach: Trademark/Brand Bundle	$7,952,778
Relief from Royalty Approach: Patent Bundle	$26,846,982
Cost Approach: Trade Secret/Technical Know-How Bundle	$1,573,347
Cannabis Corp.'s Total Core IP Value	**$36,373,107**

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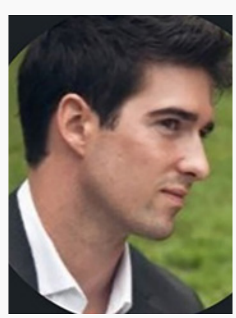

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THE EVOLUTION OF THE DLOM: PROS, CONS, AND INFLECTION POINTS[1]

Boris J. Steffen, CDBV
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The Proverbial Question[1]

Aside from having to parse the issues associated with the various influences that affect the degree of marketability of an interest, the measurement of the discount for lack of marketability ("DLOM") is confounded by the plethora of approaches and methods that have been developed by researchers and practitioners over time for use in evaluating whether the application of a DLOM is appropriate, and if so, how the size of DLOM should be measured.[2] As characterized in the IRS DLOM Job Aid,[3] the challenge is to determine whether "[u]nder the prevailing facts and circumstances and considering the nature of the interest to be valued why is the DLOM not zero?" Where the interest to be valued is that of a non-marketable minority interest in a privately held firm, historically the solution widely adopted was to apply a DLOM of roughly 35% to the preliminary indication of value based on articles and studies cited in one of Shannon Pratt's Valuing a Business texts.[4] The inference was that all DLOMs were about 35%, so the DLOM should be around that number regardless of how the subject interest might differ from the articles and studies. Perhaps as a byproduct of the number of approaches now available, however, the measurement of a DLOM has evolved to require an evaluation of the reasonableness and reliability of the approach and data being considered, its fitness for use given the facts and circumstances of the interest, its general acceptance within the valuation community and its treatment by the Courts.

Nature of the Challenge

Liquidity can be an important factor in the valuation of a business ownership interest. Conceptually, it can be thought of as the ability of an investor to buy or sell an asset quickly with little premium or discount compared to its equilibrium price. The benchmark for liquidity is that of an instant sale with cash received within three days.[5] Thus, an asset is more liquid if there is an organized market for its shares where an investor can quickly exchange their holdings for cash, frequently with minimal transaction costs. In such a market, security prices may tend to reflect the intrinsic value of the company, i.e., the value that is tied to the company's earnings fundamentals, albeit on a minority basis, in cases where a wedge exists between the value of a controlling interest and minority position.[6] The lack of readily available, organized markets for the stock of privately held companies, however, causes their securities to be relatively illiquid, and may result in their value being discounted.[7]

The ability of an investor to sell an asset is also a function of the asset's marketability. While the terms "marketability" and "liquidity" are often used loosely to convey the same meaning, the marketability of an asset is a function of the right of its owner to legally sell it, also referred to as salability,[8] while liquidity refers to the timing, or speed with which the asset may be sold. As the ability to sell an asset has value, investors require a discount to purchase an asset that is less marketable and liquid than one which is otherwise identical.[9]

For privately held companies, the ability of an investor to sell their stock is diminished as the stock is not registered with the SEC or publicly traded. The risk attributable to this limitation may result in a lower valuation for the stock, holding all else equal. For example, the traditional view of investment bankers and business appraisers has been to apply a discount of from 25 percent to 35 percent when valuing an interest in a stock having a two-year restriction period.[10] The Internal Revenue Service also recognizes this implicitly in Revenue Ruling 77-287, which states in part "Securities traded on a public market generally are worth more to investors than those that are not traded on a public market."[11]

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[1] An earlier version of this article was published as *"The Evolution of the Discount for Lack of Marketability," ABI Journal*, Vol. XLII, No. 3, 14, 59-61, March 2023. This article is published in the AIRA Journal with the copyright consent of the ABI. This article presents additional research and findings which should be considered together with the earlier version published in *ABI Journal*.

[2] James R. Hitchner, R. James Alerding, Joshua B. Antell, and Katherine E. Morris, *Discount for Lack of Marketability Guide and Toolkit* (Ventor City, NY: Valuation Products and Services, 2017), 448.

[3] Internal Revenue Service, IRS Engineering/Valuation Program DLOM Team, *Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals*, September 25, 2009, https://www.irs.gov/pub/irs-utl/dlom.pdf.

[4] Z. Christopher Mercer, *Quantifying Marketability Discounts: Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests* (Memphis: Peabody Publishing LP, 1997), 1.

[5] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit*, 3.

[6] Bradford Cornell, *Corporate Valuation: Tools for Effective Appraisal and Decision Making* (Burr Ridge: Irwin, 1993), 240.

[7] U.S. Congress, House, *Institutional Investor Study Report of the Securities and Exchange Commission Volume 5*, 92nd Cong., 1st sess., 1971, H. Doc. 92-64 Part 5, 2443-2456.

[8] Internal Revenue Service, *Discount for Lack of Marketability: Job Aid for Valuation Professionals,* 5.

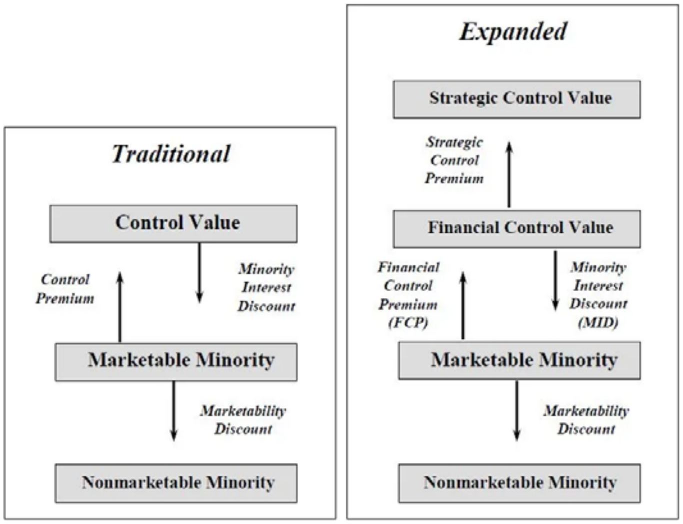
[9] Robert F. Bruner, *Applied Mergers & Acquisitions* (Hoboken: Wiley, 2004), 462; U.S Congress, House, *Institutional Investor Study Report*.

[10] Francis A. Longstaff, "How Much Can Marketability Affect Security Values," *Journal of Finance* 50 (1995), 1767-1774.

[11] Internal Revenue Service Revenue Ruling 77-287, Sec. 6.04.

Continued from p.35

Exhibit 1: The Levels of Value



Source: Chris Mercer, chrismercer.net.

Relevance to Enterprise Valuation

Insolvency case law interprets fair value to mean fair market value ("FMV"),[12] which represents the price at which an asset can be sold in a voluntary exchange between an able and willing buyer and seller, both having reasonable knowledge of the relevant facts.[13] Further, the FMV of an ownership interest in a closely held, non-publicly traded company, whether minority or majority interest, may be discounted for lack of marketability given investors preference for liquidity.[14] Still, depending on the market in which a firm is assumed to be sold, it may not be appropriate to apply a DLOM as the value of a privately held business that is sold to a publicly traded firm or in an initial public offering will be higher than if sold to a private buyer due to different assumptions and approaches to estimating discount rates and cash flows.[15]

Level of Value

As a precursor to determining a DLOM, the level of value of the interest to be valued must be identified as well as the level of value attributable to the methods applied. [16] Important in that it defines the indication of value derived from the valuation methods applied, the level of value framework has evolved in concert with valuation practice. As shown in Exhibit 1,[17] initially there were three levels of value: Control, Marketable Minority, and Nonmarketable Minority. This was then expanded to four levels, with Control Value allocated between Financial Control (change in value from better management of assets in place)[18] and Strategic Control to reflect synergies, which is still often used in practice.

However, the most recent view[19] of levels of value suggests there are six: Control Strategic, Minority Control/Standalone Liquid, Minority Liquid, Control Liquid, Control Standalone and Minority Nonmarketable (Exhibit 2).

The term "marketable illiquid" has also been proposed to distinguish between an interest that is either liquid or nonmarketable.[20] Examples of property considered marketable illiquid include a large block of thinly traded or restricted stock, a controlling interest in a public or private company, real estate, machinery, and equipment, while an actively traded public stock is liquid, and a minority interest in a private company, nonmarketable.

Influences Affecting the Degree of Marketability

The determination of whether an interest is marketable or nonmarketable is not black-and-white.[21] Rather, marketability moves along a continuum based on the facts and circumstances of the interest being valued. While there is no empirically supported formula to use in such an analysis, factors that may be considered include put rights, dividend payments, potential buyers, size of interest, a potential sale or IPO, availability of information, restrictive transfer provisions and firm characteristics.

Put Rights—A put right is a liquidity right that entitles the holder to sell their interest to a specified party at a point in time or specified circumstances, at a price or framework for determining the price, specified in a contract. As a put right in substance guarantees a market, it may reduce or eliminate a DLOM.

Dividend Payments—In the case of a stock that pays no dividend, the return to the holder is completely dependent on the sale of the stock. In contrast, the greater the dividend, the greater the return regardless of whether the stock is sold. Consequently,

[12] Grant W. Newton, *Bankruptcy and Insolvency Accounting, Volume 1*, 6th Ed. (Hoboken: John Wiley & Sons, Inc., 2009), 136, 227, 565-566.

[13] Ibid., 227; Shannon P. Pratt, *Business Valuation Discounts and Premiums* (New York: Wiley, 2001), 13-14.

[14] Newton, *Bankruptcy and Insolvency Accounting*, 394, 411-12.

[15] Aswath Damodaran, *Investment Valuation: Tools and Techniques for Determining the Value of Any Asset*, 3rd Ed. (Hoboken: John Wiley & Sons, Inc., 2012), 688-9.

[16] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit*, 13.

[17] Chris Mercer, "What Determines the Level of Value in Business Valuation?" blog post, https://chrismercer.net/what-determines-the-level-of-value-in-business-valuation/, viewed April 13, 2023.

[18] Aswath Damodaran, "The Value of Control: Some General Propositions," https://pages.stern.nyu.edu/~adamodar/pdfiles/country/controlshort.pdf, viewed April 13, 2023.

[19] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit*, 15.

[20] Ibid., 8.

[21] Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 6th Ed. (New York: McGraw-Hill, Inc., 2022), 446-9.

Exhibit 2: Levels of Value Six-Level View

Level of Value	Type of Company	Value Characteristics
Control Strategic	Public Company Private Company	Control and/or Strategic Value
Minority/Control Standalone Liquid	Public Company	Actively Traded Minority Price Per Share x Number of Shares Outstanding
Minority Liquid	Public Company	Actively Traded Minority Price Per Share
Control Liquid	Private Company	Actively Traded Public Equivalent Value
Control Standalone	Private Company	Control Private Company Value
Minority Nonmarketable	Private Company	Minority Private Company Value

Source: Hitchner et al.

dividend-paying stocks may be subject to a lower DLOM than non-dividend-paying stocks.

Potential Buyers—A group of engaged potential buyers or one particularly engaged, as might be shown through analysis of past activity in the market for the firm's shares, might reduce the DLOM.

Size of Interest—Empirical evidence suggests that larger blocks of stock have larger DLOMs than smaller blocks. Studies based on the time it takes to sell different blocks of publicly traded stock indicate blocks of all sizes are not equally liquid, and that liquidity can differ significantly between markets and within markets depending on the characteristics of the block and market conditions. Further, a large block of public stock may be worth less than the freely traded-price of that same stock even if actively traded due to reasons including, but not limited to, the size of the block in comparison to (1) the number of shares being traded on the exchange in which it is traded, (2) shares outstanding, (3) trading float, and (4) volatility of the trading price.[22]

It is also necessary to be mindful of whether the facts and circumstances are indicative of a blockage discount or DLOM. Blockage discounts come into play where the block of an actively traded stock is so large compared to sales in the market that it could not be sold in a reasonable period without depressing the market price.[23] Moreover, academic research[24] on the stock price effects of secondary distributions shows a significant stock price decrease is observed at the initial announcement of a secondary distribution, with the average two-day abnormal stock return equal to -1.96% for non-registered secondaries and -2.87% for registered. In contrast, a DLOM is an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability,[25] rather than the forces of supply and demand.

Potential sale or IPO—Though a potential sale or IPO may decrease the DLOM, the lack of certainty, and fact that the empirical IPO evidence that supports the DLOM is based on firms that subsequently went public, confounds the analysis. A business totally committed to remaining closely held for the foreseeable future might increase the DLOM in contrast.

Availability of Information—The greater the difficulty in obtaining reliable information, the greater the DLOM.

Restrictive Transfer Provisions—Any provision that has the effect of limiting the right of an interest holder to transfer their stock might increase the DLOM.

Firm Characteristics—Empirical evidence indicates that private placement discounts are related to the financial condition and characteristics of the firm, with greater DLOMS associated with firms having a history of unstable earnings and losses, high leverage, volatile stock prices and unproven or speculative product lines.

History of Transactions—Where there is evidence of a market based on transactions in a firm's stock, the DLOM may be lower than otherwise. The term "market" within this context refers to a pool of buyers rather than a single or formal exchange. Factual evidence of the pool is in general required, however. Simply hypothesizing that a pool of buyers exists is not enough to reduce the DLOM.

Measurement of the DLOM

The determination of the DLOM is achievable using qualitative and quantitative frameworks that can be categorized as belonging to one of four groups: benchmark studies, securities-based studies, analytical approaches and other.[26] Qualitative approaches focus on attributes that are not readily measured, including management expertise, industry cyclicality, the strengths, weaknesses, opportunities, and threats facing the company, its competitive environment, employee relations, government regulation and intellectual property. The methods used to calculate the DLOM based on these characteristics include the Restricted Stock studies, pre-IPO studies, Mandelbaum Factors, Acquisition method and IRS DLOM Job Aid factors.

Quantitative approaches are somewhat less subjective in that they make use of characteristics of the subject interest or business that can be measured using mathematical models.

[22] Robert F. Reilly and Robert R. Schweihs, *The Handbook of Advanced Business Valuation* (New York: McGraw-Hill, Inc.), 140-5.

[23] Ibid., 140-2.

[24] Wayne H. Mikkelson and M. Megan Partch, "Stock Price Effects and Costs of Secondary Distributions," *Journal of Financial Economics* 14:2 (1985), 165 – 194.

[25] Internal Revenue Service, *Discount for Lack of Marketability: Job Aid*, 6.

[26] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit*, 16, 21-7; 449.

Continued from p.37

Quantitative methods used to calculate the DLOM include transaction database regression analysis, option pricing models, and shareholder cash flow adjustment models.[27] Option pricing models include the Chaffe Option Pricing Model, Shout DLOM Put Model (Katsanis), Longstaff Upper Bound Lookback Put Option, Finnerty Average-Strike Put Option Model and Ghaidarov Adjusted Arithmetic Average-Strike Option, Forward-Starting Put Option and Perpetual Exchange Option models. Shareholder cash flow adjustment models included the Quantitative Marketability Discount Model (QMDM), NERA CAPM-Based Method and Non-marketable Investment Company Evaluation Method (NICE). Other models include the Bid-Ask Spread and Long-term Equity Anticipation Securities ("LEAPS") methods.

Qualitative Methods

The Restricted Stock studies and the pre-IPO studies make up the two primary ***benchmark study approaches*** to estimating the DLOM.[28] The restricted stock studies focus on the difference between the price of restricted stocks sold in private placements and that of publicly traded stocks of the issuer on a particular day. The pre-IPO series examines the difference between the IPO price of a company and the prices of pre-IPO transactions in its stock.

Restricted Stock Studies—Historically, practitioners have applied DLOMs based on an average or range of discounts indicated by these studies,[29] which have exhibited means and medians of 31.4% and 33.0%. However, the applicability of these measures or any other derived from the studies to an interest requires an analysis and understanding of whether elements other than lack of marketability may be contributing to the observed discounts, factors underlying their variance and range, why any one mean or median is appropriate, whether adjustments to the mean or median are necessary to comport with the subject interest, and why the transactions in the database used are suitable given the characteristics of the subject company.[30]

The ***pros*** of the restricted stock studies are that the securities are identical to their freely traded counterparts other than the holding period restriction, and the availability of contemporaneous price data indicating differences between liquid and illiquid shares. Further, the studies have often been relied on by practitioners given the amount of raw data available, amount of research that has been performed and the production of actual, numerical results. In the past, these studies have also been the studies most often accepted by the Tax Court. Notwithstanding, the Courts have rejected the use of averages absent an analysis and comparison of the restricted stock with the subject interest.

The ***cons*** underlying the restricted stock studies are that they rely on historical rather than contemporaneous market data, the changes in the holding period for restricted stocks over time, and the reliance on averages. Certain of the studies include data dating back to 1966, which may obviate their relevance for use given more recent market trends and conditions. The holding period for restricted stocks has also been significantly reduced over time, from a two-year holding period pre-April 1997 to a one-year holding period between April 1997 and February 2008, to a six-month holding period since. Other things being equal, a shorter holding period implies a lower DLOM. The reliance on means and averages may also mischaracterize the trading parameters (i.e., size of block, size of company and stock exchange where the stock was traded) and results. For instance, the DLOMs observed in the SEC Institutional Investors Restricted Stock Study, which reflects 398 transactions between 1966 and 1969, ranged from a negative discount of -15%, indicating a premium for lack of marketability, to a DLOM of over 80%.[31] These results also suggest that factors in addition to marketability may have contributed to the discounts.

Pre-IPO Studies—these studies estimate the DLOM by comparing the difference between the public market price at which a stock was issued in an IPO to the price for which the same stock was sold in the private market previously.[32] In order to obtain a stable and reliable measure of the pre-IPO stock price, practitioners have used different estimation periods ranging from several days to several months prior to the IPO. The measures of central tendency derived for the DLOM have ranged from 30+% to 60+%, in general higher than that estimated by the restricted stock studies. Notwithstanding, practitioners traditionally have considered the results of the pre-IPO studies together with the results of the restricted stock studies and subjectively selected a DLOM based on consideration of the summary statistics of both. More recently, the pre-IPO studies have to an extent fallen out of favor[33] due to a significant number of issues that have been identified in their use. Whether they apply to a subject interest is similarly determined based on the reasoning applicable to restricted stock studies.

The ***pros*** of the pre-IPO stock studies are that they make use of empirical market data and cover a broad period (Willamette Management Associates, 1975-1997; Emory, 1981-2000; Valuation Advisors, 1999-2001). The ***cons*** of the pre-IPO studies tend to outnumber their strengths, however.[34] In the view of the IRS and others, the pre-IPO studies overstate the DLOM and are unreliable as they artificially inflate the DLOM by ignoring unsuccessful IPOs, reflect not only the DLOM but the risk that the IPO may not occur, involve related-parties who are compensated in part by a bargain price, are underpriced as they involve rapidly developing and growing companies, are not contemporaneous due to the time gap between the pre-IPO transaction and IPO, and are skewed in cases because of the dot.com "bubble."

Flotation Cost Method—This calculates the expenses incurred, as a percentage of the gross proceeds, including underwriting, legal, and registration fees, to take a firm public as a proxy to calculate the DLOM applicable to a 100% controlling interest in a privately held firm.[35] However, as the costs are associated with registering a control interest, the method provides less of a perspective for the DLOM of a minority interest in a privately held entity. At the time of the SEC study of the issue,[36] the average cost of a total offering was 12%, though the bigger the offering, the smaller

[27] Ibid., 23.

[28] Ibid., 449.

[29] Pratt, *Valuing a Business,* 426-8.

[30] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit*, 452.

[31] Internal Revenue Service, *Discount for Lack of Marketability: Job Aid*, 77.

[32] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit*, 455.

[33] Rejected in *McCord v. Commissioner.,* 120 T.C. No. 13 (2003).

[34] Internal Revenue Service, 76.

[35] Hitchner et al, 287.

[36] United States, Securities and Exchange Commission, *Cost of Flotation of Registered Issues 1971-1972* (Washington DC: SEC, 1974).

the flotation costs as a percentage, with offerings between $100 million and $500 million having an average flotation cost of 3.19%. By comparison, the Ritter Study of registrations in 1987 shows that for firm commitments where the underwriter assumed all the risks, flotation costs were approximately 14.0% of all offerings, and for best efforts, 17.8% of all offerings.

The **pros** of the flotation cost method are that it is easily applied and that data is readily available. The **cons** include that it does not capture the risks that go along with uncertain holding periods. Consequently, it does not quantify the DLOM in its entirety. It is also not relevant for use with minority interests, which is where the DLOM most often comes into question.

Mandelbaum Factors[37]—The Mandelbaum Factors, from the Tax Court Case of the same name, specify ten variables that may be used as part of a process to adjust a DLOM based on traditional benchmark studies for the particular facts and circumstances of the subject interest. The factors and associated analysis have been cited in several court decisions and are considered by many in the valuation community to constitute a valid conceptual basis for analyzing and measuring a DLOM. Included are financial statement analysis, dividend policy, nature of the firm, history, industry position, economic outlook, company management, amount of control in shares transferred, restrictions on the transferability of stock, stock holding period, redemption policy and costs of conducting an IPO. Applying the factors requires the practitioner to consider whether to account for each of the factors in estimating the DLOM, the relative importance of each factor applied, and the reason for any adjustment to the mean or median DLOM as a result.[38]

The **pros** of the Mandelbaum Factors are that they serve to focus the analysis on the differences and similarities that may exist between the benchmark study results and the subject company, and that they are similar to the principles implicit to Revenue Ruling 59-60, 1959-1 CB 237. The **cons** are that the process is a complex undertaking for practitioners that are less experienced, and that information may be lacking for purposes of opining on each of the factors. Regardless, the application of the factors is increasingly common among practitioners, with the courts finding that (1) detailed analysis by the expert of the subject interest rather than citations to the work of studies performed by others is required to support a DLOM, (2) going above or below the study medians is acceptable if supported by reasonable and empirical evidence, (3) one size DLOM does not fit all, and (4) case specific analysis is required as blanket approaches based on historical averages are not defensible.

Not generally accepted in the appraisal community[39] and infrequently used to support a DLOM, the **Acquisition method** compares multiples paid in private company transactions to those of comparable public company transactions to infer a DLOM from the difference. Similar to the Mandelbaum Factors, the IRS *Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals* includes a detailed checklist of the types of factors to consider in deriving a DLOM in addition to IRS perspectives on DLOM models in use.

[37] *Mandelbaum, et al. v. Commissioner*, TC Memo 1995-255.

[38] Hitchner et al, 464.

[39] Ibid., 299.

Quantitative Methods

Security-based Approaches[40]—These are used to estimate the DLOM are based on option pricing models such as that of Longstaff, Chaffee and Finnerty and from illiquidity observed between traded-stock prices using the Bid-Ask Spread method and the prices of options using the LEAPS method. Option pricing models calculate the DLOM based on the opportunity cost of holding a nonmarketable versus marketable investment.[41] The holder of an illiquid interest is subject to the risk that its value will decrease prior to being realized. Accordingly, put option models estimate the theoretical cost of buying a put option to hedge against this risk over the holding period.

Long-term Equity Anticipation Securities (LEAPS)—These are publicly traded, long-term put options on the stocks of publicly traded companies that have a term to maturity of roughly 1.5 to 2.0 years. This serves to protect the purchaser against stock price decreases over the term held. With this method, the DLOM is calculated by dividing the price of the put option by the price of the subject stock. Certain practitioners regard LEAPS as representative of benchmark minimum DLOMs for reasons including differences in size between the market values of the firms issuing LEAPS as compared to that of a privately held firm, LEAPS are marketable, can be sold at any time, and have a known expiration date. Based on a safety ranking measured by the Value Line Investment Survey where 1 represented the least risk and 5 represented the most, one-year median DLOMs ranged from 8.3% to 17%, while two-year DLOMs ranged from 9.3% to 31%.[42]

The ***pros*** of using LEAPS are that there more than double the number of transactions in the LEAPS study sample than in the restricted stock studies; it is possible to identify LEAPS that are specific to a valuation date; and it is feasible to search by industry segment and comparable companies. The ***cons*** are that it is still necessary to conduct a qualitative analysis to adjust the DLOM implied by the LEAPS to comport with private company characteristics; and that the observed discount is a proxy for other qualitative factors that must be considered as the owner of a privately held firm is unable to hedge his or her interest in the options market. Perhaps for these reasons the use of LEAPS is not common for privately held firms. In addition, the courts have not evaluated the approach substantively.

Longstaff Option Model—This model is based on the price of a theoretical look-back American-style put option.[43] The model assumes the investor has perfect timing and is applicable when there is information asymmetry between the buyer and seller. The look-back feature allows the holder to retroactively exercise the put option at the highest price achieved during the contractual term of the option. The DLOM is then equal to the present value of the difference between what the option could be sold for after the option expires and the maximum price it could have sold for during the option's life. This then represents the upper bound on the DLOM since the investor is looking back in time to decide whether to buy or sell rather than deciding

[40] Pratt, *Valuing a Business*, 443-4.

[41] Ibid.

[42] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit*, 465.

[43] Longstaff, "How Much Can Marketability Affect Security Values?" 1767-1774.

Continued from p.39

based on contemporaneous evidence and expected stock price changes in the future.

The ***pros*** of the Longstaff Option Model[44] are that it is easily effected in Excel and is useful as an indication of the maximum value for the DLOM. The ***cons*** include that the model assumes that but for the trading restrictions extent during the life of the option, assuming perfect timing, the investor would know exactly the best time to exercise the option and would do so. Further, the model produces very large DLOMs with relatively low volatility of 30%, while most small cap firms have volatilities greater than 50%. Consequently, the model has seldom been used to estimate a DLOM for a privately held firm or been vetted meaningfully by the courts.

Chaffe Option Model—This is an application of the Black-Scholes ("BSM") option pricing model, commonly used to value European-style options (exercisable only at expiration).[45] The value of an at-the-money put option can be calculated with the BSM using the price of the underlying asset, option strike price, time to expiration, risk-free rate of interest and volatility. By holding this put, an investor is insured from a loss in the value of an illiquid share of restricted or nonmarketable stock during the period in which the stock's marketability is restricted. Consequently, the price of the put option is an approximation of the impairment of the stock's value due to lack of marketability. The price of the put option divided by the price of the stock is then equal to the DLOM.

The ***pros*** of the model are that it is based on the European put option Black-Scholes formula which is readily calculated using Excel. The ***cons*** include that it is like other option models a proxy for the DLOM and requires that other qualitative factors be evaluated to determine a final DLOM. It is also regarded as downward biased since it does not take into account early exercise. Further, the model has not been used with any frequency, or been tested by the courts.

Finnerty Average-Strike Put Option Model[46]—An average-strike put option, also known as an "Asian" option, gives the holder the right, but not the obligation, to sell the underlying stock at the average realized price over the life of the option.[47] The Finnerty model assumes that an investor does not have any particular market timing ability (implicit given the use of an average price) and is equally likely to sell the underlying stock at any time during the restriction period. The excess of the present value of the positive payoff from the stock's price at the expiration of the option over the average expected forward price of the stock over the restricted period represents the opportunity loss from not being able to sell the stock at the average expected price.

The ***pros*** of the Finnerty model include that it is easily programed in Excel and yields a benchmark DLOM assuming an average likelihood of sale during the restriction period; it does not assume any particular market-timing ability by an investor and consequently its relevance may be a better fit with fair market value; consistent with DLOM theory, it shows that discounts are positively correlated with volatility and holding periods, negatively correlated with dividend yields, and not greater than 100%; is appropriate for unrelated institutional investors that are less likely to have private information; and is used by some practitioners as a primary method to determine a DLOM.

The ***cons*** of the model are that DLOMs for volatilities below 45% and over 75% may be understated; given high volatilities and or long holding periods, the model cannot calculate DLOMs greater than 32%; it assumes that absent restrictions, an investor would be equally likely to sell stock at any point in the restriction period; when combined with restricted stock, the model can result in economic payoffs at expiration greater than owing the liquid stock directly, implying the option may be more valuable than the option of liquidity; the model does not always result in the same economic payoff on expiration as the real option of liquidity; and if the dividend yield is sufficiently high, the DLOM will decrease as the holding period increases, in violation of DLOM theory.

Bid-Ask Spread Method[48] —This model examines the difference between the ask price for a stock proposed by the seller and the offer price proposed by the buyer, with illiquidity being the difference. In practice, the method uses the bid-ask spread of closely held, illiquid public guideline companies with closely held ownership to develop a regression equation which is then used to calculate the DLOM based on the characteristics of the subject interest. The method is based on the findings of research showing that the lower the level of buying and selling interest for a security, and the greater the illiquidity of the market in which it trades, the bigger is the big-ask spread for the instrument.

The ***pros*** of the Bid-Ask Spread Method are that market data are available for a large number of publicly traded firms; it is possible to calculate a specific DLOM using the characteristics of the subject firm using regression data for the industry in which the firm participates; and the model can be adapted to the practitioner's choice of independent variables. The ***cons*** of the model are that while it captures an illiquidity discount, other factors relevant to the measurement of the DLOM are not (i.e., restrictions on marketability); and that it makes use of data for an industry sector as opposed to the approach used to select guideline public companies to value the firm.

Analytical Approaches

Analytical approaches examine the DLOM through the statistical analysis of transaction data sets.[49] The data sets vary in size from less than 100 transactions to several hundred thousand transactions of stock sales in private placements, typically between the stock issuer and an institutional buyer, bypassing the registration requirements of the SEC. The data sets compare the prices of sales of blocks of publicly traded stocks sold in private placements to the prices of trades of the stock on the primary market on which they are listed. This data is analyzed

[44] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit,* 468.

[45] Pratt, *Valuing a Business,* 443.

[46] John D. Finnerty, "An Average-Strike Put Option Model of the Marketability Discount," *The Journal of Derivatives*, Vol. 16. No. 24 (2012), p. 56.

[47] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit*, 322.

[48] Ibid., 375.

[49] Ibid., 471.

statistically through regression analysis to calculate the total amount of the DLOM and to allocate the DLOM across causal influences.

The Wruck Study[50]—Karen Hopper Wruck studied private placements of stock traded on the New York and American Stock Exchanges between July 1979 and December 1985 by comparing the share prices of the stock on the exchanges one day after the announcement of the private placement to the price of the share price in the placement. She found a 17.6% average difference in discounts between placements of registered versus unregistered shares, with a median of 10.4%. Her conclusions from this finding were that private placements in general sell at a discount, and that unregistered shares required greater discounts due to lack of marketability and the costs to investors of monitoring shares. Practitioners that have adopted the Wruck findings maintain that the 17.6% average difference in discount is mainly due to lack of marketability.

The ***pros*** of the Wruck study are that its hypothesis is clearly defined; both registered and unregistered placements are analyzed using firms that are listed nearly equally on two different exchanges; the resulting DLOM is conceptually supported by the analytical approach used; and the nature of the comparison serves to isolate the DLOM from factors such as monitoring and assessment costs. The ***cons*** of the Wruck study are that the sample of firms used appears to have been based on data availability rather than some well-defined selection methodology; the determination of whether the shares were registered or not was to an extent subjective and based on reports published in *The Wall Street Journal*; and choosing a measurement point of one day after the announcement might increase measured discounts given an immediate bounce in stock price. Having only been offered as background material rather than being proposed as DLOMs by practitioners, the courts have not opined on the study or its findings.

Hertzel and Smith ("H&S")[51]—H&S hypothesized that private equity placements are frequently launched by firms with limited tangible assets, engaged in speculative new product developments and/or in financial distress. Further, given the higher risks of these firms, they offer private placements priced at higher-than-normal discounts to compensate investors for higher information and monitoring costs. Using statistical techniques, H&S identified an average differential discount between private placements of registered and unregistered stock of 13.5%, which they deemed to be a surrogate for the discount, but that portions of the discount were attributable to higher assessment and monitoring costs and the inclination of markets to bid up traded shares where investors had shown an interest to invest.

H&S analyzed 106 private placements, 45 of which were for registered shares, with 18 for unregistered shares. For the remaining 43 placements for which the registration status was unknown, it was assumed that they were registered as this would lead to a conservative result with respect to the discount differential. A regression analysis using seven independent variables was conducted with the registered versus unregistered variable used to estimate the DLOM. Overall, the mean private placement discount was found to be 20.14%, with about two-thirds, or 13.5%, related to lack of liquidity, which H&S appear to use interchangeably with marketability, with the remainder to factors including the size of the placement, degree of financial distress, and nature of the buyers. H&S considered this to be the upper bound for the DLOM due to the difference in assessment and monitoring costs between registered and unregistered shares.

The ***pros*** of the H&S model are that the regression model identifies and analyzes the relationships between seven factors that potentially affect the DLOM, through which H&S were able to isolate what they believe is the effect of lack of marketability, measured at 13.5%, from other influences; over 75% of the sample was comprised of smaller firms where lack of marketability was likely to be an issue, unlike Wruck's sample that was made up of larger firms traded on major stock exchanges. The ***cons*** are similar to Wruck with respect to sample selection, measurement point and the determination of registration status, with H&S assuming that 43 out of the sample of 106 companies were registered absent verification. As with the Wruck study, the H&S study has been cited by practitioners as an introduction to the subject of DLOMs. However, as the H&S DLOM has not been proffered in court as the primary basis for a DLOM, the courts have not had the opportunity to opine on the study and its results.

Bajaj, Denis, Ferris and Sarin[52]—Bajaj et al defined marketability as the speed with which an asset could be converted to cash without the incurrence of significant transaction costs or price concessions.[53] Factors they identified as affecting the marketability of an asset included uncertainty in its value, lack of related information, availability of substitutes, trading restrictions and size of the block. To test their hypotheses, Bajaj et al analyzed 88 private placements between January 1, 1990, and December 31, 1995, using a measurement date 10 trading days after the date of the announcement. They found that all private placements, whether registered or unregistered, reflected discounts. The average discount for registered shares was 14.04% and for unregistered shares, 28.13%, while the median discounts were 9.85% and 26.47%. For registered and unregistered combined, the average was 22.21%, with a median of 20.67%.

A regression analysis conducted to parse the factors contributing to the overall discounts using four independent variables yielded a coefficient for the registration variable of 7.23%, indicating registered shares would require a smaller discount than unregistered, and providing a more refined estimate of the lack of marketability in Bajaj et al's opinion. Bajaj et al also broke down their overall discount data into a larger group, middle group and small group, and found average discounts of 43.33%, 20.36% and 2.21% respectively, which they hypothesized were due to the

[50] Karen Hopper Wruck, "Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings," *Journal of Financial Economics* 23 (1989), 3028.

[51] Michael Hertzel and Richard Smith, "Market Discounts and Shareholder Gains for Placing Equity Privately," *Journal of Finance*, 48 (1993), 459-485.

[52] Mukesh Bajaj, David J. Denis, Stephen P. Ferris, and Atulya Sarin, "Firm Value and Marketability Discounts," *Journal of Law and Economics* (2002).

[53] James R. Hitchner, et al, *Discount for Lack of Marketability Guide and Toolkit,* 477.

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size of block relative to total shares outstanding, business risk, financial distress and total proceeds realized in the offering.

The ***pros*** of the Bajaj et al study are that the basis for selecting the 88 firms appears to be better defined with the status of registered versus unregistered shares better verified; the use of smaller companies, which are more likely to reflect lack of marketability then firms traded on major exchanges; and the use of five different variables allowing for the use of what Bajaj et al considered to reflect the lack of marketability, though the 7.23% discount appears to be too low. The ***cons***, identified by critics including Pratt, Hall, Mercer, Mitchell and Norwalk relate to sample choice, remaining uncertainty of registration status, a relatively low coefficient of determination for the R2 for the regression model and the measurement date of 10 days after the announcement.

As compared to the studies of Wruck and H&S, the ***cons*** of the Bajaj et al study are that while it has received a great deal of attention in the valuation community, much of it is critical. In each case, however, the critics have supported their criticisms with their own preferred approach to the DLOM. ***In contrast***, the courts have generally regarded the Bajaj approach favorably citing its conceptual basis and use of mathematical techniques, though not accepting the 7.23% estimate of the DLOM. For example, in the McCord case, the Court looked at the data itself and determined a discount of 20% based on the average discount attributable to Bajaj's middle group of transaction results, noting that these transactions most closely represented the subject transaction in the case.[54]

Ashok B. Abbott[55]—Abbott used empirical methods to estimate marketability and liquidity discounts.[56] He defined marketability as the ability and right to sell a block of stock in an efficient market with relatively low transaction costs and minimal effect on the price of the stock, and liquidity in reference to the speed with which a block of stock may be converted to cash. Due to changes in the Rule 144 holding period, growth of the derivatives market, reduction in trading costs associated with discount brokerages, the SEC and FASB new transparency rules, Abbot believes that the pre-IPO and Restricted Stock Studies results are not very useable, and that while the changes have made public markets more liquid, they have not crossed over to the private markets, which could lead to an understatement of private company discounts.

Abbott undertook a study of existing studies and their discounts. His findings with respect to the lack of liquidity were that the least liquid stocks traded on the NYSE in 1996 had a discount for lack of liquidity ("DLOL") of 35.5%; based on 7,824 IPOs during 1993-2003, the average trimmed mean DLOL was 6.05%; depending on market capitalization, the range of the DLOL was 4.3% - 9.9% in a 2004 IPO study; from 1993-2004, small cap stocks had a holding period of 30 – 130 months, while the holding period for large cap stocks was 10 – 21 months, with a combined average range of 25 – 69 months; during 2001, large cap stocks were as much as 9 times more liquid than small cap stocks; and that the DLOL for smaller block sizes is less than 25% and for a 5% block, 15%.

The ***pros*** of Abbott's research are conceptual rather than in providing a numerical estimate of the DLOL or DLOM. Abbott recognized the differences between public and private markets and the import of block size; that innovations in the securities market reduce the discount required by investors in illiquid stock; and the relationship between firm capitalization and holding periods required to sell stock. The ***cons*** are that Abbott's research has for the most part been presented in academic and valuation association venues and therefore not vetted by practitioners or the courts.

Other Approaches

Shareholder cash flow adjustment models analyze the cash flows to a minority investor in the form of distributions and capital gains over assumed holding periods and volatility.[57] The underlying tenant is that the discount rate reflects the cost of illiquidity, expressed as an incremental required rate of return as compensation for holding a nonmarketable interest. Models in this group include the Quantitative Marketability Discount Model, NERA CAPM-Based Method and Non-marketable Investment Company Evaluation Method.

Quantitative Marketability Discount Model (QMDM")[58]—This can be used to calculate a matrix of discounts for lack of marketability based on the base value of the interest, rate of appreciation in assets, dividend yield, growth rate in dividends, rate of return to the hypothetical investor and length of holding period.[59] In practice, the practitioner estimates which of the

[54] Internal Revenue Service, *Discount for Lack of Marketability: Job Aid,* 81.

[55] Ashok B. Abbott, *Empirical Measures of Marketability and Liquidity Discounts; Discounts for Lack of Marketability: An Empirical Analysis and DLOM —Concepts and Models*; presentations at various ASA and NACVA Conferences and the BVR Teleconference of April 26, 2006.

[56] Hitchner et al, *Discount for Lack of Marketability Guide and Toolkit,* 481.

[57] Ibid., 438.

[58] Mercer, *Quantifying Marketability Discounts*.

[59] Hitchner et al, 484.

variables are most applicable given the characteristics of the interest. The point at which the variables intersect within the calculation matrix results in an indication of the DLOM.

The ***pros*** of the QMDM are that it yields a quantitative indication to support an opinion of the DLOM, and that rather than choosing what might be an arbitrary DLOM and then reciting a theoretical discussion of valuation theory in support, the practitioner is able to estimate asset specific factors to reach a particular DLOM from the calculation matrix. The ***cons*** are that the estimation of the variable inputs to the matrix calculation can be arbitrary and or biased; the use of the matrix increases the number of variables that the practitioner must have an opinion about over many years into the future; the model has not been widely used by outside valuation practitioners, rather being used for support of a primary DLOM opinion; and the courts have criticized the model's ability to produce reasonable results.

Non-Marketable Investment Company Evaluation ("NICE")[60]—The NICE method is an income valuation approach in which the discount for lack of control ("DLOC") and DLOM are treated as investment risks that are reflected in the required rate of return for the subject interest. The method is intended to determine the fair market value of an interest in closely held investments including family limited partnerships, S corporations and limited liability companies.[61] The key issue is that incremental rates of return for the DLOM must be estimated, which can be subjective depending on available information, with discounts varying in line with the inputs. Further, the method states that it should not be used where the holding period is known or reasonably estimated and that it assumes a "very long-term and illiquid investment." Otherwise, use of the method might result in too high of a DLOM.

The ***pros*** of the NICE method are that it avoids the subjective estimation of the DLOC and DLOM, as with what might be regarded as a traditional income approach. It is also thought to be a better alternative to the QMDM as the QMDM does not address the incremental required rate of return for the DLOC and DLOM. The ***cons*** of the NICE are that it assumes a hypothetical buyer can obtain a higher rate of return for a DLOC or DLOM; the determination of the basis for which the hypothetical buyer can be subjective; and the method assumes a holding period in excess of 10 years, and in cases upwards of 50 years. The use of the NICE method has also not been cited by practitioners, with the courts not referring to the method in any opinion.

NERA (David Tabak) Model—In an in-house working paper dated November 11, 2002, Dr. David Tabak of NERA, an economic consulting firm, offered a theoretical model based on the Capital Asset Pricing Model that enables the quantification of the DLOM based on objective criteria specific to the subject asset being considered.[62] The approach is the first to apply the CAPM to the calculation of the DLOM, and offers benefits over using median and mean results by a framework that measures illiquidity discounts that vary over time, the length of the restriction period and risk of the asset. The paper includes a table of implied illiquidity discounts that vary from 15.4% to 82.9%, with mid-point average discounts ranging from 37.8% to 44.8%.

According to the white paper, the ***pros*** of the approach are that the CAPM provides a quantitative basis to calculate the illiquidity discount in line with the incremental risk that increases the equity risk premium and lowers the price; and the calculation of the illiquidity discount is objective in that it is calculated based on volatility and the equity risk premium. The ***cons*** of the approach are that it requires estimates of variables based on comparable companies among other factors, which can introduce subjectivity into the result; additional subjectivity is introduced by the need to estimate the holding period; and as the model is theoretical, there is no sound way to test its results against the market. The working paper also states that "To begin, assume that these quantities are measurable…[T]his theory will still require a somewhat subjective analysis if one or more of these quantities, typically T, the time of the restriction, must be estimated based on qualitative data." The method has not been observed to have been used by practitioners in practice or opined on by the courts.

What Now?

The time has come and gone when practitioners could credibly apply a DLOM to an interest supported only with reference to the underlying theory. As the approaches and methods to measuring the DLOM have evolved over time, so have the analyses required to defend it. The challenge remains, however, that the solution to the challenge is not carved in stone. Consequently, it is necessary to evaluate the reasonableness and reliability of the approach and data being considered, its fitness for use given the facts and circumstances of the interest and business, its general acceptance within the valuation community and its treatment by the Courts.

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Boris J. Steffen, CDBV, is a Managing Director with Province, Inc. With over 30 years experience as a financial advisor and expert witness to holders of interests and claims on matters of accounting, finance, valuation and solvency, he has consulted in over $100 billion of mergers, acquisitions and restructurings. As such, his practice has included Special Litigation Committee service, acting as the independent accounting expert in post-closing working capital disputes, evaluating asset acquisitions and serving as an expert witness with respect to issues including the interpretation of accounting principles, allocation of costs, specificity of merger synergies, actual and constructive fraudulent transfers, and fair value, including before the Delaware Court of Chancery.

[60] William Frazer, "Nonmarketable Investment Company Evaluation (NICE)," *Valuation Strategies*, Vol 10. No. 2 (Warren, Gorman & Lamont, RIA Group, Boston MA, 2022).
[61] Hitchner et al, 486.
[62] Hitchner et al, 488.

LIABILITY MANAGEMENT TRANSACTIONS

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A syndicated loan is a loan extended by a group of lenders (i.e., a syndicate) to a single borrower, typically under a single agreement with common terms. By pooling their resources, the lenders share the benefits and risks of the transaction. Generally speaking, the spirit of such arrangements among lenders is all for one, one for all. ***But not always****.*

- The Honorable Joel M. Cohen (NY Sup. Ct.)[1]

This article will focus on the "not always" situations that are becoming more frequent and may become even more commonplace as the economy slows down and corporate liquidity is challenged by rising interest rates and inflation.

While there are many different types of liability management transactions, two forms of these transactions have recently become more common: *uptier transactions* and *drop-down transactions*. We will discuss in the following sections these two main types of transactions borrowers have used to achieve what is essentially a non-consensual priming.

Uptier Transactions

Generally, financing agreements (either secured loan agreements or indentures) contain protections for senior secured creditors that prevent a borrower from issuing new debt that would dilute or subordinate a creditor's collateral position or otherwise release collateral, absent their consent. However, there is a recent trend of distressed borrowers who, with the support of majority creditors, are effectuating transactions that effectively "prime" the minority creditors without their consent. Non-participating creditors, in some cases creditors holding a simple minority under the same facility, go to sleep as first-lien creditors and wake up subordinated.

Under an uptier transaction, the majority creditors (which typically refers to holders of loans or notes in an amount greater than the requisite majority required to modify the financing agreement) agree to amend the existing financing agreements to permit the issuance of new senior debt and, in many instances, subsequently exchange their existing debt for the new senior debt. The non-participating minority creditors are left with subordinated liens. Exhibit 1 presents a chart that details how an uptier transaction works under loan agreements and bond indentures.

These transactions are commonly seen as a recent trend; however, they are not a new phenomenon. While the language of financing agreements has evolved over time (often referred to as "technology"), the question as to whether a majority may act for its own benefit to the detriment of the minority is not a new issue.[2]

Recent Challenges to Uptier Transactions

Recent uptier transactions have led to lawsuits by minority creditors to enforce rights they believe exist under financing agreements that prohibit these transactions. In turn, majority creditors and borrowers have attempted to enforce tailor-made "no-action" clauses to prevent minority creditors from bringing these lawsuits. While there are nuances to each uptier transaction and related litigation, minority creditors by and large have asserted the following:

1. ***Breach-of-Contract Claim***—Violation of the pro rata payment provision of the credit agreement by the exchange of old debt for new super senior debt by majority creditors; and,
2. ***Breach of the Implied Covenant of Good Faith and Fair Dealing Claim***—Either by the undisclosed or secret nature of the transaction or by the attempt to impair the rights of non-participating minority creditors in bad faith, when borrowers agreed to subordinate existing debt inconnection with a transaction where only the majority creditors are allowed to participate, by providing the new senior debt and exchanging their preexisting debt into the senior debt.[3]

Recent "Uptier" Decisions

Exhibit 2 summarizes several recent cases that have defined the current playing field of uptier transactions.

1. ***Not Your Daughter's Jeans (NYDJ)***[4]**—**In 2017, majority lenders amended the existing credit agreement to allow the majority to lend incremental financing on a priming basis. Minority lenders sued arguing that NYDJ and the majority lenders secretly conspired to elevate the priority of the majority participating lenders, in bad faith and without providing any notice to them.

   At a hearing on the majority lenders' motion to dismiss, the court declined to dismiss the minority lenders' complaint saying, the "[r]easonable commercial expectations of the lenders participating in the arrangement are being

[1] *Audax Credit Opportunities Offshore Ltd. v. TMK Hawk Parent, Corp. ("TriMark")*, Index No. 565123/2020 (NY Sup. Ct. Aug. 16, 2021) (emphasis added).

[2] See e.g., *Hackettstown Nat. Bank v. D.G. Yuengling Brewing Co.*, 74 F. 110 (2nd Cir. 1896) (finding that the majority violated the covenant of good faith and fair dealing by agreeing to amend the terms of notes in a manner that harmed the minority).

[3] Minority creditors have also brought claims against sponsors which have allegedly tortiously interfered with non-participating creditors' rights under the financing agreement.

[4] *Octagon Credit Inv., LLC v. NYDJ Apparel, LLC., et al.*, No. 656677/17 (N.Y. Sup. Ct. 2018).

Exhibit 1: How Uptier Transactions Work

STAGE	PROCESS
Existing Indebtedness	Borrower and creditors are party to an existing financing agreement.
Amendment Provision	Financing agreement's amendment section provides that, other than with respect to enumerated "sacred rights," financing agreement may be amended by the majority creditors.
Negotiation	Majority creditors negotiate with the borrower to amend provisions of financing agreement to allow for the issuance of new senior debt and granting of priming liens, among other things.
New Senior Debt	With the existing financing agreement now amended to allow for issuances of new senior debt, majority creditors typically fund new senior debt with cash and often exchange their existing debt for the new senior debt.
Pro Rata/Open Market Purchases	Loan agreements typically provide that payments to lenders must be received on a pro rata basis; however, many loan agreements provide an exception to this pro rata construct to permit borrowers to carry out non-pro rata debt purchases on the "open market."
Press Release	Borrower announces recapitalization transaction, often without prior notice to minority creditors.
Aftermath	Borrower uses transaction to obtain an infusion of liquidity to extend its runway, commonly at the direction of their sponsors. Majority creditors use the uptier transaction to reduce the amount of debt secured by a senior lien, thus reducing the dilutive impact the minority creditors would have on their recoveries absent the uptier transaction.

Exhibit 2: Recent Definitive Uptier Transaction Cases

Cases	No-Action Clause	Breach-of-Contract Claims	ICGFFD Claims
NYDJ	N/A	✓	✓
TriMark	NO BAR	✓	✗
Serta Simmons Bedding	NO BAR	✓	✓
BOARDRIDERS	NO BAR	✓	✓

✗ Claims dismissed

✓ Claims survive dismissal

undermined by some of the lenders getting together and saying look, if we don't tell the other guys what we're doing, we can cut them out of the picture. It doesn't seem very fair."

2. ***TriMark***[5]—In 2020, majority lenders amended the existing first-lien credit agreement to allow issuance of new super senior priming debt. Thereafter, TriMark entered into a super senior credit agreement secured by the same collateral that secured the existing first-lien debt and exchanged the existing old debt for the new debt. This uptier transaction left the minority lenders in a third lien position, and they sued in New York State Court.

In August 2021, the court denied in part the defendants' motion to dismiss. The court found that plaintiffs had stated a viable claim that the transactions were invalid because they violated plaintiffs' "sacred rights." The ruling was based on the view that a change to the definition of "Intercreditor Agreement" in the financing agreement could be seen as effectively modifying the application of proceeds provision in the financing agreement, which required unanimous consent. The court also rejected the defendants' efforts to use an amended "no-action" clause in the financing agreement to prevent the minority lenders from bringing suit. However, the Court dismissed the implied covenant of good faith and fair dealing claim since it was duplicative of the breach-of-contract claim.

[5] *Audax Credit Opportunities Offshore Ltd., et al. v. TMK Hawk Parent, Corp., et al.*, 150 N.Y.S. 3d 894 (N.Y. Sup. Ct. 2021).

Continued from p.45

3. ***Serta*** [6]—In 2020, with the support of the majority lenders, Serta issued two new tranches of debt, both of which ranked senior to Serta's existing ~$2 billion first-lien loans. These new senior tranches included a new money tranche provided by majority lenders and a tranche in which the majority lenders exchanged their existing first lien debt into. To facilitate the transaction, Serta's majority lenders consented to a series of amendments to the loan documents.

   Minority lenders sued in the Southern District of New York. In March 2022, the court denied in part the motions to dismiss. With respect to the no-action clause, the court determined that because the minority lenders sought damages and injunctive relief stemming from an allegedly improper transaction, their contractual claims were not barred by the no-action clause.

   The court found that the minority lenders had adequately pled that the exchange transaction did not constitute an "open market purchase," finding that undefined concept was susceptible to multiple meanings. Therefore, the court permitted the minority creditors to continue with the claim that the exchange violated the pro rata payment provision in the credit agreement. In addition, the court allowed the minority creditors' claim for breach of the implied covenant of good faith and fair dealing to proceed, noting the secretive nature of the negotiations surrounding the transaction could support an allegation of bad faith, and majority lenders' exercise of their consent rights could have impermissibly deprived minority lenders of the benefit of their bargain.

   In January 2023, Serta filed for bankruptcy in the Bankruptcy Court for the Southern District of Texas and initiated two adversary complaints against the minority lenders excluded from the 2020 transaction. In one of these complaints, Serta sought a declaratory judgment that the 2020 transaction was valid under the terms of the 2016 credit agreement. At the summary judgment stage of these proceedings, the majority lenders argued that the term "open market purchase" clearly and unambiguously supported the 2020 transaction; conversely, the minority lenders argued that the term either clearly supported a finding of a breach of contract, or that the term was ambiguous. The Bankruptcy Court found that the term unambiguously supported the 2020 transaction and ruled that summary judgment was appropriate on that issue.

4. ***Boardriders*** [7]—In 2020, Boardriders pursued an uptier exchange whereby its existing loans were layered by new money and an exchange to benefit its majority lenders. The exchange was completed pursuant to a provision in the credit agreement permitting open market purchases. As part of the transaction, the existing credit agreement was amended with majority lenders consent to (i) permit superpriority debt incurrence; (ii) direct the agent to enter into an intercreditor agreement that subordinated liens securing the first existing lien debt; (iii) strip covenants and reporting rights; and (iv) waive all existing defaults.

   The minority lenders sued in New York State Court. In October 2022, the court denied in part the motion to dismiss. As an initial matter, the court rejected the defendants' efforts to use an amended "no-action" clause to prevent the minority lenders from suing.

   The court then allowed the breach-of-contract claim to go forward, reasoning that the lack of an express prohibition against subordinating lenders' liens cannot be understood as an authorization to vitiate the equal repayment provisions and alter the entire context of the contract. With respect to the undefined "open market" term, the court held that the term is "reasonably susceptible of more than one interpretation" and "the Credit Agreement does not unequivocally foreclose the allegations in the complaint." The court also allowed the breach of the implied covenant of good faith and fair dealing claim, concluding that they adequately pleaded that the transaction was carried out in secret and that majority lenders abused their ability to amend the credit agreement to effectuate the transaction.

Conclusion

It remains to be seen what effect the recent litigation will have on future uptier transactions. The survival of breach of contract claims and implied covenant of good faith and fair dealing claims brought by minority creditors at the motion to dismiss phase adds another layer of complexity to the analysis of uptier transactions, beyond just determining whether the financing agreements contain the "technology" that arguably allows or prevents such transactions. In addition, if challenges to the uptier transactions are ultimately determined by courts to violate the contractual provisions or the implied covenant of good faith and fair dealing, it remains to be seen what remedies courts should apply. Should the new money tranche be subordinated to the existing debt? Should the majority claims also be subordinated? Are the minority lenders entitled to monetary damages? Finally, will the debt markets change to incorporate contractual protections specially designed to prevent uptier transactions and what impact will this have on liability management transactions in the future? The final chapter on uptier transactions has yet to be written.

Drop-Down Transactions

In a drop-down transaction, a borrower utilizes basket capacity under existing investment and restricted payment covenants to transfer collateral away from the restricted entities to an "unrestricted subsidiary." Being unrestricted, the subsidiary is typically not required to be a guarantor (and, accordingly, does not pledge its assets as collateral), nor is it subject to the covenants in the financing agreements. Thus, the unrestricted subsidiary is often free to issue new debt, which is then secured by the newly transferred assets.

Unlike uptier transactions, drop-down liability management transactions do not necessarily require the consent of the majority creditors, although subsequent ratification of the transaction is often sought and obtained from participating majority creditors to avoid litigation. Recent drop-down transactions highlight how many borrowers and sponsors perceive financing agreements to

[6] *LCM XXII Ltd., et al. v. Serta Simmons Bedding, LLC*, No. 21-cv-3987, 2022 WL 953109 (S.D.N.Y. Mar. 29, 2022).

[7] *ICG Global Loan Fund 1 DAC, et al. v. Boardriders, Inc., et al.*, No. 655175/20 (N.Y. Sup. Ct. 2018).

Exhibit 3: Typical Structure of Drop-Down Transactions

STAGE	PROCESS
Facility	Borrower is party to a financing agreement, which includes capacity to invest in unrestricted subsidiaries.
Transfers	Borrower identifies investment/restricted payment basket capacity, and assets that are severable from the restricted asset group (e.g., intellectual property) and transfers such assets to an unrestricted subsidiary in reliance on the relevant baskets.
Unrestricted Subsidiary	Once the assets are transferred to the unrestricted subsidiary, the borrower has flexibility on what to do with the transferred assets. Commonly, the unrestricted subsidiary is not a guarantor under the financing agreement, and it may incur new structurally senior debt secured by the recently transferred assets to fund the borrower's continued operations. The new structurally senior debt is often provided by existing creditors, the sponsor or third parties. Alternatively, the unrestricted subsidiary could dividend the assets to the sponsor.
New Senior Debt	Borrower may offer some or all of the existing lenders (often just the majority lenders) the ability to exchange existing debt for new debt of the unrestricted subsidiary, which is now structurally senior to the existing debt and the only debt secured by the assets of the unrestricted subsidiary.
Aftermath	Borrower often uses the transaction to obtain an infusion of liquidity and extend its runway. Majority creditors may use the transaction to reduce the number of creditors who will have recourse to the assets dropped down, thus eliminating the dilutive impact the minority creditors would have on their recoveries.

be extremely flexible, providing ample room to undertake these transactions.[8]

Exhibit 3 explains how drop-down transactions are typically structured.

Representative Drop-Down Transactions and Related Litigation

As with uptier transactions, these types of out-of-court transactions often lead to litigation by creditors left behind at entities with a diminished collateral package. These creditors may claim that the transfer of assets from a restricted subsidiary to an unrestricted subsidiary is an actual or constructive fraudulent transfer, a breach of the financing agreement, or a violation of the implied covenant of good faith and fair dealing. In addition, these litigations often involve disputes on whether the investment baskets were appropriately utilized, and whether the value of the assets transferred fall within such baskets. To date, only a handful of court decisions have addressed the issues involved in drop-down transactions, and we have summarized a few of them below.

1. ***iHeart***—In 2015, iHeart noticed that its public debt was trading at a significant discount and sought to implement a repurchase strategy. iHeart had approximately US$6 billion in debt under five indentures which limited its ability to directly repurchase its debt. In December 2015, iHeart directed one of its restricted subsidiaries to transfer shares of another subsidiary (worth approximately US$516 million) to Broader Media, an unrestricted subsidiary, which would then use this capital contribution to fund the debt repurchase. The stock transfer was characterized as an "investment" made in reliance on the "Permitted Investment" basket under iHeart's indentures and based on Broader Media's ability, as an unrestricted subsidiary, to freely use the capital to repurchase iHeart's debt.

   In March 2016, holders of certain of the iHeart's priority guarantee notes issued notices of default alleging that the stock transfer to an unrestricted subsidiary was not a "Permitted Investment" under the indentures. In response, iHeart brought suit in Texas state court seeking a declaratory judgment that the stock transfer did not violate the indentures. The Texas state court ruled in favor of iHeart, holding that the transfer qualified as a "Permitted Investment" under the indenture. The noteholders appealed, and the Texas appellate court affirmed.[9] The appellate court ruling turned on whether a profit motive was required to utilize an investment basket under the indenture. After analyzing a number of dictionary definitions for the term "investment," the court found that the term does not necessarily require a profit motive and resolved the case in iHeart's favor.

2. ***J. Crew***—While J. Crew was not the first company to implement a drop-down transaction, it is likely the most renowned, even to the point the verb "J-Crewed" has been used to refer to lenders being subordinated by their borrowers.

   In late 2016, in reliance on certain investment baskets, J. Crew transferred 72% of certain intellectual property ("IP")

[8] A recent study that examined more than 600 syndicated term loans has concluded that contractual "blockers" to limit a borrowers' ability to implement drop-down transactions have not been generally adapted by the market. "Contracts could adjust to prevent dropdowns but did not." Vincent S.J. Buccola and Gregory Nini, *The Loan Market Response to Dropdown and Uptier Transactions* (June 22, 2022) at 41-42. Available at SSRN: https://ssrn.com/abstract=4143928 or http://dx.doi.org/10.2139/ssrn.4143928.

[9] *Franklin Advisers, Inc. v. iHeart Commc'ns Inc.*, No. 04-16-00532-CV, 2017 WL 4518297 (Tex. App. Oct. 11, 2017).

Continued from p.47

assets (a significant source of value that previously served as collateral for the term loan) to an unrestricted subsidiary. The unrestricted subsidiary then guaranteed and pledged its assets to secure the issuance of new secured notes. J. Crew valued the transferred IP at US$250 million, an amount far less than the amount alleged by the lenders but nearly identical to J. Crew's investment capacity under the "Permitted Investment" baskets.

J. Crew then executed a debt-for-debt exchange in which its existing unsecured notes were exchanged for both new senior secured notes (i.e., existing unsecured notes were effectively refinanced using collateral previously securing the term loan), and preferred and common equity.

Ahead of the issuance of notices of default by the term loan lenders, J. Crew filed a complaint against the lenders' administrative and collateral agent in New York state court, seeking a declaration that the transfer of the IP assets was permitted by the term loan agreement and that no default or event of default had occurred as a result of the transaction. The agent asserted counterclaims challenging the validity of the transactions. To settle the litigation, J. Crew agreed to pay down a portion of the term loan. Following settlement discussions, 88% of the term loan lenders agreed to formally consent to the transaction (ratifying the transfer); however, certain minority lenders objected and sued in New York state court.[10]

The New York court dismissed most of the minority lenders' claims given the consent provided by the majority. Significantly, a claim that the IP transfer was, in fact, a transfer of "substantially all" of the collateral requiring unanimous lender consent, survived. Ultimately, however, this litigation was resolved as part of J. Crew's chapter 11 case, albeit without of any incremental recovery to the objecting minority lenders.

3. ***Neiman Marcus***—In March 2017, Neiman Marcus disclosed that it had changed the designation of certain subsidiaries holding the valuable MyTheresa assets and certain real estate, from non-guarantor "restricted subsidiaries," subject to the restrictive covenants contained in the various funded debt agreements, to non-guarantor "unrestricted subsidiaries," which were not. For eighteen months, Neiman did nothing and the newly created unrestricted subsidiaries continued to indirectly provide credit support to the company's funded debt obligations. That changed, however, in September 2018 when Neiman Marcus disclosed that the MyTheresa subsidiaries had been conveyed through a series of distributions to an intermediate holdco wholly-owned by the sponsor, which was not, itself, an obligor on the funded debt.

   While the transfer of the MyTheresa subsidiaries to the sponsor's wholly-owned subsidiary gave rise to a fraudulent transfer claim, as Neiman Marcus was likely insolvent and did not receive any consideration for the distribution, Neiman Marcus insisted that the financing agreements expressly permitted it to designate entities as unrestricted subsidiaries as well as to distribute interests in unrestricted subsidiaries. After numerous rounds of settlement discussions (both prior to and during the subsequent bankruptcy case), the sponsor, Neiman Marcus and the various stakeholders settled the fraudulent transfer and other claims; however, the vast majority of the MyTheresa value was ultimately stripped away from the creditors for the benefit of the sponsor.

4. ***Revlon***—In 2016, Revlon entered into a US$1.8 billion term loan facility that allowed for the issuance of revolving loans. In 2020, Revlon sought the support of the majority term loan lenders under the 2016 facility to support an amendment that would allow the transfer of certain collateral, including valuable IP, to an unrestricted subsidiary. Several of the term loan lenders supported the transfer, but the majority did not and signed a cooperation agreement binding the majority lenders to oppose the amendment. However, Revlon issued US$65 million of new revolving loans to the supporting lenders, which purportedly enabled them to become majority. This was because the newly issued revolving loan voted in the same class as the term loans.

   Upon obtaining the support of the alleged new majority lenders, Revlon transferred the IP to an unrestricted subsidiary and entered into new credit facilities secured by, among other things, the valuable IP. In addition to exchanging the supporting lenders' loans into the new credit facilities, proceeds from the new term loan were quickly used to fully repay the revolver. Thereafter, Revlon filed for bankruptcy in June 2022.

   The non-supporting lenders characterized the revolver as a "sham," as it was used solely to obtain consent to the amendments, and, thus, did not serve a legitimate business purpose. These lenders have recently filed an adversary complaint in Revlon's bankruptcy case against Revlon and the supporting lenders, seeking equitable relief voiding both the 2020 amendment and the liens that were placed on the IP under the new credit facilities. On December 5, 2022, Revlon and the other defendants filed motions to dismiss the adversary complaint asserting, among other things, that the transaction was explicitly permitted by Revlon's financing agreements and that the plaintiffs lack standing to prosecute these causes of action in bankruptcy. The Bankruptcy Court of the Southern District of New York ruled in favor of Revlon and dismissed the adversary complaint on the basis that the non-supporting lenders' claims for equitable relief were derivative claims belonging to Revlon's bankruptcy estate, and the non-supporting lenders therefore lacked standing to prosecute them. The Court observed that the plaintiffs were "simply 'pleading around' causes of action that they would need to concede are derivative or exclusively reserved for the trustee and the estate," and the fact that they suffered greater injury than others did not make these claims direct instead of derivative. This ruling effectively kept the 2020 new revolving loans intact and may portend greater reliance on this and similar strategies by lenders and borrowers to manufacture majority consent.

[10] *J. Crew Group, Inc., et al. v. Wilmington Savings Fund Society*, Index No. 650574/2017 (N.Y. Sup. Ct.) (2017).

Conclusion

In some instances, the loan market has reacted to the use of drop-down transactions, by limiting a borrower's ability to transfer certain types of assets (e.g., IP) into unrestricted subsidiaries, or blocking the ability to create or designate unrestricted subsidiaries at all. However, most current loan documents still afford a great deal of flexibility that allows for drop-down liability management transactions.

It is imperative that lenders and bondholders understand these transactions and the risks they face when entering into financing transactions. A proper covenant analysis and in-depth review of baskets and flexibility provided by financing agreements is key to any debt transaction. Questions as to whether these transactions are truly contractual violations, breaches of the implied covenant of good faith and fair dealing or fraudulent transfers remain unsettled. However, liability management transactions that combine an opportunistic creditor with a distressed borrower focused on extending its runway are not going away anytime soon.

This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel.

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Douglas Mannal focuses his practice on financial restructuring, representing diverse clients in complex Chapter 11 cases, out-of-court restructurings, and other distressed situations. Mr. Mannal's clients include ad hoc creditor groups, creditors' committees, major secured and unsecured creditors, debtors, bank agents and financial institutions. Mr. Mannal has led numerous representations of creditors in high-profile Chapter 11 cases, including Gulfport Energy, Frontier Communications, Bristow Helicopters, and California Resources Corp. Recent ad hoc creditor group representations include Alpha Media, McClatchy Newspapers, Bristow Helicopters and Nine West.

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Stephen Zide has almost 20 years of experience in many of the largest and most complex Chapter 11 bankruptcies and out-of-court restructurings in recent years. Mr. Zide focuses on advising clients with respect to complex capital structures and has extensive experience representing clients in negotiating DIP financings, equity commitment agreements and rights offerings. His clients include official and ad hoc creditor committees, debtors, and strategic buyers including, most recently, creditor groups in the restructurings of Lyons Magnus, Eletson, Valaris, Noble, Payless, Westmoreland, MBIA, and Peabody.

AIRA looks forward to seeing you at AC23, June 7-10 in beautiful Newport Beach, California! AC23 includes 4 days of in–depth education, two all–day preconference seminars, three keynote presentations, and 17 panel presentations on the latest developments and trends in bankruptcy and restructuring.

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3 DISTINGUISHED KEYNOTES

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Strategic Planning – A Regular Review Is Important to All Organizations

This keynote will be conducted in a fireside chat format. Speakers **Louis Feldstein**, **Jennifer Meyerowitz**, and **Jim Lukenda** will explore the importance to any organization, whether for profit or non-profit, on a stable path or in distress, of a regular strategic plan review and update.

THURSDAY

Financial Market Perspectives on Corporate Distress

Michael Jenkins
Bloomberg LP

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Bankruptcy Taxation

The learning objectives of this all-day program are to provide timely discussion and content update for tax professionals and those working with in the areas of Corporate Tax Considerations in Bankruptcy; Working with IRS Insolvency and Tax Issues in Bankruptcy; Chapter 7 & 11 Tax Basics; and a session called: Insolvency-Prove it! At the conclusion of this program, attendees will have a current knowledge of key developments in each of the panel areas.

Financial Advisors' Toolbox

The learning objectives of the Financial Advisors' Toolbox program are to educate an intermediate practitioner about bankruptcy law and practice. Panel sessions include: Fielding the "First Call;" Subchapter V Financial Plan Requirements and Best Practices; Healthcare Restructuring and Bankruptcies; Isolating Bad Debt; Presenting Financial Information in Chapter 11; and, Negotiation Skills in a Distressed Situation.

CONFERENCE - 16 SESSIONS

THU, JUNE 8, 2023

- Procrustes Challenge: Designing Mass Tort Settlement Trusts and TDPs - One Size Does Not Fit All
- Implications of Rising Inflation on Corporate Restructuring Strategies

SESSIONS CONTINUE NEXT PAGE

CONFERENCE CONTINUED

FRI, JUNE 09 2023

- Cooperation and Conflict Between US and Cayman Insolvency Proceedings
- Disruption in the Beauty Products Industry: When Beauty and Financial Distress Meet
- Real Estate Workouts: Rising Interest Rates, Looming Defaults- Where Do We Go from Here?
- Subchapter V: What Have We Learned So Far?
- Climate Risk and Energy Sector Bankruptcies
- For Debtors Facing Post-Petition Interest and Make Whole Obligations, It 'Hertz so Good'… Unless They're Solvent
- Rise of Mediation in Chapter 11
- ABC, D & F: Getting Current on the Use of ABC's Across the Country
- Hot Topics - The Continued Fallout from Crypto Winter
- Impact of Russia Sanctions on the U.S. Economy and the Restructuring Industry
- Distress in the Capital Markets - Where Are the Opportunities Now?
- Cannabis: The Highs and Lows of an Emerging Industry

SAT, JUNE 10, 2023

- Crypto Currency Conundrums – International Issues Impacting Crypto Currency Restructurings
- Emerging Issues in Attorney Discipline: Disciplining Politically-Motivated Attorney Misconduct and Discharging State Bar Sanctions

EXCURSIONS NEXT PAGE

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Blair Woolheater is a Director at Portage Point Partners, based in Pittsburgh, specializing in Performance Improvement and Interim Management. At Portage Point Blair has led operations for two large, private maritime transportation clients and has conducted multiple successful performance improvement engagements. Prior to joining Portage Point, Blair was a strategy consultant at Wilson Perumal & Company and a submarine officer in the US Navy. While not working on engagements, Blair serves as a Lieutenant Commander in the US Navy Reserve, providing strategic support to real world submarine operations. Blair graduated with a Bachelor of Science degree in Biomedical Engineering from Duke University.

2nd PLACE: Alejandro Ramirez Disla – *Alvarez & Marsal*

Alejandro Ramirez Disla is an Associate with Alvarez & Marsal North America in Los Angeles. He specializes in restructuring and financial reporting, including capital budgeting, cash actualization, liquidity management, bankruptcy preparation, and cost reduction initiatives. Prior to joining A&M, Alejandro spent four years with PwC's Deals Valuation team in Washington, D.C., where he served as a Senior Associate, advising some of the world's largest public and private companies in financial reporting and strategic value matters. Alejandro earned a Bachelor's Degree in Commerce with a concentration in finance from The University of Virginia. He is a Chartered Financial Analyst (CFA).

3rd PLACE: Kirsten Cellier – *Deloitte & Touche LLP*

Kirsten Cellier is a Senior Manager in Financial Advisory at Deloitte & Touche LLP in the Cayman Islands. She focuses on insolvency, restructuring and forensic investigations, specializing in solvent and insolvent liquidations of distressed investment vehicles and holding companies domiciled in the Cayman Islands. She has managed all aspects of liquidations, including those under the supervision of the Grand Court of the Cayman Islands. Areas of experience include developing liquidation and asset recovery strategies, advising stakeholder and creditor groups, realizing illiquid investments and restricted securities, and investigating potential claims related to breach of fiduciary duty, asset misappropriation, and preferences. Kirsten is a chartered accountant and completed her INSOL Foundation Certificate in International Insolvency Law.

3rd PLACE: John Ferretti – *M3 Partners, LP*

is a Vice President at M3 Partners, LP and is based in New York. John specializes in financial and operational restructuring, liability management and capital markets advisory for distressed businesses and lenders across a wide variety of industry verticals. Prior to joining M3, John was a Senior Strategy Consultant for KPMG where he focused on M&A and strategic advisory for companies in the consumer, healthcare and telecommunication sectors. John received his MS and BS in accounting from the University of Alabama and is a Certified Public Accountant (CPA).

AIRA GRANT NEWTON EDUCATIONAL ENDOWMENT FUND 2023 SCHOLARSHIP

CONGRATULATIONS TO ZEDEKYAH TEH

Zedekyah Teh is a junior from Chaska, Minnesota. He is an accounting major with strong interests in managerial accounting and consulting. As the president of Pepperdine's DECA Case Competition Club, Zed keeps his critical thinking and presentation skills sharp. As a first-year undergraduate, he was part of a duo that placed second in the Financial Statement Analysis DECA Competition in 2021. In addition, he is a teaching assistant for Managerial Accounting. His favorite thing to do in Malibu is to surf. He is a tennis player and a huge tennis fan, and can often be heard discussing outcomes of professional level tennis matches with his peers. In his free time, Zed plays chess—it is a way for him to relax and to exercise his strategy skills.

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CLUB 10

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EY	**26**
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Deloitte	**18**
Huron	**17**
Riveron	**17**
Ankura	**16**
BDO USA, LLP	**12**
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