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WHAT'S INSIDE

ANNUAL AIRA & NYIC LUNCHEON AND 2024 WHARTON DISTRESSED INVESTING CONFERENCE ARE COMING IN 2024 - MORE DETAILS ON P.2

Annual AIRA & NYIC Luncheon Program

Wednesday, January 17, 2024 (11:00 AM - 1:30 PM EST)

Gain financial and market insights with the New York Institute of Credit and AIRA! NYIC and AIRA present their annual program with two panels of finance experts to help you navigate the current economic landscape. The educational sessions, lunch, and networking will be hosted by Lowenstein Sandler LLP at their New York office. This program benefits the Grant Newton AIRA Educational Endowment Fund.

AIRA Association of Insolvency & Restructuring Advisors

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AIRA Journal is published four times a year by the Association of Insolvency and Restructuring Advisors, 1314 Center Drive, Suite B-132, Medford, OR 97501.

From the Executive Director's Desk

JAMES M. LUKENDA, CIRA
AIRA

With 2024 comes the 45th year that AIRA and its predecessors have been serving the restructuring and turnaround financial community as a premier source of practice related education. Our mission at AIRA to unite and support professionals providing business turnaround, restructuring, and bankruptcy services, and develop, promote, and maintain professional standards of practice, including the two professional certification programs, CIRA and CDBV, has never been more relevant than I see today.

Late last month (October 26, 2023) Judiciary News from the United States Courts reported an overall 13% rise in bankruptcy filings and a nearly 30% increase in business bankruptcies in the 12-month period ending September 30, 2023. This is the third straight quarter of increase following a decade-plus decline in bankruptcy activity.

Despite an improving economy in many sectors, business troubles persist and are manifest as COVID era financial supports expire. In my thinking, part of a healthy economy are mechanisms for troubled businesses to mend or be removed which is where the need for competent, well trained, turnaround and financial professionals comes into play.

Throughout the aforementioned decade-plus decline in bankruptcy activity I've observed many practitioners leaving for other more active areas of professional practice. Also, for many of us who have retained our focus on turnarounds and restructurings, the years are adding up. Accordingly, the services AIRA provides through conferences, training, and certifications have been more in demand this year as new participants come into the market, some of us older codgers retire, and your firms seek the best talent of a new generation.

As this edition of *AIRA Journal* arrives, the schedule for CIRA and CDVB sessions for 2024 has been posted. As in past years, we will be conducting three cycles of CIRA 1, 2, and 3 sessions during the year and one cycle for the CDBV program. Our second CIRA 1 class for 2024 will be live in-person beginning on June 3, 2024, prior to AIRA's 40th Annual Bankruptcy and Restructuring Conference at the Four Seasons Hotel at the Baltimore, MD Inner Harbor. While our live on-line CIRA sessions provide a convenient mechanism for practitioners to complete their certification with a minimal disruption to client service needs, participating in a live in-person session, particularly for practitioners first embarking on the certification process, has the advantages of direct contact with their peers in the industry. I hope many of you will be able to take advantage of this live in-person CIRA 1 session personally or by allowing your staff to attend.

2023 concludes my fourth year as AIRA's Executive Director. My job would not be as enjoyable as it is without my colleagues, Cheryl, Michele, Mike, and Valda. I and you, the membership, are fortunate to have these dedicated individuals working to keep the association running.

Best wishes to you and your families for the many year-end celebrations and a safe and healthy new year.

As you've come to expect, another informative and timely set of articles follows. Read, enjoy, learn.

Keep well. Jim Lukenda

2023-2024 COURSES

CIRA

Part:	Dates:	Location:
3	Dec 11-14, 2023	Online
1	Feb 07-15, 2024	Online
2	Apr 17-25, 2024	Online
3	May 15-23, 2024	Online
1	Jun 03-04, 2024	Baltimore, MD

CDBV

Part:	Dates:	Location:
1	Feb 07-15, 2024	Online
2	Mar 05-14, 2024	Online
1	Jun 03-04, 2024	Baltimore, MD
3	Aug 20-29, 2024	Online

More information and registration at www.aira.org

A Letter from AIRA's President

DENISE LORENZO, CIRA
AlixPartners, LLP

Many thanks to CohnReznick for hosting the conference space for the AIRA's 22nd Annual Advanced Restructuring and POR Conference held on November 13, 2023. This one-day in person session provided many the opportunity to attend virtually. The sessions were educational and informative.

The Strategic Planning Committee and subcommittees continue to explore and assess business model options to evaluate and present potential strategies to AIRA's Board of Directors in the first quarter of 2024.

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

- Annual AIRA & NYIC Luncheon Program, January 17, 2024 (details coming soon)
- 20th Annual Wharton Restructuring & Distressed Investing Conference, February 23, 2024 — The Plaza Hotel, New York, NY
- VALCON 2024, May 18 - 20, 2024 — The Ritz-Carlton Hotel, New Orleans, LA
- AIRA's 40th Annual Bankruptcy & Restructuring Conference, June 05 - 08, 2024 — Four Seasons Hotel, Baltimore, MD

Wishing you and your families a healthy and safe holiday season. Best wishes for the coming year.

— Denise Lorenzo

Resident Scholar Column

JACK F. WILLIAMS, PHD, JD, CIRA, CDBV, CTP

Bankruptcy Busters

"Proclaim Liberty Throughout the Land": Debt Discharge as a Predicate for Freedom

Bankruptcy discharge gets no respect. Much maligned, the discharge in bankruptcy is routinely hoisted as an exemplar of how much this country has changed. Opponents of a robust discharge of debt point, without any empirical support, to the lessening of the stigma associated with the bankruptcy discharge. To them, the discharge is the prize one receives after a painless stroll through an overly indulgent institution. The nature of a discharge is even more misunderstood. It runs, after all, counter to the adage that a "person should pay his or her debts."

It has not always been that way. Debt is as old as man. And from that first debt, the dynamics of debtor, creditor, and sovereign have reflected an elegant dance of mastering power, and with that newly acquired power, mastering people. Debt is power. It can be elevating, even emancipating. Most often, as history is our teacher, it is quite the contrary; it is oppressive and domineering. Ancient civilizations and their kings acknowledged the power of debt, usually in the form of taxes. They often instituted debt tax amnesties and restoration of property rights to ensure a stable kingdom. However, as private debt increased, the holders of that debt clashed with kings. As private debt holders amassed and concentrated power by foreclosure, sovereigns pushed back, forcing discharge of private debt. As civilization moved westward from the Fertile Crescent, sovereigns conceded power over private debt to debt holders. This concession – the point not clearly delineated in time – serves as a hinge moment in history and heralded a mass redistribution of wealth from smallholders of land to oligarchs. The story begins and ends with one, and only one, type of asset – land. This is the rest of the story, to borrow a catch line from one of my favorite commentators and fellow Oklahoman, the late Paul Harvey. So let me proceed, in Harvey fashion, to the punchline first: Discharge is a foundational principle of liberty. It is the ultimate civil right. Freedom from debt is freedom from bondage. Forgiveness and redemption are core virtues of this country. And although collective virtues may be out of style, they are never out of date. It should surprise no one that the inscription on the Liberty Bell in Philadelphia – "Proclaim Liberty throughout the Land" – may be traced to the Jubilee Year described in Leviticus,[1] the Third of the Five Books of Moses.[2]

Fresh Start

Like all debtor/creditor law, bankruptcy law is designed to resolve the various legal problems caused by debtors who are unable or unwilling to pay their debts. A creditor has various alternatives under applicable non-bankruptcy law to attempt to satisfy its claim against the debtor. But the applicable non-bankruptcy law remedies, although potent in the right circumstances, contain several acute deficiencies. First, as a general rule, state law procedures reward the creditor who acts first. The general priority rule of "first in time, first in right" applies with vigor. Consequently, a debtor with assets insufficient to pay all its creditors often finds its creditors in a "race to the courthouse" in an attempt to establish priority while at the same time dismantling the debtor through piecemeal liquidation. The second acute deficiency found in state law is the lack of state law's ability to affect a forced discharge of indebtedness. Thus, an honest but unfortunate debtor who happens to be down on luck and can no longer pay creditors can never receive a discharge under state law without the voluntary consent of the creditors.

Modern bankruptcy law attempts to address the two acute deficiencies found under state debt collection law. Bankruptcy law does this by balancing and accommodating a creditor's interest in being paid with the honest, but unfortunate, debtor's interest in paying its creditors what it can and in receiving a "fresh" start in its economic life.[3] The Bankruptcy Code attempts to achieve this uneasy alliance by balancing the three principles discussed above: the efficient collection of debts, the distribution of the debtor's assets among its creditors in accordance with bankruptcy priorities, and the preservation of the debtor's right to discharge.

Article 1, § 8 of the United States Constitution states: "The Congress shall have the Power to establish uniform Laws on the subject of Bankruptcies throughout the United States." Congress first exercised the power to establish bankruptcy laws in 1800. Congress subsequently enacted bankruptcy statutes in 1841, 1867, 1898, and 1978 with the Bankruptcy Reform Act (the "Bankruptcy Code"). In 2005, Congress enacted substantial amendments to the 1978 Bankruptcy Code. Current law is based upon the Bankruptcy Code as modified by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA" or "2005 Act").

The protection of both debtor and creditor was not always a function of bankruptcy law. Not long ago, bankruptcy was designed solely to protect creditors. In England, a debtor unable or unwilling to pay its debts could be thrown in debtors' prison. Contrary to the popular view, the function of debtors' prison was not to punish the debtor but to hold the debtor for ransom. It was believed that the debtor's friends and relatives would

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[1] See also Deuteronomy 15:1-3 (discharging loans in the Sabbatical year); Deuteronomy 24:6 (exempting from collection the trade tool of millstones); Deuteronomy 24:12-13 (exempting clothing); Exodus 22:25 (same)

[2] Keith Sharfman & G. Ray Warner, "Religion and Bankruptcy," 19 *American Bankruptcy Institute Law Review* 453-458 (2011).

[3] Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934) (commenting that bankruptcy provides new life opportunities for debtors).

combine what free assets they had and pay off the debtors' creditors, thus freeing the debtor from prison.

True to its historical roots, English and early American bankruptcy law served purely as a debt collection and equal distribution mechanism. Not until 1841 did American bankruptcy law recognize a debtor's right of discharge of indebtedness. At that time, the dualism of protection, so easily taken for granted today, was established.

The paramount public policy rationale embodied in the Bankruptcy Code when the debtor is an individual is what is known as the fresh start policy. Essentially, bankruptcy permits an individual, through exemptions of property, the exclusion of future income from the estate, and the right to a discharge to begin anew her economic life. The discharge is a permanent injunction forever barring enforceability of a prepetition claim against the debtor. It exhibits, in form, a structural and prophylactic injunction designed to effectuate the goal of debtor protection.

Debt Repayment as a Public Good

All debts must be repaid. The words roll off the tongue effortlessly. We accept the thesis as acceptable economic theory and conventional wisdom. First, acceptable economic theory — the refrain just isn't true. Granted, consumer spending beyond their present means — debt — is what drives our demand economy. Modern people, like modern nation states, are built on deficit spending.[4] One would then expect a certain level of default and a certain percentage of write-off. "A lender is supposed to accept a certain degree of risk. If all loans, no matter how idiotic, were still retrievable – if there were no bankruptcy laws, for instance – the results would be disastrous. What reason would lenders have not to make stupid loans."[5]

Loans are not designed, so we have learned, to work that way. "Financial institutions are supposed to be ways of directing resources toward profitable investments. If a bank were guaranteed to get its money back, plus interest, no matter what it did, the whole system wouldn't work."[6]

Second, conventional wisdom — one should keep his word. Implicit in all debt relationships is a promise. Keeping one's promises is a good thing, a morally right thing. That tack exposes the true nature afoot when we speak of debt in the modern sense. It is less about sound economic policy than it is about morality.

> The reason it's so powerful [the refrain that one has to pay his debts] is that it's not actually an economic statement: it's a moral statement. After all, isn't paying one's debts what morality is supposed to be all about? Giving people what is due them. Accepting one's responsibilities. Fulfilling one's obligations to others, just as one would expect them to fulfill their obligations to you. What could be a more obvious example of shirking one's responsibilities than reneging on a promise, or refusing to pay a debt?[7]

Yet what appears lucid is, in fact, deceptive. A careful study of the history of debt presents a confounding of policies and moral confusion. Most people have entertained simultaneously two conflicting thoughts: (1) a debtor should pay back the money he has borrowed as a simple matter of morality; and (2) anyone in the habit of lending money — a creditor — is simply evil.

Amnesty in the Ancient Fertile Crescent

History – and pre-history – simply do not support the thesis that all debts must be repaid. Initially, let's engage in a thought experiment. What would be the reasons that a subject with allegiance to King Hammurabi back over 5,000 years ago would incur significant debt? We have learned that the source of debts would have been taxes, seed for planting, weddings, and funerals. These are credit transactions, not loans, at least in the modern sense. As discussed later in this essay, the ancient kings of Mesopotamia learned well the lessons that stable reigns rested on a productive citizenry tied to the land. People who own property do not riot and torch property. The same citizenry provided the infantry necessary to protect, repel, and expand empires. It should not surprise us that some of the most stable empires may be traced back to this era and the kings of the Fertile Crescent. Conquering armies, and all revolutionary movements, quickly embraced a singular program — "[c]ancel the debts and redistribute the land."[8]

Amnesty programs were the cornerstone of the Near East policy of dynastic stabilization. Tax and seed amnesty were routine policies to ensure a landed citizenry free from bondage, decentralized land ownership, a source of infantry and corvee labor, and a tax base. "The effect was to restore balance and sustain economic growth by preventing widespread insolvency."[9]

Careful study of cuneiform tax records uncovered some interesting practices. Tax accountants kept great records. Debts to the sovereign came in two forms – taxes and seed for planting. The two sources were two sides of the same coin (literally and figuratively).[10] A person, planning his planting for the year, would obtain seed on credit from the government's public agent who maintained a house (where the debtor could also purchase ale on credit – money rarely existed in circulation).[11] The public agent, or pub, would keep meticulous records and would seek repayment after harvest "at the threshing floor."[12] The sovereign would also impose taxes on the proceeds of land, that is, the harvest. All worked well when all worked well. However, a bad harvest, drought, bad luck, violence or war, mismanagement, or sheer incompetence might lead to insufficient wealth to pay the pub house or the sovereign.[13]

[4] David Graeber, *Debt: The First 5,000 Years* (New York: Melville House, 2014). I highly recommend this book. David was a thoughtful person with a keen sense about him. He will be missed. You may access the book on the internet at https://warwick.ac.uk/fac/arts/english/currentstudents/undergraduate/modules/fulllist/special/statesofdamage/syllabus201516/graeber-debt_the_first_5000_years.pdf.

[5] Ibid., 3.

[6] Ibid.

[7] Ibid., 4

[8] Moses I. Finley, *Politics in the Ancient World* (Cambridge University Press, 1983), 108.

[9] Michael Hudson, *…and forgive them their debts: Lending, Foreclosure and Redemption from Bronze Age Finance to the Jubilee Year* (ISLET-Verlag, 2018), xi.

[10] It should not surprise us to learn that coinage and currency often includes a symbol of the sovereign on one side and of commerce on the other.

[11] Hudson, xv.

[12] Ibid., xv ("Early economies operated on credit, not cash on the barrelhead.").

[13] Ibid.

Continued from p.7

> Babylonian scribes were taught the basic mathematical principle of compound interest, whereby the volume of debt increases exponentially, much faster than the rural economy's ability to pay. That is the basic dynamic of debt: to accrue and intrude increasingly into the economy, absorbing the surplus and transferring land and even the personal liberty of debtors to creditors.[14]

Debt amnesties or jubilees were designed to make loss of liberty temporary. "Proclaim liberty throughout the land," inscribed on the Liberty Bell is a quote from Leviticus 25. The liberty to which Leviticus speaks is freedom from debt peonage.

> To insist that all debts must be paid, regardless of whether this may bankrupt debtors and strip away their land and means of livelihood, stands at odds with the many centuries of Near Eastern clean slates. Their success stands at odds with the assumption that creditor interests should take priority over those of the indebted economy at large.[15]

Historically, a sovereign embraced debt amnesty to restore solvency to the population. One can advance this factual observation too far, however. The goal of amnesty was to establish and maintain a minimum standard of living for the population to be self-sustaining. "Wealth accumulation was permitted and even applauded, as long as it did not disrupt the normal functioning of society at large."[16]

Private lenders entered this rhythmic dynamic, advancing their interests in accumulating wealth through debt as a means of forced sale upon default. Loan to own is not a modern private equity innovation; rather, private equity has simply excavated an ancient tool. Armed with the concept of compounding interest – often usurious interest – as debt innovation, the private lender pushed personal returns over political stability. Parts of the Near East as early as 3200-2500 BCE, for example, Sumer in southern Mesopotamia, permitted interest. Interest, however, does not appear to exist in Near Eastern pristine gift exchanges or Mycenaean Greece (1600-12—BCE). Interest, like the development of cities, moved westward to the Aegean and Mediterranean around 750 BCE.[17]

Near Eastern dynasties restored economic imbalances by amnesty programs, discharging agrarian debt, reversing land forfeiture, and liberating servants.[18] Dynasties recognized that debts easiest to discharge were those owed to the sovereign. Dynasties found it more challenging to discharge debt and restore land where private creditors were at work amassing wealth. Defaults led to land forfeitures and debt bondage. Debt bondage usurped human capital from a sovereign's need to amass a military or corvee labor force. In this context, one can understand why rulers did not perceive amnesty as radical; they were remedial, seeking to restore lands to prior small owners, free bonded servants, and restore stability. Bronze age rulers recognized that free markets were exceptional at growing wealth, but less than acceptable at spreading that wealth among the citizenry. "Rulers recognized that if they let debt arrears mount up, their societies would veer out of balance, creating an oligarchy that would impoverish the citizen-army and drive populations to flee the land."[19]

Eventually, merchant entrepreneurs deviated from common exchange to provide loans to agrarian debtors. As previously mentioned, these entrepreneurs used loans with compounding interest to effect a forced sale of land upon default and to force bondage. Put differently, private creditors sought ownership over the personal economic goodwill of human beings. And they succeeded beyond imagination. As they amassed powers, this new class of entrepreneur, the aristocracy, overthrew rulers and ended land reversion, debt amnesty, and liberty from debt bondage. The cyclical nature of debt – repayment – debt – default – foreclosure – bondage – jubilee yielded to a linear notion of debt with little hope of a debtor recovering his "free status."[20] "Creditors translated their economic gains into political power, casting off the fiscal obligations that originally attached to land tenure rights."[21] The aristocrats yielded to creditor oligarchs. These creditor oligarchs amassed great wealth and power, relegating citizens to bondage with no means of self-support.[22] It was no great leap from bondage to abject slavery. By the time of the Roman Emperor Hadrian, his acts of amnesty ran only to tax discharge, no longer having power to impair the rival power of creditors over their debtors. Rome eventually will fall, not because of the barbarians, but to them; the barbarians had always been at the gates. Oppressive consumer debt without amnesty brings down even the greatest of empires.[23]

Antecedents to the American Bankruptcy Discharge

Professor Charles Tabb has authored a thoughtful article on bankruptcy discharge. His focus is on the historical development of the bankruptcy discharge in the United States. He begins with our antecedents in England.

> By the time of the first United States bankruptcy law in 1800, some form of bankruptcy law had been in place in England for more than two hundred and fifty years, since 1542, and Parliament had passed at least thirty-three acts dealing with bankruptcy." By 1800 English law furthermore had contained a provision for a discharge in bankruptcy for almost 100 years, since 1705.[24]

Modern bankruptcy, however, begins with the 1841 Act. At that time, American law recognized a voluntary commencement of a bankruptcy case for the first time[25] and expanded relief to all debtors (not simply merchants) that sought relief from debt.[26] American bankruptcy law loosened its moorings to its Anglo cousin that limited bankruptcy relief to merchant debtors in involuntary cases.

[14] Ibid., xi.
[15] Ibid.
[16] Ibid.
[17] Ibid., xxv.
[18] Ibid.

[19] Ibid.
[20] Ibid.
[21] Ibid., xxvi.
[22] Ibid.
[23] Ibid.
[24] Charles Jordan Tabb, "The Historical Evolution of the Bankruptcy Discharge," 65 *Am. Bankr. L.J.* 325 (1991) (citations omitted).
[25] This is the first time in Anglo-American, not just American, law.
[26] Tabb, 349-350.

Contemporary commentators advocated the rationale for an individual debtor's discharge in a voluntary case under the 1841 Act; the discharge was a means to induce a debtor's compliance with bankruptcy dictates, in essence, a carrot-and-stick policy. That changed with the 1898 Act.

> Thus, the notion that the debtor's entitlement to a discharge rests solely on the impact on the interests of the immediately affected creditors was rejected in 1898. No longer was the discharge to be viewed as primarily an inducement to debtors to cooperate in the collection of assets in the bankruptcy case for the benefit of the creditor body. Instead, the 1898 law recognized formally for the first time the overriding. The theory is that society as a whole benefits when an overburdened debtor is freed from the oppressive weight of accumulated debt. That debtor then is able to resume his or her place as a productive member of society. Furthermore, societal forgiveness of the debts of the honest unfortunate is considered to be humane.[27]

This reunification of sorts with ancient practice regarding debt was itself a hinge moment in bankruptcy history. Professor Charles Seligson captures this evolution elegantly.

> [T]he attitude towards and the treatment of delinquent debtors have been subjected to significant changes since the days of torture and slavery under the Roman law and the days of pillory and imprisonment under English law. The enlightened approach of today is to give the unfortunate but honest debtor an opportunity to free himself from the burden of debt. The Bankruptcy Act treats the delinquent debtor with compassionate regard.[28]

Professor Steven Resnicoff has accomplished an exceptional job in journaling the role of religion and bankruptcy in the United States. Although he writes from a perspective of an expert in both Jewish law and Bankruptcy law, his chronicling of religion's influence and limitations on the development of bankruptcy law is enlightening. After reviewing the existence of debtor's prison in the United States, an institution that lived into the nineteenth century, he has this to share:

> It was not until 1833 that Congress abrogated imprisonment for the failure to pay federal debts. Throughout the remainder of the nineteenth century, many states followed suit. Nevertheless, writs of *capias ad satisfaciendum,* permitting someone to be imprisoned for failure to pay debts, continued on the books in some jurisdictions well into the twentieth century. A number of courts have limited these statutes to situations in which debtors were found to have the means with which to pay. Interestingly, use of the writ of *capias ad satisfaciendum was* successfully upheld in New Jersey as recently as 2000, when an attorney had a former client imprisoned for failing to pay his legal fees. The debtor was jailed even though he claimed to lack the ability to pay.[29]

Professor Resnicoff then addresses an interesting peculiarity he maintains exists in American law. Initially, he notes the moral imperative of paying one's debts – and fulfilling one's promises – under Jewish law.

> Because Jewish law is inseparably intertwined with Jewish moral teachings, it is relatively easy to describe the Jewish law's perspective. It regards the repayment of debt as a moral and religious imperative." Most Jewish law authorities characterize paying one's debts as an affirmative biblical injunction. Yisroel Meir Kagan (1838-1933) points out that if a debtor refuses to pay despite the ability to do so, the debtor also violates the biblical proscription against "oppressing one's neighbor."
>
> The Psalms label a borrower who fails to repay a debt as "wicked." In the *Mishnah,* Rabban Yohanan ben Zakhai asks his five greatest students to identify the evil path that would alienate a person from others. Rabbi Shimon bar Yohai answers, "An evil person borrows and does not pay .... "[30]

The Professor then contrasts the state of biblical law with American law.

> Even if the language of a contract states that a *party promises* to provide a specific performance, rather than just "agreeing" to do so, the party is perceived as having only agreed *either* to perform under the contract or to be legally responsible for the contract law consequences. As a result, under American law, there is no *moral* imperative to fulfill one's contractual commitment.[31]

This delightful state of contrasts between biblical law and American jurisprudence necessitates a need to explore the moral predicates of debt discharge and an individual's economic fresh start.

Morale Predicate to Discharge

The holy books of the world's greatest religions devote precious yet copious amounts of ink to the debtor/creditor relationship. It is in these sources we encounter the moral confusion referred to above – debtors should pay their debts and creditors lending money are evil. Of course, like much in scripture, the import of the matrix of directives is more nuanced, more subtle. I want to focus on just a few concepts drawn largely from the Book of Leviticus. I apologize for not expounding on related topics in the holy scriptures of other religions. Time and space prevent that excursion.

An Equality of Dignity

Leviticus does not seek equality of wealth or of power. Leviticus seeks something more compelling, more fundamental. It seeks equality of dignity. "Thus, the inequalities of freedom

[27] Ibid., 364-365 (citations omitted).

[28] Charles Seligson, "Major Problems for Consideration by the Commission on the Bankruptcy Laws of the United States," *45 Am. Bankr. L.J.* 73, 78 (1971).

[29] Steven H. Resnicoff, "Jewish and American Bankruptcy Law: Their Similarities, Differences and Interactions," 19 *Am. Bankr. Inst. L. Rev*. 551 (2011) (citations omitted).

[30] Ibid., 557 (citations omitted).

[31] Ibid., 558 (citations omitted).

Continued from p.9

are mitigated."[32] Rabbi Jonathan Sacks sees this recognition of human dignity in the importance of the holy number of "seven." Every person – including bondage servants – rested on the Sabbath, the seventh day. All debts were discharged every seven years. Ancestral land was restored each fiftieth year, the year following seven cycles of seven years. Thus, Leviticus recognizes that dignity is tied to liberty, and liberty is tied to ownership of one's personal economic goodwill.[33]

"The land must not be sold permanently, because the land is Mine and you reside in My land as strangers and temporary residents."[34] "God therefore has the right, not just the power, to set limits to inequality. No one should be robbed of dignity by total poverty, endless servitude, or unrelieved indebtedness."[35]

Virtues of Freedom and Equality

Discharge encapsulates the struggle between two intractable fundamental ideas: freedom and equality. "Much of human history has illustrated the fact that you can have freedom (laissez-faire economics), or equality without freedom (communism, socialism), but not both."[36] At least, not both at the same time.

> The power of Leviticus is that you can, in fact, have both; but not at the same time. Therefore, time itself has to become part of the solution, in the form of the seventh year and, after seven sabbatical cycles, the Jubilee. These become periodic corrections to the distortions of the free market that allow some to become rich while others suffer the loss of land, home, and even freedom. Through the periodic liberation of slaves, release of debts, and restoration of ancestral lands, [Leviticus] provides a still-inspiring alternative to the individualism on the one hand, collectivism on the other.[37]

Leviticus is nothing less than a revolutionary template that takes us back to the future. It envisions a society of justice, freedom, and human dignity. "Proclaim liberty throughout all the land unto all the inhabitants thereof." The implication is clear; bondage is wrong. It is an assault on the human condition. Debt bondage may be a temporary condition; it is not a state of permanent being.[38]

> By cancelling debts, releasing slaves, leaving the produce of the land to be enjoyed by everyone equally, and restoring ancestral property to its original owners, we inhabit a world in which the inequities of the market economy have been redressed and for a year, sometimes two, we suspend the world of competition and live in a world of co-operation and the fellowship of equals.[39]

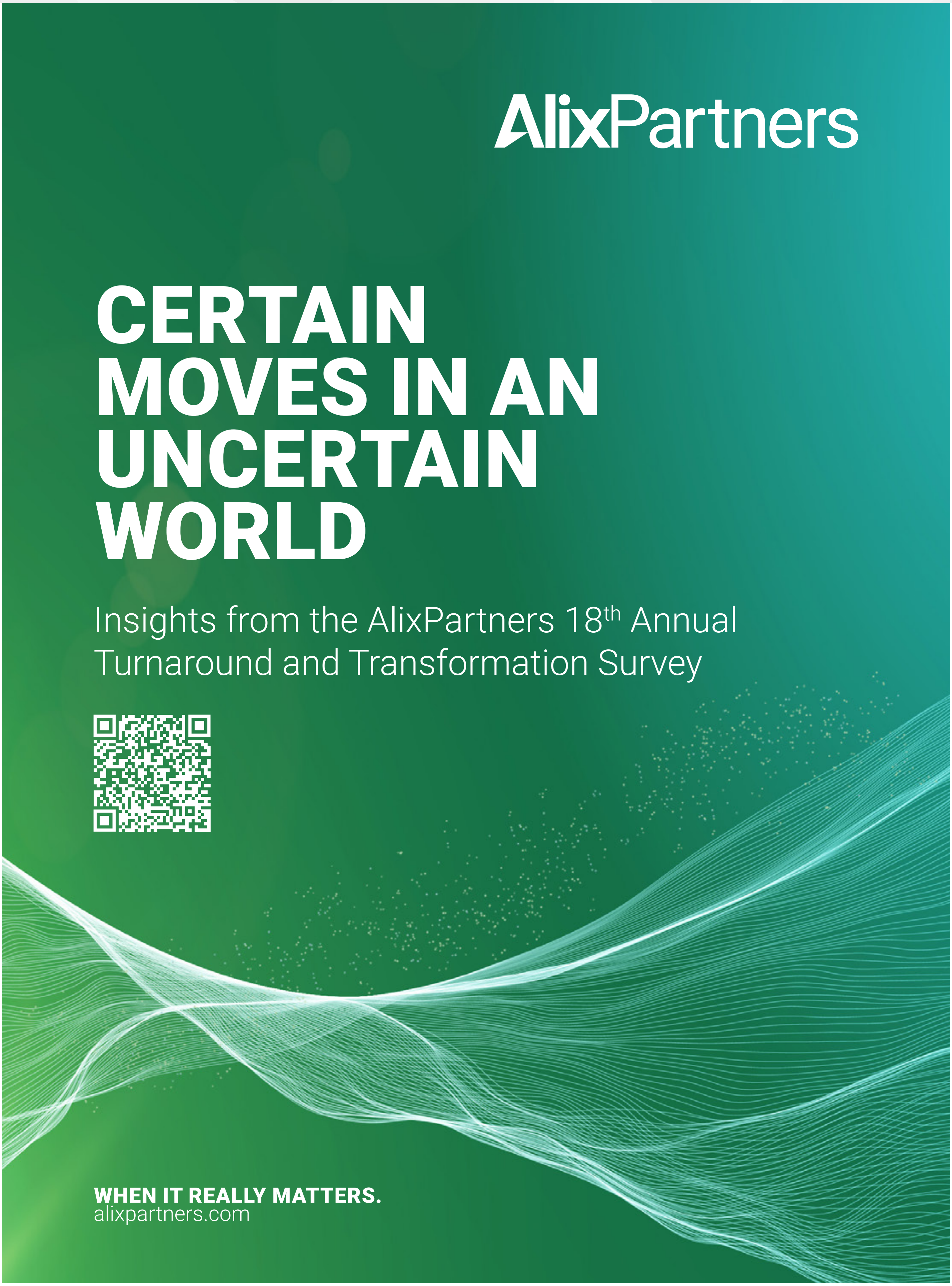
Discharge, then, combines liberty and equality, not simultaneously but sequentially. Unless there are compelling reasons otherwise, one has a right to the fruits of one's labor, one's personal goodwill. The chapter 13 discharge may require five years of a "voluntary" form of debt bondage, but no more. The chapter 7 discharge allows a debtor to shed his debt, impair certain liens on property that is exempt, and retain his future income from postpetition services. The fresh start elevates the human soul and goes a long way in balancing the unprecedented growth and wealth creation embodied in a free market with a need to temper that great engine of wealth with fundamental notions of fairness and equality.

Closing Remarks

Discharge plays a significant role in American society. As a form of debt amnesty, the discharge seeks to temper the free market with equality and the recognition that wealth inequality is a recipe for oppression and, ultimately, political instability. And, yet, it is more. It is part of the vision of a just society. Discharge nurtures habits of the heart. Its import is not in what it does for the individual. Rather, its import is in what it does to us. The biblical predicate to debt discharge, release from bondage, and restoration of ancestral property rests on a vision of a society that values freedom and equality, that seeks release and redemption, and that honors the bonds of citizenship and the love of stranger.[40] When these societal qualities combine, we witness a beautiful thing – a harmony, dare I say, holiness, that surrounds a people and transforms a Superpower, like the America of today, into a Great Nation, like the America we are destined to be.

Let me know what you think! Appreciate you all.

[32] Jonathan Sacks, *Covenant & Conversation: Leviticus: The Book of Holiness* (Jerusalem: Koren Publishers, 2015), 286.
[33] Ibid.
[34] Leviticus 25:23.
[35] Sacks, 286.
[36] Ibid., 359.
[37] Ibid.
[38] Ibid., 387.
[39] Ibid.
[40] Ibid.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HOW EXTREME WEATHER EVENTS HAVE BANKRUPTED UTILITY PLAYERS AND CHANGED THE ELECTRIC GRID

Fengrong Li, CIRA, and Caroline Heilbrun
FTI Consulting

Climate risk is difficult for large corporations to mitigate and is increasingly a C-suite agenda item. In this article, the authors draw upon their experience in climate risk-related bankruptcy, dispute advisory, restructuring, and resource strategies to summarize the regulatory, operational, and financial impacts of recent extreme weather events on electric utilities. They also examine the implications and importance of strengthening physical and financial asset performance in a rapidly evolving electric grid.

Increasing Occurrence of Bankruptcies Associated with Extreme Climate Events

Recent years have seen an increasing number of energy sector bankruptcies linked to high-cost climate disasters, including:

- The Puerto Rican Electric Power Authority (PREPA) restructuring before and after Hurricanes Irma and Maria, which destroyed most of Puerto Rico's grid in 2017[1];
- PG&E's bankruptcy after the deadly Camp Fire in Northern California in 2018[2];
- Various bankruptcies in the Electric Reliability Council of Texas (ERCOT) grid region in the wake of Winter Storm Uri in 2021[3];
- Lincoln Power's bankruptcy in the Pennsylvania-New Jersey-Maryland Interconnection (PJM) grid, also following Winter Storm Uri.[4]

Most recently, after wildfires devastated the island of Maui in August 2023, Hawaiian Electric Industries, Inc. (HEI) and its electric utilities—which supply 95% of Hawaii's electricity—are facing increasing scrutiny amid mounting financial and legal pressure.

Observed Increases in Frequency and Magnitude of Extreme Weather Events

According to the National Oceanic and Atmospheric Administration's National Centers for Environmental Information (NCEI), the United States has sustained 363 weather and climate disasters since 1980, each causing over one billion dollars in damage adjusted for inflation.[5] The total cost of these extreme weather events exceeded $2.59 trillion. More than 40% of these incidents, costing over one trillion dollars in total, occurred in the last decade (2014-2023), as shown in Exhibit 1.[6]

The observed increases in frequency and magnitude of extreme weather events pose elevated risks and unprecedented challenges to customers, utilities, independent power producers, and the power grid itself. Market participants must initiate new strategies to strengthen the physical and financial performance of energy assets around the clock, and load-serving entities must revamp their plans to keep performance resilient and rates affordable under tremendous

[1] Mary Williams Walsh, "Puerto Rico's Power Authority Effectively Files for Bankruptcy," *The New York Times*, July 2, 2017, https://www.nytimes.com/2017/07/02/business/puerto-ricos-electric-power-authority-effectively-files-for-bankruptcy.html; "FEMA P-2020 Mitigation Assessment Team Report - Hurricanes Irma and Maria in Puerto Rico," FEMA, October 2018, https://www.fema.gov/sites/default/files/2020-07/mat-report_hurricane-irma-maria-puerto-rico_2.pdf.

[2] "PG&E Bankruptcy," California Public Utilities Commission, 2020, https://www.cpuc.ca.gov/industries-and-topics/pge/pge-bankruptcy.

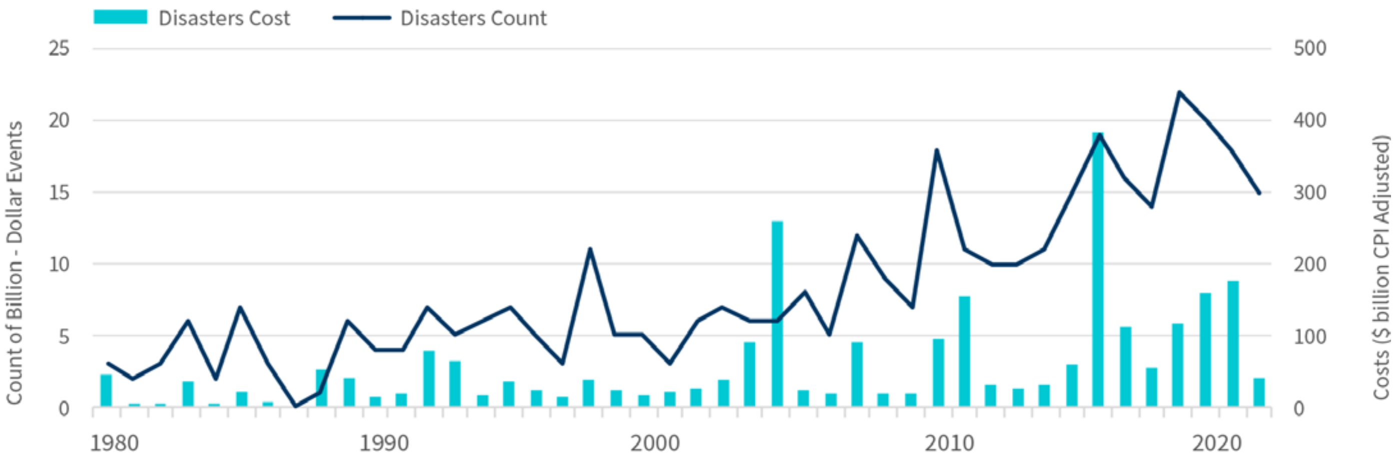
[3] Khristopher J. Brooks, "Texas electricity company Griddy declares bankruptcy as winter storm fallout continues," CBS News, March 15, 2021, https://www.cbsnews.com/news/griddy-energy-texas-files-bankruptcy/; Jaclyn Diaz, "Texas Energy Co-Op Files For Bankruptcy After Storm, High Bill," NPR, March 1, 2021, https://www.npr.org/2021/03/01/972408584/texas-energy-co-op-files-for-bankruptcy-after-storm-high-bill; Paula Sambo, "Just Energy seeks bankruptcy after hit from Texas freeze," Financial Post, March 9, 2021, https://financialpost.com/commodities/energy/just-energy-files-to-restructure-in-canada-after-hit-from-texas-freeze.

[4] Ethan Howland, "Lincoln Power files for bankruptcy after $38.9M PJM charge for failing to run during Winter Storm Elliott," Utility Dive, April 3, 2023, https://www.utilitydive.com/news/lincoln-power-nautilus-power-ferc-pjm-penalties-elliott-complaint/646615/.

[5] "U.S. Billion-Dollar Weather and Climate Disasters," NOAA National Centers for Environmental Information (NCEI) DOI: 10.25921/stkw-7w73 (2023), https://www.ncei.noaa.gov/access/billions/.

[6] Ibid.

Exhibit 1: U.S. Billion-Dollar Weather and Climate Disasters



Source: NOAA National Centers for Environmental Information

upward cost pressure driven by winter storm or wildfire-related securitization,[7] supply chain disruption, and inflation.

In the following discussion, the authors draw on their firm's experience as advisor to the Unsecured Creditors' Committee for the Brazos Electric Power Cooperative, Inc. bankruptcy and advisor to the Unsecured Creditors' Committee for the Pacific Gas and Electric Company (PG&E) bankruptcy to discuss the potential financial impact of severe weather events as well as a series of grid reforms in Texas and California that aim to enhance asset performance and grid resiliency under the new climate paradigm.

The Brazos Bankruptcy

On March 1, 2021, facing a disputed claim of $1.9 billion by ERCOT for electricity and ancillary services purchased during Winter Storm Uri, Brazos Electric Power Cooperative (Brazos) filed for bankruptcy protection.

Situation

In February 2021, Winter Storm Uri caused power blackouts throughout Texas. After ERCOT declared its highest state of emergency and issued load-shedding instructions on February 15th, ERCOT informed the Public Utility Commission of Texas (PUCT) that energy prices were clearing below the system-wide offer cap of $9,000 per megawatt-hour (MWh).[8] The PUCT directed ERCOT to account for load shedding in its scarcity pricing signals.[9] ERCOT implemented manual workarounds to effectively peg prices at or near $9,000/MWh for an 83-hour period.

[7] Winter storm or wildfire-related securitization allows the payment of costs by issuing bonds repaid over a longer term. It minimizes the immediate financial impacts of a winter storm or wildfire to ratepayers.

[8] "Order Directing ERCOT to Take Action and Granting Exception to Commission Rules," Public Utility Commission of Texas PUC Project No. 51617, February 15, 2021, https://interchange.puc.texas.gov/Documents/51617_3_1111656.PDF.

[9] Ibid; "Second Order Directing ERCOT to Take Action and Granting Exception to Commission Rules," Public Utility Commission of Texas PUC Project No. 51617, February 16, 2021, https://interchange.puc.texas.gov/Documents/51617_4_1111709.PDF.

Following the storm, Brazos, the oldest and largest generation and transmission electric cooperative in Texas, filed for Chapter 11 bankruptcy on March 1, 2021. Brazos, in an adversary proceeding, sought to reduce ERCOT's $1.9 billion claim for the cooperative's wholesale power purchases during the storm by more than $1.1 billion—the amount of the claim attributable to ERCOT's adjustment to wholesale market prices. The trial, followed by mediation, culminated in Brazos filing a plan of reorganization.

On November 14, 2022, the U.S. Bankruptcy Court for the Southern District of Texas confirmed Brazos's plan of reorganization. Brazos successfully emerged from bankruptcy with a full resolution of ERCOT's claim after 22 months in Chapter 11 proceedings. Brazos agreed to exit its generation business to become a transmission and distribution cooperative, and to create a $140 million ratepayer hardship fund for low-income ratepayers to help offset surcharges from the securitization associated with Winter Storm Uri.

Grid Reform

Following Winter Storm Uri, ERCOT implemented a series of market reforms which aim to improve reliability and mitigate the risk of customers paying scarcity prices for a prolonged period during future grid emergencies.

In January 2022, ERCOT adjusted its scarcity pricing mechanism —the operating reserve demand curve—by increasing the minimum contingency level from 2 to 3 gigawatts and decreasing the value of lost load[10] from $9,000 to $5,000 per MWh. This change allows for an earlier trigger of price signals under tight reserve conditions and lowers the maximum price that consumers pay. In addition, generators, transmission resources and gas supply facilities designated as critical infrastructure are required to winterize.

[10] The value of lost load represents a customer's willingness to pay for reliable electricity service.

Continued from p.13

Other reforms include firm fuel supply service (FFSS),[11] which compensates generation resources for meeting a higher level of resiliency and reliability.

Finally, in January 2023, the PUCT proposed a performance credit mechanism (PCM) construct, which would compensate generators that commit in advance to provide power during hours of high reliability risk. If implemented, the PCM would constitute a de facto departure from ERCOT's history of energy-only market design, which only compensates power producers for electricity already generated.

Policy Response

House Bill (HB) 1500, effective September 2023, institutes requirements for generation facilities that execute a generation interconnection agreement from 2027 onward to annually meet certain performance standards and serve peak demand;[12] on- or off-site resources can participate. These measures aim to strengthen the generators' capability to serve load under irregular weather patterns that impact grid supply and demand.

Senate Bill (SB) 2627 seeks to further enhance grid resiliency by providing $10 billion in loans and grants to support new dispatchable generation and microgrids in ERCOT as well as to enhance generation, transmission, and distribution infrastructures outside of ERCOT in Texas.[13] SB 2627's funding will require Texans to vote on a constitutional amendment this fall.

These market reforms and policy responses will have long-lasting impacts on ERCOT's resource mix, asset economics, pace, and type of infrastructure development, as well as affordability to ratepayers. Grid performance will be stress-tested in real time by the prolonged summer heat, including above 100-degree temperatures, freezing winter temperatures, and seasonal and diurnal resource variability.

PG&E Bankruptcy

Facing potential liabilities of $30 billion from catastrophic wildfires in Northern California, PG&E (California's largest utility company) filed for bankruptcy on January 29, 2019.

Situation

In November 2018, the Camp Fire in Northern California claimed 86 lives and destroyed thousands of acres of property. Faced with legal, safety and financial challenges, and approximately $30 billion in claims due to wildfires in California in 2017 and 2018, PG&E filed for Chapter 11 bankruptcy.

Governor Gavin Newsom was a vocal participant in the bankruptcy process and advocated for transformed governance and higher regulatory scrutiny. PG&E's plan of reorganization included provisions such as financing PG&E's costs through securitization, electing new safety officers, granting the California Public Utilities Commission (CPUC) greater oversight, monitoring PG&E's safety goals with an independent observer, and dividing PG&E's service territory into five regions to increase responsiveness and local accountability.[14]

PG&E emerged from its contentious bankruptcy on July 1, 2020, after the CPUC and the Bankruptcy Court approved the $58 billion plan, which included more than $25 billion to resolve victim claims.[15] Outside of the bankruptcy proceeding, the CPUC found PG&E culpable for several ongoing safety violations and levied an additional $1.9 billion penalty.[16]

Grid Reform

Both PG&E and the grid operator, the California Independent System Operator (CAISO), have made technical improvements to reinforce the grid. As part of its 2022 Wildfire Mitigation Plan, PG&E introduced drones and detection cameras to improve monitoring capabilities and started a multiyear process of undergrounding overhead power lines in high-wildfire-risk areas. In parallel, CAISO released its 2022-2023 Transmission Plan, which identifies 46 transmission projects to upgrade over the next 20 years to provide 40 gigawatts of renewable power to consumers.[17] PG&E and CAISO are also offering incentives to developers of community microgrids so that disadvantaged and at-risk communities have a backup power source in case of an emergency.[18] Such distributed supply options reduce the reliance on bulk power systems.

CAISO, like ERCOT, is instituting market reforms to benefit from outside generation resources. CAISO's new subscriber participating transmission owner model enables new transmission lines outside CAISO to be financed through the Federal Energy Regulatory Commission (FERC) approved subscriber process, and outside the revenue requirement of CAISO's transmission access charge.[19] This allows California to import out-of-state clean energy resources to meet its zero-carbon goals and enhance reliability while reducing the financial burden associated with new transmission buildout.[20]

[11] ERCOT procures FFSS resources in advance of the winter season to maintain resource availability during a potential fuel supply disruption.

[12] Texas Legislature, House, HB 1500, 88th Legislative Session, introduced in House March 1, 2023, https://capitol.texas.gov/BillLookup/History.aspx?LegSess=88R&Bill=HB1500.

[13] Texas Legislature, Senate, SB 2627, 88th Legislative Session, introduced in Senate May 1, 2023, https://capitol.texas.gov/BillLookup/History.aspx?LegSess=88R&Bill=SB2627.

[14] "General FAQ – PG&E Emerges from Chapter 11 Bankruptcy," Pacific Gas & Electric Company, 2020, https://www.pge.com/pge_global/common/pdfs/about-pge/company-information/reorganization/Plan-of-Reorganization-FAQ.pdf.

[15] Mark Chediak, "PG&E Wins California Approval of Bankruptcy Plan," BNN Bloomberg, March 28, 2020, https://www.bnnbloomberg.ca/pg-e-wins-california-approval-of-bankruptcy-plan-1.1442592.

[16] Kavya Balaraman, "CPUC imposes largest ever penalty of $1.9B on PG&E for Northern California wildfires," Utility Dive, May 11, 2020, https://www.utilitydive.com/news/cpuc-imposes-largest-ever-penalty-of-19b-on-pge-for-northern-california/577625/.

[17] "2022-2023 Transmission Plan," California Independent System Operator, 2023, https://www.caiso.com/InitiativeDocuments/Revised-Draft-2022-2023-Transmission-Plan.pdf.

[18] "Community Microgrids," Pacific Gas & Electric Company, last accessed August 24, 2023, https://www.pge.com/en_US/safety/emergency-preparedness/natural-disaster/wildfires/community-microgrid-enablement-progam.page.

[19] Robert Mullin, "CAISO Board OKs Plan to Admit Subscriber-funded Tx Lines," RTO Insider, July 20, 2023, https://www.rtoinsider.com/50780-caiso-board-subscriber-pto-member-model/.

[20] Ibid.

Policy Response

In early 2019, Assembly Bill (AB) 1054 established a $21 billion Wildfire Fund financed by revenue from ratepayers. PG&E's plan of reorganization allowed the utility to use this unique mechanism to recover costs. In 2022, to further California's existing zero-carbon target, SB 1020 mandated that renewable and zero-carbon resources account for 90 percent of statewide electricity sales by 2030, and 95 percent by 2035.[21] New clean energy resources or imports will diversify the renewable supply profiles for enhanced reliability.

In March 2023, pursuant to SB 846, the California Energy Commission approved a $1 billion Clean Energy Reliability Investment Plan to accelerate the deployment of clean energy resources, support demand response, and increase reliability. In 2023-2024 alone, the plan earmarks $33 million for "extreme events."[22]

Conclusions

With increasing weather irregularities, market participants must take measures to avoid preventable damages and mitigate inevitable risks. With energy demand and supply both correlated with weather patterns, planning reliability contingencies to address imbalances due to increasing demand and constrained supply becomes paramount.

HEI must chart its course to rebuild grid infrastructure while keeping pace with Hawaii's commitment to net-zero carbon emissions by 2045. For Hawaii and Puerto Rico, building resiliency in an island environment presents unique challenges, as the two regions are especially vulnerable to climate disasters and isolated from the mainland's electric grid.

California and Texas have shown that transformative grid reforms can occur in both regulated and deregulated markets. In California, public sentiment and state legislation led to a high degree of regulatory oversight. In Texas, ERCOT is beginning to move away from a long history of energy-only market design, generators are now required to be reinforced for cold fronts, and mandatory firming requirements and incentives will be instituted to build redundancy and make asset performance more reliable and accountable.

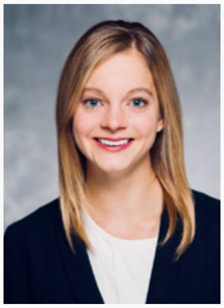
These measures are costly upfront. Texas' winterization, PCM and resource firming requirements, and the CAISO and PG&E's efforts towards undergrounding, vegetation management, transmission upgrades, and microgrid development represent significant investments. However, these efforts will make generators, utilities, and other energy market participants less vulnerable to climate events and mitigate the risk of catastrophic destruction and costs in the future. Investors, shareholders, and ratepayers expect transparency with regard to the climate risks that energy market players face and demand concrete mitigation strategies. As demonstrated in the aftermath of the Maui wildfires, every stakeholder faces its own unique set of climate, operational, regulatory and financial risks, and investment decisions made today will affect performance and assets values for years to come.

The views expressed herein are those of the author(s) and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals. FTI Consulting, Inc., including its subsidiaries and affiliates, is a consulting firm and is not a certified public accounting firm or law firm.

ABOUT THE AUTHORS

Fengrong Li, CIRA
FTI Consulting

Fengrong Li, CIRA, CFA, is a Managing Director at FTI Consulting in the Power, Renewables and Energy Transition practice. She has more than 20 years' experience in energy and infrastructure. She specializes in sustainability, market advisory, strategy development, utility resource planning, investment analysis, and asset valuation across the energy value chain. Ms. Li's work addresses grid challenges, deep decarbonization, increasing demand and resources variability, and the need to enhance reliability and resiliency. She advises clients on strategies and concrete portfolio positions to achieve 247 clean power and carbon-neutral goals. She has provided expert analysis for restructuring and bankruptcy before arbitrators, regulators, commissions, boards, councils, investment committees, and stakeholders.



Caroline Heilbrun
FTI Consulting

Caroline Heilbrun is a Senior Consultant at FTI Consulting in the Power, Renewables, and Energy Transition practice. Ms. Heilbrun specializes in regulatory advisory, rate design, wholesale power and gas market analysis, utility mergers and integrations, and long-term strategic planning for North American electric, gas, and water utilities. Ms. Heilbrun has been engaged by utilities, state and federal regulators, and private capital firms to ensure an affordable, safe, and reliable energy supply that is fully compliant with legislative mandates.

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[21] California Legislature, Senate, SB 1020, Chapter 361, 2021-2022 Regular Session, introduced in Senate February 14, 2022, https://legiscan.com/CA/text/SB1020/id/2606962.

[22] "Clean Energy Reliability Investment Plan," California Energy Commission, March 2, 2023, https://www.energy.ca.gov/publications/2023/clean-energy-reliability-investment-plan.

EMPLOYEE BENEFITS IN BANKRUPTCY: UPDATE ON KEY ISSUES

Israel Goldowitz and Dannae Delano
The Wagner Law Group

The Employee Retirement Income Security Act of 1974 (ERISA) codifies employee benefits law at the federal level and broadly preempts state law. For employee benefits issues in bankruptcy, therefore, ERISA generally provides the "underlying substantive law."[1] In some cases, the Bankruptcy Code overrides ERISA, in others Congress has harmonized the two bodies of law, and in others the relationship is unclear.

This article shows how ERISA interacts with the Bankruptcy Code in several areas: defined benefit pension plan termination and withdrawal and resulting claims, fiduciary duties in plan administration and termination, and an individual debtor's ability to protect retirement income from creditor claims. In addition, the article addresses how the Code treats top-hat plans, severance, and bonus arrangements.

Defined Benefit Pension Plans

Defined benefit pension plans provide lifetime benefits based on length of service. For salaried workers, compensation is also a factor, such as an annual benefit of 1.5% of final compensation per year of service. Plans for hourly workers may use a flat dollar amount per year of service or another measure, such as a percentage of contributions made for the worker's service.

Employers must fund defined benefit plans by making annual contributions equal to the present value of pension obligations incurred during the year and annual expenses (normal cost), plus amortization of unfunded past service obligations.[2] These obligations can be volatile, given the effect of interest rates on liabilities and market performance on assets, though Congress's recent extension of the amortization period from seven to fifteen years and other relief lessen the burden.[3] For collectively bargained multiemployer plans, the labor contract allocates the funding obligation among employers through a formula (such as a certain amount per hour worked).

The employer and all members of its controlled group are jointly and severally liable for minimum funding contributions to a single-employer plan, and for the other obligations discussed in this section. A controlled group consists of all corporations or unincorporated trades or businesses under common control. Specifically, this includes: a parent-subsidiary group (one or more chains of organizations connected through ownership with a common parent organization that owns, directly or indirectly, at least 80% of the other organizations); a brother-sister group (two or more organizations in which five or fewer individuals own at least 80% of each organization and more than 50% of each organization, taking into account each individual's ownership only to the extent it is identical across organizations); or a combined, parent-subsidiary/brother-sister group.[4]

Single-Employer Plans

If a single-employer defined benefit plan does not have enough assets to meet its benefit liabilities, the plan may be terminated in a distress termination initiated by the employer or in an involuntary termination initiated by the Pension Benefit Guaranty Corporation (PBGC). When an underfunded plan terminates, PBGC becomes its trustee and pays benefits at statutory levels.

A plan can terminate in a distress termination only if the sponsor and each controlled group member meets one of the statutory tests, including (a) liquidation in bankruptcy; (b) in a Chapter 11 case, if the court determines that "unless the plan is terminated, [the debtor] will be unable to pay all its debts pursuant to a plan of reorganization and will be unable to continue in business outside the chapter 11 reorganization process"; or, (c) outside bankruptcy, if PBGC determines that "unless a distress termination occurs, [the organization] will be unable to pay [its] debts when due and will be unable to continue in business."[5]

The second test "does not permit a distress termination simply because a particular plan [of reorganization] requires it; rather the test is whether the debtor can obtain confirmation of *any* plan of reorganization without termination of the retirement plan."[6] Other relevant factors include whether the debtor's projected cash flow will be adequate to support projected minimum funding contributions; the debtor has considered benefit freezes and other measures to reduce costs, trimmed other fixed costs, and identified discretionary spending; and the debtor can obtain exit financing or an equity infusion.

Courts have reached varying results when the exit loan or equity infusion is conditioned on plan termination.[7] Courts have also differed over whether the debtor may terminate all defined benefit plans, when it can afford one but not all of them.[8]

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[1] Raleigh v. Illinois Department of Revenue, 530 U.S. 15, 24 (2000).

[2] See I. Goldowitz, *Defined Benefit Pension Issues Expected in the Next Wave of Bankruptcies*, 33 AIRA Journal 46, 47-48 (Nov. 1, 2020).

[3] The American Rescue Plan Act of 2021, § 9701 *et seq.,* Pub. L. No. 117-2, 135 Stat. 184-206 (2021).

[4] 29 U.S.C. § 1301(a)(14), (b)(1); 29 CFR § 4001.3, *incorporating by reference* 26 CFR § 1.414(c)-2(a), (b), (c).

[5] 29 U.S.C. § 1341(c)(2)(B)(ii)(IV), (iii)(I).

[6] In re US Airways Group, Inc., 296 B.R. 734, 743-44 (Bankr. E.D. Va. 2003) (emphasis in original).

[7] *Compare* In re Harry & David Holdings, Inc., No. 11-10884 (Bankr. D. Del. Aug. 8, 2011) (investors entitled to insist that they not be placed behind the plan), *with* In re Philip Servs. Corp., 310 B.R. 802, 808 (Bankr. S.D. Tex. 2004) ("existential financial realities" showed that "the pension terminations were not necessary even though they were desired by the [i]nvestor.").

[8] *Compare* In re US Airways Group, Inc., 365 B.R. 624 (Bankr. E.D. Va. 2007), *with* In re Kaiser Aluminum Corp., 456 F.3d 328 (3d Cir. 2006).

To effect a distress termination under the second test, the debtor submits a motion to terminate the plan, typically with a declaration and documentary evidence showing that it meets the reorganization test. The PBGC may or may not object to the motion. But the termination cannot be completed if a collective bargaining agreement prohibits plan termination, which may lead to modification of the collective bargaining agreement.[9]

PBGC may initiate termination when the plan has not met the minimum funding standard, the plan will be unable to pay benefits when due, or PBGC's possible long-run loss with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated.[10] Under the "long-run loss" criterion, PBGC has successfully terminated plans in advance of a controlled group breakup that would allow a strong company to escape liability and to curtail benefit accruals where the plan was inherently unsustainable.[11]

Usually, the plan administrator signs an agreement terminating the plan and appointing the PBGC as the statutory trustee. If termination is contested, PBGC can file suit in a United States district court to seek a decree terminating the plan and appointing the agency as the trustee.[12]

PBGC claims in bankruptcy are often among the largest. They typically are for the pension plan's unfunded benefit liabilities, unpaid minimum funding contributions, unpaid premiums, and termination premiums. Generally, the courts hold that these claims are not entitled to priority.[13]

Outside bankruptcy, the termination liability and minimum funding claims may have the status of a federal tax lien, which PBGC may perfect and enforce. Specifically, lien treatment applies to termination liability up to 30% of controlled group net worth and to unpaid minimum funding contributions when they exceed $1 million.[14] While the automatic stay prevents the liens from attaching to the debtor's property, the liens also attach to non-debtor controlled group members' property.[15]

The amount of the unfunded benefit liabilities claim is the value of the benefit liabilities under the plan determined as of the plan's termination date and based on PBGC assumptions, minus the value of plan assets as of that date. A PBGC regulation requires that liability values be based on annuity prices, which vary inversely with interest rates.[16] The regulatory interest assumption can have a substantial effect on the amount of the claim, and courts have differed over its applicability in bankruptcy.[17] Courts have also differed over whether the employer liability duplicates the claim for unpaid contributions.[18]

The termination liability claim is contingent on plan termination, and PBGC's right to pursue unpaid contributions is contingent on PBGC trusteeship of the plan.

The termination premium applies when there is an involuntary termination or a distress termination where the sponsor or at least one controlled group member meets the second or third distress test.[19] In bankruptcy, the termination premium arises only after discharge, so in a true reorganization, it represents a liability of the reorganized debtor.[20]

An employer considering bankruptcy should have its actuary calculate projected minimum funding contributions, including the effect of a freeze on benefit accruals if the plan is not yet frozen, the underfunding using ongoing plan assumptions, and the termination liability using PBGC assumptions.

The debtor will often seek permission to make pension contributions in a first-day order. Though the debtor may not be compelled to make contributions, maintaining the plan can help in retaining employees and preserving going concern value. It may also prevent an involuntary termination, which would dilute the claims of noncontingent creditors, the attachment of liens to the assets of non-debtor controlled group members, and the assessment of termination premiums against the reorganized debtor.[21]

If the plan has sufficient assets to fund all benefit liabilities, or nearly so, the debtor should consider closing the plan out in a standard termination, which may include a "top-up" contribution.[22] The cost of a standard termination depends on the price of closeout annuities or ERISA's minimum standards for valuing lump sum benefit payments, both of which are sensitive to interest rates.

The same is true of a distress or involuntary termination, as a termination liability claim is based on interest factors derived from quarterly annuity price surveys. For example, the PBGC "select" interest factor increased from less than 200 basis points to more than 500 basis points between 2021 and 2023, which would significantly decrease the value of liabilities. To the extent

[9] See 29 U.S.C. §§ 1113, 1341(a)(3).

[10] 29 U.S.C. § 1342(a)(1), (2), (4).

[11] PBGC v. FEL Corp., 798 F. Supp. 239 (D.N.J. 1992); In re UAL Corp. (Pilots' Pension Plan Termination), 468 F.3d 444, 451-52 (7th Cir. 2006).

[12] 29 U.S.C. § 1342(b)(1).

[13] E.g., In re Bayly Corp., 163 F.3d 1205 (10th Cir. 1998) (employer liability); In re Sunarhauserman, Inc., 126 F.3d 811 (6th Cir. 1997) (priority of minimum funding contributions limited to normal cost portion); In re Kent Plastics Corp., 183 B.R. 841 (Bankr. S.D. Ind. 1995) (premiums).

[14] 29 U.S.C. §§ 1083(k), 1368(a).

[15] 29 U.S.C. §§ 1362(a), 1368(a).

[16] *See* 29 U.S.C. § 1344; 29 CFR pt. 4044.41 et seq.

[17] *Compare* Pension Benefit Guaranty Corp. v. CF&I Fabricators of Utah, Inc., 150 F.3d 1293 (10th Cir.1998) (use of a "prudent investor" rate to discount liabilities), *with*, e.g., In re U.S. Airways Group, Inc., 303 B.R. 784 (Bankr. E.D. Va. 2003) (use of PBGC regulatory assumption required by bankruptcy choice of law principles); *accord*, In re Rhodes, Inc., 382 B.R. 550 (Bankr. N.D. Ga. 2008).

[18] *Compare* In re CF&I Fabricators of Utah, Inc., 16 Employee Benefits Cas. 1364 (Bankr. D. Utah Dec. 31, 1992) (employer liability claim reduced by probable collectible value of the contributions claim), *with* In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, 160 B.R. 882, 893–894, (Bankr. S.D.N.Y. 1993) (reduction by collectible value only is at odds with bankruptcy policy of equality of distribution).

[19] 29 U.S.C. § 1306(a)(7); 29 CFR § 4007.13(a)(1).

[20] Pension Ben. Guar. Corp. v. Oneida Ltd., 562 F.3d 154 (2d Cir. 2009).

[21] That claim also runs against controlled group members. PBGC v. Asahi Tec Corp., 829 F.Supp.3d 118 (D.D.C. 2012).

[22] In either case, bargaining with the union will be required if the plan is maintained pursuant to a collective bargaining agreement.

that the debtor controls the timing of plan termination, the debtor should consider the likely direction of interest rates.

PBGC is authorized to settle its claims, and it typically does. Often, the agency settles for a single allowed claim, with partial priority.

Multiemployer Plans

A multiemployer pension plan covers the employees of more than one unrelated employer and is collectively bargained.[23] PBGC does not take over failed multiemployer plans. Rather, multiemployer plans can restructure contribution and benefit obligations under ERISA, and if they do not succeed, PBGC provides special financial assistance to allow them to continue paying benefits at adjusted levels.[24]

ERISA imposes withdrawal liability on an employer who withdraws from a multiemployer plan, representing the employer's share of the plan's underfunding. An employer withdraws from a multiemployer plan when it permanently ceases to have an obligation to contribute under the plan or permanently ceases all covered operations under the plan. A partial withdrawal occurs when an employer has a 70% decline in contribution base units (for example, hours worked) or its obligation to contribute ceases under one but not all collective bargaining agreements or at one but not all facilities and it continues the same type of work on a non-contributory basis.[25]

Withdrawal liability is the employer's allocable share of unfunded vested benefits, subject to certain adjustments. Like plan termination liability, withdrawal liability is based on the difference between the present value of benefits (in this case, only those benefits that are vested), and the value of plan assets. And like termination liability, withdrawal liability is the obligation of all controlled group members.[26]

In bankruptcy, withdrawal liability is generally not considered a priority claim. The Second Circuit has held that withdrawal liability represents benefits already earned, and that the consideration is pre-petition labor. The Third Circuit has held, however, that the post-petition portion of the claim would be entitled to priority.[27]

As with termination liability, employers may challenge the valuation of liabilities if the plan's actuary uses conservative assumptions.[28] But PBGC assumptions are required if the plan has received special financial assistance from the PBGC.[29]

A withdrawal would not occur if the debtor assumes the collective bargaining agreement and emerges as a going concern. In that case, the withdrawal liability claim would remain contingent and should ride through the bankruptcy.[30]

Fiduciary Duties in the Administration and Termination of Pension and Welfare Plans

A bankruptcy trustee's core function is to take possession of and administer or liquidate the assets of the debtor-employer for the benefit of its creditors. The trustee is a fiduciary with respect to the estate.[31]

The trustee also succeeds to the debtor's rights and obligations.[32] When the debtor was the administrator of an ERISA plan, the trustee succeeds to the plan administrator's duties.[33] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) codified that result for both the trustee and the debtor in possession.[34]

ERISA defines a fiduciary as a person or entity exercising "any discretionary authority or discretionary control respecting management" of a plan or "any authority or control respecting management or disposition of its assets."[35] A bankruptcy trustee or debtor in possession would succeed to the debtor's duties as plan administrator with respect to benefit payments, reporting and disclosure, investment of plan assets, and implementing a plan termination, among other things. Accordingly, the Labor Department takes the position that a bankruptcy trustee is a fiduciary and subject to the requirements of ERISA when it administers or terminates a plan.[36]

As an ERISA fiduciary, the trustee is subject to personal liability for any losses sustained by the plan as a result of a breach of its fiduciary duties.[37] The trustee also has standing as an ERISA fiduciary to sue other fiduciaries for breach of fiduciary duty on behalf of the plan.[38]

Any amounts withheld from employee wages for contribution to a plan that have not been transferred to the plan at the time of the bankruptcy filing are not property of the bankruptcy estate.[39] The trustee or debtor in possession has a fiduciary duty to segregate and transfer those assets to the plan and participant accounts.[40] Similarly, in an individual bankruptcy, amounts withheld from the debtor's employee wages for contribution to

[23] 29 U.S.C. §§ 1002(37), 1301(a)(3).

[24] 29 U.S.C. §§ 1085, 1432.

[25] 29 U.S.C. §§ 1383(a), 1385(a).

[26] 29 U.S.C. §§ 1301(b)(1), 1381.

[27] *Compare* Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc., 789 F.2d 98, (2d Cir. 1986), *with* In re Marcal Paper Mill, Inc., 650 F.3d 311 (3d Cir. 2011).

[28] E.g., United Mine Workers of America v. Energy West Mining Co., 39 F.4th 730 (D.C. Cir. 2022), *cert. denied* 143 S. Ct. 1024 (2023). A PBGC proposed rule would permit the use of PBGC assumptions, among other approaches. Actuarial Assumptions for Determining an Employer's Withdrawal Liability, 87 FR 62316 (Oct. 14, 2022).

[29] 29 U.S.C. § 1432(m); 29 CFR § 4262.16(g).

[30] CPT Holdings v. Indus. & Allied Employers Union Pension Plan, 162 F.3d 405 (6th Cir. 1998).

[31] *See* In re NSCO, Inc., 427 B.R. 165, 174 (Bankr. D. Mass. 2010), *citing* Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 12, (2000).

[32] *See* Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149, 1154–62 (3rd Cir.1989).

[33] *See* In re New Ctr. Hosp., 200 B.R. 592, 593 (E.D. Mich. 1996).

[34] 11 U.S.C. §§ 521(a)(7), 704(a)(11).

[35] 29 U.S.C. § 1002(21).

[36] *See*, for example, Department of Labor amicus brief in In Re 1 Point Solutions, LLC et al v. Regions Bank, 10-5480 (6th Cir.).

[37] 29 U.S.C. § 1109(a).

[38] In re Trans-Industries, Inc., 538 B.R. 323 (Bankr. E.D. Mich. 2015).

[39] In Patterson v. Shumate, 504 U.S. 753 (1992), the Supreme Court held that ERISA's prohibition against assignment or alienation of pension plan benefits is enforceable nonbankruptcy law under Bankruptcy Code §541(c)(2) and that those benefits are excluded from the bankruptcy estate. First-day wage motions will generally seek approval to contribute previously withheld amounts to the 401(k) plan.

[40] IRM 4.71.23.4 General Bankruptcy Principles (4) (12-03-2018), https://www.irs.gov/irm/part4/irm_04-071-023#idm139977016846464 (last visited 9-5-2023).

a plan should be promptly transferred to the plan and treated as excluded from the estate.[41]

As a practical matter, the trustee's liability risks are heightened when a plan is terminated. Once assets are liquidated and distributed to the plan's participants, it becomes almost impossible to make any corrective adjustments to participants' benefits. If contributions or expenses are incorrectly allocated to participant accounts or other errors are made in benefits administration, an aggrieved participant would have little recourse against the plan once it has been liquidated and must turn to the trustee for recourse.

To minimize the risk of personal liability under ERISA, bankruptcy trustees should take their fiduciary duties seriously and educate themselves on ERISA's requirements and those of the governing plan document and trust instrument.

A pension plan administrator has a duty to ensure that the plan maintains its tax-qualified status, and it must also ensure that the plan's annual Form 5500 and other required reports are properly filed. In addition, an ERISA fiduciary must make any distributions to plan participants owed under the plan documents, ensure that plan assets are invested prudently, and ensure that fees for services provided to the plan are reasonable.[42] And, in a Chapter 7 or liquidating Chapter 11 case, the trustee will generally need to terminate the plan, complying with ERISA's requirements and those of the plan document.[43]

Healthcare and other welfare plans are subject to the same fiduciary provisions of ERISA as pension plans. They are generally unfunded, so there are usually no plan assets. But they otherwise present similar challenges.

The debtor may need to reduce or eliminate welfare benefits if it is to reorganize. In making that decision, the debtor will need to consider protections provided by the Affordable Care Act (the "ACA"). An employer with 50 or more full-time or full-time equivalent employees may be subject to penalties if it terminates healthcare coverage or reduces the employer-paid portion of the cost of coverage. In addition, the ACA requires a plan sponsor to provide a 60-day notice to participants before making any material modifications to health benefits unless the changes are being made during the plan's regular open enrollment period.[44]

Expenses for retiree health care can be significant for employers facing bankruptcy. The Bankruptcy Code contains special protection for retiree health benefits that limit a debtor's ability to terminate or modify retiree health benefits without a court order or an agreement with an authorized representative of the retirees.[45] An employer may propose modifications to retiree health coverage to a representative of the retirees and to negotiate in good faith to reach an agreement. If that process fails, a court may order modification of retiree health benefits only when the retirees' representative has refused to accept the proposal without good cause, the modification is necessary to allow reorganization, and the modification assures that all creditors and other affected parties are treated fairly and equitably.[46]

The debtor should also consider its obligations to provide continued healthcare coverage under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). A bankruptcy filing is not a COBRA-qualifying event for active employees. Retirees will have a qualifying event, however, if they experience a "substantial elimination of coverage" within one year of the bankruptcy filing.[47] Substantial elimination of retiree medical coverage may entitle a qualified beneficiary to COBRA coverage for life[48]—a significant extension from the normal COBRA period—and the coverage may not be terminated if the beneficiary becomes entitled to Medicare.[49]

These COBRA rights are only applicable, however, if the sponsoring employer or any entity in its controlled group continues to offer group health plan coverage. If all group health plan coverage within the controlled group is terminated, the plan sponsor will not be required to offer COBRA coverage to retirees who lose coverage in connection with the bankruptcy proceeding.[50] That may well be the case in a Chapter 7 liquidation.

Debtors should also monitor insurance premiums and other costs of providing welfare benefits. The Supreme Court has held that participants in defined benefit pension plans generally do not have standing to challenge fiduciary breaches.[51] Lower courts have found welfare plans to be similar for that purpose, but absent a Supreme Court decision, the law remains unsettled.[52]

Treatment of Top-Hat Plans and Other Executive Compensation Arrangements

Top-hat and excess benefit plans are non-qualified plans for management and highly compensated employees. They permit tax deferral of amounts above those that can be provided by qualified plans.[53]

Benefits under such arrangements are subject to the claims of the employer's general creditors even if they are funded by a "rabbi

[41] IRC §401(a)(1); 26 CFR §1.401-1(b); IRC §401(a)(2); 26 CFR §1.401-2.

[42] See, e.g., USDOL v. Kirschenbaum, 508 BR 257 (E.D.N.Y. 2014), *aff'd sub nom* Kirschenbaum v. USDOL (In re Robert Plan Corp.), 777 F.3d 594 (2d Cir. 2015).

[43] Reasonable plan expenses may be paid from plan assets. *See* In re Franchi Equip., 452 B.R. 352 (Bankr. D. Mass. 2011). Expenses for "settlor" functions, such as plan design, should be paid from estate assets. See ERISA Adv. Op. 2001-01A, https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/2001-01a. The trustee's Final Report may provide exoneration on this issue, though the Labor Department would not be bound if it has not been put on notice.

[44] 29 U.S.C. § 1024(b)(1); 29 CFR § 2520.104(b)-3.

[45] 11 U.S.C. § 1114.

[46] 11 U.S.C. § 1114(e), (g), (h).

[47] 29 U.S.C. § 1163; 26 CFR § 54.4980B-4 Q/A1(c).

[48] IRC § 4980B(f)(2)(B)(iv)(III); 29 U.S.C. § 1162(2)(A)(iii); 26 CFR § 54.4980B-7, Q&A-4(e).

[49] IRC § 4980B(f)(2)(B)(iv)(II); 29 U.S.C. § 1162(2)(D)(ii).

[50] IRC § 4980B(f)(2)(B)(ii); 29 U.S.C. § 1162; 26 CFR § 54.4980B-7, Q&A-1(a)(3).

[51] Thole v. U.S. Bank, N.A., 140 S Ct. 1615 (2020), holds that participants in a defined benefit pension plan do not have Article III standing to bring breach of fiduciary duty claims against defined benefit plan fiduciaries based on investment losses. The Court contrasted the rights of participants in defined benefit plans, who receive fixed regular benefit payments funded by employer and employee contributions, from participants in defined contribution plans, whose benefits are directly tied to the value of the assets in their individual accounts time to time. In the former case, the risk of loss is borne by the employer, so participants do not have Article III standing. In the latter case, the participants bear the risk of loss, which can support Article III standing.

[52] *See* Winsor v. Sequoia Benefits & Insurance Services, 62 F. 4th 517 (9th Cir. 2023); Knudsen v. Met Life Group, Inc., 2:23-cv-00426 (D. N.J. July 18, 2023); Gonzalez de Fuente v. Preferred Home Care of New York, LLC, 2020 WL 5994957 (E.D.N.Y. 10/09/20).

[53] See B. McNeil, Nonqualified Deferred Compensation Plans § 1:1 (West 2021).

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trust."[54] That risk was magnified by the 2005 adoption of Section 409A of the Internal Revenue Code. Section 409A was enacted, in part, as a response to Enron executives' accelerating payments under their deferred compensation arrangements ahead of Enron's bankruptcy.[55] Section 409A significantly restricted participant control over payment, including acceleration of payment and the termination of such arrangements. Termination restrictions under Section 409A have even resulted in executives losing their nonqualified deferred compensation arrangements where the plan was terminated well before the plan sponsor filed for bankruptcy.[56]

Such plans may be rejected as executory contracts under the Bankruptcy Code, resulting in unsecured claims for rejection damages.[57] Although retired executives have satisfied all conditions for receiving benefits, the arrangement may be treated as executory for both active and retired executives to achieve equality of treatment.[58] Rejection damages claims may be brought to present value using the mortality and interest assumptions used for financial statement disclosure.[59]

A severance pay plan may be either a pension plan or a welfare plan.[60] Under ERISA, a plan or program that provides retirement income or defers income "for periods extending to the termination of covered employment or beyond" is a pension plan.[61] A severance plan that meets this definition would be subject to ERISA's "anti-alienation" rule, and the severance benefits would likely be excluded from an individual debtor's estate.[62] If a severance plan is a welfare plan, the severance benefits would be includable in the estate unless excluded or exempted by the provisions of state law.[63]

An employee's claim for severance pay is generally not entitled to administrative expense priority when the employee terminates employment post-petition.[64] The courts have reasoned that severance pay is mainly attributable to prepetition service.[65] Under the Bankruptcy Act, the Second Circuit had held that severance pay becomes due when the employee separates from employment, and therefore is entitled to administrative priority if he separates from employment post-petition.[66] Later decisions questioned the applicability of these decisions under the Bankruptcy Code,[67] and most lower courts in the Second Circuit find another basis to deny administrative expense priority to severance pay.[68]

The Fourth Circuit has followed the Second Circuit Bankruptcy Act cases in holding that severance benefit claims are entitled to fourth priority, which grants priority up to a statutory cap to "wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by individual" within 180 days before the filing of debtor's bankruptcy petition, for employees terminated in that 180-day period.[69] That holding may be limited to cases in which fourth priority is claimed.[70]

BAPCPA imposed limits on bonus and severance programs for insiders:

- a bonus unless it is essential to employee retention because of a competing job offer, the employee's services are essential to survival of the business, and the amount is no greater than ten times the mean for nonmanagement employees during the calendar year or (if none) 25 percent of the bonus payments to the employee during the previous calendar year;
- a severance payment unless it is part of a program that is generally applicable to all full-time employees and the payment is no greater than ten times the mean for nonmanagement employees during the calendar year; and
- other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case.[71]

Thus, key employee retention plans are subject to specific limits, but key employee *incentive* plans, which require that insiders meet performance objectives, are not.[72] Courts are skeptical

[54] See J. Kagan, Rabbi Trust: Definition, Origin, Advantages & Disadvantages, Investopedia (2020), https://www.investopedia.com/terms/r/rabbitrust.asp.

[55] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 107TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 627 (Comm. Print 2003), www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html.

[56] *See* In re RTI Holding Co., No. 20-12456 (Bankr. D. Del. Aug. 4, 2021).

[57] 11 U.S.C. §§ 365, 502.

[58] In re Peabody Energy Corp., 579 B.R. 208 (Bankr. E.D. Mo. 2017).

[59] 11 U.S.C. § 502(b); see In re JCK Legacy Co., 20-10418 (MEW) (Bankr. S.D.N.Y. Mar. 3, 2022).

[60] Labor Department regulations generally provide that a severance pay plan will be deemed a welfare plan rather than a pension plan if: (a) payments are not contingent upon retirement; (b) the total amount of payments is no more than twice the employee's compensation for the year immediately preceding his termination of service; and (c) all payments are completed within 24 months. 29 C.F.R. § 2510.3-2(b)(1).

[61] 29 U.S.C. § 1002(2)(A).

[62] See TREATMENT OF PENSION RIGHTS IN INDIVIDUAL BANKRUPTCIES, *post*.

[63] In re Jokiel, 447 B.R. 868 (Bankr. N.D. Ill. 2011), *subsequent determination,* 2012 WL 33246 (Bankr. N.D. Ill. 2012) (post-petition severance payment to debtor subject to turnover to chapter 7 trustee as property of the estate).

[64] See 11 U.S.C. §§ 503(b)(1)(A), 507(a)(2).

[65] See, e.g., In re Marcal Paper Mills, Inc., 650 F.3d 311 (3d Cir. 2011); In re Roth American, Inc., 975 F.2d 949 (3d Cir. 1992); see also Matter of Health Maintenance Foundation, 680 F.2d 619 (9th Cir. 1982); In re Mammoth Mart, Inc., 536 F.2d 950, 955 (1st Cir. 1976) (Bankruptcy Act cases).

[66] In re W. T. Grant Co., 620 F.2d 319 (2d Cir. 1980); Matter of Unishops, Inc., 553 F.2d 305 (2d Cir. 1977); Straus-Duparquet, Inc. v. Local Union No. 3 Intern. Broth. of Elec. Workers, A F of L, CIO, 386 F.2d 649 (2d Cir. 1967).

[67] See, e.g., In re Jamesway Corp., 199 B.R. 836, 840 (Bankr. S.D. N.Y. 1996); In re Hooker Investments, Inc., 145 B.R. 138 (Bankr. S.D. N.Y. 1992); In re Drexel Burnham Lambert Group Inc., 134 B.R. 482, 489 (Bankr. S.D. N.Y. 1991).

[68] See, e.g., In re Applied Theory Corp., 312 B.R. 225 (Bankr. S.D. N.Y. 2004) (*Straus-Duparquet* not applicable where claimed entitlement arises from termination of a rejected prepetition contract and amounts at issue do not constitute the kind of "severance" *Straus-Duparquet* deemed worthy of priority status); In re Jamesway Corp., 199 B.R. 836 (payments under employment agreement not severance pay where promised as inducement to former executive to give up benefits at his former employment to work with the debtor); In re Child World, Inc., 147 B.R. 847, 853 (Bankr. S.D. N.Y. 1992) (amounts payable under employment agreement upon termination not severance pay because they were an inducement to employees to remain with company during financially troubled times).

[69] Matson v. Alarcon, 651 F.3d 404 (4th Cir. 2011); 11 U.S.C. § 507(a)(4)(A).

[70] E.g., In re New WEI, Inc., 2018 WL 1115200, *4 (Bankr. N.D. Ala. 2018).

[71] 11 U.S.C. § 503(c).

[72] In re Journal Register Co., 407 B.R. 520 (Bankr. S.D. N.Y. 2009).

about attempts to characterize retention programs as incentive programs.[73]

A bonus or severance program might also be approved under Code § 363, as an "ordinary course" transaction. Courts have applied both "horizontal" and "vertical" tests to determine the reasonableness of a transaction and whether it is ordinary course.[74] The horizontal test examines whether the transaction is unusual or reasonably common. The vertical test "reviews the transaction from the perspective of creditors, asking whether the transaction is one that creditors would reasonably expect the debtor or trustee to enter into."[75] A plan that is primarily incentivizing and not retentive is reviewed under both Sections 503(c)(3) and 363(b). Under these provisions, an incentive plan will be approved so long as it is within the debtor's "sound business judgment."[76]

Treatment of Pension Rights in Individual Bankruptcies

In an individual bankruptcy, the debtor's right to retirement income may be excluded from property of the estate. Property of the estate includes "all legal and equitable interests of the debtor." But a restriction on transfer of the debtor's beneficial interest in a trust enforceable under "applicable nonbankruptcy law" is enforceable in bankruptcy.[77]

Under ERISA, a pension plan must provide that benefits "may not be assigned or alienated," and the Internal Revenue Code makes that a condition of tax qualification.[78] In *Patterson v. Shumate*, the Supreme Court held that ERISA creates a federal restriction on the alienation of pension benefits that is "enforceable under applicable non-bankruptcy law."[79] The Court reasoned that when an "ERISA qualified" pension plan contains the required anti-alienation language, ERISA's anti-alienation rule is "applicable nonbankruptcy law."

It is not clear what the Court meant by "ERISA qualified." A "qualified plan" is one that satisfies the Internal Revenue Code's requirements to qualify the related trust as a tax-exempt entity. But a plan does not "qualify" under ERISA. ERISA applies to any plan that "provides retirement income to employees" and is not exempt, whether it is tax-qualified or not.[80] Lower courts have therefore split on whether *Shumate* applies to all plans covered by ERISA or only those that are also tax qualified.[81]

ERISA's anti-alienation provision does not apply, for instance, to unfunded top-hat plans, individual retirement accounts (IRAs), governmental plans, church plans, unfunded excess benefit plans, or "owner-only" plans.[82] Governmental and church plans may be tax qualified, and if so, they must contain an anti-alienation provision, but that provision would be enforceable if at all under state law and not ERISA.

Assuming "ERISA qualified" means tax qualified, it may be possible to challenge a plan's tax qualification. It is not clear whether the bankruptcy court has authority to make that determination, and some courts have therefore deferred to IRS's determination of tax qualification.[83] The trustee might challenge the tax qualification as part of a turnover proceeding, however, and creditors might object to the debtor's claim of exemption.

Conversely, plans that are not covered by ERISA or not subject to ERISA's anti-alienation requirement may be excluded from property of the estate under state or other federal transfer restrictions. Examples have included Keogh plans and IRAs (though some courts have required that the IRA document contain a restriction on transfer) and plans for state or federal employees.[84]

In addition, certain property may be exempt from the estate, including "a payment under a stock bonus, pension, profit-sharing, annuity, or similar plan ... on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor."[85] In addition, "retirement funds" are exempted, including interests in qualified plans, annuities, conventional and Roth IRAs, deferred compensation arrangements for government and tax-exempt

[73] See In re PG&E Corporation, 2019 WL 4686765, *1 (Bankr. N.D. Cal. 2019); In re Foothills Texas, Inc., 408 B.R. 573 (Bankr. D. Del. 2009); In re Dana Corp., 351 B.R. 96, 47 (Bankr. S.D. N.Y. 2006); In re Mesa Air Group, Inc., 2010 WL 3810899 (Bankr. S.D. N.Y. 2010).

[74] In re Mesa Air Group, Inc., 2010 WL 3810899, *3 (Bankr. S.D. N.Y. 2010), *quoting* In re Crystal Apparel, Inc., 207 B.R. 406, 409, 30 (S.D. N.Y. 1997) ("t]he inquiry deemed horizontal is whether, from an industry-wide perspective, the transaction is of the sort commonly undertaken by companies in that industry. The inquiry deemed vertical analyzes the transactions 'from the vantage point of a hypothetical creditor and [asks] whether the transaction subjects a creditor to economic risk of a nature different from those he accepted when he decided to extend credit")).

[75] In re Mesa Air Group, Inc., 2010 WL 3810899, *3 (Bankr. S.D. N.Y. 2010).

[76] In re Aralez Pharmaceuticals US, Inc., 2018 WL 6060356, *6 (Bankr. S.D. N.Y. 2018). Courts generally consider the following factors in determining whether to approve a compensation proposal under the business judgment rule: (1) whether there is a reasonable relationship between the plan proposed and results to be obtained; (2) whether the plan's cost is reasonable in light of debtor's assets, liabilities, and earning potential; (3) whether plan's scope is fair and reasonable; (4) whether plan is consistent with industry standards; (5) what due diligence the debtor exercised when investigating the need for the plan; and (6) whether the debtor received independent counsel in performing due diligence and in establishing the incentive program. In re Borders Group, Inc., 453 B.R. 459, 474 (Bankr. S.D. N.Y. 2011), *quoting* In re Dana Corp., 358 B.R. 567, 575, 47 (Bankr. S.D. N.Y. 2006).

[77] 11 U.S.C. § 541(1), (c)(2).

[78] 29 U.S.C. § 1106(d)(1); 26 U.S.C. § 401(a)(13).

[79] 504 U.S. 753, 759 (1992).

[80] 29 U.S.C. § 1002(a).

[81] *Compare* In re Hall, 151 B.R. 412 789, 16 Employee Benefits Cas. (BNA) 2768, Bankr. L. Rep. (CCH) ¶75166 (Bankr. W.D. Mich. 1993), *with* In re Hanes, 162 B.R. 733 (Bankr. E.D. Va. 1994).

[82] An owner-only plan may be tax qualified, treating the self-employed owner as an "employee." I.R.C. §401(c)(1).

[83] *Compare* Matter of Youngblood, 29 F.3d 225 (5th Cir. 1994), *with* In re Plunk, 481 F.3d 302 (5th Cir. 2007) (limiting *Youngblood* to situations where IRS declined to disqualify plan).

[84] In re Silviera, 186 B.R. 168 (Bankr. D. Mass. 1995); Whetzal v. Alderson, 32 F.3d 1302 (8th Cir. 1994); In re Sawyers, 135 B.R. 371 (Bankr. W.D. Mo. 1992).

[85] 11 U.S.C. § 522(d)(10((E).

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organizations, and plans funded only with employee contributions, subject to a dollar cap on the non-rollover portion of an IRA (currently $1,512,350).[86] But "retirement funds" does not include an inherited IRA.[87]

Finally, property of the estate does not include amounts withheld from wages or received by an employee for contributions to an ERISA or government plan, a deferred compensation plan, or a tax-deferred annuity that do not constitute disposable income.[88]

Debtor interests in retirement funds may be vulnerable where they result from fraudulent transfers or other abuses. Generally, debtors may convert nonexempt assets into exempt assets.[89] But the court may deny a discharge to a debtor who "with intent to hinder, delay or defraud a creditor" transferred, removed, or concealed property within one year before filing the petition.[90]

The trustee may also recover plan contributions that constitute fraudulent transfers[91] or preferences.[92] For qualified plans, ERISA provides that plan assets "shall never inure to the benefit of any employer" and limits the circumstances in which contributions may be returned.[93] ERISA may therefore conflict with the Code in this area.

Conclusion

Addressing employee benefits and executive compensation issues in bankruptcy requires an understanding of ERISA and the Internal Revenue Code, the Bankruptcy Code, and the principles governing choice of law in bankruptcy. Counsel, trustees, and other bankruptcy professionals should keep this in mind when confronting such issues and should confer with employee benefits counsel as necessary.

86 11 U.S.C. § 522(b). In this context, tax qualification can be shown by a current IRS determination or substantial compliance with the qualification requirements (though the exemption applies if the debtor is not materially responsible for a substantial compliance failure).

87 Clark v. Rameker, 573 U.S. 122 (2014). State exemptions may apply, however. In re Kapsinow, 220 A.3d 1231 (R.I. 2019); In re Pacheco, 537 B.R. 935, 940 (Bankr. D. Ariz. 2015).

88 11 U.S.C. §§ 541(b)(7), §1325(b)(2); see In re Perkins, 2023 Bankr. LEXIS 946 (Bankr. S. D. Tex. 2023) (401(k) plan contributions are excluded from disposable income under a Ch. 13 plan, even if they exceed historical contributions and the amount subject to employer match).

89 See, e.g., In re Carey, 938 F.2d 1073, 1076 (10th Cir. 1991); In re Addison, 540 F.3d 805, 813 (8th Cir. 2008); In re Stern, 345 F.3d 1036, 1043 (9th Cir. 2003); In re Soza, 542 F.3d 1060, 1068 (5th Cir. 2008).

90 11 U.S.C. § 727(a)(2); see, e.g., In re Davis, 911 F.2d 560 (11th Cir. 1990).

91 *Compare* In re Springfield Furniture, Inc., 145 B.R. 520 (Bankr. E.D. Va. 1992), *with* Matter of Loomer, 198 B.R. 755 (Bankr. D. Neb. 1996). For a fuller discussion see Norton Ch. 176:17.

92 *Compare* In re Jones Truck Lines, Inc., 130 F.3d 323 (8th Cir. 1997) (contributions to multiemployer plan were "contemporaneous exchanges" for "new value," employee labor), and In re WCI Steel, Inc., 313 B.R. 414, 33 Employee Benefits Cas. (BNA) 1613 (Bankr. N.D. Ohio 2004) (post-petition contributions required under unmodified collective bargaining agreement were not avoidable under Section 349), *with* In re Pulaski Highway Exp., Inc., 41 B.R. 305 (Bankr. M.D. Tenn. 1984) (denying summary judgment to multiemployer plan in preference action).

93 29 U.S.C. § 1103(c).

ABOUT THE AUTHORS

Israel Goldowitz
The Wagner Law Group

Izzy Goldowitz is a partner with The Wagner Law Group. His practice focuses on single- and multiemployer defined benefit plans, employee benefits in mergers and acquisitions, litigation, and bankruptcy. He is a Fellow in the American College of Employee Benefits Counsel, Inc., he served on the Labor and Benefits Advisory Committee to the American Bankruptcy Institute's Chapter 11 Reform Commission, and he is a contributing author of Norton Bankruptcy Law and Practice. Izzy earned his J.D. from George Washington University and his B.A. from Boston University.

Dannae Delano
The Wagner Law Group

Dannae Delano is a partner with The Wagner Law Group. She has been in private practice for more than 20 years concentrating her practice in employee benefits law, executive compensation and taxation. She counsels clients on all aspects of employee benefits design, implementation, termination, and compliance for retirement plans, health and welfare plans, and executive and incentive compensation arrangements. She also has considerable experience at integrating a range of benefits plans in mergers and acquisitions and in correcting plan errors. Dannae was named 30 Under Thirty in 2004 and 40 Under Forty in 2013 by the St. Louis Business Journal.

UNDERSTANDING DISCOUNTS ON DEBT FOR EQUITY-LIKE INSTRUMENTS

Jason Levine and Jake Marinelli
Stout

Background

Debt securities occasionally include equity instruments such as warrants or options. When debt is issued with an equity-like instrument, it is important to determine whether the instrument is freestanding or embedded. A freestanding financial instrument is defined as an instrument that is either (i) entered into separately and apart from any of the entity's other financial instruments or equity transactions, or (ii) entered into in conjunction with some other transaction and is legally detachable and separately exercisable.[1] U.S. GAAP requires a discount on the issue price of debt based on the value of a freestanding equity instrument at the time of investment.[2] Specifically, ASC 470-20-25-2 stipulates that the "portion of the proceeds allocated to the warrants shall be accounted for as paid-in capital," and the "remainder of the proceeds shall be allocated to the debt instrument portion of the transaction."[3] Thus, the debt and the freestanding equity instrument are accounted for separately.

Ultimately, the issue price of debt equals the amount issued minus any stated original issue discount (OID) minus the value of the freestanding warrants at investment. Similarly, the par value equals the issue price of the debt at investment plus any stated OID plus the value of the freestanding warrants as a percent of debt issuance.

Why Do Issuers Issue Equity with Debt?

Typically, issuers that provide equity with debt carry higher risk. For example, the issuing company may be a newly combined entity with integration risk, be in the early stages of development with expansion risk, or have other risk characteristics. In return for the added equity component, the issuers may receive a lower interest rate, all else equal, and potentially a higher dollar commitment.

Why Do Credit-Focused Funds or Other Investment Firms Accept This Structure?

Debt investments have modeled cash flows as described in a credit agreement and do not have much upside beyond what is known at the time of investment. Warrants, when converted to common equity or sold to another party, provide additional returns. Further, debt has a stated maturity, while warrants can be held beyond the debt maturity, which acts like a continuation vehicle for firms beyond the stated maturity of debt. Additionally, refinancing typically occurs at par, while a buyout of the warrants would occur at the fair value of the warrants, or they can be converted to common. If common stock value rises, value to warrant shareholder increases.

Methodologies to Determine Fair Value

In determining the fair value of an equity instrument, there are two commonly used methodologies: the fully diluted method and the option pricing method.

Fully diluted method

The fully diluted method is used for scenarios such as when the issuer has a simple equity structure, an exit is expected in the near-term, the warrants were issued with a low strike price, and/or there is a lack of information. When determining the value of the equity instrument using the fully diluted method, the issuers equity value is allocated equally among all share classes as if they are pari passu. Downsides to the fully diluted method include the lack of consideration to additional upside or preferences offered to each specific share class, such as a guaranteed return to preferred shares prior to common stock, warrants, or options receiving any value. Additionally, the fully diluted method is not a forward-looking methodology such as an option pricing model.

Option pricing model (OPM)

Option pricing models are typically used for complex capital structures using a series of Black-Scholes models to allocate the equity value by creating a portfolio of artificial options with specific strike prices, or breakpoints, and using each security's liquidation preference.[4] The OPM method considers the preferences offered to each specific class of preferred shares, common shares, restricted shares, options, and warrants, rather than allocating the subject equity value to all share classes equally as done in the fully diluted basis method.

Discounts for Lack of Marketability (DLOM)

A discount for lack of marketability may be used whether the equity instrument is valued using a fully diluted method, an OPM, or a combination of the two. DLOMs are used to adjust the value of closely held and restricted securities. The theory behind a DLOM is that a valuation discount exists between a security that is publicly traded, which has a marketplace, and the market for a privately held security, which has little or no marketplace.[5] Warrants issued with debt may be subject to lock-up terms, whereby the warrants are unable to be sold for a strict period of time. Thus, it is customary to include a discount for lack of marketability to account for the illiquidity of the security. The Finnerty put option model is commonly used to calculate

[1] PWC, "Chapter 5.3: Equity-linked instruments model," December 31, 2022.

[2] Sean R. Saari, "Drafting Considerations for Attorneys Blog Series: Debt Issued With Warrants and Convertible Debt," MarcumLLP.com, September 8, 2016, https://www.marcumllp.com/insights/drafting-considerations-attorneys-blog-series-debt-issued-warrants-convertible-debt.

[3] PWC, "Chapter 8.4: Accounting for freestanding instruments issued together," December 31, 2021.

[4] BDO USA LLP, "Demystifying Valuation Methodologies: Part 1 - The Option Pricing Model (OPM)," November 19, 2019, https://www.bdo.com/insights/industries/financial-services/demystifying-valuation-methodologies-part-1-the-option-pricing-model-(opm).

[5] Will Kenton, "Discounts For Lack of Marketability (DLOM): Role in Valuation," Investopedia.com, updated May 29, 2020.

the DLOM and uses an average-strike put option. The strike price is based on the predetermined period average value of the underlying asset.[6]

Example Using Fully Diluted Method

Inputs		
in Thousands		
Issued Debt Par Amount	$	100,000.0
Stated OID		1.25%
Total Shares Outstanding		50,000.0
Warrants Issued with Debt		2,500.0
Total Equity Value	$	100,000.0
Discount for Lack of Marketability		25.0%

Calculation		
Warrants Issued with Debt		2,500.0
Divided by: Total Shares Outstanding		50,000.0
Warrant Ownership Percentage		**5.0%**
Total Equity Value	$	100,000.0
Multiplied by: Warrant Ownership Percentage		5.0%
Warrant Value before DLOM	$	5,000.0
Warrant Value before DLOM	$	5,000.0
Multiplied by: (1 - DLOM)		75.0%
Warrant Value including DLOM	**$**	**3,750.0**
Warrant Implied Discount	$	3,750.0
Divided by: Issued Debt Par Amount		100,000.0
Warrant Implied OID		**3.75%**
Warrant Implied OID		3.75%
Add: Stated OID		1.25%
Total OID		**5.00%**
Debt Par Value Percent		100.0%
Less: Total OID		5.0%
Debt Issue Price as a Percent		**95.0%**

The table above presents an example using a fully diluted method. In this example, we assume the following facts: $100.0 million in debt was issued with a stated 1.25% OID, there are 50.0 million shares outstanding (including the freestanding warrants issued), 2.5 million warrants were issued with the debt, the equity value is $100.0 million, and the discount for lack of marketability was determined to be 25.0%.

First, we calculate the warrants' ownership percent as a percent of the fully diluted shares — this is 5% (2.5 million shares divided by 50 million shares times 100%). Next, we apply the 5% ownership to the total equity value of $100 million, which would imply a freestanding warrant value of $5 million, before the DLOM. Then, the discount is applied to the subject warrant value for the lack of marketability by multiplying the subject interest by one minus the DLOM of 25%. The resulting equity value available to the warrants equals $3.75 million. This value is used as an implied discount on the debt. Thus, the value allocated to the debt at issuance is $96.25 million, prior to the stated OID, and the warrant implied OID equals 3.75%. After applying the stated OID of 1.25% and the implied warrant OID of 3.75%, the issue price of the debt equals 95% or $95 million.

[6] Withum Smith+Brown, PC, "Discount for Lack of Marketability: Finnerty Model," October 17, 2017, https://www.withum.com/resources/discount-lack-marketability-finnerty-model/.

Conclusion

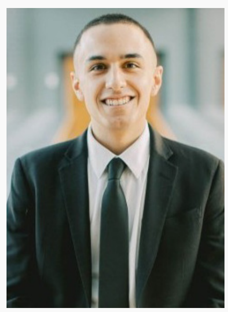
A discount on the issue price of debt for a freestanding equity instrument issued in conjunction with the debt is required to calculate the fair value of debt and implied OID at investment. Additionally, credit-focused funds or other investment firms accept warrants, as they can provide additional upside over the contractual cash flows of the debt structure, while issuers can receive more favorable terms than issuing debt without the equity-like instruments.

Ultimately, creditors that seek to enhance returns via attaching warrants to debt need to ensure they value the equity interests separately from the debt component for financial reporting purposes.

ABOUT THE AUTHORS

Jason Levine
Stout

Jason is a Director with Stout who has extensive experience providing valuation and financial advisory services to clients for financial reporting purposes, including fair value accounting (ASC 820). With over 10 years of experience, Jason has served numerous industries and provided valuation services to a broad client base, including business development companies, private equity funds, hedge funds, small and middle market businesses, multi-billion-dollar enterprises, law firms, and accounting firms. jlevine@stout.com



Jake Marinelli
Stout

Jake Marinelli is an Analyst in the Valuation Advisory group. In his two years at Stout, he has provided valuation services to both publicly traded and privately-owned companies on purchase price allocations, goodwill impairments, stock-option valuations, and business enterprise valuations. He works with corporate boards, management teams, high-net-worth individuals, various private credit, and private equity boards in the context of business valuation, equity valuation, debt valuation, investments, and venture capital. jmarinelli@stout.com

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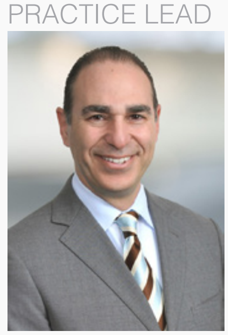

Harris Antoniades
Stout

Managing Director Harris Antoniades leads the complex securities & financial instruments practice with over 20 years of experience in complex securities and derivatives valuations, advance financial analytics, and risk management issues. hantoniades@stout.com

COMMERCIAL REAL ESTATE SEEMS DOOMED — CORPORATE RESTRUCTURING MAY BE A VIABLE STRATEGY

Daniel B. Butz, *Morris Nichols*
Travis Vandell, *Stretto*

According to the Mortgage Bankers Association, approximately $1.4 trillion of commercial real estate loans will mature this year and the next, which raises important questions about how the sector will fare with remote work continuing to remain dominant and with an uncertain economic environment in the post-pandemic world. Described as a "debt time bomb" in recent news reports from *Bloomberg Businessweek*, office buildings have not returned to pre-pandemic occupancy levels due to the shift to work-from-home office policies and the latest rounds of layoffs. With interest rates at their highest point since 2001, there seems to be no end in sight to the financial distress facing the commercial real estate market, leaving many to speculate what will come next and how these challenges can be surmounted.

Distressed building owners, lessors, and lenders are in the difficult position of determining the best strategy to weather the coming storm and address the challenges they are facing. Interestingly, they are all generally in the same proverbial boat: softening occupancy rates. While far from ideal, some owners might consider handing over the keys and walking away from the debt (and the building). Others may consider repositioning property for a mixed-use strategy combining residential, commercial, and retail tenants. Sound familiar? Shopping malls have looked to this solution in recent years with only mixed results for most.

However, the conditions seem ripe for an uptick in chapter 11 filings within this distressed sector. Why? There is currently no reason to believe there will be a significant improvement expected on the horizon. In the long-term, the challenges facing the commercial real estate sector will work themselves out — one way or the other; however, many of these companies are not going to be able to survive in their current, over-leveraged state. It would take significant economic growth and expansion for commercial real estate companies to rebound to occupancy levels seen prior to the pandemic. Going a step further, it may take a full-blown paradigm shift back to office occupancy seen during pre-pandemic days for the sector to return to "healthy" levels of substantially full tenancy in the near future.

Why have we not seen more commercial real estate chapter 11 filings? You hear that nearly daily — and have for the past two or even three years. Some speculate that one of the reasons we haven't seen more chapter 11 filings in this sector is the systemic nature of the problem: all parties are in a similar predicament. After all, let's be honest here: most lenders do not want to own (or operate) commercial properties — even if such commercial properties were profitable. That is not their bailiwick. And if no one can make commercial real estate profitable right now in light of the prevailing economic environment, then all involved parties may hunker down to minimize the losses as much as possible until the market recovers. Additionally, rising interest rates make the prospect of refinancing and renegotiating debt a more challenging process whether in or outside of a bankruptcy environment.

Regardless, corporate restructuring remains one of the few avenues for distressed commercial real estate companies to weather the storm. As commercial real estate entities teeter on the brink of insolvency, their advisors and turnaround professionals must evaluate the circumstances of each case to determine whether corporate restructuring might play a beneficial role in stabilizing them and returning them to a more profitable state. In doing so, it's crucial that turnaround professionals ask the right questions and keep in mind important considerations so they can determine the best course of action.

What Is the Goal of the Restructuring?

Each commercial real estate company will have unique needs and circumstances, and therefore it's critical to fully understand the desired outcome and purpose of the restructuring. For example, for some commercial real estate companies, chapter 11 may offer an advantage and alternative to just handing the keys to the lender. Perhaps they can maintain control of their assets. Instead, they may be able to renegotiate with the lender from a slightly stronger position using bankruptcy as a strategy. Many reject corporate bankruptcies as a solution, arguing they are too expensive. While that remains debatable, the carrying costs to hold on to unprofitable assets with no end in sight is itself very expensive. In fact, corporate bankruptcy could be used to provide commercial real estate companies with more time to hold out until market conditions begin to improve — or provide the necessary leverage to reorganize their portfolios into a form better able to weather the current economic conditions.

Understanding the Company Structure

The first step in evaluating whether corporate restructuring is the proper path for a commercial real estate company is understanding the company structure. Does the entity have one property or multiple properties? How is it incorporated? Where is it incorporated? How is financed and what are the terms? These and other factors will often determine what can be accomplished in chapter 11… and what cannot.

For example, if each building is a separately incorporated entity, and some are underwater and some are not, equity could theoretically cast off the underperforming ones and reorganize around the healthy ones. In doing so, equity could still maintain its prevailing interests because of the way the structure is laid out and where the banks have liens and where they don't.

However, if the company holdings are held as separately incorporated businesses but are each simply a piece of real estate, such properties might disadvantageously be considered a single-asset real estate (SARE) case which would face its own unique set of challenges in chapter 11. If an entity qualifies as a SARE, that limits its ability to use the Bankruptcy Code as a

means to reorganize and get out from under the impending debt load. Congress put restrictions in place for what can be done in SARE cases because of its potential for abuse as they represent mostly two-party disputes involving owners and the lenders without any other operations.

Evaluating the Capital Structure

Another important step to gaining insight into whether chapter 11 is an advantageous strategy for a commercial real estate company is to evaluate the capital structure of the company. Commercial real estate entities vary significantly in how they are financed, their capital structures and layers of debt. An analysis of these complexities can shed light on whether filing for chapter 11 would be an appropriate course of action.

An important element of the capital structure is whether the debt is cross-collateralized. Is there one lender or many lenders? Are there separate lenders for each building? While cross-collateralization of loans helps a borrower to secure a larger loan with better interest rates, it also protects the lenders by giving them more collateral and hamstrings the borrower/building owner's ability to reorganize around better properties. For example, in the hypothetical scenario above discussing options where a multi-building real estate company has separately incorporated a company holding each building, it would be theoretically possible for the company to only file underperforming holding companies for bankruptcy. In a cross-collateralization situation, all of the holding companies would necessarily need to file as they are all co-borrowers for the entire debt.

Embrace a Proactive Strategy

Whatever the scenario may be for a commercial real estate case, it's always better to be proactive than reactive. In fact, this is a rule-of-thumb for all companies facing financial troubles. Bankruptcy is a complex process, and it takes a great deal of planning and time to do it right. And time is money, as they say. It's always best to file for bankruptcy before the last dollar goes out the door. That gives the debtor the flexibility that's needed, allows them to hire the best counsel possible and with any luck, encourage lenders and other players to dance to their tune and cut a better deal at the end of the day. Put another way, act early and their arsenal has many more options.

If a commercial real estate entity is already under water, it may be advantageous to file chapter 11 so that creditors do not have any causes of action against the debtor, wiping the proverbial slate clean. However, these protections are only in place if and when the plan is confirmed. Conversely, filing for chapter 7 can paint a target on your back for trustees who may be seeking to sue for breaches or violations – clawing back more funding for the estate. This underscores the importance of taking action sooner than later.

As part of a proactive strategy, the prospective debtor and its advisors should also carefully consider the venue for a chapter 11 filing. In most cases, the available venue(s) for each debtor will depend on the size and headquarters of the company but there may be other circumstances to consider in each unique case. One important consideration concerns the complexity of the company and its finances — certain jurisdictions are more experienced with large and complex reorganizations and better able to facilitate quicker resolutions than others.

Conclusion

For companies in the commercial real estate sector, the advantage of filing chapter 11 is mostly cut-and-dry: they can drive the process rather be driven — rather than handing the keys over to the landlord/owner (who likely wants nothing to do with actually running the property itself). Ultimately, the goal is to line up the lenders, reorganize the loan structure, and emerge leaner and more profitable than before. With the right analysis, asking the right questions, and acting *early*, turnaround professionals can assist in guiding the process, and in making the appropriate determination, corporate restructuring can serve the needs of this distressed sector until it recovers.

ABOUT THE AUTHORS

Daniel B. Butz
Morris Nichols

Daniel is Senior Counsel with the Bankruptcy and Restructuring Group at Morris Nichols. He has been involved in bankruptcy proceedings and litigation on behalf of a variety of national and regional clients, including debtors, creditors, official committees of unsecured creditors, an official committee of equity security holders and various ad hoc committees. He currently represents publicly held- and privately-held companies in their efforts to restructure. In addition, Daniel acts as counsel for both plaintiffs and defendants in various bankruptcy related litigation matters, including among others, preference, fraudulent transfer, and turnover actions.

Travis Vandell
Stretto

Travis brings over 20 years of turnaround experience to his role as Managing Director. Drawing on his substantive knowledge and valuable insight as a former corporate-restructuring Attorney, he applies a practical application to case management. Throughout his career, Travis has effectively led teams on some of the largest and most notable Chapter 11 matters including Whiting Petroleum Corporation, General Growth Properties, and Six Flags Amusement Parks. He began his professional career as a legal intern for Hon. Stephen D. Gerling, Chief Bankruptcy Judge, NDNY, and Hon. Cecelia G. Morris, Chief Judge, SDNY. Travis is a former recipient of the Annual M&A Advisor 40 Under 40 Award.

TAX EFFECTS OF CANCELLATION OF DEBT INCOME ACROSS DIFFERENT ENTITY TYPES: AN INTRODUCTORY PRIMER

Patrick M. Phillips and Nate Meyers
RSM US LLP

Cancellation of debt income—or CODI—can have significant tax implications for various entities, depending on their classification for federal income tax purposes, as well as their solvency and bankruptcy status. Understanding the tax treatment of CODI for partnerships, S corporations, and C corporations is vital for taxpayers to make well-informed decisions and optimize their tax positions. With analysis and illustrative examples, this article provides an introductory guide for navigating CODI in different entity structures.

General Cancellation of Debt Provisions

CODI is a fundamental concept in federal tax law, wherein debtors recognize income when they settle their outstanding debt obligations for an amount less than the adjusted issue price (AIP). This principle was formally established in the landmark case *Kirby Lumber*[1] and later codified in Section 61(a)(11)[2] by including CODI as a part of a taxpayer's gross income. For instance, if a debtor owes $100 of debt but settles it for $60, the debtor generally recognizes $40 of CODI as taxable income.

Certain exclusions are provided, which allow CODI to be excluded from taxable income to the extent a debtor is insolvent.[3] The amount excluded by reason of the insolvency exception cannot exceed the amount by which the taxpayer is insolvent immediately prior to the discharge.[4]

> _Example:_
>
> Debtor Corp. ("D") has assets of $100 and liabilities of $150 (thus insolvent by $50). Creditor ("C") cancels the indebtedness in exchange for D's stock worth $100. D satisfied $100 of its debt with stock and had $50 forgiven. D has no taxable CODI because the amount forgiven ($50) does not exceed the amount by which D was insolvent ($50).

Another prominent exclusion is the bankruptcy exclusion, in which CODI is excluded if the discharge occurs in a title 11 case.[5] The term "title 11 case" means a case under the Bankruptcy Code[6] if the taxpayer is under the jurisdiction of the court, and the discharge of indebtedness is granted by the court or pursuant to a plan approved by the court.[7] Where a debt cancellation occurs during the bankruptcy process, but not pursuant to a plan approved/granted by the court, the bankruptcy exclusion does not apply.[8] If the debt discharge occurs pursuant to a plan approved by the court, the level of insolvency of the debtor is irrelevant to the amount of the exclusion. In other words, the burden of proof is on the taxpayer to establish the amount of insolvency outside of a title 11 bankruptcy case.[9] One benefit of a title 11 bankruptcy filing is the absence of the requirement for the taxpayer to establish the amount of insolvency.

Generally, where an exclusion (i.e., bankruptcy or insolvency) applies, tax attribute reduction is required under Section 108(b), which provides mechanical ordering rules.[10]

Additionally, as a way to prevent debtors from avoiding CODI by transferring their indebtedness to related parties, the Code treats the acquisition of outstanding debt by a related person as if the debtor had acquired the debt.[11] This means that if a party related to the debtor acquires the debtor's debt at a discount, the debtor is deemed to have realized CODI.

> _Example:_
>
> X borrows $1,000 from a bank. If an entity related to X [as defined in section 108(e)(4)] acquires the debt from the bank for $900, X is treated as the purchaser of the debt and consequently must recognize $100 of CODI.[12]

Partnerships

When a partnership's debt is forgiven, the consequences are shaped by the interplay of general discharge of indebtedness principles and the rules governing allocation of partnership income and liabilities. For federal income tax purposes, partnerships pass through items of income, gain, deduction, loss, and credit to individual partners. Consequently, when income arises from the discharge of partnership indebtedness, such income is determined at the partnership level, and each partner is responsible for reporting their distributive share of the income on their own income tax returns. Such income is allocated in accordance with the partnership agreement and reflected on Schedules K-1 issued by the partnership to its partners.

The insolvency and bankruptcy exclusions are applied at the partner level and each partner's individual situation determines eligibility to exclude CODI.[13] As such, even in situations where the partnership itself is insolvent, the insolvency exclusion is unavailable to a partner to the extent that the partner is solvent. Likewise, a partner will generally only qualify for the bankruptcy

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[1] Kirby Lumber v. United States, 284 U.S. 1 (1931).

[2] All section references are to the Internal Revenue Code of 1986 (the "Code"), as amended, or to underlying regulations.

[3] Section 108(a)(1)(B).

[4] Section 108(a)(3).

[5] Section 108(a)(1)(A).

[6] Title 11 U.S.C.

[7] Section 108(d)(2).

[8] For example, if during the bankruptcy proceedings, the debtor and creditor independently agree to a modification of the debt, or the debtor buys back its debt for stock at a discount, all without the court's approval.

[9] Note that a Chapter 7 (liquidating) or Chapter 11 (reorganizing bankruptcy) are two examples of title 11 bankruptcies.

[10] The mechanics of the attribute reduction resulting from excluded CODI is beyond the scope of this article.

[11] Section 108(e)(4); Treas. Reg. Sec. 1.108-2.

[12] Timing of the acquisition of the debt when compared to the timing of becoming related is also relevant, for example: Treas. Reg. Sec. 1.108-2(c)(3) "a holder of indebtedness is treated as having acquired the indebtedness in anticipation of becoming related to the debtor if the holder acquired the indebtedness less than 6 months before the date the holder becomes related to the debtor."

[13] Section 108(d)(6).

exclusion if they are a party to the bankruptcy (or join in a bankruptcy filing with the partnership).[14]

Example:

A, B, and C are equal partners in XYZ LLP, a partnership for US federal tax purposes. XYZ LLP's creditors forgave $300,000 of indebtedness, creating CODI. A is insolvent by $150,000, B is insolvent by $100,000, and C is insolvent by $50,000. A and B can each exclude their $100,000 allocable amounts from income, while C can only exclude $50,000 and must include the remaining $50,000 in income.

This allocation of CODI impacts each partner's basis in the partnership interest, effectively increasing it by the amount of their share of income.[15] However, this increase in basis is generally accompanied by an offsetting reduction due to the partnership tax rules treating a decrease in a partner's share of partnership liabilities as a distribution of money.[16] As a result, partners must include in their income their pro rata share of the discharged debt without enjoying a net basis increase that usually accompanies other types of partnership income.

Example:

A and B are equal partners in a partnership. $100,000 of the partnership's outstanding debt is forgiven by their creditor without consideration in return. A and B separately report $50,000 as their distributive share of the CODI on their returns. Each partner adjusts their basis in the partnership interest by increasing it by $50,000 (i.e., the decrease in partners' share of partnership liabilities). However, the reduction in each partner's share of the liabilities is treated as a distribution of money. Consequently, both A and B must reduce their basis in the partnership by $50,000, resulting in no net basis increase despite the inclusion of the CODI in their taxable income.

As mentioned above, to the extent there is CODI excluded there are attribute reduction ordering rules that apply. In the case of partnerships, attribute reduction applies at the partner level based on the amount of excluded CODI and based on the partner's tax attributes.

S Corporations

While S corporations are similar to partnerships in their flow-through nature, for purposes of CODI the insolvency and bankruptcy exclusions are applied at the corporate level as opposed to the shareholder level.[17] Just as a partner in a partnership is entitled to deduct their share of the partnership's losses, so too is the shareholder of an S corporation entitled to deduct their share of the corporate losses.[18] In the S corporation context, losses are taken into account by the shareholder, but are generally limited to the shareholder's basis in the stock or debt of the corporation. As such, a shareholder may have losses allocated in excess of basis which are suspended.[19]

Shareholders must carry forward their suspended losses, and since there is no carryover at the S Corporation level, a special rule treats these suspended losses of the shareholder as deemed NOLs of the corporation for that tax year.[20] As a result, the suspended losses are subject to reduction when CODI is excluded from income under the insolvency or bankruptcy exclusions.[21]

CODI that is taxable to the S Corporation increases the shareholders' tax basis[22] and also increases the S corporation's accumulated adjustments account (AAA, or "triple A").[23] However, to the extent that CODI is excluded from the S corporation's income because of its bankruptcy status or insolvency, the shareholders do not increase their basis for the excluded CODI.[24]

Example:

XYZ, an S corporation, has two shareholders, A and B, who each own 50%. XYZ incurred CODI of $600,000 and was fully solvent at the time of discharge but had no other income in the year of discharge. Both A and B have $100,000 of suspended losses from the prior tax year. A and B each are allocated $300,000 of the CODI which increases their basis in the XYZ stock, thereby freeing up each of their $100,000 suspended losses. As such, after taking into account their suspended losses, A and B each have CODI of $200,000 includable in their gross income ($300,000 of CODI less $100,000 of suspended losses).

C Corporations

C corporations recognize CODI at the corporate level, and it is included in gross income, subject to specific exceptions. As mentioned above, Section 108(a) outlines circumstances under which CODI is excluded from a C corporation's gross income and generally includes discharge in a title 11 bankruptcy and discharge when the corporation is insolvent.[25] Again, while Section 108 allows for the exclusion of CODI, it generally comes at a cost by way of tax attribute reduction.[26]

The ordering rules generally provide reduction in the following order:

- **A.** Net Operating Losses (NOL)
- **B.** General Business Credits
- **C.** Minimum Tax Credits
- **D.** Capital Loss Carryovers
- **E.** Basis Reduction
- **F.** Passive Activity Loss and Credit Carryovers
- **G.** Foreign Tax Credit Carryovers

[14] Treas. Reg. Sec. 1.108-9(b). Note: There are Tax Court cases wherein a partner was permitted to exclude CODI, where the partnership was in bankruptcy, but the partner was not in their individual capacity; however, the IRS has come out against these decisions in nonacquiescence in A.O.D. 2015-001. *See e.g.,* Estate of Martinez v. Commissioner, T.C. Memo. 2004-150; Gracia v. Commissioner, T.C. Memo. 2004-147; Mirarchi v. Commissioner, T.C. Memo. 2004-148; and Price v. Commissioner, T.C. Memo. 2004-149 (essentially identical opinions for three partners in the partnership).

[15] Section 705.

[16] *See* Sections 752(b) and 733. Note however, that depending on the nature of the debt discharged, the basis decrease may differ from the increase pursuant to Section 705.

[17] Section 108(d)(7)(A).

[18] Section 1366(a)(1).

[19] Section 1366(d)(1); (d)(2).

[20] Section 108(d)(7)(B).

[21] Treas. Reg. Sec. 1.108-7(d).

[22] Section 1367(a)(1)(A).

[23] Section 1368(e).

[24] Section 108(d)(7)(A).

[25] Note: also includes discharge of qualified farm indebtedness.

[26] Section 108(b).

Continued from p.27

To the extent that any CODI remains after the attribute reduction is applied, it is essentially erased, something that practitioners have come to refer to as "Black-hole COD." By reducing tax attributes, to the extent they exist, the debtor is provided with a fresh start, but also facilitates an equitable tax deferral rather than a permanent tax difference.

Example:

Debtor Corp. is insolvent by $75 and realizes $100 of CODI. $25 is taxable income and the remaining $75 is excluded from income according to Section 108(a)(1)(B). If Debtor Corp. has $25 of NOL carryforwards into the year of discharge, and $25 tax basis in its assets and has no other attributes, it will reduce both the NOLs and tax basis to $0 and the remaining $25 is Black-hole COD.

Additionally, the attribute reduction (described above) occurs after determination of the debtor's tax liability for the year of the debt discharge.[27] This ordering rule can significantly impact a debtor corporation's tax liability, particularly in instances of liquidating bankruptcies. When it is clear that a corporation will not become profitable even after its outstanding debt is reduced, the purpose of the bankruptcy process is then to ensure the orderly liquidation and distribution of the debtor's assets to its creditors.[28] A liquidating bankruptcy process often involves taxable sales of debtor assets under section 363 of the Bankruptcy Code, and also potential CODI.

Example:

Debtor Corp. is undergoing a liquidation in bankruptcy. At the time of liquidation, Debtor Corp. had assets with a total fair market value of $10x and tax basis of $0x. Debtor Corp. also had $10x of NOL carryforwards from prior years. Debtor Corp. sells its assets to a Buyer in year 2 and distributes the proceeds to Creditor in partial repayment of its $100x loan. Debtor Corp. had no other items of income or loss. Debtor Corp. then legally liquidates.

Here Debtor Corp. will recognize a $10x gain on the sale of the assets, and likely recognizes $90x of CODI. The CODI would likely be excluded under section 108(a) and will reduce the $10x NOLs after the determination of the tax for the year of the discharge.[29] As such, the ordering rule will allow Debtor Corp. to use its NOLs to offset the gain on the sale, prior to the attribute reduction. Thus, when the attribute reduction is made, there are no attributes left to reduce and the entire $90x of CODI is Black-hole COD.

Consolidated Group Setting[30]

If a debtor corporation that is a member of a consolidated group recognizes CODI and excludes it from income under Section 108(a), there are special rules regarding attribute reduction.[31] The consolidated group's tax attributes are generally subject to reduction, after reduction of the debtor's own tax attributes, following a mechanical ordering rule. Additionally, in the consolidated context, there is a "tier-down" attribute reduction mechanism that applies to reduce the tax attributes of a lower-tier member in certain circumstances.[32]

For U.S. federal tax purposes, the exclusion of CODI under Section 108(a) (i.e., bankruptcy, insolvency, etc.) does not apply to cancellation transactions between members of a consolidated group involving intercompany debt.[33]

The ultimate impacts of debt workouts for a consolidated group are complex, and can often have odd results depending on which consolidated group member is the true debtor. Careful consultation and modeling from knowledgeable tax advisors is always recommended in these contexts.

Conclusion

The tax consequences of CODI are highly dependent on the entity's classification, solvency, and bankruptcy status. Successfully navigating the complexities of CODI requires a thorough understanding of the tax implications specific to each entity type and the equity owners. Consulting with experienced tax advisors and legal professionals is critical in handling CODI and related tax matters effectively.

[27] Section 108(b)(4)(A).
[28] This process has various tax consequences, but for purposes of this article the discussion is limited to CODI.
[29] Section 108(b)(4)(A).
[30] A detailed discussion of the consolidated return rules regarding CODI is beyond the scope of this limited discussion.
[31] Treas. Reg. Sec. 1.1502-28.
[32] Treas. Reg. Sec. 1.1502-28(b).
[33] Treas. Reg. Sec. 1.1502-13(g)(4)(i)(C).

ABOUT THE AUTHORS

Patrick M. Phillips, JD, LLM
RSM US LLP

Patrick is a Principal in the RSM Washington National Tax M&A group, where he focuses on all transaction related tax issues, including those related to distressed companies. Patrick received JD and LLM degrees from Villanova Law and is an attorney licensed in Pennsylvania. Patrick has authored and co-authored numerous articles on a broad array of business taxation topics. Email: Patrick.Phillips@rsmus.com.

Nate Meyers, JD, LLM
RSM US LLP

Nate is a supervisor in the RSM Washington National Tax M&A group, where he focuses on federal tax issues related to deal transactions, debt restructuring, and internal restructuring. Nate received his JD from the Mercer University School of Law, and his LLM in taxation from the University of Florida Levin College of Law. Nate is an attorney licensed in the District of Columbia and Georgia and is a member of the ABA. Email: Nate.Meyers@rsmus.com.

SHOULD MARKETABILITY DISCOUNTS BE APPLIED TO CONTROLLING INTERESTS IN COMPANIES?[1]

Examined through the Lens of Fair Market Value

Z. Christopher Mercer
Mercer Capital

This article addresses the nagging question raised in the title: Should "marketability discounts" be applied to controlling interests of companies? I first addressed the question in 1994 in response to issues raised before the International Board of Examiners of the American Society of Appraisers (ASA), of which I was vice chair for business valuation.[2] My answer to the question was then, and is now, "no."

It is a question that has not gone away, despite the fact that, in my view, such a discount does not exist.

Upon receipt of my copy of *A Consensus View: Q&A Guide to Financial Valuation*[3] in early 2016, I hoped that three leading business valuators would put the question to rest. They did not. While addressing the issue, the authors quoted four pages from *Business Valuation: An Integrated Theory*,[4] which concluded that a marketability discount for controlling interests is not a meaningful concept.

Immediately following the quoted text, the authors commented:

> In any event, most experts agree that typical discounts for lack of marketability for controlling interests, if appropriate, are nowhere near as large as those applied to minority interests. Per Pratt, U.S. Tax Court cases have a "range from 3 percent to 35 percent." [Note: These Tax Court cases are very fact-specific, and we caution the use of such Tax Court decisions as the sole basis for a discount.]
>
> In practical application, when *analysts who believe* in a discount apply them, they are typically in the range of 5% to 20%. Obviously, those *analysts who do not believe* a discount applies would have no discount. *We believe* that this is still an unsettled area, and each analyst must decide what his or her position is and how to support that position.[5]

The existence or nonexistence of a marketability discount for controlling interests is not a matter of belief. I contend that if a discount cannot be defined in terms of differences in expected cash flows, growth, or risk between one level of value or another, it does not exist. And it cannot be so defined.

An Earlier Article in *The Valuation Examiner*

The title question was addressed in a recent article in *The Valuation Examiner* entitled "The DLOM Conundrum: Measuring Marketability Discounts for Controlling Interests."[6] The article's author addressed the question better than most. Following his discussion of marketability discounts, looking at minority interests and controlling interests, an example was developed using internal rate of return analysis for a 51 percent controlling interest in a small, private company under two scenarios:

1. **Marketability discount applied**. In the first scenario, an appraiser applies a marketability discount of 20 percent to a 51 percent controlling interest in a company valued at $1 million. The assumption in this example is that because it would take two years to sell the business, the discount is warranted. The company has paid average distributions of $200,000 in recent years, so the effective capitalization rate for distributions is 20 percent ($200,000/20% = $1,000,000). The interest is worth $408,000 [($1,000,000 x 51% x (1 – 20%)]. The internal rate of return is then calculated assuming a buyer paid $408,000 for the 51 percent interest on the valuation date and would expect to receive distributions of $102,000 (51% x $200,000) at the end of years one and two, and the proceeds of sale (undiscounted) of $510,000 for the 51 percent interest at the end of year two. The internal rate of return under these assumptions is 35.6 percent. The author reasons, correctly, that this expected return is unwarranted and excessive, and that the marketability discount of 20 percent would certainly be challenged. I would note that this conclusion could not represent fair market value because no hypothetical (or real) seller would sell at such a discount.
2. **No marketability discount applied**. In the second example involving the same company, it is assumed that no marketability discount should be applied. The internal rate of return for the investment of $510,000 with the same returns over two years as in the first example is 20 percent, which is equal to the capitalization rate on dividends (the implied assumption is that expected growth is 0 percent). This rate of return is reasonable, per the article's author, so a marketability discount is not appropriate.

[1] This article (or a version of it) originally appeared in *The Value Examiner*, July/August 2023 issue, published by the National Association of Certified Valuators and Analysts® (NACVA®). All Rights Reserved. To learn more, please visit www.NACVA.com/ValueExaminer.

[2] Z. Christopher Mercer, "Should 'Marketability Discounts' Be Applied to Controlling Interests of Companies?" *Business Valuation Review* 13, no. 2 (June 1994), 55.

[3] James R. Hitchner, Shannon P. Pratt, and Jay E. Fishman, *A Consensus View: Q&A Guide to Financial Valuation* (Ventnor City, NJ: Valuation Products and Services, LLC, 2016), 195–202 (Question 90: "Lack of Liquidity and Control Valuations").

[4] Z. Christopher Mercer and Travis W. Harms, *Business Valuation: An Integrated Theory,* 2nd ed. (Hoboken, NJ: John Wiley & Sons, Inc., 2008), 94–97.

[5] Hitchner et al., *A Consensus View* (bracketed text in original, citation omitted, emphasis added).

[6] Jim Turner, "The DLOM Conundrum: Measuring Marketability Discounts for Controlling Interests," *The Valuation Examiner* (November/December 2022), 18–21.

Continued from p.31

The concept of internal rate of return is appropriate for application to minority interests. The mirror calculation of the present value of expected cash flows is at the heart of the Quantitative Marketability Discount Model (QMDM), which is designed to facilitate the appraisal of illiquid minority interests.[7]

Taking the example's internal rate of return one step further, we see that if we assume that the required rate of return in the appraisal (20 percent) is expected to be received following a valuation date, then there will be no reason to discount a controlling interest on the valuation date. The result will be the same as in the second example. While the article did not reach the conclusion that marketability discounts are not applicable to controlling interests, it came close, providing another rationale for answering the title question.

This short review of the *Valuation Examiner* article provides a good lead-in to the rest of this piece.

Business Value Defined

The value of a business is the present value of its expected cash flows into the indeterminate future, including expected growth of those cash flows, discounted to the present at a rate reflective of the risks of achieving them. Business (enterprise) value, then, is a function of three factors: expected cash flow (CF_e), growth (G_e), and risk (R_e). Business value can be summarized by the familiar Gordon Model, which we refer to as the fundamental valuation equation:[8]

$$V_e = CF_e / (R_e - G_e)$$

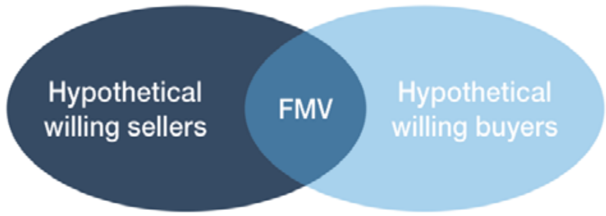
This equation is equivalent to the discounted cash flow model under assumptions that growth into the indefinite future is equal to G_e, and that all cash flows are reinvested in the business at the discount rate of R_e. With this basic understanding of the components of business valuation, we now turn to the standard of value known as fair market value.

Fair Market Value Defined

Every appraisal involves the specification of the relevant standard, or type, of value. Fair market value is the most frequently used standard of value employed by business appraisers. Often, appraisers cite the definition of fair market value in Revenue Ruling 59-60, and list the eight factors described in that ruling in their reports. The ruling defines fair market value as follows:

> Section 20.2031-1(b) of the Estate Tax Regulations (section 81.10 of the Estate Tax Regulations 105) and section 25.2512-1 of the Gift Tax Regulations (section 86.19 of Gift Tax Regulations 108) define fair market value, in effect, as the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.[9]

Exhibit 1: Fair Market Value Conceptual Framework



Both are able and willing to trade

Both fully (reasonably) informed

Both have financial capacity

Neither acting under compulsion

Negotiate over price

Value = *f* (expected cash flow, risk, growth) for the entity or an interest in the entity

Engage in a (hypothetical) transaction for the interest for "money or money's worth" (cash equivalent basis) …

… on the valuation date (after the hypothetical negotiations and all "marketing" have occurred)

Section 4 of the ruling sets forth the following eight factors, often called the "basic eight factors":

1. The nature of the business and the history of the enterprise from its inception.
2. The economic outlook in general and the condition and outlook of the specific industry in particular.
3. The book value of the stock and the financial condition of the business.
4. The earning capacity of the company.
5. The dividend-paying capacity.
6. Whether or not the enterprise has goodwill or other intangible value.
7. Sales of the stock and the size of the block of stock to be valued.
8. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in the free and open market, either on an exchange or over the counter.

These are relevant factors for consideration, but Revenue Ruling 59-60 also states that the elements of common sense, informed judgment, and reasonableness must enter the process of weighing those factors and determining their aggregate significance. I call these the "critical three factors."

Fair Market Value Reflects Hypothetical Negotiations

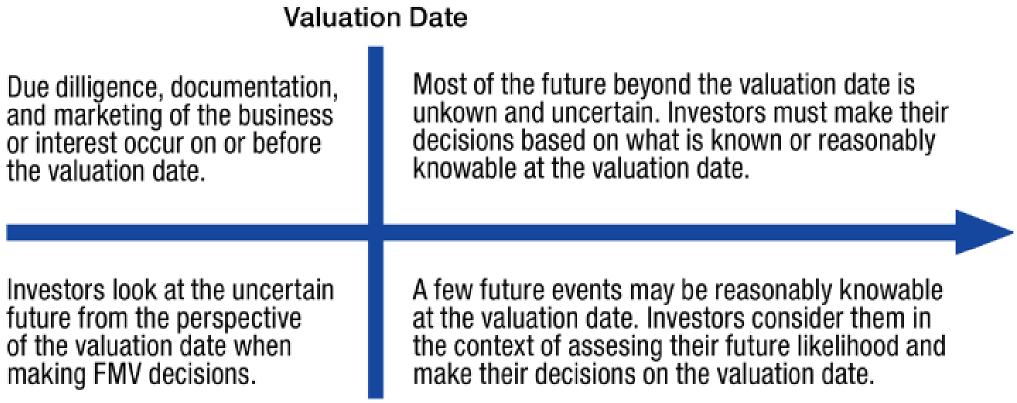
Fair market value occurs at the intersection of hypothetical negotiations between hypothetical willing, knowledgeable, and able buyers and sellers. Therefore, in every fair market value determination prepared by business appraisers, it is critical that both buyers and sellers are present for the negotiation. A fair market value appraisal should reflect considerations of both

[7] Mercer and Harms, *Business Valuation: An Integrated Theory*. See esp. chapters 9–11 for a full discussion of the QMDM.

[8] Ibid. See Chapter 2 for a discussion of the integrated theory of business valuation.

[9] Rev. Rul. 59-60, 1959-1 C.B. 237.

Exhibit 2: Hypothetical Transactions



buyers and sellers, and land within the intersection of their hypothetical negotiations over the expected cash flows, growth, and risks associated with receiving those cash flows (whether for a business or an interest in one). The fundamental valuation equation above summarizes the basis for those hypothetical negotiations.

Exhibit 1 on the previous page provides a conceptual look at fair market value. The key elements from the definitions are highlighted. Hypothetical willing sellers have different interests than hypothetical willing buyers.

In the world of fair market value:

1. Hypothetical buyers are seeking to acquire expected business cash flows and negotiate price based on their associated risks and expected growth (from their viewpoints).
2. Hypothetical sellers, who, if a transaction occurs, are giving up the expected business cash flows that the hypothetical buyers are acquiring, must consider the very same risk and growth factors (from their viewpoints). They negotiate price based on these factors.
3. Hypothetical (or real) buyers desire to pay the lowest possible price, but that is not fair market value.
4. Hypothetical (or real) sellers desire to receive the highest possible price, but that is not fair market value either.
5. Fair market value necessarily assumes that:
   - All hypothetical negotiations and marketing of the subject interest have occurred prior to the consummation of any hypothetical transaction, which occurs on the valuation date.
   - Each party to the hypothetical negotiations has considered all relevant information that is known or reasonably knowable as of the valuation date.
   - The hypothetical parties have agreed to and signed the documentation customarily needed for a transaction prior to or on the valuation date.
   - A hypothetical transaction occurs on the valuation date.

This discussion highlights several important implications of the definition of fair market value. They are necessary for the next element for consideration: the hypothetical transaction itself.

Fair Market Value Assumes a Hypothetical Transaction

Fair market value assumes that both hypothetical buyers and hypothetical sellers are knowledgeable, willing, and able to transact, and that neither acts under any compulsion. The hypothetical parties negotiate at arm's length and in their respective self-interests. And they engage in a hypothetical transaction with the following characteristics:

- The transaction occurs for money or money's worth, i.e., for a cash-equivalent price. The requirement for cash-equivalency is described as "money or money's worth" in Revenue Ruling 59-60 outside of the definition above. However, a cash-equivalent price is implied by the definition. Rational and informed hypothetical sellers negotiating in their self-interests could only agree on a cash-equivalent price in their negotiations. The analysis in the article discussed above affirms this conclusion.
- The transaction occurs on the valuation date. This fact is critical to understanding fair market value. We address this issue in more depth below.
- The transaction is entered into by hypothetical buyers and sellers based on information that was known or reasonably knowable on the valuation date.[10]

The hypothetical transactions of fair market value could not occur on the valuation date unless all hypothetical negotiations, including the marketing of the subject interest, had been concluded on or before that date. Similarly, the hypothetical transactions could not be concluded unless all customary documentation of the transactions had been completed. Exhibit 2 depicts the nature of such hypothetical transactions.

The purpose of an appraisal is to simulate the hypothetical negotiations of hypothetical willing buyers and sellers and to determine, in the form of an opinion of fair market value, the intersection of their negotiations. When the hypothetical seller is

[10] In Estate of Noble v. Commissioner (T. C. Memo. 2005-2), the court considered a transaction that occurred about 14 months after the date of death as being indicative of fair market value on the date of death, or the valuation date. This is a clear violation of the basic tenet of fair market value that the hypothetical transaction occurs on the valuation date. See also Z. Christopher Mercer, "The Estate of Noble and Subsequent Events," *Business Valuation Review* 27 no. 4 (Winter 2008), 187.

Continued from p.33

not present in an appraisal, the conclusions are too low to reflect fair market value. When the hypothetical buyer is not present in an appraisal, the conclusions are too high to reflect fair market value.

What brings hypothetical willing buyers and sellers to the intersection point of fair market value? It is their respective assessments and negotiations regarding the expected cash flows, risks, and growth associated with the subject business. The interests of both buyers and sellers should be reflected in fair market value determinations.

The So-Called Marketability Discount for Controlling Interests

We now examine the so-called marketability discount for controlling interests.

In Light of the Definition of Fair Market Value

We address the question based on the definition of fair market value, which represents a hypothetical transaction in a subject interest on the valuation date for cash or its equivalent. If there is a hypothetical transaction for a controlling interest in a company, say Acme Manufacturing, on the valuation date for cash at fair market value, what reason could there be for discounting that value for "lack of marketability?" It has just been marketed and sold, and the interest became fully liquid.

Proponents of a marketability discount for controlling interests suggest that the prospective marketing of the subject company might take months after the valuation date and, therefore, a discount is warranted. This overlooks the fact that marketing has already occurred before the valuation date. Refer to the discussion and figure above. The very definition of fair market value proves this perspective is wrong.

Consider this marketing concept in light of market data for guideline company transactions. The multiples (of revenue or EBITDA, for example) from these transactions are based on the closing prices of transactions that occurred on specific transaction dates. These multiples necessarily reflect all considerations of marketing and any liquidity issues over the time it took to sell each company. If the multiples that appraisers use to determine values for controlling interests of companies reflect all prior marketing and liquidity issues, how then can an appraiser apply a marketability discount to lower value?

Also recall the article example summarized above. Any marketability discount applied to a controlling interest is a disguised transfer of value in the form of excess returns to hypothetical or real buyers. No seller would accept this result, either in the hypothetical world of fair market value or in the real world where businesses transact.

In Light of the Integrated Theory of Business Valuation

We now address the question of marketability discounts for controlling interests from the viewpoint of the integrated theory of business valuation.[11] Any valuation discount represents differences in expected cash flow, growth, and risk between one conceptual level of value and another.[12] No valuation discount (or premium) has any meaning unless the base level to which it applied is defined.[13] Commonly accepted levels of value, displayed in Exhibit 3, include the following[14]:

- **Strategic control value**. The base value to which a conceptual strategic control premium might be applied is the financial control/marketable minority level in the middle of Exhibit 3's levels-of-value chart. The strategic control premium shown above it reflects expected cash flows for strategic or synergistic buyers as well as their costs of capital. It is the expected differences in cash flow (likely higher than CF_e for strategic buyers) and/or the lower risk that may be considered by strategic buyers (possibly lower costs of capital than R_e) that create the strategic control premium. This conceptual premium measures the differences in value between financial control/marketability minority values and strategic values.[15]
- **Financial control/marketable minority value**. The Gordon Model represents the value of a business at the financial control/marketable minority level of value. It is increasingly accepted that the marketable minority and financial control levels of value are coincident. Eric Nath was the first to write that public pricing of securities represented (financial) control value in 1990.[16] Since then, there has been a growing recognition that there is little inherent difference between financial control and marketable minority values.[17] This combined level of value provides the base value to which any strategic control premium might be applied; although it would be quantified based on differences in expected cash flow for strategic acquirors relative to CF_e.

[11] Ibid.; Mercer and Harms, *Business Valuation: An Integrated Theory.*

[12] Shannon P. Pratt and ASA Educational Foundation, *Valuing a Business,* 6th ed. (New York: McGraw Hill, 2022). On page 54, the section titled "Levels of Value" begins with the following:

> A given business or business ownership interest is likely to have more than one value at a given valuation date. This multiplicity of values is attributable to the different perspectives from which one may consider the value of a business or business ownership interest. Valuation analysts have traditionally referred to the available perspectives as *levels* of value. While a variety of charts have been offered by analysts and observers over the years, the Exhibit 3-2 [identical to the levels of value figure below] includes the primary components that are common to all such charts [emphasis in original].
> Exhibit 3-2 identifies four distinct levels of value and four discounts or premiums that relate the levels to one another. The different levels of value, and the corresponding discounts or premiums, are rooted in differences in economic income [i.e., expected cash flow and growth] and risk from each different perspective represented on the exhibit.

[13] American Society of Appraisers, *ASA Business Valuation Standards,* February 2022, BVS-VII, "Valuation Discounts and Premiums," secs. II.A and II.B, 16.

[14] Mercer and Harms, *Business Valuation, An Integrated Theory,* Exhibit 2.15.

[15] For discussions of the causes of strategic control premiums, see Mercer and Harms, *Business Valuation: An Integrated Theory*, chapter 2. See also, The Appraisal Foundation, *Valuations in Financial Reporting Valuation Advisory 3: The Measurement and Application of Market Participant Acquisition Premiums* (2017). This publication makes it clear that strategic control premiums must be based on cash flow or risk differences as viewed by strategic buyers. The market participant acquisition premium is analogous to the strategic control premium.

[16] Eric W. Nath, "Control Premiums and Minority Interest Discounts in Private Companies," *Business Valuation Review* 9, no. 2 (June 1990), 39.

[17] Mercer and Harms, *Business Valuation: An Integrated Theory,* Appendix 7-A, "A Historical Perspective on the Control Premium and Minority Interest Discount," 247.

- **Nonmarketable minority value**. This value is the lowest conceptual level of value on the levels-of-value chart. The marketability discount, or discount for lack of marketability (DLOM), represents differences in expected cash flow, growth, and risk between the marketable minority/financial control levels of value and the nonmarketable minority level of value. Recall from the Gordon Model (fundamental valuation equation) that CF_e represents the normalized expected cash flow of an enterprise (business), G_e represents the expected growth of that cash flow, and R_e represents the risks associated with the business and achieving the expected cash flows.

The nonmarketable minority level of value can be represented conceptually by the equation:[18]

$$V_{sh} = CF_{sh} / (R_{hp} - G_v)$$

V_{sh} is the nonmarketable minority value, or the value to the shareholder. CF_{sh} is the expected cash flow to the shareholder of a subject illiquid minority interest. Any cash flow to a shareholder is derivative of CF_e. G_v is the expected growth in value of the illiquid minority interest over the expected holding period of the investment (including liquidity assumed at the marketable minority/financial control level of value at the end of the expected holding period). R_{hp} represents the risks associated with achieving CF_{sh}, including growth, over the expected holding period of the investment.

Why do DLOMs exist for illiquid minority interests?

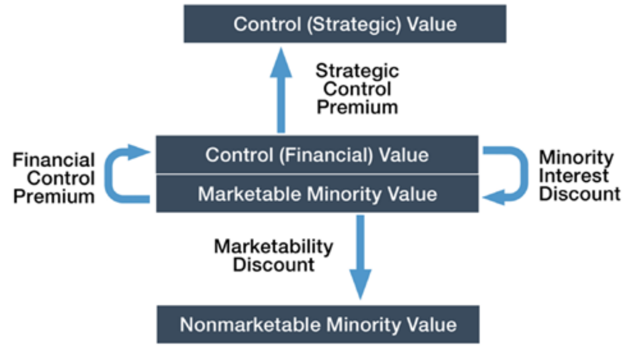
1. CF_{sh} is most often less than CF_e. This can be the result of reinvestment of all or a portion of cash flow into the business by controllers or of agency costs imposed by controllers (e.g., suboptimal reinvestments and/or non pro rata distributions).
2. G_v may be less than G_e, particularly if agency costs are involved.
3. R_{hp} is almost certainly greater than R_e, since the risks associated with achieving interim returns over an expected holding period of uncertain length are greater than the risks of the business.

The lower cash flows of the illiquid interest and the greater risks (relative to the base value) create the wedge of lower value called the marketability discount. We can attempt to conduct a similar analysis relative to the so-called marketability discount for controlling interests in businesses.

The marketable minority/financial control level of value is defined by the Gordon Model, a summary statement of the discounted cash flow (DCF) model. The DCF model is normally developed in two stages. Normalized, expected cash flows of a business are projected into the future for a finite period of time and then, a terminal value is calculated to represent the then value of all remaining cash flows beyond the finite forecast period. All of these cash flows are then discounted to the present at the discount rate, R_e.

[18] The actual formulation is a two-stage, shareholder-level discounted cash flow model considering expected cash flows to minority interests over an expected holding period and a terminal value consisting of the expected financial control/marketable minority value at the end of the expected holding period. See Mercer and Harms, *Business Valuation: An Integrated Theory,* 333.

Exhibit 3: Commonly Accepted Levels of Value



Are the cash flows attributable to a controlling interest any different at the valuation date than those already projected in an appraisal? No. It is the same business and the same interest at the same date. It is not possible to define lower cash flows attributable to the subject interest, or greater risks, or slower growth beyond the valuation date. After all, that is the date on which the assumed hypothetical transaction of fair market value occurs for cash.

On a practical note, I have been involved in more than 100 business transactions over the last 40 years or so working on behalf of buyers and sellers. The notion of a marketability discount for a controlling interest in a company has not been present in any of these transactions. In fact, sellers would consider the idea to be laughable.

Rationales for Marketability Discounts for Controlling Interests

In this section, we deal with several qualitative "rationales" for marketability discounts for controlling interests that have been advanced by some in the profession.

1. The benchmark for marketability (of minority interests) is an actively traded stock that can be sold at will (at or very close to the current market price), with cash proceeds available in three days. Since controlling interests cannot meet this "instant liquidity" standard, marketability discounts may be necessary.

Private companies (and controlling interests in them) do not trade in the same markets as publicly traded minority shares, which trade on the New York Stock Exchange and the NASDAQ markets. Given the differences in ownership attributes (control versus minority), liquidity (cumbersome to sell versus freely tradable), information access (SEC disclosure is mandated for public companies), and information reliability (some believe that private company disclosure is less reliable than public company disclosure), the universe of buyers of controlling interests of private companies is largely different from the universe of investors in the public stock markets. Both buyers and sellers of companies know from experience that transactions take considerable time to complete. Since there is no expectation of "cash in three days," and since transactions normally take several months to complete, any consideration of "lack of marketability" is incorporated into pricing.

Author's note: "Lack of liquidity" is not a reason to apply a marketability discount to controlling interests in companies for the same reasons as above.

Continued from p.35

2. There are transaction costs in selling a company. A marketability discount is needed to account for these costs.

Applying a marketability discount to a controlling interest to account for a seller's transaction costs would be a buyer's dream. It would lower the purchase price and the seller still would have to pay the costs. Transaction costs do not impact price or fair market value. They do affect the net proceeds of a sale.

> **Author's note**: Transaction costs provide no reason to apply a marketability discount to controlling interests in companies.

3. It can take six months to a year or more to sell a company. Therefore, we should discount the initial value for lack of marketability because of the time it takes to market a business.

The definition of fair market value presumes that, when a controlling interest in a company is to be valued, a hypothetical transaction between hypothetical buyers and sellers occurs on the valuation date. This necessarily requires that all marketing time has been accounted for in the hypothetical transaction that occurs.

The concept of marketing before the valuation date is analogous to the concept of exposure time in real estate appraisal. Exposure time is defined in the Uniform Standards of Professional Appraisal Practice (USPAP) as the "estimated length of time that the property interest being appraised would have been offered on the market prior to the hypothetical consummation of a sale at market value on the effective date of the appraisal." There are no concepts of "marketability discounts" or "illiquidity discounts" in real estate appraisal because it is clear that a property has been assumed to have been on the market for a sufficient time and that appropriate effort has been expended before the valuation date so that the assumed hypothetical transaction reflected by the appraisal (for cash or its equivalent) can occur on the valuation date.

The same holds true for fair market value determinations of controlling interests in businesses. There has been (assumed) sufficient "exposure time" (marketing, due diligence, and documentation) and effort that the hypothetical sale contemplated by the definition of fair market value can occur on the valuation date for cash or its equivalent. There can be no "marketability discount" or "illiquidity discount" based on time or expense to market companies after the valuation date.

Regardless of the length of marketing time, the sellers have control over all cash flows during the marketing period. They can make distributions during this period or reinvest in the business if such reinvestment will add value to the business for the ultimate sale. These are the very same cash flows that buyers are seeking, so there is no reason to discount them.

Finally, the example from the *Valuation Examiner* article discussed above illustrates that considering the implied internal rate of return for a controlling interest transaction, the imposition of a marketability discount would provide excess returns (over the discount rate for the company) to the buyer and would, in essence, transfer value from the sellers to the buyer. No seller in the context of fair market value or the real world would allow for that.

> **Author's Note**: Time to market controlling interests is not a reason to apply a marketability discount when valuing them.

4. A company might not be ready for sale and a marketability discount is necessary to allow time to get it ready.

Appraisers value companies as they find them. Some are ready for sale and others are not. For example, consider that one company has a large customer concentration, a significant product that is growing obsolete, and a key salesperson. It will take time to get it ready for sale. This company is clearly not "ready for sale" on optimal terms. However, an appraiser would value this company based on its expected cash flows and growth, and the risks associated with achieving them.

An otherwise similar company does not have these issues and is "ready for sale." An appraiser would value this second company based on its expected cash flows and growth, and the risks associated with achieving them.

Even assuming that near-term cash flows are identical, the expected growth in cash flows would be less, and the riskiness of cash flows would be greater, for the first company relative to the second company. The first company is clearly worth less than the second company. The difference in value, however, is not based on any "lack of marketability." The difference is caused by differences in expected cash flow, growth, and risk.

> **Author's note**: Whether companies are "ready for sale" or not, readiness is not a basis to apply marketability discounts to controlling interests. They are worth what they are worth based on the expected cash flows, growth, and risk at their valuation dates.

5. Controlling interests in companies are not liquid so we should discount them for their lack of liquidity.

Of course, controlling interests in companies are not liquid. Some appraisers suggest that controlling interests are "marketable" in that they can be sold, but they are not "liquid," since they cannot normally be sold in three days. See the response to the first rationale above. Also, see the discussion of liquidity versus marketability in the next section of this article.

> **Author's note**: Lack of liquidity is not a reason to apply marketability discounts to controlling interests in companies.

Liquidity versus Marketability

As noted, I began writing (and speaking) that there was no such thing as a "marketability discount" for controlling interests in 1994.

Chapter 19 of the sixth edition of *Valuing a Business* is titled "Discounts for Lack of Liquidity and Lack of Marketability."[19] In a section of the chapter titled "Liquidity and Marketability—Closely Related but Not the Same," an attempt is made to distinguish between "liquidity" and "marketability."[20] Comparisons are made to attempt to show a difference, but they are strained. Based on my overall analysis, I find no practical difference between the two concepts as they might relate to controlling interests in businesses. See the more detailed analysis in the third edition of *An Integrated Theory of Business Valuation*[21] and the quote from that portion of the book below.

[19] Pratt et al., *Valuing a Business,* 6th ed., 419.

[20] Ibid., 421.

[21] Z. Christopher Mercer and Travis W. Harms, *Business Valuation: An Integrated Theory*, 3rd ed. (Hoboken, NJ: John Wiley & Sons, Inc., 2020).

The sixth edition of *Valuing a Business* appears to have given up on the idea of a DLOM for controlling interests in businesses. The only references to marketability discounts for controlling interests in Chapter 19 relate to the U.S. Tax Court. There is no section in the chapter with the title of "Discounts for Lack of Marketability for Controlling Ownership Interests" as there was in the fifth edition.[22] Instead, the authors are now banking on illiquidity. The last major section of Chapter 19 is titled "Discounts for Lack of Liquidity for Controlling Ownership Interests."

There is a section titled "Illiquidity Factors Affecting Controlling Ownership Interests" that mentions five "illiquidity factors" that purportedly affect controlling interests of companies.[23] The factors are listed in items 1-5 below, followed by my comments.

1. *Uncertain time horizon to complete the offering or sale.*

The fact that, at the initiation of a sale process for a business, the time horizon to closing may be uncertain is not an "illiquidity factor." Controlling owners have control over the cash flows (i.e., the ones they want to sell) during any marketing period.

2. *Cost to prepare for and execute the offering or sale.*

The costs of selling a company are, well, costs of selling cumbersome assets like businesses. They have nothing to do with the "liquidity" of businesses. Businesses sell in the market for businesses. It is simply incorrect to attempt to compare their liquidity, whether implicitly or explicitly, with the liquidity of publicly traded securities.

3. *Risks concerning eventual sale price.*

When substantial businesses are sold, sellers attempt to get the best possible price in the market at the time the companies are marketed.[24] There is always uncertainty regarding the eventual sale price until a sale is closed. However, controlling sellers have control over the business's cash flows and assets that give rise to value to buyers during the selling period.

4. *Noncash and deferred transaction proceeds.*

Some companies sell entirely for cash. Others have cash and noncash and deferred transaction proceeds. The existence of such noncash consideration is not an "illiquidity factor." Noncash proceeds, including promissory notes, earnouts, and others are converted to their cash-equivalent values, and do not provide a reason to discount a controlling interest for lack of liquidity.

5. *Inability to hypothecate.*

Buyers and sellers in the hypothetical world of fair market value are able (financially) and willing to engage in transactions. Whether the stock of any particular company can be pledged for personal loans is not a reason to discount value for illiquidity.

As already discussed, proponents of a marketability discount for controlling interests opine that such interests are marketable (they can be sold) but illiquid (cash is not available in three days). As pointed out above, transactions often take time to close. Any consideration for a lack of marketability/liquidity is incorporated into the price of the transaction.

The next section in Chapter 19 of the sixth edition of *Valuing a Business* is titled "Benchmark for Discount for Lack of Liquidity for Controlling Interests."[25] It begins by acknowledging that the base value to which any discount is applied must be specified. In the text below, I quote the alternatives for benchmark levels of value and then respond with author's notes.

> If the appropriate standard of value is fair market value, the price ultimately expected to be reached between ***a willing buyer and a willing seller***—before the costs and risks listed above are considered—is a benchmark from which the discount for lack of liquidity could be taken (emphasis in original).

Author's note: Wait a minute. Under fair market value, "the price ultimately expected to be reached between a willing buyer and a willing seller … is a benchmark" from which to discount a control value for illiquidity? No. The price that willing buyers and sellers agree on for a business is its fair market value. It is certainly not the benchmark from which an illiquidity discount for a controlling interest should be taken.

> Other possibilities concerning the appropriate base from which an illiquidity discount on a controlling business ownership interest basis should be taken are:
>
> 1. The price one might receive in an initial or secondary public stock offering (i.e., the publicly traded equivalent value).

Author's note: The price in a potential IPO is simply irrelevant for the great majority of private businesses. Most companies will never have the size or characteristics to make them attractive public candidates. They may, nevertheless, be quite attractive companies. Further, in IPOs, normally only a small portion of companies are offered to the public. That is different than placing entire companies up for sale.

The "publicly traded equivalent value" is a hypothetical concept. Appraisers value companies at the marketable minority level, which is also called the "as-if-freely-traded" value. It is a hypothetical price at which appraisers assume a private company's shares would trade if there was a free and active market for its shares.

The as-if-freely-traded value is not a benchmark from which a discount for illiquidity for controlling interests might be taken. It is coincident with financial control value, so there is no reason to apply any discount for lack of liquidity. See the levels-of-value chart above. And see the levels-of-value charts in the sixth edition of *Valuing a Business*. As noted above, there is no such discount.

> 2. The price achievable in a private sale of the entire closely held business enterprise.

[22] Interestingly, in the previous edition of *Valuing a Business,* the DLOM for controlling interests was equated to the discount for illiquidity. See Shannon P. Pratt and Alina V. Niculita, *Valuing a Business*, 5th ed. (New York: McGraw Hill, 2008), 439.

[23] Pratt et al., *Valuing a Business,* 6th ed., 456. Interestingly, these same factors were called "Marketability Factors Affecting Controlling Interests" in Pratt's Third Edition, published in 1996 (at 250).

[24] I am not talking about "mom and pop" businesses in this article. Mercer Capital provides appraisals to companies ranging from a few million in revenues to more than a few billion in revenues. Substantial companies can generally be sold, and the more attractive they are, the easier they are to sell. But there is inherent uncertainty regarding the ultimate price. However, sellers always have the option to "buy" their companies by not selling. And they control the cash flows and business direction during any marketing period.

[25] Pratt et al., *Valuing a Business,* 6th ed., 457–458.

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Author's note: If a company achieves a price in a private sale of the entire business, that is the price and value of the business. This value does not represent a benchmark level from which an illiquidity discount for controlling interests might be taken.

3. A control transaction of a publicly funded company.

Author's note: Frankly, I am not sure what this means. But it is not a base or benchmark value from which an illiquidity discount for controlling interests might be taken.

The bottom line of this discussion is that there is no benchmark, or base value, from which a discount for illiquidity for controlling interests might be taken. Why? Because the discount does not exist.

The above quotes from the sixth edition of *Valuing a Business* reflect recognition that the specific requirements of the ASA Business Valuation Standards hold. The two most relevant standards are quoted, just to be clear:

- "A discount has no meaning until the conceptual basis underlying the base value to which it is applied is defined." (BVS-VII, Valuation Discounts and Premiums, sec. II.A.)
- "A discount or premium is warranted when characteristics affecting the value of the subject interest differ sufficiently from those inherent in the base value to which the discount or premium is applied." (BVS-VII, Valuation Discounts and Premiums, sec. II.C.)

The sixth edition of *Valuing a Business* has not shown "the conceptual basis underlying the base value to which the discount or premium is applied." And we have been shown no "characteristics affecting the value of the subject interest" that "differ sufficiently from those in the base value" to warrant a discount for illiquidity for controlling interests of companies.

The issue of liquidity versus marketability is addressed in the third edition of *An Integrated Theory of Business Valuation*:[26]

> We conclude that, on a minority interest basis, a discount for lack of liquidity is not distinct from the traditional discount for lack of marketability. If there is a discount for lack of liquidity it is precisely the same as the discount for lack of marketability. On a controlling interest basis, our analysis using the Integrated Theory reveals that there is no conceptual basis for applying a discount for lack of liquidity. When applied, they are nothing more than discounts of convenience.
>
> - If the base controlling interest value is too high, the resulting (discounted) value may, by chance, be correct.
> - If, on the other hand, the base controlling interest value is correct, the resulting (discounted) value will be understated ...

The Integrated Theory confirms that there is no conceptual basis for lack of liquidity distinct from the traditional marketability discount applied to minority interests.[27]

Conclusion

Is there a "marketability discount" for controlling interests of companies? Based on the foregoing analysis, the answer has to be "no."

For the reasons discussed in this article, there is no conceptual rationale for a discount for lack of marketability (or lack of liquidity) for controlling interests in companies. The discount does not exist. It cannot be defined in terms of differences in expected cash flows, growth, or risk between any of the conceptual levels of value.

[26] Mercer and Harms, *Business Valuation: An Integrated Theory*, 348-358, Appendix 8-A ("Liquidity and Marketability").

[27] Ibid., 358.

ABOUT THE AUTHOR

Z. Christopher Mercer, FASA, CFA, ABAR
Mercer Capital

Z. Christopher Mercer is the founder and chairman of Mercer Capital, a national business valuation and financial advisory firm that is owned and managed by its employees through the Mercer Capital ESOP. He has valued businesses in many industries for numerous purposes. He has testified at deposition or trial in more than 20 states on matters pertaining to statutory fair value, business valuation, economic damages, marital dissolution, ESOPs, and other purposes. Mr. Mercer has written numerous books and many articles on valuation and related topics, and speaks frequently at conferences of business appraisers, attorneys, accountants, financial planners, and business owners. Email: mercerc@mercercapital.com.

COMPARABILITY IS CRUCIAL FOR INFORMED INVESTMENT DECISIONS[1]

Steve Cooper

Investors require financial data that is comparable over time, comparable within a single set of financial statements, and comparable between companies. Unfortunately, this is not always the case. We explain how differences between IFRS and US GAAP, accounting policy options, differing interpretations and accounting estimates, can all reduce comparability and make financial analysis challenging.

Convergence and comparability should be a priority for the IASB and FASB. Present consultations by the IASB and FASB regarding the accounting for credit losses are a good opportunity to better align IFRS and US GAAP, and to remove the confusing disconnect between purchased and originated loans.

In our recent article "Expected Credit Losses: Beware the Day 2 Effect,"[2] we explain how the accounting for loan loss provisions leads to a lack of comparability (and we argue a lack of relevance) of the financial statements of banks. Comparability is compromised by the different approach to the accounting for originated loans compared with (some) purchased loans. However, the biggest issue for investors is the difference between the accounting under IFRS and US GAAP, with the latter producing a higher provision and an earlier expense in profit and loss.

Following the 2008 Global Financial Crisis, both the FASB and IASB developed a more forward looking 'expected credit loss' model for loan impairments. Initially the two boards worked together to produce a globally converged approach; however, for various reasons, including managing the conflicting views of different prudential regulators, a common standard never materialized. Unfortunately for investors, the present requirements differ significantly.

FASB and IASB consultations on loan impairment accounting make no mention of convergence.

Both the FASB and IASB are now consulting investors and other stakeholders about their respective loan impairment accounting standards. FASB has issued an exposure draft of a proposal to expand the use of their gross-up method (the main subject of our earlier article[3]), while the IASB has issued a more general consultation as part of their post implementation review of IFRS 9. Neither consultation mentions convergence. It is an ideal opportunity for the two boards to once more work together to try and finally produce a converged approach to loan losses and improve comparability for investors in this area.

We have written a letter addressed to both FASB and IASB in response to their respective consultations in which we urge renewed efforts to find a common approach.[4]

In this article we focus on the wider issue of comparability in financial reporting. Many investors do not appear to appreciate how often financial statement data may not be comparable, the causes of that lack of comparability, and how this can impact investment decisions.

Comparability in Financial Reporting

Comparability (or the lack of it) in financial reporting is a significant issue for investors. Whatever the type of investor or the approach to making investment decisions, financial statement data invariably plays an important part of the process. If that data is not comparable, investment decisions may be sub-optimal, with negative consequences for capital allocation in the wider economy.

Comparability of financial statement data is important for all types of investors.

The need for comparability is perhaps most obvious where investors use quantitative analysis, such as in factor investing or in initial screening before more detailed fundamental analysis. Such analysis typically focuses on headline metrics such as earnings, leverage and return on investment, with limited, if any, adjustments made to reported data. If that data is not comparable, the factors may be misrepresented[5] and the screening of limited use.

Where more detailed analysis is done, and investors delve into the financial statements in more detail, there is more opportunity to allow for accounting differences, including adjusting to produce comparable metrics. However, such adjustments can be difficult or impossible, with the allowance for accounting differences being imprecise.

The need for comparability is recognized in the IFRS and US GAAP conceptual frameworks. In the case of IFRS, the framework includes this explanation:[6]

> *… information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date. …. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items.*

[1] This article appears on the author's website, TheFootnotesAnalyst.com, https://www.footnotesanalyst.com/comparability-is-crucial-for-informed-investment-decisions/. Posted September 4, 2023.

[2] https://www.footnotesanalyst.com/expected-credit-losses-beware-the-day-2-effect/. Posted June 28, 2023.

[3] Ibid.

[4] https://www.footnotesanalyst.com/wp-content/uploads/2023/08/Credit-losses-letter-The-Footnotes-Analyst.pdf.

[5] We examined the value factor and the impact of inconsistent intangible asset accounting in our article "Intangible asset accounting and the value false negative."

[6] From the IFRS conceptual framework paragraphs 2.24 and 2.25.

Exhibit 1: Stellantis Capitalization of Development Costs

Development expenditures for vehicle production and related components, engines and production systems are recognized as an asset if all of the following conditions within IAS 38 – *Intangible assets* are met: (i) development expenditures can be measured reliably, (ii) technical feasibility of the product, projected volumes and pricing support the view that the development expenditure will generate future economic benefits and (iii) the intention to complete the intangible asset as well as the availability of adequate technical, financial and other resources for this purpose. Capitalized development expenditures include all costs that could be directly attributed to the development process. All other development expenditures are expensed as incurred.

Capitalized development expenditures are amortized on a straight-line basis from when the related asset is available for use, generally from the beginning of production, over the expected life cycle of the models (generally 5-7 years) or propulsion systems (generally 10-12 years) developed.

Source: Stellantis financial statements 2022.

Comparability refers to both the ability to make comparisons over time for a single company and the ability to compare one company with another. A further aspect of comparability is that companies should account for economically similar transactions in the same way (which is part of the problem with credit losses). If any of these aspects are compromised, so too is the understandability and usefulness of financial statements.

The challenge for investors is that while a lot of accounting data is highly comparable, this is not always the case. A lack of comparability can arise from different sources, including:

- A difference in accounting standards, such as IFRS versus US GAAP
- Options within accounting standards
- The application of judgement
- Differences in the interpretation of 'probability' or 'threshold' words
- A lack of clarity of accounting standards or lack of guidance for certain transactions
- A lack of retrospective adjustments when accounting changes

We think it is important for investors to be aware of each of these sources of a potential lack of comparability. What follows is by no means comprehensive, but we hope it will at least help alert investors to the dangers of automatically assuming data used in making investment decisions is comparable.

IFRS versus US GAAP

In many respects IFRS and US GAAP are very similar, with several IFRS standards themselves based upon earlier US GAAP pronouncements. More recently the IASB and FASB actively worked together to reduce differences or, when working on new standards such as revenue recognition, to issue the same requirements. Unfortunately, the boards are no longer engaged in active convergence, and we have seen some more recent examples of new differences emerging where previously the requirements were the same.

At a detailed level there are many differences between IFRS and US GAAP. A useful summary of these, which we often recommend to investors, is provided by Ernst & Young in "US GAAP versus IFRS - The Basics." [7] In specific cases any one of these could be material, although most of the time they do not 'move the dial' for investors for the vast majority of companies. However, there are several areas where the differences have more widespread effects. Here are some examples:

Intangible assets

While the IFRS and US GAAP accounting for purchased intangibles, including those purchased as part of a business combination, is essentially the same, intangibles that are internally generated are treated quite differently. Under US GAAP any expenditure on research and development must be immediately expensed, whereas, under IFRS, expenditure on 'development' must be capitalized. IFRS capitalization is subject to several criteria, but for many companies it results in the recognition of a significant asset, that would not appear in balance sheets under US GAAP. This capitalization versus expensing also has an impact on the timing of the recognition of the related expense.

A good example is provided by the automobile industry. IFRS reporter Stellantis capitalizes development expenses, as explained in their accounting policy note in Exhibit 1. This has a material impact on both balance sheet, income statement and performance metrics.

The balance sheet amount of previously capitalized expenditure less accumulated amortization is €15.7bn, which represents about 22% of shareholders' equity. The amount capitalized in 2022 was €3.1bn whereas the amortization of previously capitalized amounts in the same year is €1.6bn, a net benefit of €1.7bn, or about 9% of reported pre-tax profit, compared with a policy of immediately expensing development costs that is applied by US GAAP reporters.

For more about intangible asset accounting, and how the inconsistent and limited recognition of intangibles affects return on capital, see our article, "Missing intangibles distorts return on capital."[8]

Lease accounting

From 2019 both IFRS and US GAAP were changed to require the recognition of (almost) all leases as a liability and a corresponding right-of-use asset in the balance sheet. While there are some

[7] https://www.ey.com/en_us/assurance/accountinglink/us-gaap-versus-ifrs--the-basics-february-2023.

[8] https://www.footnotesanalyst.com/missing-intangible-assets-distorts-return-on-capital/.

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differences in liability[9] and particularly right-of-use asset measurement, the balance sheet is reasonably comparable. However, the same cannot be said for the income statement, where for many leases US GAAP does not separate the interest and depreciation components of the lease expense. This has a significant impact on key performance metrics such as EBITDA and EBIT.

We discussed these differences in "Operating leases: You may still need to adjust," and show the numerical impact in "Interactive model: Convert US lease accounting to IFRS."[10]

Pension liabilities

Like lease accounting, the balance sheet impact of defined benefit pension liabilities of IFRS and US GAAP reporters are reasonably consistent, with the comparability issue once again affecting performance metrics.

One difference is the treatment of actuarial gains and losses (the effects of remeasuring pension assets and liabilities to current values at each balance sheet date). In both systems these are generally reported outside profit and loss in other comprehensive income. However, only in the case of US GAAP is the effect 'recycled' to profit and loss in subsequent periods. US GAAP also provides an option to report these items in profit and loss in the period the remeasurement occurs, which is not available in IFRS. (Although, because this item is generally omitted from non-GAAP metrics, the adverse impact on comparability is arguably reduced.)

A more important and often overlooked effect is how the pension financial income and expense is calculated. IFRS calculates an interest amount based on the net surplus or deficit whereas US GAAP incorporates a separate expected return on pension assets. The latter produces a more favourable profit and loss effect, with the impact being material for many companies with significant pension schemes.

We examined the impact of IFRS and US GAAP on apparent pension leverage in our article "Pension leverage under IFRS and US GAAP."[11]

Operating cash flow

Some differences between IFRS and US GAAP are presentational, but these are no less annoying for investors. A good example is in the cash flow statement.

Both IFRS and US GAAP present cash flows in operating, investing, and financing categories, and reconcile to a bottom line of the change in cash and cash equivalents; but how these categories are defined when using the indirect format is different. Under US GAAP the operating category includes the cash flow effects of all gains and losses reported in net income, whereas under IFRS it is common for operating cash flow to be the cash flow equivalent of operating profit, with non-operating items reported as investing or financing cash flows. IFRS companies do presently have the option to use the US approach, but this will come to an end when the soon-to-be released IFRS Primary Financial Statements standard becomes effective — another example of IFRS and US GAAP further diverging (although we support the changes being made by the IASB).

Options in Accounting Standards

Some accounting standards give companies the option to select from different accounting methods. This could be a difference in measurement, when gains and losses are recognized, or in presentation. We have the impression that IFRS has more options than US GAAP. Some options in IFRS exist because when international standards were first developed there was an attempt to accommodate the different approaches of some jurisdictions. Subsequently accounting options were often

[9] One such difference concerns leases where payments are indexed to inflation — see our article, "Beware the IFRS 16 inflation headwind," https://www.footnotesanalyst.com/beware-the-ifrs-16-inflation-headwind/.

[10] https://www.footnotesanalyst.com/leases-you-may-still-need-to-adjust/; https://www.footnotesanalyst.com/interactive-model-convert-us-lease-accounting-to-ifrs/.

[11] https://www.footnotesanalyst.com/pension-leverage-under-ifrs-and-us-gaap/.

Exhibit 2: Rolls Royce Hedge Accounting Disclosure

Financial instruments – Hedge accounting

Forward foreign exchange contracts and commodity swaps (derivative financial instruments) are held to manage the cash flow exposures of forecast transactions denominated in foreign currencies or in commodities respectively. Derivative financial instruments qualify for hedge accounting when: (i) there is a formal designation and documentation of the hedging relationship and the Group's risk management objective and strategy for undertaking the hedge at the inception of the hedge; and (ii) the hedge is expected to be effective.

In general, the Group has chosen to not apply hedge accounting in respect of these exposures.

The Group economically hedges the fair value and cash flow exposures of its borrowings. Cross-currency interest rate swaps are held to manage the fair value or cash flow exposures of borrowings denominated in foreign currencies and are designated as fair value hedges or cash flow hedges as appropriate. Interest rate swaps are held to manage the interest rate exposures of fixed and floating rate borrowings and may be designated as fair value hedges or cash flow hedges as appropriate. If the swaps are not designated as fair value or cash flow hedges, the economic effect is included in the underlying results – see note 2.

Changes in the fair values of derivatives that are designated as fair value hedges are recognised directly in the income statement. The fair value changes of effective cash flow hedge derivatives are recognised in OCI and subsequently recycled to the income statement in the same period or periods during which the hedged cash flows affect profit or loss. Any ineffectiveness in the hedging relationship is included in the income statement.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated, exercised, or no longer qualifies for hedge accounting. At that time, for cash flow hedges and, if the forecast transaction remains probable, any net cumulative gain or loss on the hedging instrument recognised in SOCIE is retained until the forecast transaction occurs. If a hedged transaction is no longer expected to occur, the net cumulative gain or loss is recycled to the income statement.

Source: Rolls Royce 2022 financial statements.

provided to try and manage the very different views (often around the use of cost versus fair value measurement) of different constituents.

Hedge accounting is optional under both IFRS and US GAAP.

One option that appears in both IFRS and US GAAP (and which may surprise investors) relates to hedge accounting. When companies use derivatives to hedge risks (including those related to currency fluctuations, commodity price changes and interest rates) recognition and measurement mismatches can arise. For example, the use of currency swaps to hedge the currency exposure in forecast revenues results in the fair value changes of the swaps being reported in profit and loss (if hedge accounting is not applied) while no gains and losses are reported in respect of the yet to be recognized revenues.

Hedge accounting is the process of adjusting the accounting to eliminate these mismatches — in this case by applying cash flow hedging and deferring the gains and losses for the currency swaps in other comprehensive income. However, the application of hedge accounting is optional. The accounting policy note in Exhibit 2 (on the previous page) shows that IFRS reporter Rolls Royce applies hedge accounting to some transactions but not ("in general") to the currency exposure for forecast purchases and sales – the example we describe above.

The application of hedge accounting by some companies, and not others, and its application to some hedges and not others by individual companies, is confusing and impairs comparability. In the case of Rolls Royce, this lack of comparability is mitigated through their non-GAAP metrics where they adjust for the effect of their hedges. However, these adjustments are company specific and themselves may not be comparable with similar non-GAAP metrics provided by others that do not apply hedge accounting, or those companies that elect to apply hedge accounting as specified in IFRS 9.[12]

The application of judgement

Investors often seem surprised by the amount of judgement that is required to produce financial statements. While much of accounting is a process of recording past transactions, many aspects of this require judgement, including how gains and losses are classified and allocated to the appropriate accounting periods. Furthermore, the measurement of assets and liabilities often involves more than a simple calculation of the transaction amount, with remeasurement at current values necessary to provide relevant metrics.

Many disclosures in financial statements are designed to inform investors about how judgements are made and of the key measurement inputs used. It is always worth noting the assumptions used to measure significant items in financial statements.

[12] There is a further option in IFRS accounting where companies can elect to apply the hedge accounting requirements specified either in IFRS 9, the most recent standard on accounting for financial instruments, or the previous requirements in IAS 39. The difference is unlikely to be material in most cases but nevertheless allowing two approaches seems unnecessary and inevitably confusing for investors.

Interpretation of Probability and Threshold Words

Some accounting standards differentiate between different accounting methods based on threshold terms that refer to either the probability of an event occurring or significance of an item. The number of such terms is surprisingly large and includes: substantially all, probable, highly probable, significant, insignificant, more than insignificant, and reasonably certain.

The problem is that most of these terms do not have a clear definition for the purpose of financial reporting. The exception is the use of 'probable' in IFRS, which means more likely than not (i.e., a greater than 50% probability). Unfortunately, the same term has a different, and less precise, meaning in US GAAP where it represents a higher level of probability, which is confusingly closer to the use of 'highly probable' in IFRS.

Loan impairment standards have thresholds that may be interpreted differently.

Loan impairments provide a good example of the impact of threshold terms. Under IFRS the switch from a 12-month loan loss allowance to a full lifetime allowance takes place when there has been a significant increase in credit risk compared with the credit risk on the date the loan was originated. Because the word 'significant' is not defined by IFRS, it is left to companies to identify exactly how they implement the requirement based on their own internal systems and how they measure credit risk. Inevitably, the way this 'significant' test is applied will differ and lead to a lack of comparability.

The US GAAP approach to loan impairments does not feature the same 'significant' test given that a lifetime allowance applies in all cases. However, a different threshold test applies to determine whether the gross-up method or the normal CECL lifetime loss approach is used for purchased loans. The gross-up method applies if there has been a 'more than insignificant' increase in credit risk since origination. The proposed change to US GAAP we explained in our last article[13] would remove this threshold, although it introduces a different (and, in our view, still artificial) divide in distinguishing between originated and purchased loans and a new threshold of "seasoned."[14]

Exhibit 3 on the next page shows how IFRS reporter Ping An describe the 'significant increase in credit risk' threshold, followed by their explanation about the judgements that are necessary to establish their provision for credit losses. Reading the extract in Exhibit 3, the extent of management discretion over how threshold terms are interpreted may appear to be so great that it is difficult to see how any financial data can be comparable. However, in practice, the application of these thresholds may not produce as many comparability problems for investors as you might expect. Practice develops in financial reporting and the global coordination of auditing and securities regulation serves to produce generally accepted approaches to the implementation of seemingly vague requirements of accounting standards. However, if it appears that the approaches

[13] https://www.footnotesanalyst.com/expected-credit-losses-beware-the-day-2-effect/.

[14] 'Seasoned' refers to the time between origination of a loan and its subsequent purchase by another company.

Continued from p.43

Exhibit 3: Ping An — Credit Risk and Critical Accounting Estimates Footnotes Extracts

Judgement of significant increase in credit risk ("SICR")

Under IFRS 9, when considering the impairment stages for financial assets, the Group evaluates the credit risk at initial recognition and also whether there is any significant increase in credit risk for each reporting period. The Group considers various reasonable supporting information to judge if there is significant increase in credit risk, including the forward-looking information, when determining the ECL staging for financial assets, Major factor being considered include regulatory and operating environment, internal and external credit ratings, solvency, and operational capabilities. The Group could base on individual financial instruments or portfolios of financial instruments with similar credit risk characteristics to determine ECL staging by comparing the credit risks of the financial instruments at the reporting date with initial recognition.

The Group set quantitative and qualitative criteria to judge whether the credit risk has SICR after initial recognition. The judgement criteria mainly include the PD changes of the debtors, changes of credit risk categories and other indicators of SICR, etc. In the judgement of whether the financial instruments have SICR after initial recognition, the Group considers the 30 days past due as one of criteria of SICR, in accordance with the standard.

(3) MEASUREMENT OF THE EXPECTED CREDIT LOSSES

The measurement of the expected credit losses for financial assets measured at amortized cost and FVOCI is an area that requires the use of complex models and significant assumptions about future economic conditions and credit behaviour. Explanation of the inputs, assumptions and estimation techniques used in measuring ECL is further detailed in Note 53.

A number of significant judgements are also required in applying the accounting requirements for measuring ECL, such as:

- Determining criteria for significant increase in credit risk;
- Choosing appropriate models and assumptions for the measurement of ECL;
- Establishing the number and relative weightings of forward-looking scenarios for each type of product and the associated ECL; and
- Establishing groups of similar financial assets for the purposes of measuring ECL.

Source: Ping An financial statements 2022

adopted by companies in dealing with thresholds seem to differ, then you may find it worth asking questions.

A Lack of Clear Guidance or Different Interpretations of Accounting Standards

Although accounting standards cover most transactions, there are situations for which there is no specific guidance. Companies must then resort to developing an accounting policy based on their interpretation of the conceptual framework or by analogizing to other accounting standards. Even where standards do exist, sometimes they may be unclear or incomplete. In these situations, there is further potential for a lack of comparability. Practice tends to gravitate towards a common approach and additionally the FASB and IASB have interpretation committees that help to reduce any diversity in practice. Nevertheless, differences remain, and investors may well be impacted.

We highlighted a good example of this in our article "When investors need to restate liabilities,"[15] in which we discussed the discount rate used to measure long-term non-financial liabilities under IFRS, such as environmental or decommissioning provisions. In IAS 37 there is a reference to allowing for risk in determining the discount rate. There is, however, no clear explanation of what risk this is and whether it should include credit risk applicable to the liability. We understand that practice varies in this case.

The lack of clarity in IAS 37 is presently being considered by the IASB and hopefully should be fixed soon.

A Lack of Retrospective Adjustment When Accounting Changes

When a company changes the accounting methods it uses, such as when a new accounting standard is first applied, the revised approach is generally applied retrospectively with assets and liabilities restated as though the new accounting had always been applied. Comparability is further enhanced by the restatement of the prior period results so that these are also based on the same accounting methods.

Unfortunately, this 'fully retrospective' approach is not always applied, often due to concerns about the cost or difficulty for companies to prepare the information. Any alternative approach (which should be clearly explained in the footnotes) has potential to impair comparability.

Historical restatement never extends beyond the one comparative period. Historical trends over several periods are often used in equity analysis and inevitably a discontinuity will arise when accounting practices change. Investors need to be careful when using growth rates or in making historical comparisons of metrics such as profit margins or leverage.

Exhibit 4 presents an extract from the 5-year historical summary published by UK retailer Tesco which includes two discontinuities. In 2021 the company changed their accounting policy regarding property buybacks — there is no indication of whether this

[15] https://www.footnotesanalyst.com/when-investors-need-to-restate-liabilities-edf/.

Exhibit 4: Tesco 5-year Historical Summary Extract, 2018-2022

	2018[a]	2019	2020[b]	2021 (restated[c])	2022
Other financial statistics					
Diluted earnings/(losses) per share – continuing operations	12.11p	13.04p	7.54p	5.58p	19.64p
Adjusted diluted earnings per share (adjusted for share consolidation)Δ[d][e]	11.90p	14.01p	18.98p	11.58p	21.86p
Dividend per share[f]	3.00p	5.77p	9.15p	9.15p	10.90p
Cash generated from retail operating activities (£m)Δ	2,773	3,637	3,580	321	3,614
Retail free cash flow (£m)Δ	1,388	889	1,493	1,340	2,277
Return on capital employed (ROCE)[d]	11.0%	7.9%	6.1%	5.4%	7.8%
Total shareholder return[d]	8.7%	10.2%	5.2%	2.6%	32.4%
Net debt (£m)Δ[d]	2,625	13,204	12,298	11,955	10,516
Discounted operating lease commitments – continuing operations	6,931	–	–	–	–
Pension deficit, net of deferred tax – Group (£m)	2,728	2,338	2,573	1,004	242
Total indebtedness (£m)[d]	**12,284**	**15,542**	**14,871**	**12,959**	**10,758**
Enterprise value (£m)[d]	19,452	35,024	34,676	29,336	32,403

Source: Tesco financial statements 2022.

significantly affects comparability. The second discontinuity occurred in 2019, from when the company applied IFRS 16 to capitalize most operating leases that were previously off balance sheet.

The change in lease accounting is the primary reason for a significant increase in net debt from 2018 to 2019. Most companies would have simply noted that the change has taken place, to warn investors; Tesco helpfully went further. The company provides a separate disclosure of "*Discounted operating lease commitments*" in 2018. This is not exactly what the additional capitalized leases would have been had they applied IFRS 16 to that period, but it should be a reasonable proxy. This amount is included in their measure of "*Total indebtedness*" which does appear to be more comparable over time.

Conclusion: Insights for Investors

- **Do not assume that financial statement data is always comparable, even if companies report under the same accounting standards.**
- **There are multiple differences between IFRS and US GAAP. Most will not materially affect investment decisions, but some have a more significant and widespread impact. Look out for differences in the accounting for intangible assets, leases and pension liabilities.**
- **Companies are sometimes able to choose between alternative accounting approaches, including differences in presentation and measurement.**
- **Financial statements depend on estimates and judgements. Where the effect could be significant, make sure you check the footnote disclosures to identify any potential comparability issues.**
- **Be careful when analyzing bank financial statements – allowances for credit losses are not comparable due to the difference between the accounting for purchased and originated loans, and because of the differences between IFRS and US GAAP.**

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.

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MARKET BIPOLARITY: EXUBERANCE VERSUS EXHAUSTION

Aswath Damodaran

As we enter the last quarter of 2023, it has been a roller coaster of a year. We started the year with significant uncertainty about whether the surge in inflation seen in 2022 would persist as well as about whether the economy was headed into a recession. In the first half of the year, we had positive surprises on both fronts, as inflation dropped after than expected and the economy stayed resilient, allowing for a comeback on stocks, which I wrote about in a post in July 2023.[1] That recovery notwithstanding, uncertainties about inflation and the economy remained unresolved, and those uncertainties became part of the market story in the third quarter of 2023. In July and the first half of August of 2023, it looked like the market consensus was solidifying around a soft-landing story, with no recession and inflation under control, but that narrative developed cracks in the second half of the quarter, with markets giving back gains. In this post, I will look at how markets did during the third quarter of 2023 and use that performance as the basis for examining risk capital's presence (or absence) in markets.

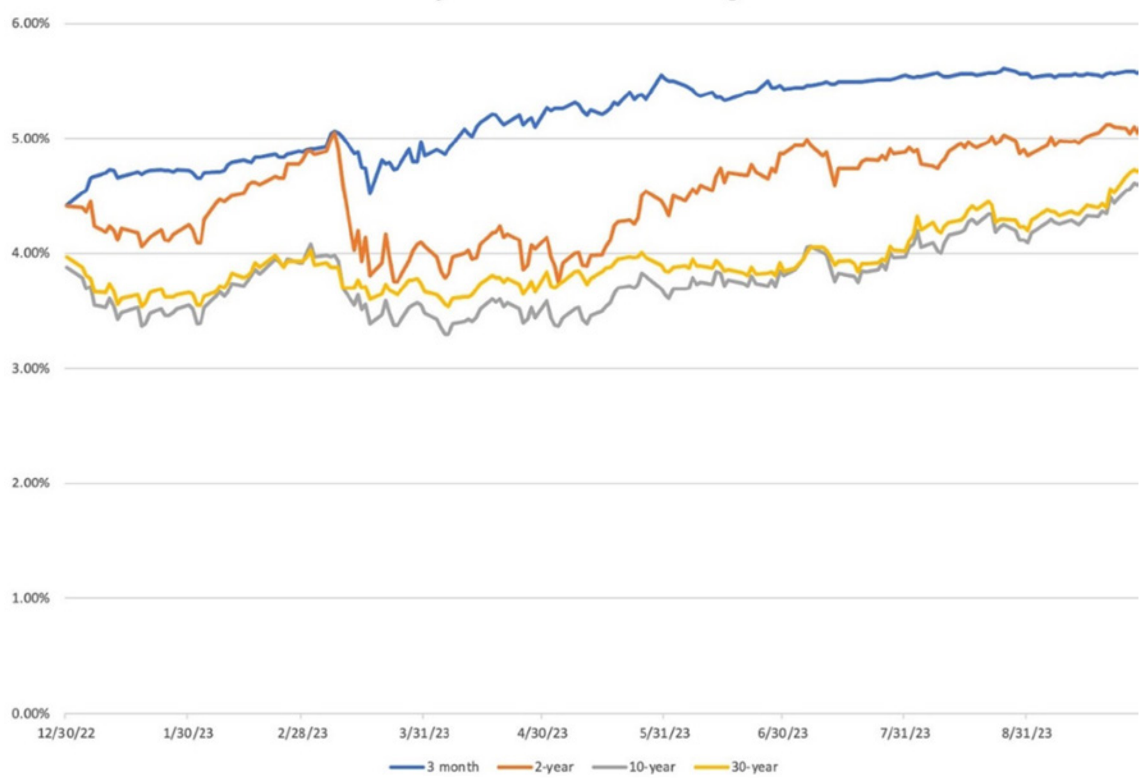
[1] https://aswathdamodaran.blogspot.com/2023/07/market-resilience-or-investors-in.html

The Markets in the Third Quarter

Coming off a year of rising rates in 2022, interest rates have continued to command center stage in 2023. While the rise in treasury rates has been less dramatic this year, rates have continued to rise across the term structure. See Exhibit 1.

While short term rates rose sharply in the first half of the year, and long term rates stabilized, the third quarter has seen a reversal, with short term rates now stabilizing and long term rates rising. At the start of October, the ten-year and thirty-year rates were both approaching 15-year highs, with the 10-year treasury at 4.59% and the 30-year treasury rate at 4.73%. As a consequence, the yield curve which has been downward sloping for all of the last year, became less so, which may have significance for those who view this metric as an impeccable predictor of recessions, but I am not one of those.

Exhibit 1: U.S. Treasury Rates in 2023



	3 month	2-year	10-year	30-year
Start of 2023	4.42%	4.41%	3.88%	3.97%
6/30/23	5.43%	4.87%	3.81%	3.85%
9/30/23	5.55%	5.03%	4.59%	4.73%
Change YTD	1.13%	0.62%	0.71%	0.76%
Change 3Q 2023	0.12%	0.16%	0.78%	0.88%

Source: US Treasury

Continued from p.47

Moving on to stocks, the strength that stocks exhibited in the first half of this year continued for the first few weeks of the third quarter, with stocks peaking in mid-August, but giving back all of those gains and more in the last few weeks of the third quarter of 2023. See Exhibit 2

As you can see, it has been a divergent market, looking at performance during 2023. In spite of losing 3.65% of their value in the third quarter of 2023, large cap stocks are still ahead 12.13% for the year, but small cap stocks are now back to where they were at the start of 2023. The NASDAQ also gave back gains in the third quarter, but is up 27.27% for the year, but those gaudy numbers obscure a sobering reality. Seven companies (NVIDIA, Apple, Microsoft, Alphabet, Meta, Amazon and Tesla) account for $3.7 trillion of the increase in market cap in 2023 and removing them from the S&P 500 and NASDAQ removes much of the increase in value you see in both indices.

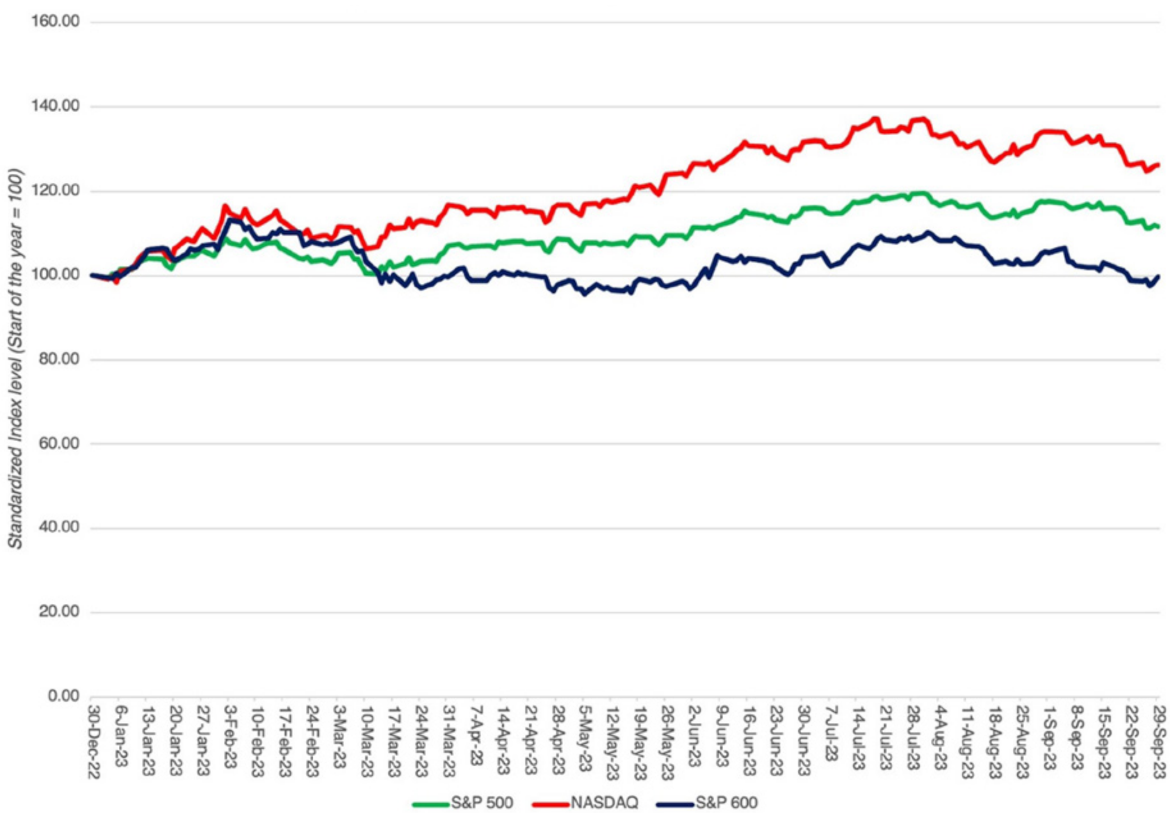
Breaking global equities down by sector, and looking at the changes in 2023, both for the entire year as well as just the third quarter, we arrive at the graph in Exhibit 3 on the next page.

In keeping with our findings from contrasting the NASDAQ to other U.S. indices, technology has been the best performing sector for 2023, followed by consumer discretionary and communication services. However, also in keeping with our findings on divergence across stocks, five of the eleven sectors have decreased in value in 2023, with real estate and utilities the worst performing sectors. Some of these differences across sectors reflect reversals from the damage done in 2022, but some of it is reflective of the disparate impact of inflation and higher rates across companies.

Finally. I looked at global equities, broken down by region of the world, and in U.S. dollars, to allow for direct comparison. See Exhibit 4 on the next page.

India is the only part of the world to post positive returns, in U.S. dollar terms, in the third quarter, and is the best performing

Exhibit 2: U.S. Equities in 2023: S&P 500, NASDAQ and S&P 600



	S&P 500	NASDAQ	S&P 600
Start of 2023	3,824.14	10,386.98	1,157.53
30-Jun-23	4,450.38	13,787.92	1,214.95
30-Sep-23	4,288.05	13,219.32	1,159.12
% Change YTD	12.13%	27.27%	0.14%
% Change 3rd Qtr 2023	-3.65%	-4.12%	-4.60%

Exhibit 3: Global Equities by Sector – Changes in 2023

		Market Capitalization			% Change	
Region	*# firms*	*12/31/22*	*6/30/23*	*9/30/23*	*YTD 2023*	*3rd Qtr, 2023*
Communication Services	2,269	$6,120,550	$7,272,081	$7,153,001	16.87%	-1.64%
Consumer Discretionary	6,214	$10,470,170	$12,356,619	$11,657,740	11.34%	-5.66%
Consumer Staples	3,102	$8,074,260	$8,119,029	$7,631,823	-5.48%	-6.00%
Energy	1,483	$5,017,895	$4,934,892	$5,337,081	6.36%	8.15%
Financials	16,263	$30,005,187	$32,348,146	$31,454,703	4.83%	-2.76%
Health Care	4,662	$10,819,550	$10,794,080	$10,270,314	-5.08%	-4.85%
Industrials	8,502	$12,495,038	$13,616,550	$12,801,553	2.45%	-5.99%
Information Technology	6,175	$14,195,512	$18,985,420	$17,670,013	24.48%	-6.93%
Materials	6,310	$6,110,719	$6,162,273	$5,913,367	-3.23%	-4.04%
Real Estate	2,835	$3,342,594	$3,268,743	$3,046,644	-8.85%	-6.79%
Utilities	930	$3,448,774	$3,453,462	$3,164,003	-8.26%	-8.38%
All firms	58,919	$110,723,948	$122,044,758	$116,109,321	4.86%	-4.86%

market of the year, running just ahead of the U.S.; note again that of the $5.2 trillion increase in value U.S. equities, the seven companies that we listed earlier accounted for $3.7 billion. Latin America had a brutal third quarter, and is the worst performing region in the world, for the year-to-date, followed by China. If you are an equity investor, your portfolio standing at this point of 2023 and your returns for the year will be largely determined by whether you had any money invested in the "soaring seven" stocks, as well as the sector and regional skews in your investments.

Price of Risk

The drop in stock and bond prices in the third quarter of 2023 can partly be attributed to rising interest rates, but how much of that drop is due to the price of risk changing? Put simply, higher risk premiums translate into lower asset prices, and it is conceivable that political and macroeconomic factors have contributed to more risk in markets. To answer this question, I started with the corporate bond market, where default spreads capture the price of risk, and looked at the movement of default spreads across ratings classes in 2023. See Exhibit 5 on the next page.

As you can see, bond default spreads, after surging in 2022, had a quiet third quarter, decreasing slightly across all ratings classes. Looking across the year to date, there has been little movement in the higher ratings classes, but default spreads have dropped substantially during 2023, for lower rated bonds.

In the equity market, I fall back on my estimates of implied equity risk premiums, which I report at the start of every month on my website,[2] and you can see the path that these premiums have taken during the course of the last two years. See Exhibit 6 on the next page.

The equity risk premium declined in the first half of the year, from 5.94% on January 1, 2023, to 5.00% on July 1, 2023, but has been relatively stable in the third quarter, albeit on top of higher risk free rates. Thus, the equity risk premium of 4.84% on October 1, 2023, when added to the ten-year T.Bond rate of 4.58% on that day yields an expected return on equity of 9.42%, up from 8.81% on July 1, 2023. Put simply, notwithstanding the ups and downs in stock prices and interest rates in the third quarter of 2023, there is little evidence that changes in the pricing of risk had much to do with the volatility. Much of the change in stock and corporate bond prices in the third quarter has come from rising interest rates, not a heightened fear factor.

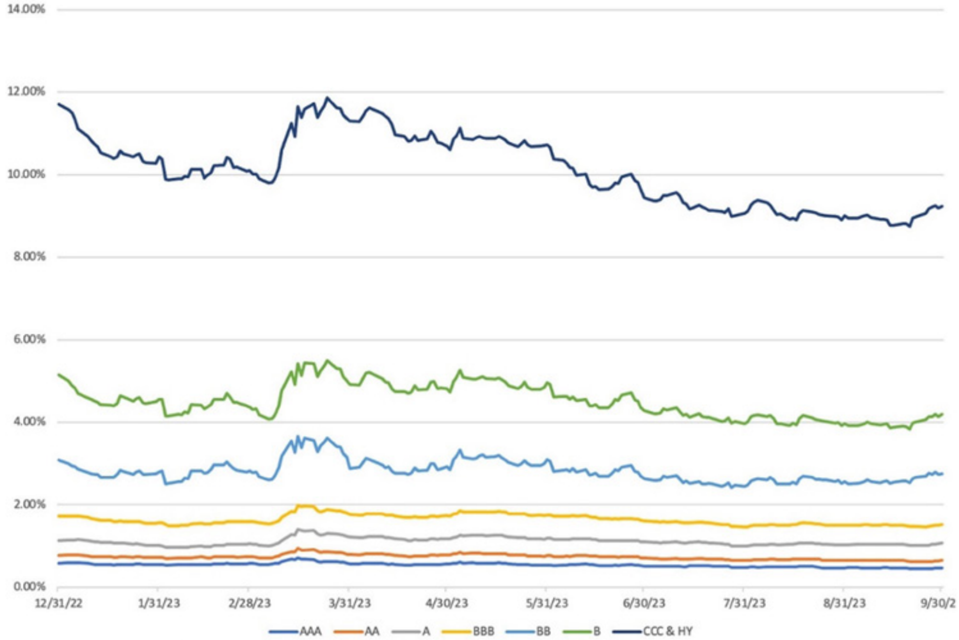
[2] https://pages.stern.nyu.edu/~adamodar/New_Home_Page/home.htm.

Exhibit 4: Global Equities Market Cap by Region for 2023

		Market Capitalization			% Change	
Region	*# firms*	*12/31/22*	*6/30/23*	*9/30/23*	*YTD 2023*	*3rd Qtr, 2023*
Africa and Middle East	2,526	$2,084,457	$2,118,458	$2,105,687	1.02%	-0.60%
Australia & NZ	2,107	$1,734,020	$1,810,285	$1,665,552	-3.95%	-8.00%
Canada	3,676	$2,770,954	$2,984,515	$2,831,301	2.18%	-5.13%
China	6,227	$13,300,060	$13,362,743	$12,653,114	-4.86%	-5.31%
EU & Environs	9,305	$15,054,014	$16,815,892	$15,623,110	3.78%	-7.09%
Eastern Europe & Russia	443	$172,671	$180,034	$176,778	2.38%	-1.81%
India	4,130	$3,397,829	$3,604,039	$3,796,950	11.75%	5.35%
Japan	4,182	$5,741,069	$6,271,169	$6,093,757	6.14%	-2.83%
Latin America & Caribbean	4,383	$6,818,739	$7,198,899	$6,052,258	-11.24%	-15.93%
Small Asia	9,966	$5,830,732	$6,310,887	$6,061,422	3.96%	-3.95%
UK	1,491	$2,904,825	$3,036,120	$2,878,425	-0.91%	-5.19%
United States	10,410	$50,911,295	$58,347,041	$56,167,271	10.32%	-3.74%
All firms	58,919	$110,723,948	$122,044,758	$116,109,321	4.86%	-4.86%

Continued from p.49

Exhibit 5: Corporate Default Spreads in 2023



	AAA	AA	A	BBB	BB	B	CCC & HY
Start of 2023	0.58%	0.77%	1.14%	1.72%	3.08%	5.15%	11.70%
6/30/23	0.51%	0.71%	1.10%	1.61%	2.64%	4.28%	9.43%
9/30/23	0.47%	0.65%	1.07%	1.53%	2.75%	4.19%	9.23%
YTD Change	-0.11%	-0.12%	-0.07%	-0.19%	-0.33%	-0.96%	-2.47%
3Q 2023 Change	-0.04%	-0.06%	-0.03%	-0.08%	0.11%	-0.09%	-0.20%

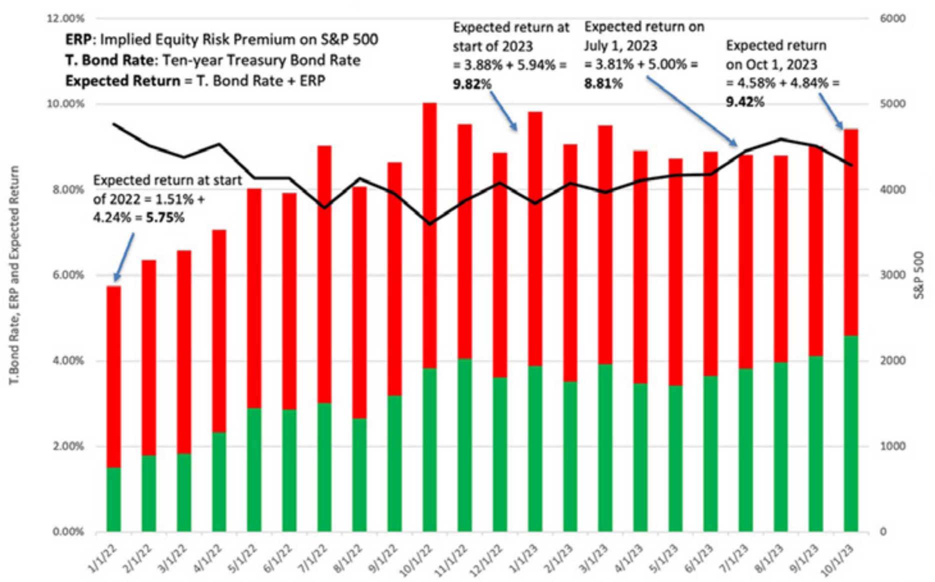
Risk Capital

In a post in the middle of 2022,[3] I noted a dramatic shift in risk capital, i.e., the capital invested in the riskiest investments in every asset class — young, money-losing stocks in equities, high-yield bonds in the corporate bond market and seed capital, in venture capital. After a decade of excess, where risk capital was not just abundant, but overly so, risk capital retreated to the sidelines, creating ripple effects in private and public equity markets. In making that case, I drew on three metrics for measuring risk capital — the number of initial public offerings, the amount of venture capital investment and original issuances of high yield bonds — and I decided that it is time to revisit those metrics, to see if risk capital is finding its way back into markets.

With IPOs, there have been positive developments in recent weeks, with a few high-profile IPOs (Instacart, ARM and Klaviyo) hitting the market, suggesting a loosening up of risk capital. To

[3] https://aswathdamodaran.blogspot.com/2022/07/risk-capital-and-markets-temporary.html.

Exhibit 6: The S&P 500, ERP and T.Bond Rate in 2022 and 2023



	1/1/22	2/1/22	3/1/22	4/1/22	5/1/22	6/1/22	7/1/22	8/1/22	9/1/22	10/1/22	11/1/22
ERP (T12m)	4.24%	4.56%	4.75%	4.73%	5.14%	5.07%	6.01%	5.42%	5.45%	6.21%	5.48%
T.Bond Rate	1.51%	1.79%	1.83%	2.33%	2.89%	2.86%	3.02%	2.65%	3.19%	3.82%	4.05%
S&P 500	4766	4515	4374	4530	4132	4132	3785	4130	3955	3596	3872

	12/1/22	1/1/23	2/1/23	3/1/23	4/1/23	5/1/23	6/1/23	7/1/23	8/1/23	9/1/23	10/1/23
ERP (T12m)	5.26%	5.94%	5.54%	5.58%	5.44%	5.30%	5.25%	5.00%	4.83%	4.90%	4.84%
T.Bond Rate	3.61%	3.88%	3.52%	3.92%	3.47%	3.42%	3.64%	3.81%	3.97%	4.11%	4.58%
S&P 500	4080	3840	4077	3970	4109	4169	4180	4450	4589	4508	4288

get a broader perspective, though, I took a look at the number of IPOs, as well as proceeds raised, in 2023, with the intent of detecting shifts. See Exhibit 7.

The good news is that there has been some recovery from the last quarter of 2022, where there were almost no IPOs, but the bad news (for those in the IPO ecosystem) is that this is still a stilted recovery, with numbers well below what we observed for much of the last decade. In addition, it should be noted that the companies that have gone public in the last few weeks have had rough going, post-issuance, in spite of being priced conservatively (relative to what they would have been priced at two years ago).

Turning to venture capital financing, we look at both the dollar value of venture capital investing, as well as the breakdown into angel, early-stage and late-stage funding. See Exhibit 8. The drop off in venture capital investing that we saw in the second half of 2022 has clearly continued into 2023, with the second quarter funding down from the first. I have long argued that venture capital pricing is tied to IPO and young company pricing in public markets, and given that those are still languishing, venture capital is holding back. In short, if you are a venture capitalist or a company founder, battered by down rounds and withheld capital, the end is not in sight yet.

Finally, companies that have ratings below investment grade need access to risk capital to make original issuances of bonds. In Exhibit 9 (see next page), I look at corporate bond issuances in 2023. The good news is that corporations are back to issuing bonds, perhaps recognizing that waiting for rates to come down is futile. However, the portion of these issuances that are high-yield bonds has stayed low for the last six quarters, suggesting that the market for these bonds is still sluggish.

Looking across the risk capital metrics, notwithstanding the recovery we have seen in equities this year, it looks like risk capital is still on the sidelines, perhaps because that recovery is concentrated in large and money-making companies. Until you start to see stock market gains widen and include smaller, money-losing companies, it is unlikely that we will see bounce backs in the venture capital and high-yield bond markets. Even when that recovery comes, I believe that we will not return to the excesses of the last decade, and that is, in my view, a good development.

What Now?

Entering the last quarter of 2023, it is striking how little the terrain has shifted over the last nine months. The two big uncertainties that I highlighted at the start of the year — whether inflation would persist or subside and whether there would be a recession — remain unresolved. If anything, the failed prognostications of economists and market gurus on both of these macro questions has left us with even less faith in their forecasts, and more adrift about what's coming down the pike. On the economy, the consensus view at the start of 2023 was that we were heading into a recession, with the only questions being when it would kick in, and how deep it would be. One reason for market outperformance this year has been the performance of the economy, which has managed to not only avoid a recession but also deliver strong employment numbers (Exhibit 10, p. 53).

It is true that if you squint at this graph long enough, you may see signs of slowing down, but there are few indicators of a recession. This data may explain why economists have become

Exhibit 7: IPOs by Quarter: 2018 Q2 – 2023 Q3*

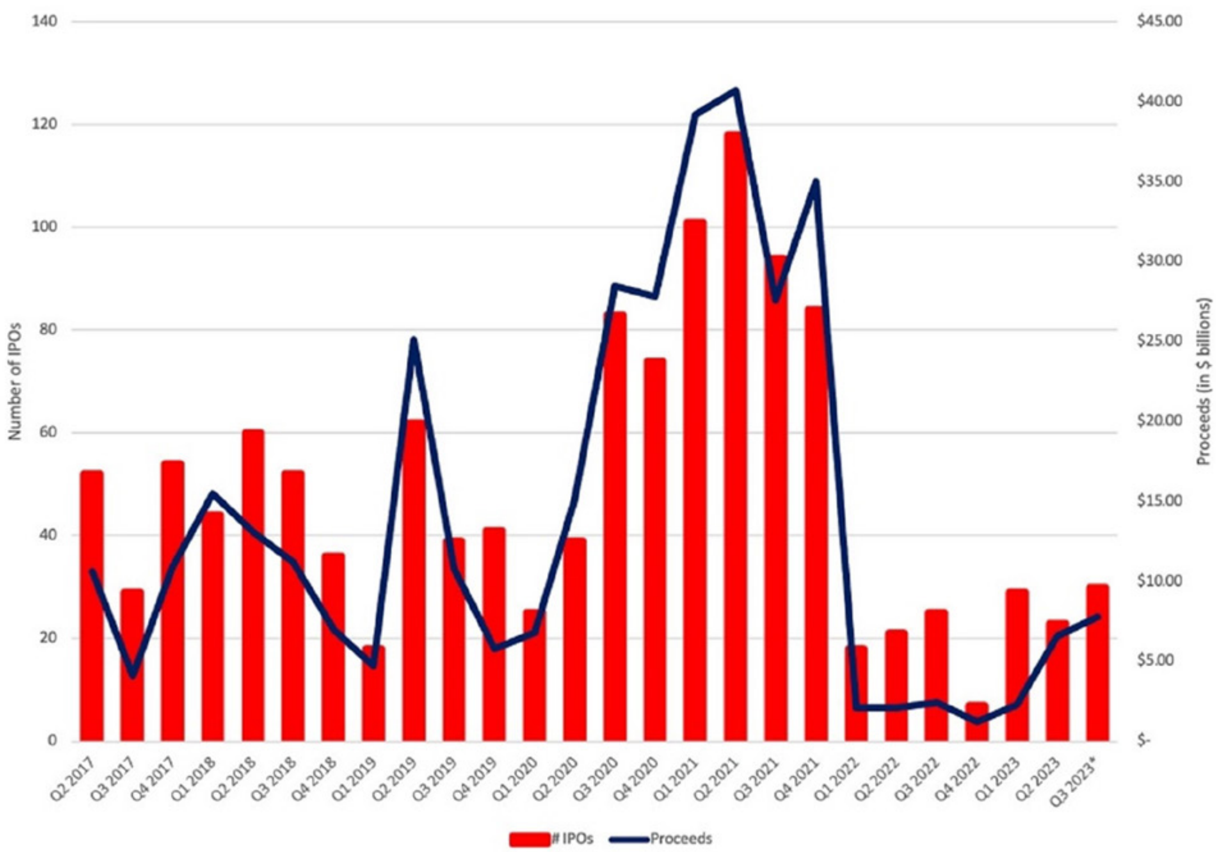


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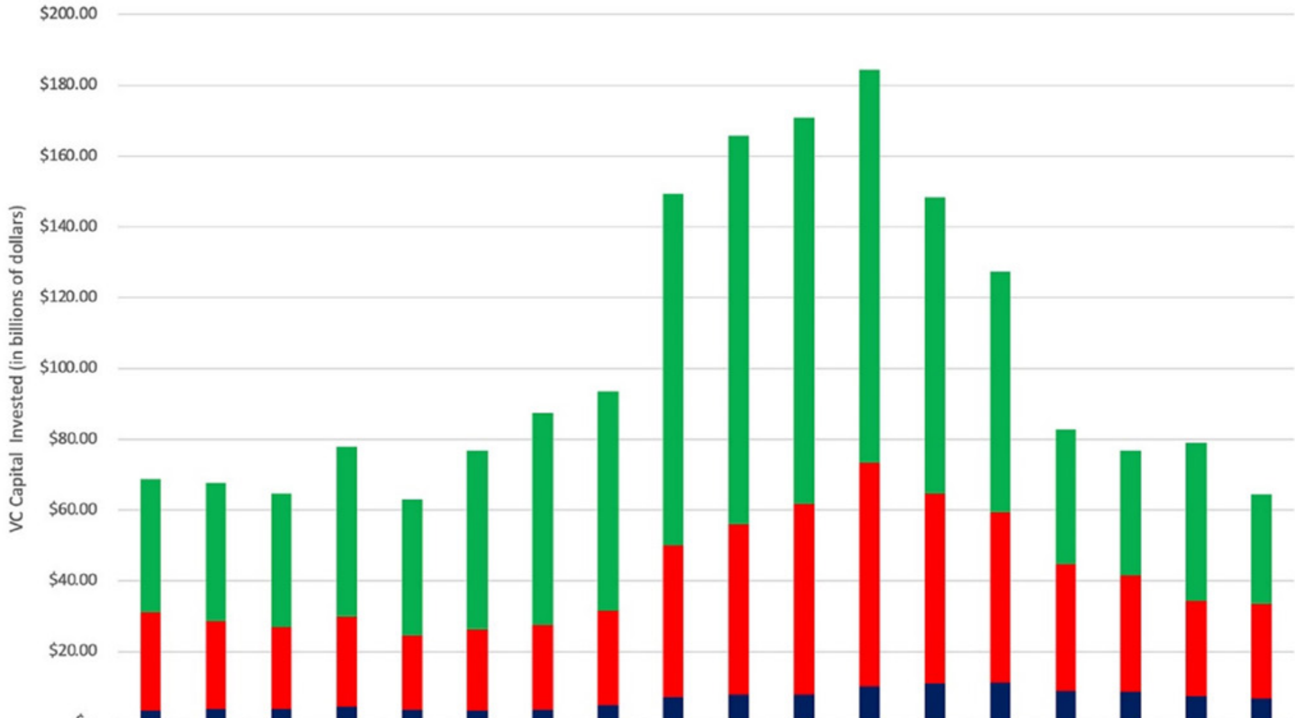
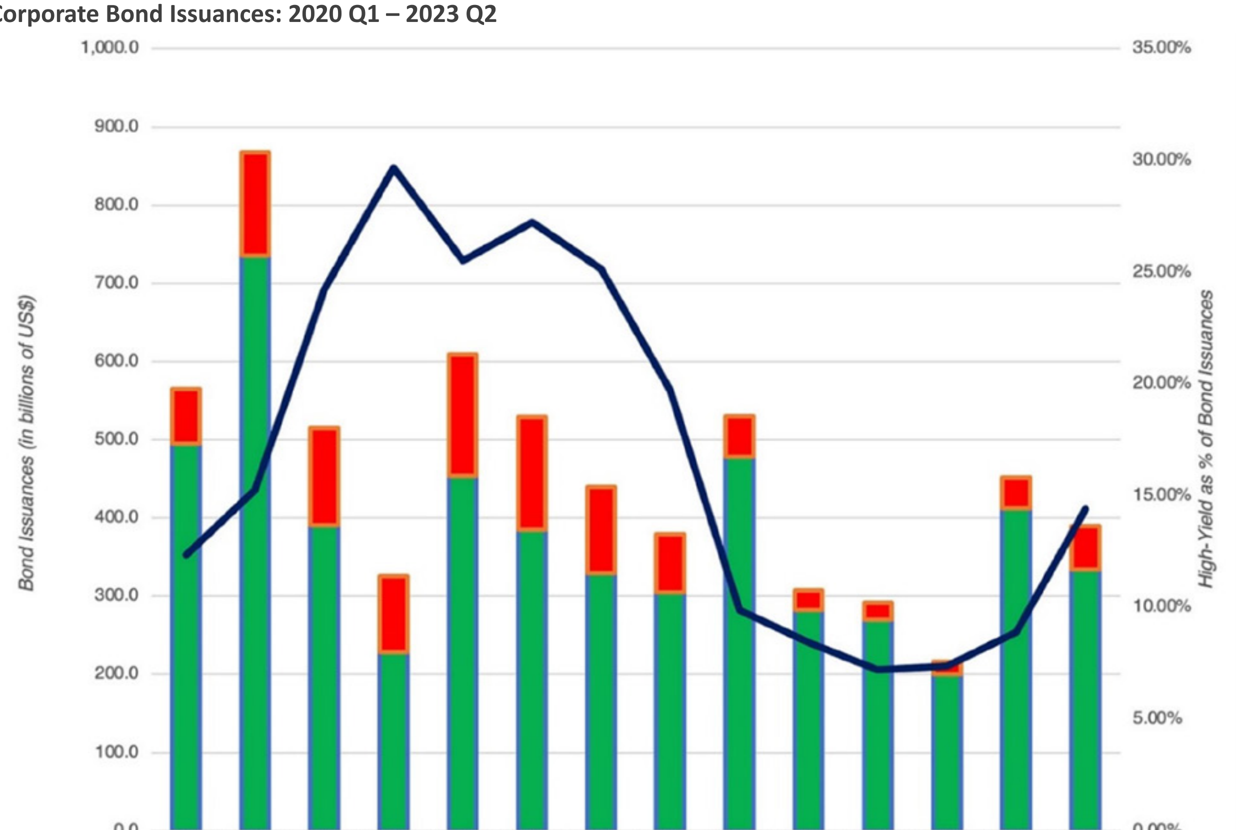
Exhibit 8: VC Investing: 2019 – 2023



	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023
Late Stage	$37.50	$39.10	$37.90	$48.00	$38.30	$50.40	$59.80	$62.00	$99.20	$109.8	$109.1	$110.9	$83.60	$67.80	$38.00	$35.10	$44.60	$30.90
Early Stage	$27.80	$24.90	$23.10	$25.40	$21.10	$23.00	$24.10	$26.70	$43.00	$48.10	$53.90	$63.30	$53.70	$48.20	$35.90	$32.90	$26.90	$26.70
Angel Seed	$3.40	$3.70	$3.80	$4.50	$3.50	$3.30	$3.50	$4.90	$7.10	$7.90	$7.90	$10.10	$11.10	$11.20	$8.90	$8.70	$7.40	$6.80

Exhibit 9: Corporate Bond Issuances: 2020 Q1 – 2023 Q2



	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23
High Yield	69.9	132.4	124.8	96.5	155.6	144.0	110.7	74.7	52.4	26.0	21.0	15.9	40.2	56.1
Investment Grade	495.3	735.1	390.4	229.0	453.8	385.2	329.2	304.7	478.1	282.1	270.4	200.2	412.0	333.8
% from High Yield	12.37%	15.26%	24.22%	29.66%	25.53%	27.22%	25.16%	19.69%	9.87%	8.45%	7.22%	7.36%	8.90%	14.39%

more optimistic about the future, over the course of 2023, as can be seen in their estimates of the probability of a recession, in Exhibit 11. The economists polled in this survey have reduced their likelihood of a recession from more than 60% to about 40%, with the steepest drop off occurring in the last two months.

On inflation, we started the year with the consensus view that inflation would come down, but only because of economic weakness. The positive surprise for markets in 2023 is that inflation has come down, without a recession yet in sight. See Exhibit 12 on next page.

The drop off in inflation in the first half of 2023 was steep, both in actual numbers (CPI and PPI) and in expectations (from surveys of consumers and the treasury market). While the third quarter saw a levelling off in those gains, it is clear that inflation has dropped over the course of the year, albeit to levels that still remain about Fed targets. If you are one of those who argued that inflation was transitory, this year is not a vindication, since prices, even if they level off, will be about 20% higher than they were two years ago. There is work to be done on the inflation front, and declaring premature victory can be dangerous.

Exhibit 10: A Slow-Motion Slowdown: The Economy in 2022-2023

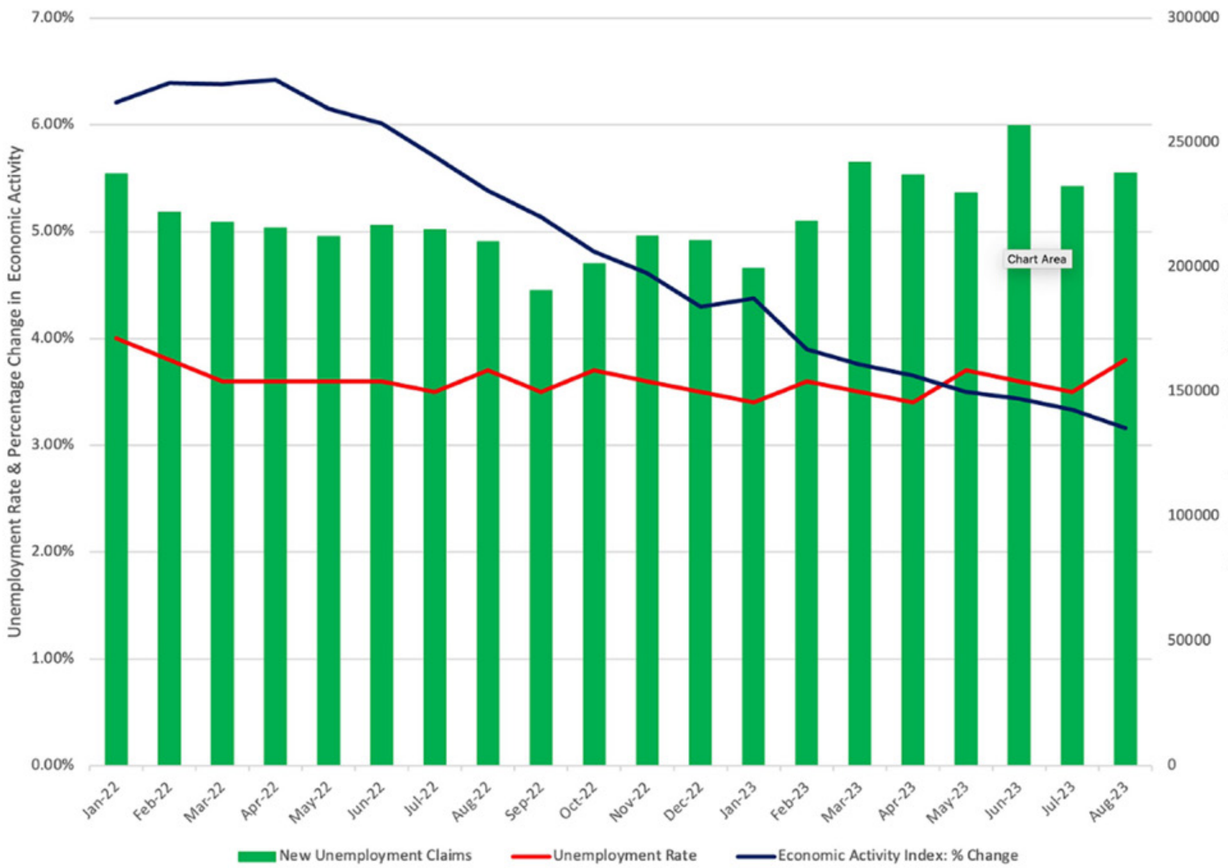
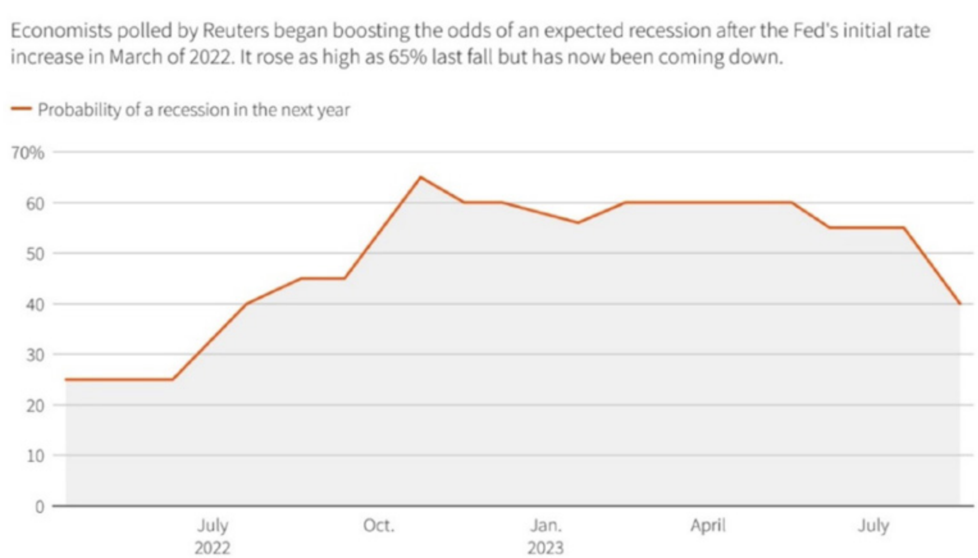


Exhibit 11: Perceived Recession Risk Falls



Continued from p.53

Exhibit 12: Inflation: Actual (CPI) and Expected (Survey & US Treasury Market) – 2020 through 2023

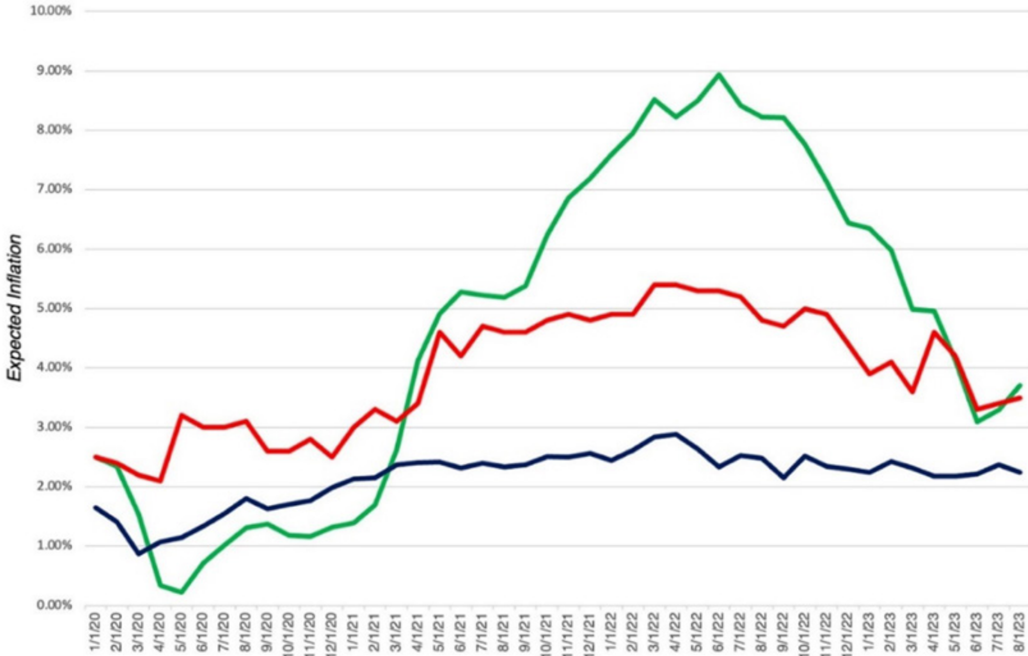


Exhibit 13: An Intrinsic Value of the S&P 500

At Current Interest Rates and With Market Consensus Earnings Estimates

Earnings estimates: Analyst estimates of earnings for 2023, 2024 & 2025, followed by steady state growth (set equal to the riskfree rate)

Riskfree rate: The treasury bond rate of 4.58% will remain as the steady state.

ERP: The equity risk premium converges on 5%, the average since 2008.

Intrinsic Value Estimate (based on your choice of ERP)	2022	2023	2024	2025	2026	2027	*Terminal Year*
Expected Earnings	$218.09	220.65	247.29	277.49	290.20	303.49	317.39
Earnings Growth Rate		1.17%	12.07%	12.21%	4.58%	4.58%	4.58%
Expected cash payout ratio	78.81%	78.81%	78.30%	77.80%	77.29%	76.79%	76.79%
Expected Dividends + Buybacks =	$171.87	$173.89	$193.63	$215.88	$224.30	$233.04	243.71
Expected Terminal Value =						$4,874.26	
Riskfree Rate	4.58%	4.58%	4.58%	4.58%	4.58%	4.58%	4.58%
Required Return on Stocks	9.58%	9.58%	9.58%	9.58%	9.58%	9.58%	9.58%
Present Value =		$169.96	$172.71	$175.72	$166.61	$3,462.05	
Intrinsic Value of Index =	4147.04						
Intrinsic Trailing PE =	19.02						
Intrinsic Forward PE =	18.79						
Actual Index level on 10/1/23 =	4288.05						
% Under or Over Valuation =	3.40%						

Cash Payout as % of Earnings: Starts at 2022 levels, but changes over time to reflect sustainable payout, given growth and ROE.

Exhibit 14: Four Different Scenarios

Inflation stubborn, Economy Soft Landing
1. Interest rates will stay high and even rise (6%)
2. Equity Risk Premiums will level off at historic norms (5%)
3. Earnings will come in at expectations
Market Implications: Intrinsic value for the index is 3804, overvalued by 12.7%
Asset Allocation: Stocks↓ , Bonds↓, Cash↑

Inflation stubborn, Economy in Recession
1. Interest rates will stay high and even rise (6%)
2. Equity Risk Premiums will rise to top end of histotoric range (6%)
3. Earnings will come in below expectations (20% below in 2023, 10% below in 2024)
Market Implications: Intrinsic value for the index is 2874, overvalued by 49.2%
Asset Allocation: Stocks↓ , Bonds↓, Cash↑

Market Consensus (Inflation subsides, Economy Soft Landing)
- Inflation will stay down, albeit at levels higher than the Fed target
- The economy will slow, but any recession, even if it occurs, will be mild; earnings come in at expectations
Market Implications: Intrinsic value for the index is 4147, overvalued by 3.4%

Inflation subsides, Economy Strengthens
1. Interest rates will decline as inflation drops (to 3%)
2. Equity Risk Premiums will level off at historic norms (5%)
3. Earnings come in above expectations (10% above in 2023, 5% above in 2024)
Market Implications: Intrinsic value for the index is 4754, undervalued by 9.8%
Asset Allocation: Stocks↑ , Bonds↑, Cash↓

Inflation subsides, Economy in Recession
1. Interest rates will decline as inflation drops (to 3%)
2. Equity Risk Premiums will rise to top end of histotoric range (6%)
3. Earnings come in below expectations (20% below in 2023, 10% below in 2024)
Market Implications: Intrinsic value for the index is 3408, overvalued by 25.8%
Asset Allocation: Stocks↓ , Bonds↑, Cash→

Exhibit 15: Monte Carlo Simulation – Estimates Based on 3 Key Variables

Percentile	Index Value	% Under or Over
0.00%	2607.30	64.46%
10.00%	3658.01	17.22%
20.00%	3842.43	11.60%
30.00%	3976.30	7.84%
40.00%	4096.14	4.69%
50.00%	4198.95	2.12%
60.00%	4308.41	-0.47%
70.00%	4427.83	-3.16%
80.00%	4563.73	-6.04%
90.00%	4744.06	-9.61%
100.00%	5640.43	-23.98%

Valuing Equities

In response to what this means for the market, I have to start with a confession, which is that I am not a market timer, making it very unlikely that I will find the market to be mis-valued by a large magnitude. In keeping with a practice that I have used before (see my start-of-the year and mid-year valuations), I valued the S&P 500, given current market interest rates and consensus estimates of earnings for the future.[4] See Exhibit 13.

As you can see, with the 10-year treasury bond rate at 4.58% and the earnings estimates from analysts for 2023, 2024 and 2025, *I estimate an intrinsic value of the index of 4147, about 3.4% below the actual index level of 4288, making it close to fairly valued*.

My assessment is a bit of a cop-out since they are built on current interest rate levels and consensus earnings estimates. The extent that your views about inflation and the economy diverge from that consensus can cause you to arrive at a different value. I have tried to capture four scenarios in the chart below, with a contrast to the market consensus scenario above, and computed intrinsic value under each one. See Exhibit 14.

As you can see, your views on inflation (stubborn or subsides) and the economy (soft landing or recession) will lead you to very different estimates of intrinsic value, and judgments about under or over valuation. Since I am incapable of forecasting inflation and economic growth, I fall back on another tool in my arsenal, Monte Carlo simulation, where I allow three key variables – risk free rate, equity risk premium, and earnings in 2024 & 2025 – to vary, and estimate the effect on index value. See Exhibit 15.

The median value across 10,000 simulations is 4199. 2.1% below the index value of 4288, confirming my base case conclusion. If there is a concern here for equity investors, it is that there is more downside than upside, across the simulation, and that should be a factor in asset allocation decisions. It can also explain not only why there is reluctance on the part of investors to jump on the bandwagon, but also the presence of high-profile investors, short selling the entire equity market.

Conclusion

As I was writing this post, I am reminded of one of my favorite movies, *Groundhog Day*, where Bill Murray is a weatherman who wakes up and relives the same day over and over again. We started the year talking about inflation and a possible recession, and we keep returning to that conversation repeatedly. You may want to move on, but it is unlikely that either uncertainty will be resolved in the near future. In the meantime, the market will continue swinging between wild optimism (where inflation is no longer viewed as a threat and the economy has a soft landing) and extreme pessimism (where inflation comes back with a bang and the economy falls into a recession). The truth, as is often the case, will fall somewhere in the middle, but it will not be easy to find.

Editor's Note: To better view the charts in this article, see https://aswathdamodaran.blogspot.com/2023/10/market-bipolarit-exuberance-versus.html

ABOUT THE AUTHOR

Aswath Damodaran

Aswath is the Kerschner Chaired Professor of Finance at the Stern School of Business at New York University, where he teaches corporate finance and valuation to MBAs, executives, and practitioners. He has been at NYU since 1986 and was elected as the most popular business school professor in the U.S. by MBA students across the country in a 2011 survey by Business Week. He has written five books on valuation, three on corporate finance and three on portfolio management, and his most recent book is Narrative and Numbers, published by Columbia University Press. His blog, Musings on Markets, was selected by The Times of London as one of the top ten stock market blogs in the world. He has a semi-active presence online, on Twitter (@AswathDamodaran) and with his website (http://www.damodaran.com). His classes are carried online and on iTunes U and were listed among the top ten MOOCs in the world in 2012.

[4] Download valuation spreadsheet here: https://view.officeapps.live.com/op/view.aspx?src=https%3A%2F%2Fpages.stern.nyu.edu%2F~adamodar%2Fpc%2Fblog%2FS%26P500ValueOct2023.xlsx&wdOrigin=BROWSELINK.

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EY	**20**
Deloitte	**18**
Huron	**17**
BRG	**16**
Ankura	**14**
PwC	**14**
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Accordion	**11**
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Development Specialists, Inc.	**10**
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MEMBER ON THE MOVE

MYCHAL HARRISON JOINS KPMG AS HEAD OF US TURNAROUND AND RESTRUCTURING

Tuesday, October 24, 2023—It is with great pleasure that we announce Mychal has joined KPMG as Head of US Turnaround and Restructuring. With more than 20 years of experience in turnaround and restructuring and special situations, Mychal has been instrumental in advising clients during some of their most transformative times. He has helped clients turnaround and transform their businesses by successfully executing financial and operational restructurings, recapitalizations, divestitures of assets, make strategic acquisitions, and execute in-court and out-of-court transactions. Leveraging a broad range of engagements, Mychal has served as lead advisor for middle market and Fortune 500 companies, advising corporate boards and other key stakeholders when stakes were at their highest. With experience in healthcare/life sciences, industrials, and manufacturing, he is able to offer a broad range of solutions to meet clients' needs. In 2022, Mychal was named by Consulting Magazine as one of its top consultants. Additionally, Mychal was honored by M&A Advisor's as an Emerging Leader for Dealmakers and is a member of the AIRA Board of Directors.

These representative clients are a sample of Mychal's extensive experience:

- Financial Advisor for a generic pharmaceuticals company that faced significant operational and financial headwinds as it looked to relocate and expand its operations. Working with the Company and other key constituents, a plan was devised and implemented to stabilize operations and refinance its existing lenders. The engagement received numerous accolades as Life Sciences Restructuring of the Year.
- Advisor to the Commonwealth of Pennsylvania during the bankruptcy (Section 363) sale of one of its largest mental health and substance use disorder facilities. Despite an increase in uninsured patients, rising SG&A, and reductions in reimbursement, a plan was executed to allow a new buyer to assume operations of the facility without disrupting patient care.
- Lead advisor to a global consumer products company that was facing increasing pressures from its existing bank syndicate due to its inability to accurately forecast and manage liquidity requirements. A cash management tool was developed to provided visibility throughout the Company's five geographical regions and protocols and checks were implemented to identify material variance in reporting prior to closing periods.

Email: mychalharrison@kpmg.com

Phone direct: 212-220-5938 | mobile: 646-548-3008

THE RECIPIENT OF AIRA'S 2023 JUDICIAL SERVICE AWARD: HON. BRENDAN LINEHAN SHANNON, UNITED STATES BANKRUPTCY JUDGE FOR THE DISTRICT OF DELAWARE

AIRA's Judicial Service Award was presented to Hon. Brendan Linehan Shannon at the 22nd Annual Advanced Restructuring and POR Conference on November 13, 2023.

Brendan Linehan Shannon is a United States Bankruptcy Judge for the District of Delaware. Judge Shannon received his undergraduate degree from Princeton University, and his law degree from the Marshall-Wythe School of Law at the College of William and Mary in Williamsburg, Virginia.

Prior to his appointment to the bench, Judge Shannon was a partner with Young Conaway Stargatt & Taylor, LLP in Wilmington, Delaware. At Young Conaway, Judge Shannon primarily represented corporate debtors and official committees in Chapter 11 cases. Since his appointment in 2006, Judge Shannon has managed a full Chapter 11 docket, and also handles all Chapter 13 consumer bankruptcy cases filed in the State of Delaware. He served as Chief Judge of the Bankruptcy Court from 2014 through 2018.

Judge Shannon is an adjunct professor in the Bankruptcy L.L.M. Program at St. John's University School of Law in New York, and at Widener School of Law in Delaware. He serves on the Board of Editors of Collier on Bankruptcy (16th ed.) and is a contributing author for Collier Forms and for several chapters covering the Federal Rules of Bankruptcy Procedure. Judge Shannon also serves on the Advisory Board for the American Bankruptcy Institute Law Review.

In 2011, Judge Shannon was appointed to serve as a member of the National Bankruptcy Conference. The Conference was created in the 1930's at the request of Congress and serves as a resource to Congress on bankruptcy legislation. In 2020, Judge Shannon was inducted as a member of the American College of Bankruptcy.

Judge Shannon is a member of the Delaware State Bar Association, the American Bar Association, the American Bankruptcy Institute and the Rodney Inns of Court in Wilmington, Delaware. He is also a member of the Board of Directors of the Delaware Council on Economic Education.

BOARD OF DIRECTORS

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