AIRA Journal

VOL 37: NO 3
2024
AIRA.ORG

PUBLISHED BY THE ASSOCIATION OF INSOLVENCY & RESTRUCTURING ADVISORS

WHAT'S INSIDE

Fall Programs: Dallas Summit, October 30 and NYC POR, November 18 — See pg. 2!

12th Annual Healthcare (formerly Energy) Summit

October 30, 2024, Dallas, TX

AIRA and TMA Dallas/Ft. Worth are excited to present the 12th Annual Healthcare Summit on October 30th! This innovative program will bring together bankruptcy and restructuring advisors, attorneys and other practitioners for an afternoon of informative programming on the healthcare industry's current issues, trends and developments.

Topics include:

- **Healthcare Industry Overview**
- **PPM's**
- **Rural & Community Hospitals**

A networking reception will close out the program.

Registration coming soon to www.aira.org

23rd Annual Advanced Restructuring & Plan of Reorganization Conference (POR24)

November 18th, 2024, at the Offices of CohnReznick, LLP, New York, NY

Mark your calendars and plan now to attend AIRA's Annual POR Conference! POR includes 5 sessions, a luncheon, networking reception and keynote presentation by Jamie Sprayregen.

Topics include:

- **ABCs/Receiverships**
- **Private Debt & the Valuation of Private Debt**
- **Impact of Purdue**
- **2024 – The Year in Review**
- **Ethics**

Earn up to 6.7 CPE / 5.6-6.7 CLE*

**Application for New York accreditation pending approval. CLE for other states applied for on request.*

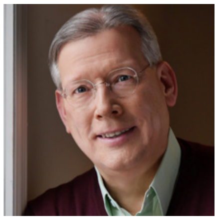
Registration coming soon to www.aira.org

For more information on AIRA upcoming events visit www.aira.org/conference.

CONTENTS

PAGE# VOL 37: NO 3

From the Executive Director's Desk



James M. Lukenda, CIRA
AIRA

We are back from Baltimore, having celebrated AIRA's 40th annual conference. I have to say, I began to wonder whether the collapse of the Key Bridge in the months prior to the conference was an ill omen. While I feel for the families of the bridge workers who were killed when the bridge collapsed and the many residents whose commutes became that much more difficult, I am pleased to say Baltimore opened its arms to AIRA and our many members attending the conference. The weather, the venue, the sessions, were all exceptional. My thanks for their effort bringing the conference to fruition goes out to the conference co-chairs, **Angela Shortall** and **Jeffrey Rothleder**, and **Judge Elizabeth Gunn**, conference judicial co-chair. Thanks also to **Andy Barg** and **Kim Lam** and **Karl Knechtel** and **Matthew Bentley** for their efforts organizing and moderating the pre-conference tax and toolbox sessions, respectively. And not to overlook the logistical effort, thank you, Cheryl, Mike and Dom, and Michele for your hard work to make the conference a success.

One of AIRA's signature program events at each conference since 2000 has been AIRA board recognition of a member of our restructuring community who has demonstrated exceptional leadership, dedication, and service to the bankruptcy, restructuring, and turnaround field. The **Emanuel M. Katten Founders Award** was proposed in 1999 to honor Manny Katten, a founding member of AIRA and its predecessors. Over the years, the many awardees have demonstrated the best professional skills and dedication to the continued education and professionalism of our practice area. For 2024, AIRA's board selected **David Berliner**, recently retired from BDO USA, LLP, as the Emanuel M. Katten Founders Award honoree.

David has been a presence in the turnaround and restructuring practice since very early in his accounting career. As a BDO partner, he dedicated his time and effort to AIRA, first as a member beginning in 2002, becoming a CIRA in 2004, and joining AIRA's board in 2009. From June 2013 until 2023 David ably served as AIRA treasurer working first with Grant Newton, then Tom Morrow, and most recently with me to keep AIRA on a stable financial path. On behalf of the AIRA's board and membership, I extend our collective thanks to David and wish him the best in his retirement years.

The flip side of the "retirement" coin is the opening of opportunities for younger professionals to engage with AIRA and colleagues in the profession. For those of you who may be long time AIRA members, like me, I encourage you to bring your newer colleagues to AIRA programs and encourage them to become involved. When I started the portion of my career devoted to restructuring, it was my then boss, Barry Monheit, who brought me out to my first AIRA annual conference. It was that conference that started me on a relationship from which I have gained much and I hope I've given some back.

The conclusion of the June 40th Annual Conference also brought with it a changing of the guard. **Eric Danner (CohnReznick LLP)** closed the annual meeting session in his capacity as incoming President. As immediate past president, **Denise Lorenzo (AlixPartners, LLP)** commenced her term as AIRA Board Chair, and **Boris Steffen (Province, LLC)** moved from Board Secretary to President Elect. With Boris's change, **Ken Enos (Young Conaway Stargatt & Taylor, LLP)** accepted the position of Board Secretary. **Rob Swartz (PriceWaterhouseCoopers)** continues as Board Treasurer.

A number of years ago, the term for officer positions was changed from a two-year term to a one-year term. This past fall, the board reconsidered term length and concluded it was in the best interest of the association that officers' terms should be returned to a two-year duration. Accordingly, Eric and the officer team above will be serving the AIRA membership for the next two years. I am grateful for their continued involvement and ideas and look forward to our continuing collaboration.

There is a lot of material following this letter. Please read, enjoy, and learn.

—Jim

Resident Scholar Column

Jack F. Williams, PhD, JD, CIRA, CDBV, CTP

Bankruptcy Busters

PROFESSIONAL WELLNESS IN AN UNWELL WORLD

"Elvis is dead, and I don't feel so good myself," wrote the Southern humorist, Lewis Grizzard, eons ago. I am feeling that vibe. After an enriching experience at the AIRA's 40th Annual Bankruptcy & Restructuring Conference in Baltimore—where my colleague and friend David Bart and I shared some thoughts with those in attendance on professionalism, mentorship, work-life balance, and the challenges of practice—I returned home and received several emails and calls about the topic. We had hit a nerve. One comment has stuck with me like gum on a shoe midway through a summer stroll: how does professional wellness have any meaning in world that is so divisive, mean spirited, and downright violent at times? Here is my modest response.

Let's start with the obvious that, in fact, may not be so obvious at the start. In our ever-evolving world, the professions of accounting, finance, and law stand as pillars of stability and trust. Yet, these professions, known for their high demands and rigorous standards, present unique challenges that impact the well-being and ethical integrity of their practitioners. Our slice of the profession, steeped in a world of regret and despair, amplifies these challenges.

Our CPE and CLE mandates enhance our skills training; our conferences allow us to reconnect and share experiences; and our firms and practices generally, some generously, support both. Yet, as we grow as accountants, financial advisors, lawyers, and judges, who and what is nurturing our heart and soul as professionals and people?

I am neither prophet nor priest. Personal spiritual guidance is not my forte. I struggle like many of you. I am, however, fascinated by those that participate in our profession and have been blessed with longstanding relationships with many of the exemplars in our field. I seek only to share with you their wisdom and what I will call their "human-centric" approach as professionals. I humbly suggest that there may be some gems to mine in their words of wisdom. Although I will eschew naming many of them and you may know many of them, I will name one personal exemplar: Professor Grant Newton.

My mentors live a life reflecting an active connection between personal well-being, ethical conduct, and professional excellence. Professor Newton teaches by example the importance of seeing every individual as created in the image of God, deserving of dignity and care. Ours is a profession of intense pressures, relentless deadlines, and high stakes; that kind of pressure and concomitant stress erodes mental well-being, leading to anxiety, depression, and burnout. You have been there—me, too.

Professor Newton often shares with me that there is no silver bullet, no right answer or approach to every challenge that must be faced. However, there is a healthy process and both context and environment matter.

Organizations like the AIRA must commit to recognizing the sanctity of professional wellness and foster an environment where discussions about wellness are met with empathy and understanding. When we value the wellness of our professionals, we honor their humanity and enhance their capacity to contribute meaningfully to their work and society. I hope to see a continuing commitment to programming of this type by the AIRA.

At the AIRA's 2024 Conference in Baltimore, we talked a lot about balance, which is often discussed under the more limited and somewhat mechanical guise of seeking "work-life" balance. We talked about the need to understand the interactions and interplays between our private and professional worlds and how they can affect and inform one another. I suggested that a healthier way to address this challenge is to seek a harmonious existence. I observed that we can't have it all, at least not all at the same time. Those that have been successful at achieving this harmony recognize the demands of a demanding profession and the need for rest and rejuvenation as essential for human flourishing. Achieving this harmony is vital. The demands of our profession often extend beyond regular working hours, slowly and then quickly enveloping our personal time.

Embracing flexible working arrangements and remote work opportunities and encouraging employees to set boundaries between their professional and personal lives are steps toward a harmonious existence. Here, little steps matter. Ask yourself the following: have you sent detailed emails or left voice messages off-hours and either demanded an answer immediately or created an impression of expecting immediate attention, when it was not actually necessary to have an answer at that time and the response could have waited until the beginning of the next workday?

Stop!

People need time to recharge, preventing burnout and enhancing overall productivity and satisfaction. Protect the wellbeing of your people and, yes, yourself. Stress is an inevitable part of life, but how we manage it can make all the difference. In the high-pressure world of bankruptcy accounting and restructuring, effective stress management techniques are crucial. Mindfulness practices, meditation, and time management skills can help professionals navigate their demanding roles with greater ease. Providing resources such as counseling and stress-relief activities, like yoga or relaxation spaces, supports employees in cultivating inner peace amidst their busy schedules. These practices not only enhance individual well-being but also contribute to a more harmonious and productive environment.

A supportive workplace culture, one that values everyone, is the bedrock of professional wellness. Our exemplars emphasized the power of community and mutual support. In the workplace, this translates to creating an environment where employees feel valued, respected, and included. Outside the workplace, this translates to professional involvement, engagement with family and friends, and service to community.

Our leaders play a pivotal role in this endeavor. By modeling empathy, promoting open communication, and recognizing achievements, they set the tone for a supportive culture. A workplace where individuals feel supported and valued is one where they can perform at their best. Your colleagues will be happier, stay longer, and live productive robust lives. So will you.

Let me put this in perspective. I know many of our colleagues who have been blessed with working with the same core group of people for 10, 15, 20, 25 years. I am not that interested in how many engagements you have won, how great your performance has been in the courtroom or boardroom, or your title or treasure. Success is measured by those that stand with you for decades. Be that professional.

Look!

Our exemplars exhibit the power of lifelong learning, the continuous pursuit of knowledge and growth. In the ever-changing fields of bankruptcy, insolvency and restructuring, continuous professional development is vital. Staying current with industry trends, regulations, and technological advancements ensures that professionals can perform their roles effectively and ethically. Encouraging certifications such as the CIRA and CDBV, attending the AIRA conferences, and fostering a culture of mentorship and networking provide valuable opportunities for growth.

Listen!

Effective communication is essential for professionalism. Our exemplars have shown us the power of words and the importance of clear, compassionate communication, offering guiding principles for us as professionals. Developing strong presentation and report-writing skills and actively listening to clients and colleagues are critical for better understanding, trust, problem-solving, and delivering value. And yet, our exemplars inspire us to take this one step further—learning and practicing attentive listening on a deeper level in order to bridge gaps and build strong, lasting relationships.

Conclusion

Integrating wellness and professionalism is not only possible but essential. A workforce that is supported in both their well-being and professional development is better equipped to perform professionally. Organizations must create environments that support mental and physical health, promote continuous learning, and foster ethical behavior.

Leaders play a crucial role in this integration, modeling healthy behaviors, supporting professional development, and encouraging open communication. By prioritizing both wellness and professionalism, organizations can create a positive and productive workplace that attracts and retains top talent and fosters ethical behavior. That level of commitment redounds to the benefit of all stakeholders.

The lives of our exemplars offer profound insights into the importance of wellness and professionalism. By valuing mental and physical health, promoting ethical behavior, encouraging lifelong learning, and fostering effective communication, we can create a work environment where professionals thrive.

Wellness and professionalism are not separate endeavors but intertwined aspects of a harmonious approach to work and life. By integrating these principles, we honor the humanity of everyone, uphold the integrity of our profession, and contribute to a more just and compassionate world. And that is my segue to responding to the initial question posed by those emails and calls—how does professional wellness have any meaning in a world that is so divisive, mean spirited, and downright violent at times?

Repairing the world begins with repairing you … and me.

As Professor Newton patiently and lovingly taught me, it is a process that begins with yourself and ends at a place beyond your imagination. As it says in the Chapters of Our Fathers, “You are not obligated to complete the work, but neither are you free to desist from it.”

Tell me what you think!

ABOUT THE AUTHOR:

AIRA Scholar in Residence Jack F. Williams is a professor at Georgia State University College of Law and the Middle East Studies Center. His current teaching interests include accounting & finance for lawyers; admiralty & maritime commerce; American Indian law; archaeology; bankruptcy & business reorganization; board governance & business ethics; business valuations; corporate finance; counterterrorism, intelligence & national security; forensic investigations; Islamic law & finance; mergers & acquisitions; remedies; and statistics & the law.

THE IMPACT OF ACCOUNTING ESTIMATES ON REPRESENTATIONS AND WARRANTIES INSURANCE UNDERWRITING AND CLAIMS

William (Bill) Marquardt, Kenneth Mathieu, and Frank Dery

BRG

Introduction

The use of representations and warranties insurance (RWI) to diversify mergers and acquisitions (M&A) deal risk has become commonplace for private transactions. In 2022 and Q1 2023, RWI was referenced in 55% of private M&A transactions.[1] The area most susceptible to RWI claims, as evidenced by both frequency and severity, relate to the assurances and guarantees that accompany an entity's financial statements. These assurances or management representations include accounting estimates which rely on the proper application of professional judgment.

When considering the likelihood and potential impact of inaccuracies in financial reporting, assessing accounting estimates is an essential part of the underwriting risk management and due diligence processes. Accounting estimates represent the informed judgment of management regarding uncertain future events, such as market and economic conditions, that might affect the financial outcomes of an entity. These estimates involve considerable discretion and subjectivity, increasing the potential for misstatements or errors. Accordingly, identifying and assessing the reasonableness of accounting estimates is necessary to evaluate financial and operational risks associated with underwriting a transaction.

Management estimates are prevalent throughout financial statements and impact revenue recognition, provisions for bad debts, inventory valuations, depreciation and amortization (useful lives and long-lived assets), fair-value measurements for assets and liabilities not traded in active markets, pension and other post-employment benefits, environmental liabilities, warranty obligations, other contingent liabilities, and tax provisions. Less-common management estimate issues include off-balance-sheet transactions, noncompliance with accounting standards, and use of complex transactions and structures. Due diligence efforts must also consider the impact of errors and occupational fraud, intentional misstatements, or the failure to disclose material information by the employees or owners of an organization.

RWI underwriters generally assess the materiality and financial or operational risk associated with accounting estimates within each transaction, while facing challenges such as access to data and the time constraints associated with M&A.

Mitigating Risks Associated with Accounting Estimates

Given the inherent risk of accounting estimates and the potential occupational fraud, underwriters should be aware of warning signs or indicators of risk during their evaluations. These "red flags" of financial and operational issues vary significantly based on specific circumstances and context (including jurisdictional issues) and directly impact the ability to assess an entity's financial strength, liquidity, leverage, and solvency. Common accounting estimate issues include:

1. Revenue Recognition and Fictitious Revenues: Accounting estimates related to revenue recognition, such as the timing of recognizing revenue from long-term contracts or complex arrangements, could lead to disputes if actual revenue falls short of what was estimated. Fictitious revenue refers to revenue recorded on a company's financial statements that does not represent actual earnings from legitimate business activities.
2. Overstating Assets or Asset Valuations: Overstating assets involves inflating the reported value of assets on the balance sheet, such as inventory, property, plant and equipment, or investments. The impact of estimating the value of intangible assets, such as patents, trademarks, or goodwill, could also lead to claims if the actual value of these assets is significantly lower than what was represented during the transaction.
3. Understating Liabilities/Expenses: This involves reporting liabilities at amounts lower than their actual obligations, which can occur through techniques like under-stating reserves for claims, warranties, or debt obligations.
4. Inadequate Reserves and Allowances/Expenses: Understating provisions involves evaluating the sufficiency of setting aside funds for future losses or expenses, including allowances for bad debts or inventory obsolescence.
5. Contingent Liabilities/Expenses: These potential liabilities may arise from past events and may not be recognized in financial statements because their occurrence depends on the probability of uncertain future events occurring and the ability to estimate the amount of the liability. Examples include pending lawsuits, rebates and returns, discounts and allowances, warranties, or guarantees. Contingent liabilities can significantly impact a company's financial health and risk profile. Even if they do not reach the threshold for recording a liability or expense, the parties should evaluate whether disclosure is necessary.
6. Deferred Tax Assets and Liabilities: Estimates related to deferred tax assets and liabilities can result in claims if discrepancies exist between estimated tax liabilities or benefits and actual tax obligations post-acquisition.
7. Depreciation Methods: These methods determine how the cost of long-lived assets is allocated over their useful lives. Depreciation methods can significantly affect reported financial results and asset values.
8. Capitalization Policies: Recording expenses as capital expenditures instead of reflecting them in the income statement could lead to an overstatement of earnings.

[1] American Bar Association Business Law Section, *2023 Private Target M&A Deal Points Study* (including transactions from 2022 and Q1 2023), https://www.americanbar.org/content/dam/aba/administrative/business_law/deal_points/2023-private-study.pdf.

Understanding and adherence to the capitalization policy could prompt earnings adjustments if there is excess capitalization.

Apart from accounting estimates, other general financial and operating matters are pertinent to underwriting a transaction and warrant consideration. These include:

1. Unexplained Fluctuations or Trends: Significant and unexplained fluctuations or trends in financial data, such as sudden changes in revenue, expenses, or profit margins, may indicate unanticipated market fluctuations, purposeful manipulation, or irregularities.
2. Inconsistent Financial Performance: Inconsistencies between reported financial performance and industry benchmarks, economic conditions, or the company's operating environment may raise concerns about accuracy or reliability of financial statements.
3. Changes in Customer Base (Revenue Concentration): A significant change in the customer mix, a decrease in quantity of customers, or loss of a major customer(s) can increase revenue concentration risks and expose financial instability.
4. Unusual Accounting Practices: The adoption of aggressive accounting practices or frequent changes in accounting policies or methods that obscure underlying economic reality can present red flags for potential financial misstatements.
5. Unusual or Complex Transactions: Unusual or complex transactions, such as round-trip transactions, increases in customer incentives, or off-balance-sheet arrangements that are not consistent with the company's normal business operations or industry practices may be red flags for financial irregularities.
6. Lack of Transparency or Disclosure: Inadequate or incomplete disclosure of significant accounting policies and procedures involving related-party transactions, contingent liabilities, or other material information in the financial statements or footnotes may suggest attempts to conceal details or risks material to the buyer's decision-making process.
7. Excessive or Unusual Related-Party Transactions: High volumes or significant amounts of transactions with related parties, such as affiliates, subsidiaries, or key management personnel, without proper disclosure or at non-arm's-length terms, may indicate potential conflicts of interest or manipulation of financial results.
8. Poor Governance and Oversight: Corporate governance structures may exhibit weaknesses such as insufficient independent oversight, inadequate board supervision, or conflicts of interest among key executives, directors, or owners.
9. Weak Internal Controls: Weaknesses or deficiencies in internal controls or adherence to internal controls over financial reporting increase the risk of errors, misstatements, or occupational fraud going undetected. Red flags include a lack of segregation of duties and management override of controls.
10. Management Turnover or Disputes: Frequent turnover or abrupt exits of executives, board members, or auditors; conflicts between management and auditors; and discord among top management could indicate deeper governance problems or doubts regarding the credibility of financial reporting. Significant turnover also can indicate underlying issues such as poor morale or company culture, inadequate training, or ineffective leadership, which can adversely affect the company's productivity, customer service quality, and overall performance.
11. Legal or Regulatory Issues: Ongoing legal proceedings, regulatory inquiries, or enforcement actions related to financial reporting, accounting practices, or corporate governance serve as indicators of potential financial misconduct or failure to comply with laws and regulations. Failure to comply with voluntary industry standards may also suggest operational difficulties within an organization, potentially impacting accounting assessments involving liabilities, including contingent ones.
12. Unexplained Balance Sheet Items: Unexplained or poorly supported balance sheet items, such as sudden changes in inventory levels or accounts receivable and accounts payable aging discrepancies, can represent potential red flags.
    a. Inventory Issues: Inventory issues encompass challenges related to the management, valuation, tracking, and risk mitigation of a company's inventory. Persistent inventory shortages, excess and obsolete inventory, or frequent write-offs suggest issues with inventory management, forecasting, and/or supply chain inefficiencies.
    b. Unexplained Asset Valuations or Impairments: Significant discrepancies between reported asset values and market or comparable transaction values, frequent asset impairments, or lack of supporting documentation for valuation assumptions may indicate potential overstatement of asset values or an unrecognized asset impairment.
13. Cash-Flow Problems: Cash-flow shortages, delays in A/R collections (days sales outstanding (DSO)), or increased A/P (days payable outstanding (DPO)) balances can indicate liquidity challenges, poor working-capital management, and underlying financial distress.
14. Supplier/Vendor Issues: Supplier issues refer to challenges related to the reliability, performance, and stability of the company's suppliers and supply chain partners. Supply chain disruptions, quality control issues, or supplier bankruptcies can disrupt production, lead to inventory shortages, and impact the company's ability to meet customer demand.
15. Quality Control Problems: Inadequate quality control measures, substandard or inefficient production processes, and insufficient product testing can increase the risk of product defects and quality-related incidents. Increasing customer complaints, customer returns, and warranty claims are indicators of these issues.

Continued from p.9

16. Safety Incidents or Violations: Safety concerns encompass risks related to workplace accidents, injuries, and occupational hazards. Failure to maintain a safe working environment, inadequate safety protocols, or noncompliance with health and safety regulations can lead to employee injuries, lawsuits, regulatory fines, and reputational damage. Increased workplace accidents, violations or fines, or regulatory noncompliance issues may indicate inadequate safety protocols, training deficiencies, or a disregard for regulatory requirements.

17. Data Security Breaches: Cybersecurity incidents, data breaches, or unauthorized access to sensitive information may indicate structural problems in IT, training deficiencies, or inadequate data security protocols. These issues can disrupt business operations, leading to a loss of revenue (customer trust), increased expenses, impairment of intangible assets (customer data or intellectual property can be stolen), increased regulatory compliance costs, and litigation expenditures.

Impact of Occupational Fraud on RWI Underwriting

Recognizing the risks posed by occupational fraud in a specific industry, market, or jurisdiction; comprehending the types of fraud (i.e., asset misappropriation, corruption, and financial statement manipulation); and acknowledging the financial impacts on RWI claim underwriting highlight the necessity of conducting a thorough, risk-based due diligence process. According to the Association of Certified Fraud Examiners' (ACFE) 2024: *A Report to the Nations,*[2] global fraud is a multibillion-dollar issue, and Certified Fraud Examiners estimate that organizations lose 5% of annual revenues each year due to occupational fraud. Of particular concern to businesses and underwriters is that tips identified 43% of frauds, half of which come from employees, a figure three times higher than any other method identified, including accidentally discovering fraud. Further, fraud carried out by owners/executives of an organization had a median loss seven times greater than fraud conducted by employees.

As it relates to risks associated with accounting estimates, financial statement fraud is the least likely type of occupational fraud to occur (5%) but tends to have the highest associated losses. From an underwriting perspective, the risk of financial statement fraud is low in frequency but high in severity. According to the 2024 *A Report to the Nations*, financial statement fraud had a median financial statement misstatement of $766,000, which was more than three times the median loss associated with corruption ($200,000) and more than six times the median loss associated with asset misappropriation ($122,000). Consequently, although the risk of occurrence may be low, potential losses associated with financial statement fraud make it a focal point for underwriting diligence.

[2] ACFE, Occupational Fraud 2024: *A Report to the Nations* (2024), https://legacy.acfe.com/report-to-the-nations/2024/.

Challenges with Diligence Accounting Estimates

The difference between a poor accounting estimate and fraud can be thin—reasonable minds may come to different conclusions when evaluating complex transactions, and both conclusions may fall within the spectrum of Generally Accepted Accounting Principles (GAAP). At what point do those conclusions deviate from adhering to GAAP standards and transition into potentially fraudulent activities? The three elements of the fraud triangle offer a helpful starting point for addressing this question.

According to the National Whistleblower Center: "...the fraud triangle is widely used by anti-fraud professionals to explain conditions that could incentivize individuals or companies to engage in fraud."[3] The three elements of the fraud triangle—sometimes a diamond with the addition of Capability—are (i) Motivation, (ii) Opportunity, and (iii) Rationalization. Each element is discussed below in the context of M&A:

i. **Motivation →** In a transaction, the seller of a company is motivated to maximize the purchase price. The company's historical financial results and future business opportunities drive the valuation of the target company, and a seller may take steps to maximize the consideration received from the sale process.

ii. **Opportunity →** Accounting estimates provide a unique opportunity for a seller to manipulate the financial information of the target company. For example, overstating a project's completion percentage or understating the required level of effort to complete the project increases the target company's revenue. However, estimates of the percentage of project completion can vary widely, and GAAP guidance on developing estimates is principle-based, allowing for the application of professional judgment. Consequently, two project managers faced with similar facts and circumstances may reasonably come to different conclusions, and both conclusions may be acceptable under GAAP. Given this, a seller may adopt a more aggressive approach than it otherwise would have if there were no prospects for a transaction.

iii. **Rationalization →** Because estimates are not guarantees of future performance, the seller may rationalize an outcome materially different from the estimate. For example, a seller may point to unforeseen issues or changes in facts and circumstances arising after the date of the estimate as the reason for the difference. The buyer may argue that the facts were knowable before closing and the estimate should have been updated and disclosed.

Capability: Consideration should also be given to the ability and characteristics of the individuals in a position to commit fraud. The ability and characteristics of the individual presented with motivation, opportunity, and rationalization could increase or decrease the risk of attempting or perpetrating fraud.

[3] National Whistleblower Center, "The Fraud Triangle," https://www.whistleblowers.org/fraud-triangle/.

To determine whether a well-intentioned yet inaccurate estimate devolves from a reasonable business judgment to potential fraud is ultimately a legal conclusion, as a lack of knowledge or negligence can also cause misstatements. However, evaluating the underlying facts and economic intent supporting the estimate could provide the additional information necessary to assess management's logic, basis, and reasoning. For instance, if management possesses information that contradicts its estimate but persists in relying on the estimate, questions arise regarding whether the estimate complies with GAAP standards. If management disregards available data because it doesn't align with their desired outcome, it could be argued that the financial statements no longer adhere to GAAP, constituting a breach of financial statement representations, irrespective of the underlying cause.

RWI Claims Involving Accounting Estimates

The ramifications of accounting estimates on an RWI claim can be substantial. The overstatement or understatement of revenue or expenses driven by a flawed accounting estimate can directly affect the financial statements covered by the representations and warranties in the purchase agreement commonly relied upon to determine an acceptable purchase price. The buyer's methodology for valuing the business typically relies on historical financial statements to calculate reported or adjusted EBITDA (earnings before interest, taxes, depreciation, and amortization) and forecast future financial performance. Claims based on misstated financial statements could be magnified by the multiplier effect when based on a discounted cash flow or EBITDA-based business valuation.

Recent RWI claims have been tied to discrepancies arising from errors in accounting estimates, highlighting the significance of assessing these estimates as part of the underwriting process. According to a recent study of RWI claim activity,[4] 20% of claims are based on financial statement misrepresentations, while 47% of RWI claim losses paid involved financial statement issues.

Recent Case Studies[5]

The following case studies illustrate recent RWI claims involving accounting estimates that led to the overstatement of revenue and understated expenses. Each of these claims involved allegations of numerous financial statement misstatements, and the case studies address only an example involving an estimate. When evaluating the duration of the impact of the misstatement, distinguishing between a permanent or temporary decline in forecasted profits and cash flow is crucial, as there could be a material impact on the diminution in the target company's perceived value and, therefore, purchase price damages. Overstatements that reflect structural business issues could lead to a permanent decline in the earnings capacity of the business as compared to the seller's representations. Consequently, expert opinions may vary depending on the unique context of each transaction, underscoring the nuanced factors that shape professional perspectives.

Case Study 1: Revenue Recognition: Discounts and Allowances

Discounts and allowances describe reductions in the price of goods or services provided by a seller to a buyer. These reductions can take various forms and are typically offered as incentives to encourage prompt payment, promote sales volume, or address specific customer needs. In this case, the understatement of discounts and allowances resulted in the overstatement of revenue and the ongoing earnings capacity of the business, a permanent impact on the forecasted cash flow.

Case Facts:

- Purchase price: $500 million
- RWI coverage: $75 million
- Seller: Individual with an apparently rapidly growing company selling consumer goods via retailers
- Buyer: Multibillion-dollar publicly traded company

Timeline of Events:

- Buyer diligence identified an increase in inventory prior to closing and was assured by seller it was an ordinary course event and part of the normal seasonality of the business.
- Buyer and seller agreed that revenue was overstated by $10 million at closing during the post-closing working capital true-up.
- After closing, buyer received communications from customers demanding discounts and allowances for products sold prior to the transaction that were not reflected in buyer's financial statements.
- The entity's customers provided evidence of pre-closing negotiations with seller supporting the amounts demanded. Yet buyer could not locate any record maintained by seller to support or refute the customers' claims.
- Buyer engaged counsel and a financial and accounting expert to assist with the investigation, which led to the discovery of millions of dollars in additional returns and allowances related to preclosing revenue that should have been reflected as a reduction to gross revenue.

Claim:

- Seller's financial statements overstated the target company's net revenue and earnings capacity due to an under-accrual of discounts and allowances for pre-closing product sales.
- Buyer relied on these financial statements to forecast future revenue and earnings to determine a reasonable purchase price.

GAAP Adjustment:

- Buyer's accounting and valuation expert identified over $15 million in discounts and allowances adjustments that were required to be reflected in the pre-closing financial statements based on the accounting terms of

[4] Lockton, *Lockton Transaction Liability Insurance: Market Update | The Americas* (Fall 2023), https://lockbox.lockton.com/m/417d5b9f4d93a902/original/Transaction-Liability-Market-Update-The-Americas-2023.pdf. The study analyzed RWI policies underwritten, and claims received, between 2018 and Fall 2023.

[5] These engagements took place before the professional joined BRG.

Continued from p.11

the purchase agreements and company policy, leading to a decrease in revenue and profits.

Loss:

- Based on buyer's valuation method for determining a reasonable purchase price, the overstatement of revenue led to a permanent decline in the forecasted earnings capacity of the business.
- Buyer's accounting and valuation expert analyzed and adjusted the discounted cash-flow valuation model to calculate purchase price damages.

Key Takeaways:

- If the target company has a rapid increase in sales compared to historical volumes or its industry competitors, perform substantial diligence on the business and economic factors driving the sales increase to assess the accuracy and reasonableness of the amounts reported.
- Compare inventory levels within the entire sales channel to identify anomalies, such as inventory growing faster than sales without a valid economic purpose or reason.
- Understand the policies and procedures employed by seller to prepare the estimates impacting reported revenue.

Case Study 2: Capitalization vs. Expense and Disclosure of Equipment Condition Age

This case involves failure to disclose deferred equipment maintenance and inappropriate capitalization practices in the years leading up to the transaction, which led to a critical production shutdown after closing. The inaccurate disclosure impacted multiple periods in the forecasted cash flow but did not extend into perpetuity due to buyer's ability to mitigate the damages by repairing the production equipment and rebuilding goodwill with major customers.

Case Facts:

- Purchase price: $100 million
- RWI coverage: $10 million
- Seller: Individual shareholders of an industrial manufacturing company
- Buyer: Privately held industrial manufacturing company

Timeline of Events:

- The target company's revenue and profits steadily increased in the years leading up to the transaction. Buyer utilized the trend to forecast revenue and profits to determine a reasonable purchase price.
- In the year after the acquisition, the company could not meet its pre-closing contractual obligations to major customers due to equipment downtime attributed to the target's unsatisfactory maintenance protocols.
- Buyer faced lawsuits from two significant customers, alleging breach of contract and failure to deliver agreed-upon goods.
- Buyer hired repair technicians to assess and restore the equipment in line with conditions necessary for regular operations to resume.
- Once repaired, buyer operated the company at the levels represented by seller, but the disruption caused a delay in the execution and achievement of the financial forecast used to establish a reasonable purchase price.

Claim:

- Allegations included inaccuracies in maintenance expense reporting, failure to disclose critical information regarding equipment condition, deviation from industry-standard maintenance practices, and the equipment's unsuitability for its intended purposes immediately after acquisition.
- Buyer relied on financial statements and representations regarding the condition of the equipment, including disclosures material to buyer's decision-making process, to determine a reasonable purchase price.

GAAP Adjustment:

- Buyer's accounting and valuation expert identified over $1 million in capitalized expenditures that should have been expensed in the financial statements based on the definitions of accounting terms in the purchase agreement.
- The proper application of GAAP was impacted by the failure to perform proper maintenance, resulting in the need to recognize impairment charges for the identified equipment (i.e., a lower net carrying value of the asset) and the capitalization of maintenance costs that are typically expenses and incurred. The failure to disclose this information was material to buyer's assessment of a reasonable purchase price.

Loss:

- Buyer's accounting and valuation expert analyzed methods used to determine purchase price and the calculated damages exceeding policy limits due to interruption of the business and delays due to the condition of the equipment and the need to repair it, as well as the damage to existing customer relationships.
- The impact of the production shutdown led to a one-year delay in the forecasted cash flows, in addition to the equipment repair costs, which resulted in the determination of a lower purchase price. Buyer's valuation model forecasted seven years, and the accounting and valuation expert assumed the business would meet its original forecast in year seven, resulting in a temporary impairment lasting six years.

Key Takeaways:

- Evaluate the condition of critical production equipment.

Additional Consequences Associated with Accounting Estimates

Beyond the direct financial impacts of an RWI claim, accounting estimates can lead to further ramifications including regulatory scrutiny and market reactions. These regulatory actions and market responses further emphasize the necessity of transparent and precise accounting practices.

1. SEC (Securities and Exchange Commission) – Civil Actions: Violations of SEC regulations can result in lengthy and costly investigations, enforcement actions, fines, restatements of financial statements, and loss of investor confidence.
2. DOJ (Department of Justice) – Criminal Actions: DOJ investigations or legal actions can have severe consequences including fines, penalties, and, in extreme cases, criminal charges against the company and/or its executives. Legal battles with the DOJ can be protracted and expensive, impacting the company's financial health and reputation.
3. Securities Class Action Lawsuits: These lawsuits can result in substantial financial settlements, damage to the company's reputation, and increased insurance costs. They often lead to prolonged legal battles and negative publicity, impacting shareholder confidence.
4. Regulatory Fines: Industry regulatory bodies may impose sanctions, restrictions, or fines for noncompliance with industry regulations. Regulatory scrutiny can further disrupt operations, increase compliance costs, and tarnish the company's image.
5. Increased Lending Costs: Legal and regulatory issues can raise borrowing costs for the company as lenders perceive higher risks associated with lending. Higher interest rates or more stringent lending terms can strain the company's financial resources and limit its ability to invest and grow.
6. Employee Retention: Legal and regulatory challenges can create uncertainty and instability within the company, leading to employee morale issues and increased turnover. Difficulty in retaining talent can disrupt operations, hinder innovation, and impede the company's long-term success.
7. Reputational Damage: Negative publicity from legal or regulatory issues can harm a company's brand and reputation. Reputational damage can erode customer trust, drive away investors, and hinder the company's ability to attract top talent and secure business partnerships.
8. Stock-Price Declines: Legal and regulatory challenges can cause stock prices to plummet, resulting in shareholder losses and decreased market capitalization. A significant stock drop can signal underlying issues within the company and trigger further investor concerns.

Conclusion

The significance of accounting estimates on RWI claims lies in their potential to affect the accuracy and reliability of management representations relied upon in determining a purchase price. Accounting estimates play a crucial role in determining a company's financial health and performance. Inaccurate or misleading accounting estimates can lead to misrepresentations that may trigger RWI claims if they result in financial losses for the buyer due to overpayment of the purchase price or post-acquisition costs. Therefore, comprehensive due diligence, including an evaluation of accounting estimates, is essential to mitigate the risks associated with RWI underwriting and claims management.

The views and opinions expressed in this article are those of the authors and do not necessarily reflect the opinions, position, or policy of Berkeley Research Group, LLC or its other employees and affiliates.

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2024 RESTRUCTURING OUTLOOK: RISE IN BANKRUPTCIES IS LIKELY TO CONTINUE[1]

Steven J. Fleming, CIRA, CDBV, and David Tyburski
PwC US

Higher interest rates and economic uncertainty fueled a surge in restructurings in 2023 and are setting the stage for another potential increase in 2024.

While there are glimmers of hope in the economy, economic uncertainty has not dissipated and significant rate relief is likely still months away. Cost cutting and new sources of cash helped some companies limp along in 2023. But those tactics are likely to run out of steam soon and macro improvements later this year may likely be too little, too late, for some companies.

We can also expect to see more debt downgrades and fewer upgrades this year. Some distressed companies will find relief out of court through amend-and-extend and liability management transactions. Commercial real estate owners, particularly in the office space class, will continue to hand back the keys on underwater assets leaving more lenders taking these assets onto their balance sheets.

2023 in Review

Last year saw a 68% jump in bankruptcies compared to the previous year.[2] The increase, especially in the first half of the year, reflected a return to more normalized levels than we have observed in recent years—see Exhibit 1. Bankruptcies were lower than normal in 2021 and 2022, as companies that might have otherwise been forced into restructuring benefited from low interest rates and hundreds of billions of dollars in government stimulus.

Sector insights (Exhibit 2)

Commercial real estate restructurings, as they have since 2021, made up nearly a third of all bankruptcies. Work-from-home trends, economic uncertainty and other factors continued to weigh on demand in some sectors and markets while higher interest rates squeezed cash flow.

Consumer goods companies had more filings in absolute terms —up from 64 in 2022 to 109 in 2023. But this higher number represents more of a return to historic norms—the sector averaged 109 restructurings annually from 2016-2020.

Healthcare providers faced more difficulties in 2023, with 76 filings—the highest in recent years. Government stimulus helped bolster healthcare balance sheets during the pandemic, however some of that stimulus came in the form of advance payments. That meant some providers had to repay these funds, squeezing cash flow and pushing some organizations into restructuring.

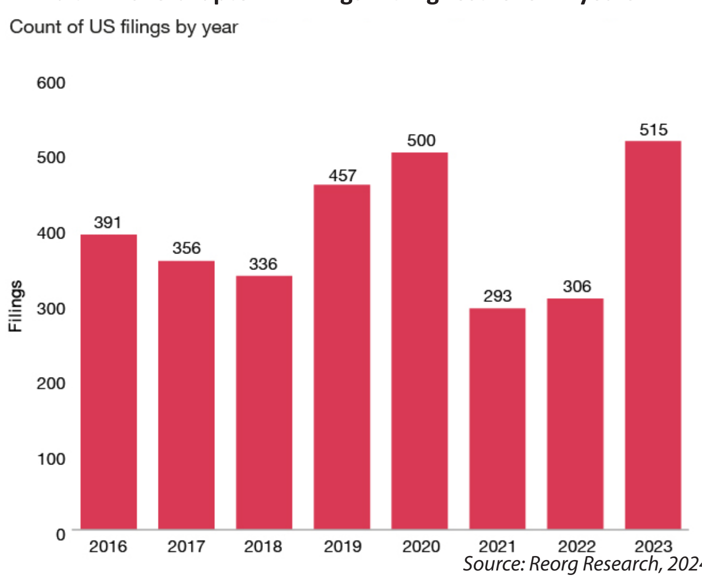
2024 Outlook

Bankruptcies and other forms of restructuring are broadly driven by macroeconomic factors, including interest rates, inflation, overall economic growth and other forces. However, under pressure many companies will hold out as long as they can before turning to restructuring as a last resort. It typically takes 12-18 months to see the overall effect of the macro environment show up in restructuring trends.

Therefore, despite 2023's high bankruptcy numbers, even higher numbers are likely in 2024. Many distressed companies will watch for rate cuts, a more positive economic outlook or positive geopolitical changes as they battle compressed margins. But we do not expect significant positive overall change until the second half, at the earliest, and many borrowers may not have the runway to hang on long enough.

[1] This article is also available at https://pwc.to/4fGEwDp.
[2] https://bankruptcy.epiqglobal.com/blog/commercial-chapter-11-filings-increased-68-percent-in-first-half-2023.

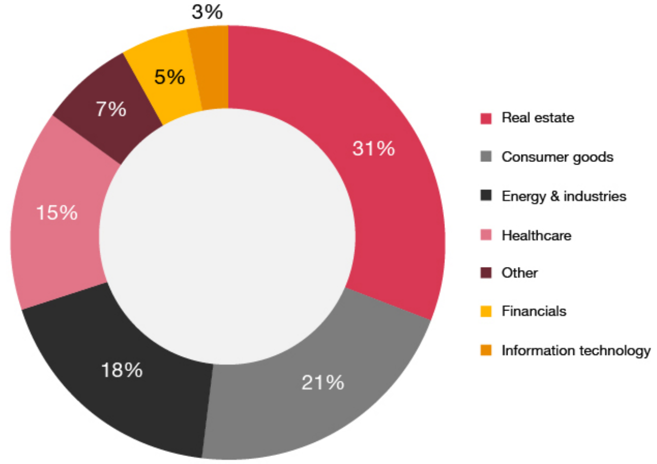
Exhibit 1: 2023 chapter 11 filings hit highest level in years



Source: Reorg Research, 2024

Continued from p.15

Exhibit 2: Certain sectors dominated restructuring activity in 2023



Source: Reorg Research, 2024

Here are the trends to watch in 2024:

Default rates (Exhibit 3)

Excluding the unusual circumstances of the 2020 COVID-19 pandemic and the 2008 Great Recession, we are now at one of the highest rates of issuer defaults in the past 20 years. The size of the loan market has increased significantly in that time, creating the potential for greater impacts on borrowers and investors.

Interest rates (Exhibit 4)

Higher interest rates have made it more difficult for companies to maintain sufficient cash flow to pay debt service and to stay in compliance with loan covenants. Rates are likely to decline in 2024, but the pace of the decline will depend on the strength of the economy. A recession would likely push rates down faster while a soft landing might keep them higher for longer.

Inflation

Inflation moderated in the second half of 2023, but it was still above the long-term target. The Federal Reserve's December 2023 Summary of Economic Projections had a median year-end personal consumption expenditures (PCE) rate of 2.8%—down from 3.3% three months earlier. In addition to its impact on the Fed's interest rate actions, inflation increases consumer uncertainty, compresses margins and pressures cash flow and liquidity.

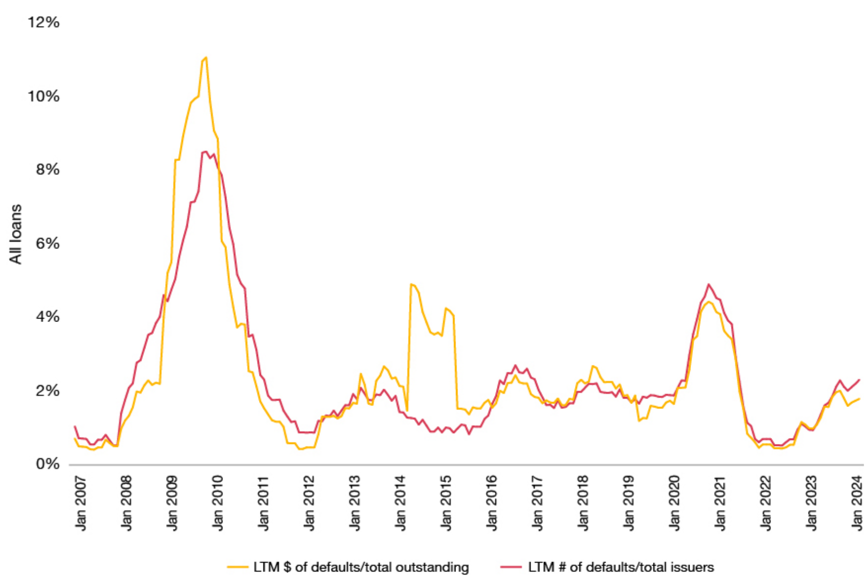
M&A activity

If transactions rise—more likely later in the year than earlier—— stressed companies could find relief in an acquirer. Likewise, more M&A activity can lead to more successful bankruptcy proceedings, with a bigger pool of potential rescuers to draw on. For private equity firms, distressed debt could be a source of outsized returns, depending on how they select and structure those deals.

Liability management transactions

Bankruptcy is not the only option for distressed borrowers. Some companies may be able to take advantage of older, more flexible debt agreements to address over-leveraged balance sheets or

Exhibit 3: Debt defaults are on the rise



Source: Pitchbook / LCD, 2024

liquidity needs. We expect up-tier transactions, asset transfers, and unrestricted subsidiaries raising new capital will continue to provide creative work-arounds in some situations.

Nonetheless, capital for distressed debt will likely remain scarce and expensive for the foreseeable future. Companies seeking these kinds of bankruptcy alternatives should make sure they understand their options and the nuances involved in these types of financing vehicles and the time necessary to execute these options.

Amend-and-extend transactions

Another option for companies trying to stay out of bankruptcy may be amend-and-extend transactions. These typically involve patient lenders and companies that can make a compelling, value-based argument for easier terms on existing debt. These transactions are not, however, an easy out for struggling firms. They often come with high fees, higher interest rates, more restrictive covenants and more reporting requirements.

Sectors to Watch

The headwinds that we see impacting 2024 will stretch across all sectors, but commercial real estate and healthcare are facing additional secular challenges that warrant a watchful eye in 2024.

Distressed debt concentrated among issuers in certain sectors:

Commercial real estate

As previously noted, commercial real estate has faced multiple headwinds in recent years. The pandemic disrupted occupancy and usage patterns across industry sectors and then 2023's sharp interest rate increases put pressure on new deals and refinancing transactions. These difficulties will likely persist in 2024 and with the sector facing record debt maturities over the next three years we expect this sector to be overrepresented in distressed transactions for years to come.

While lower rates may provide some relief later in the year, borrowers also have to keep an eye on economic fundamentals, which vary considerably across markets and asset type. We believe we will likely see a challenging environment overall, with pockets of acute distress and but also opportunities for investors in some places.

The bankruptcy statistics in commercial real estate can be a bit deceiving. Unlike with other kinds of debt, real estate borrowers can often simply hand the keys to the owner—in effect defaulting without the expense and complexity of formal bankruptcy proceedings. That means that the overall real estate environment may be more challenging than it appears.

Too many defaults—in court or outside of court—could also pressure regional banks, which have large amounts of real estate debt on their balance sheets. Poor real estate fundamentals could lead to negative follow-on effects for those lenders.

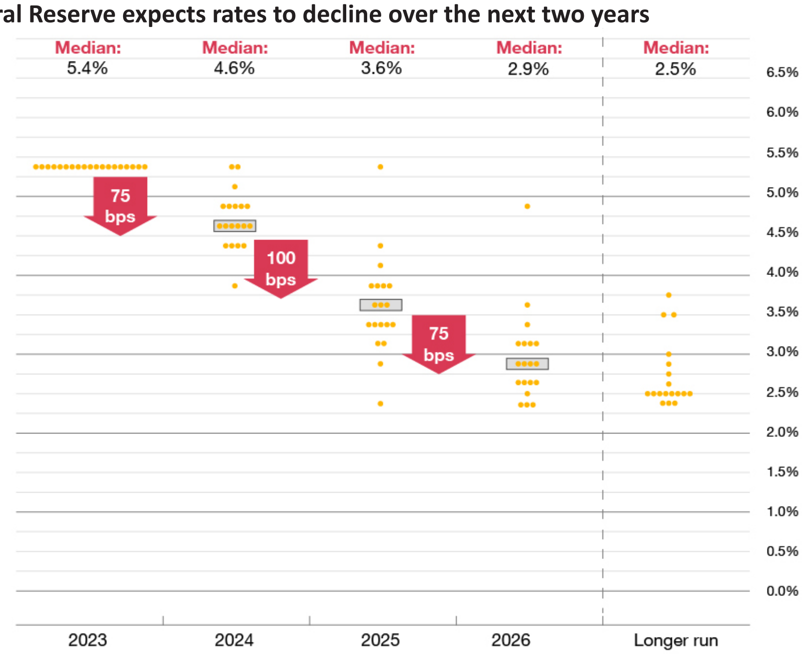
With office occupancy rates unlikely to return to pre-pandemic highs any time soon, there are signs that owners and developers are exploring ways to make use of office assets for residential, wellness and digital infrastructure plays. These transitions are typically capital intensive and financing for these alternative uses will be tough as long as interest rates are high, and the market remains skeptical of real estate investments. But if pressure on banks leads to fire sales, there may be opportunities for well-capitalized firms.

Healthcare

As the industry works through its COVID-19 recovery, high interest rates and regulatory pressures could make for a rocky road for healthcare providers. There is also considerable pressure on the industry to reinvent business models and transform portfolios to match a changing care and payor environment.

Smaller and more rural providers will likely remain at the greatest risk of default and restructuring. The pandemic brought temporary lifelines in the form of state and federal provider

Exhibit 4: Federal Reserve expects rates to decline over the next two years



Source: US Federal Reserve summary of economic projections, December 13, 2023, dot plot of projected year-end federal funds rate.

Continued from p.17

relief programs, but many of those are now gone. Many rural providers still face the fundamental challenge of operating in sparsely populated markets with many residents covered by Medicaid or Medicare, which usually reimburse at lower rates than commercial insurance.

Heightened federal scrutiny over antitrust issues has scuttled M&A efforts among some bigger hospitals and provider networks. That can make at least one alternative to restructuring —sale to another organization with a stronger balance sheet—more difficult. Overall, we can expect 2024 to be a challenging year for providers unless there is a step change in reimbursement rates, or until interest rates drop significantly.

Looking ahead

Companies facing uncertainty or financial challenges should keep the following in mind:

- Time is critical; the earlier companies act the more options they have available.
- Companies should plan for the next 18 months to have the runway needed to deal with potential problems and to pull value creation levers.
- Stress testing assumptions and considering downside scenarios is key. Companies should be prepared for the downside even as they plan for growth.
- Distressed situations are complex and need to be examined holistically across a range of issues, functional areas and technical expertise.

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A TALE OF TWO DEBT BURDENS: A DAY OF RECKONING FOR CHINA'S DEBT-FUELED INFRASTRUCTURE DEVELOPMENT AT HOME AND ABROAD*

Steven T. Kargman

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From its development in recent years of the most extensive network in the world of high-speed railways to its gleaming new, ultra-modern airports in cities large and small across China, to what is reputed to be the longest sea-crossing bridge in the world, China has developed a global reputation as a master builder of infrastructure. Yet, in light of China's history, this should not be a surprising development since China has long had a reputation as a master builder of impressive public works as reflected, for example, in the Grand Canal, the Forbidden City, and, of course, the Great Wall of China that were all constructed by Chinese dynasties in ancient times.

In the current era, China has undertaken large-scale infrastructure development both at home and abroad. Overseas, China has undertaken massive infrastructure development around the globe under the umbrella of its widely heralded Belt and Road Initiative (BRI), a signature initiative of Xi Jinping's tenure as the leader of China.

The BRI has supported the construction of, among other things, ports, airports, highways, railways, power projects, and special economic zones in numerous countries extending from Asia to Africa to Latin America and points in between. Within China itself, a significant amount of infrastructure development has been carried out at the level of local governments, principally through entities known as Local Government Financing Vehicles (LGFVs).

This development of infrastructure, whether in China or abroad, has involved raising massive amounts of debt. Specifically, with respect to BRI projects, Chinese financial institutions, principally its so-called "policy banks" (e.g., China Development Bank, Export-Import Bank of China, etc.) and its large, leading state-owned commercial banks (e.g., ICBC, China Construction Bank, etc.) have loaned BRI borrower countries, mostly developing countries and emerging economies, on the order of approximately a trillion dollars.[1] LGFVs, on the other hand, have issued bonds and borrowed money on a truly staggering scale, with the IMF, for example, estimating that LGFVs have total outstanding debt of approximately nine trillion dollars.[2]

To be sure, the incurrence of large amounts of debt to finance infrastructure development is not in and of itself problematic. On the contrary, it is virtually a sine qua non of infrastructure development that, in addition to whatever equity may be invested in an infrastructure project, a certain amount of debt will be also necessary to finance the development and construction of infrastructure projects.

The concern arises, though, when the borrowing entities become overleveraged and encounter serious problems in their ability to repay outstanding debt, i.e., when borrowers begin to experience financial distress and/or face debt sustainability challenges. Unfortunately, that is exactly where things stand today with many BRI borrower countries and LGFVs as a whole: they are now facing serious financial distress and huge debt sustainability challenges.

In the world of infrastructure development, borrowers are not likely to have an unsustainable debt burden if the underlying infrastructure project is generating adequate cash flow to repay the outstanding debt. Generally, before lenders and investors put money into infrastructure projects, they will (or should) conduct an economic feasibility study to determine whether the proposed project will be economically viable.

This involves undertaking a careful and thorough analysis of the project's ability to generate sufficient revenues over the life of the project both to repay debt to the project's lenders and to produce an equity return for the project's investors. This in turn requires an assessment or forecast of whether there will be adequate demand for a project's services or outputs (as well as an assessment, for example, of the costs of constructing and operating the project and the price or tariff for the project's output or services and the costs for any project inputs).[3]

If there is not such adequate demand (or if there are other problems affecting the project's economics such as cost overruns and construction delays) and consequently not a sufficient revenue stream to service debt and provide equity returns, then the infrastructure project in question may become economically unviable and therefore unable to service its debt, as we will see in greater detail in our discussion below of specific BRI projects. In a worst-case scenario where there is inadequate demand for a project's output, such a project may develop into an underutilized or even unused asset, i.e., a 'white elephant' (assuming that the project does not receive revenues from other sources such as government subsidies or other cash or equity infusions).

There are many factors that have contributed to the serious financial stress currently being experienced by BRI borrower

* Note: This article originally appeared in International Insolvency & Restructuring Report 2024/25 (IIRR) and is reprinted with the kind permission of IIRR's publisher, Capital Markets Intelligence Ltd. (https://www.capital-markets-intelligence.com). This article speaks of developments only as of mid-May 2024 and does not address any subsequent developments.

[1] See, e.g., "China Owed More Than US$1 trillion in Belt and Road Debt: Report," Agence-France Presse (AFP), August 11, 2023. See also Bradley Park, et al., "Belt and Road Reboot: Beijing's Bid to De-Risk Its Global Infrastructure Initiative," AidData (William & Mary), November 6, 2023 (available at https://www.aiddata.org/publications/belt-and-road-reboot)(indicating that estimates suggest that up to 75% of loans will be in the principal repayment period by 2030, with a total outstanding debt of US$1.1 to US$1.5 trillion).

[2] "China to Replace US$140bn LGFV Debt with Local Bonds - Bloomberg News," Reuters, August 11, 2023 (the IMF "estimates 66 trillion yuan (US$9.1 trillion) in total debt is held by LGFVs…").

[3] See generally John M. Niehuss, *International Project Finance in a Nutshell* (3rd edition), West Academic Publishing (2020), 20 (describing features of a feasibility study for a proposed project, including market studies and "an assessment of the basic economic viability of the project").

countries and LGFVs. In this article, however, we will focus on one important factor: namely, the underlying financial/ economic viability (or the lack thereof) of Chinese infrastructure projects overseas (i.e., BRI-financed projects) and domestically (i.e., LGFV-financed projects) and how this has seriously affected the debt sustainability of the respective debt burdens of specific BRI projects and LGFVs generally.

In other words, we will consider how the debt distress being experienced by BRI countries, on the one hand, and LGFVs, on the other hand, can in many ways be traced back to the lack of economic/financial viability of the underlying infrastructure projects.

BRI Projects

There are many BRI borrower countries around the globe that are experiencing some degree of sovereign debt distress. And within a number of BRI countries, there are many BRI projects that have proven to be uneconomic – whether due to construction delays, cost overruns, the failure to produce anticipated revenues, and so forth – and which are therefore unable to service their outstanding debt. In turn, this has been a major contributing factor to the sovereign debt distress being experienced by a range of these BRI countries.

Hambantota Port Project (Sri Lanka)

Of course, the poster child for this phenomenon has been the now-infamous Hambantota port project in southern Sri Lanka. There was hardly any vessel traffic coming into the port in its first few years of operations, and what vessel traffic there was fell far below what had been fairly healthy projections for anticipated vessel traffic[4] on the order of 2500 vessels annually.[5]

In fact, it was reported that, in all of 2012, only 34 vessels (or less than one vessel a week) in total berthed at the Hambantota port,[6] hardly the type of vessel traffic that could be reasonably be expected to support such a costly and expansive port project. (The Hambantota port project was completed and went into service in the early 2010s even before the formal launch of the BRI program in 2013, but it is generally thought of as a BRI project because the Chinese government folded the project into the BRI program after the BRI's official launch.)

A key problem with the Hambantota port project was that shipping companies saw no need to call on the Hambantota port which was located in a relatively remote part of Sri Lanka. This stood in contrast to Sri Lanka's other major port, the port in the capital city of Colombo, which was much more easily accessible and had much greater capacity and infrastructure to handle a decent flow of vessel traffic.

There has been widespread speculation that the Hambantota port project was sited in such a remote location in Sri Lanka because the Hambantota area of Sri Lanka was the political home base of the Rajapaksa family, the political dynasty that ruled Sri Lanka for many years until President Gotabaya Rajapaksa was forced to flee Sri Lanka in July 2022 in the face of massive demonstrations against his rule.

The net result was that the Hambantota port generated scant revenues and therefore found itself unable to service its outstanding debt on schedule. In 2017, the financial difficulties of the Hambantota port project ultimately led to what has widely (but not universally[7]) been referred to as a debt-for-equity swap. Under the debt-for-equity narrative, the Sri Lankan borrower, the Sri Lanka Ports Authority, was forced to give up control of the port in exchange for a substantial write-off of the outstanding debt owed to Chinese lenders.

This narrative further provides that a Chinese state-owned company, China Merchants Port Holdings Company Limited, was granted a 99-year lease concession on the port and surrounding land in return for the Chinese lenders in question agreeing to write off a significant portion of the outstanding debt that they were owed. (The total debt for the project amounted to approximately US$1.3bn or more.)

Crucially though, whether or not one subscribes to the debt-for-equity narrative or to an alternative narrative, the Chinese government gained control of an asset with potentially great strategic significance as the Hambantota port sits astride important shipping lanes in the Indian Ocean and is in relatively close proximity to India, a geopolitical rival of China.

Other troubled BRI projects

Apart from the Hambantota project, there have been a host of other BRI projects that have proven to be economically unviable or that have otherwise been beset by major problems such as significant cost overruns on construction, lengthy delays in completing construction, contractor disputes, and governance/ corruption issues.

Standard Gauge Railway (Kenya)

Africa has been home to numerous BRI projects, but many of these BRI projects have encountered significant difficulties that have rendered the projects uneconomic and/or financially distressed with the attendant serious debt sustainability challenges.

A case in point has been the Standard Gauge Railway (SGR) project in Kenya stretching over a route of approximately 480 kilometers that was designed to connect Nairobi, Kenya's capital city and commercial center, with Mombasa, its major port on the Indian Ocean. The SGR was intended to serve as a replacement for a railway along the same route dating to the British colonial era that was in a state of serious disrepair. As was intended,

[4] See, e.g., Shihar Amaz, "Sri Lanka Takes Next Step to Opening Strategic China-Built Port," Reuters, March 4, 2013 ("[t[housands of ships were meant to use Hambantota port soon after its November 2010 launch").

[5] "Sri Lanka launches new port in Hambantota," DW.com, August 16, 2010 (available at https://www.dw.com/ en/sri-lanka-launches-new-port-in-hambantota/a-5915470) ("[t]he new harbor has been designed to initially handle 2,500 ships a year to take off some of the pressure from the country's only port in Colombo, which handles some 6,000 ships annually").

[6] Maria Abi-Habib, "How China Got Sri Lanka to Cough Up a Port," *New York Times*, June 25, 2018.

[7] See, e.g., Maria Adele Carrai, "Questioning the Debt-Trap Diplomacy Rhetoric Surrounding Hambantota Port," Georgetown Journal of International Affairs, June 5, 2021 (available at https://gjia.georgetown. edu/2021/06/05/ questioning-the-debt-trap-diplomacy-rhetoric-surrounding- hambantota-port/).

Continued from p.21

the SGR has dramatically improved travel times by rail between Nairobi and Mombasa, cutting them roughly in half.[8]

However, the SGR project has been plagued by a wide range of problems. Among other issues, passenger and freight volumes on the SGR came in far below projections. For example, in its early years at least, the SGR ended up carrying only four to five million tons of cargo annually, "implying that the SGR was seriously underutilized and thus not generating expected revenues", according to a Council on Foreign Relations report.[9]

In addition, there have been major delays and cost overruns in construction of the project, and competition from road and air transport on the Nairobi-Mombasa route has been greater than expected, especially in light of the fact that shipping costs by road have proven to be less expensive than by rail transport via the SGR.[10] Furthermore, non-governmental organizations (NGOs) have long expressed concerns about, and the Kenyan parliament has launched inquiries into, the lack of transparency in the procurement process[11] for the construction and development of the SGR as well as allegations of corruption that have shadowed the SGR from the outset.

The SGR has thus experienced increased project costs and lower-than-expected revenues, with the result that the SGR has had difficulty in covering its operating costs. Moreover, the failure of the SGR to generate the expected revenues has adversely affected the ability of the Kenyan government to service the sovereign debt that it owes to Chinese lenders. To support the development of the SGR, the Kenyan government incurred debt of at least US$3bn, which is not an insignificant amount of debt for an economy of Kenya's size.

Kenya's debt to GDP ratio nearly doubled as a result of its BRI-related and other borrowings, from 37% in 2010 to 68% in 2021, according to *Bloomberg*.[12] It has also been reported that in 2024 a projected one-third of total government revenues will be needed for the servicing of interest alone on outstanding debt, thereby limiting the Kenyan government's resources that are available for expenditures on health, education, social welfare, and other important priorities.[13]

China-Pakistan Economic Corridor (Pakistan)

The China-Pakistan Economic Corridor (CPEC) has widely been seen as the flagship project of the entire Belt and Road Initiative. In reality, the CPEC consists not just of one project but rather a score of ambitious projects across a range of sectors. The CPEC encompasses power projects (including hydro, coal, and solar) and transmission lines, highways, railways, a major deep-sea port (Gwadar), industrial parks, and a fiber optic network. These BRI projects are all meant, in one way or another, to advance the economic development of Pakistan, whether for instance through increased power generation, increased connectivity, or increased international trade and commerce.

Nonetheless, a number of BRI projects under CPEC have suffered from a range of problems. Such problems include cost overruns, delays in project completion, questions about the competitiveness of the projects vis-à-vis the existing alternatives, environmental concerns, and land acquisition challenges. Furthermore, there have been questions and concerns as to whether there is adequate demand for the service or output that various CPEC projects are providing.

Many of these problems have contributed to the fact that a number of the CPEC projects have not generated the cash flows that they were expected to generate, and this in turn has complicated Pakistan's ability to repay its BRI-related debt.

In connection with CPEC projects, Pakistan has incurred a huge mountain of debt, with estimates ranging from US$50bn-US$60bn or more,[14] and Pakistan has certainly faced serious debt sustainability challenges in the last few years. Just under a year ago, Pakistan came literally within days of defaulting on its outstanding external debt but was saved from that eventuality at the last minute by new funding from the IMF as well as from certain Middle Eastern countries. But even so, observers still believe that Pakistan, at the present time, continues to be in very dire financial and economic straits.[15]

And yet a silver lining for China in BRI project difficulties

Even though BRI countries may experience financial distress as a result of unsustainable BRI loans, the Chinese government may see BRI lending as furthering certain broader objectives.

'String of Pearls' strategy and overarching geopolitical considerations

Outside analysts have posited that, for many years now, the Chinese government has been guided by a so-called "String of Pearls" strategy in which, for commercial reasons and/or naval force projection purposes, China has sought to exert control over ports along crucial waterways and sea lanes, particularly in the Indian Ocean but even extending through the Middle East to Africa.

For instance, China's gaining control of the Hambantota port in Sri Lanka via the so-called debt-for-equity swap discussed above

8 Mwamoyo Hamza, "New Railway Halves Travel Time from Nairobi to Mombasa" Voice of America News, June 4, 2017 (available at https://www.voanews.com/a/new-railway-halves-travel-time-from-nairobi-to-mombasa/3881432.html) ("[previously, passenger train service between Mombasa and Nairobi took 10 hours. Kenya says the new service will complete the 440-kilometer (275 miles) trip in five").

9 Oscar Otele, "China's Approach to Development in Africa: A Case Study of Kenya's Standard Gauge Railway " Council on Foreign Relations, October 13, 2021, available at https://www.cfr.org/sites/default/files/pdf/Otele_A%20Case%20Study%20of%20Kenya%E2%80%99s%20Standard%20Gauge%20Railway.pdf. The paper states, "In 2018, only 5.039m tons of cargo were ferried from Mombasa to Nairobi, while 3.25 million tons of cargo were transported between January and September 2019, implying that the SGR was seriously underutilized and thus not generating expected revenues."

10 See, e.g., Ian Goreki, "Kenya's Standard Gauge Railway: The Promise and Risks of Rail Megaprojects," The Wilson Center (blog post), September 24, 2020 (indicating that 'last-mile' costs of delivery have made cargo delivery by the SGR more expensive than by trucking); Duncan Miri, "Kenya Forcing Importers to Use Costly New Chinese Railway, Businessmen Say," Reuters, December 3, 2019.

11 Oscar Otele, "China's Approach," *supra* note 9.

12 David Herbling, "World Bank Urges Kenya to Cut High Debt Levels Sapping Economic Growth," Bloomberg, October 17, 2023.

13 Rachel Savage and Mark Jones, "Kenya's Double-Digit Debt Costs Sign of the Tough Times," Reuters, February 15, 2024.

14 Asif Shahzad, "Pakistan Says China Has Rolled Over US$2.4bn Loan for Two Years," Reuters, July 27, 2023 (indicating that China has pledged over US$60bn for BRI projects in Pakistan). Note: pledged amounts do not necessarily translate into disbursed loan amounts.

15 Reuters, "How Bad is Pakistan's Debt Crisis and Can the IMF Save It?" February 14, 2024 ("…the risk of a full-scale economic crisis remains").

would be totally consistent with this 'String of Pearls' strategy, as well as with the objectives of the Maritime Silk Road component of the overall Belt and Road Initiative.

Furthermore, beyond the Hambantota port project, China has several other BRI port projects underway, including among others the Djibouti port project in the Horn of Africa located at the mouth of the Red Sea and the Gwadar port project in Pakistan overlooking the Arabian Sea, that would support this 'String of Pearls' narrative. These ports occupy strategically important locations as they sit astride important sea lanes and so-called maritime choke points. Indeed, the strategic importance of Djibouti's location in particular was underlined by the fact that, in 2017, China opened its first-ever overseas naval base in that faraway locale.

To be sure, in order for China ultimately to gain control over these ports (at least in a commercial, non-military context), the Chinese lenders would have to foreclose on collateral (if the ports themselves were pledged as collateral for the loans) or, for instance, otherwise effectuate a debt-for-equity swap-type transaction along the lines of the deal that was struck with respect to the Hambantota port.

Another way in which China might potentially gain control over a key infrastructure project is a situation in which a Chinese contractor becomes indispensable in providing ongoing, on-site maintenance and repair following completion of the local infrastructure project where the local parties cannot properly provide such services. A lack of maintenance has been seen recently in the dysfunction and disrepair of the BRI-financed metro system in Addis Ababa, Ethiopia where Chinese companies have stepped in to provide technical support and spare parts to help address the problems plaguing that metro system.[16]

'Debt trap diplomacy'

For Chinese lenders and the Chinese government itself, the inability of the BRI projects to generate adequate cash flow may not have been of any particular concern. In fact, various observers and critics of the BRI program have speculated the BRI program was designed with exactly this in mind—namely, what has generally been referred to as 'debt trap diplomacy' pursued by the Chinese government (or what is sometimes simply referred to as the 'debt trap thesis').

Nonetheless, whether or not one agrees with this thesis (and opinion has been sharply divided on its validity[17]), to the extent that China can gain control of an important asset, such as a port in a geopolitically strategic position in the world (e.g., the Hambantota port on the Indian Ocean at relatively close distance to India) or can otherwise render BRI countries financially and/or economically dependent on China due to debt repayment or other economic and financial difficulties, then China will have achieved an important geopolitical objective. It will also have achieved an important political objective if the indebted country aligns itself more closely with China on matters of foreign policy, such as the China-Taiwan dispute, whether at the United Nations or at other international forums.

Financial losses for state-owned banks as a 'cost of doing business'

The fact that China's BRI lenders, mostly state-controlled entities such as the 'policy banks' and large state-owned commercial banks, may have to suffer financial losses on BRI projects might be viewed by Chinese policymakers as a mere "cost of doing business."

Such financial losses might be viewed by Chinese policymakers as an acceptable cost if they are incurred in service of a greater cause, i.e., permitting China to expand its geopolitical footprint, influence, and position in world affairs. In this context, Chinese policymakers might be seen as prioritizing China's geopolitical interests over the purely financial or economic interests of its leading financial institutions (which are predominantly state-owned in any case).

Nonetheless, while it has not necessarily been the only factor contributing to their sovereign debt distress, the lack of economic viability of BRI projects in their countries has left many BRI borrower countries saddled with sovereign debt burdens that they cannot possibly service.

As I discussed in an article published last year,[18] it has also left other countries bogged down in sovereign debt restructurings (e.g., restructurings involving Zambia, Sri Lanka, Ghana, etc.) that have taken much longer than usual to complete or even to make significant progress. China has been a central player in several of these restructurings by virtue of the fact that it is often one of the largest, if not the largest, creditor to the sovereigns in question.

LGFV Debt and LGFV-Financed Projects

While China's central government funds most infrastructure in China that has a nationwide scope, much of China's infrastructure development of a local scope is not funded by the central government but rather is funded at the local level. And it is not even provincial governments or municipalities which fund most of the infrastructure development at the local level. Instead, it is a Chinese entity known as a Local Government Financing Vehicle (LGFV).

Essentially, LGFVs are special-purpose vehicles set up by local governments for the purpose of financing the development of a wide array of infrastructure projects (e.g., roads, bridges, public buildings, etc.) but basically without the constraints facing local governments, particularly in their ability to incur debt.[19]

[16] See, e.g., Jevans Nyabiage, "China Hands a Lifeline to Ethiopian Capital's Crumbling Light Rail," South China Morning Post, February 17, 2023 ("China has come to the rescue of the Chinese-built Addis Ababa light rail transport service, agreeing to provide spare parts worth 155 million yuan (US$23m) for the struggling network's rolling stock"); Linda Poon, "Addis Ababa's China-Funded Metro Is Crumbling," Bloomberg, April 12, 2024.

[17] See, e.g., Lee Jones and Shahar Hameiri, "Debunking the Myth of 'Debt-trap Diplomacy,'" Chatham House, December 14, 2020 (available at https://www.chathamhouse.org/2020/08/debunking-myth-debt-trap- diplomacy/4-sri-lanka-and-bri).

[18] Steven T. Kargman, "The Brave New World of Sovereign Debt Restructuring: The China Conundrum and Other Challenges," International Insolvency & Restructuring Report 2023/24, 15-21, republished in *AIRA Journal*, Vol. 36, No. 3 (2023), 15-19.

[19] For an excellent and comprehensive discussion and analysis of the key legal issues related to LGFVs and LGFV debt, see Donald G. Clarke, The Law of China's Local Government Debt Crisis: Local Government Financing Vehicles and Their Bonds," GWU Law School Public Law Research Paper No. 2016-31, June 5, 2016, available at https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?article=2472&context=faculty_publications.

Continued from p.23

In recent years, however, LGFVs have become a major concern of Chinese government officials, from President Xi Jinping on down, in light of the sheer scale of the debt issued by LGFVs as well as issues about the ability of LGFVs to continue to service their outstanding debt on a timely basis. It remains to be seen whether recent strong pronouncements from the leaders in Beijing will be translated into concrete results at the local government level with respect to reining in the debt excesses of LGFVs. This will certainly be one of the most pressing and complex financial/economic challenges confronting the Chinese leadership in Beijing in the next few years.

LGFVs have also become a major focus of the credit rating agencies that rate Chinese government debt. In fact, last December when Moody's downgraded its 'outlook' on China's sovereign debt rating from 'stable' to 'negative' on an A1 rating (its third-highest rating), it specifically mentioned local government debt as one of the factors that contributed to its decision since a bailout of LGFVs by the central government would weigh on the Chinese government's finances.[20] Fitch took a similar action in early April and also cited the issue of LGFVs as a contributing factor to its decision.[21]

Obviously, the ratings assigned by the rating agencies to bonds are important because they can potentially affect the pricing on debt issuances (with lower ratings generally translating into more expensive debt for the issuer). Thus, the Chinese government will presumably be very attuned to any future actions by the rating agencies on China's sovereign debt and the potential impact that any future government actions might have on China's credit ratings.

Staggering LFGV debt burden and broader effects

Over the years, LGFVs have incurred a truly staggering amount of debt (consisting principally of both publicly issued bonds and bank loans), with the International Monetary Fund estimating that outstanding LGFV debt overall totals approximately US$9 trillion dollars.[22] And to put the enormity of that LGFV debt burden into broader perspective, a debt-to-GDP ratio involving only LGFV debt (and not Chinese government debt or even local government debt) generally would be just over fifty percent.[23]

The absolute amount of outstanding LGFV debt and the LGFV debt-to-GDP ratio represent high (and potentially worrisome) numbers from the standpoint of the soundness of China's overall financial system given the significant exposure of Chinese banks to LGFVs both through their purchase of LGFV bonds and their bank loans to LGFVs. If there were ever to be widespread defaults and/or restructurings with significant haircuts with respect to LGFV debt, that could potentially affect the capital position of the banks in light of the resulting requirement for the banks to take loan losses or set aside loan provisions.

It also could, in a worst-case scenario, potentially lead to financial stability concerns for the Chinese banking system if the relevant stakeholders ever were to lose confidence in Chinese banks. That is what has probably concentrated the minds of Chinese policymakers in recent times since they certainly do not want to see a financial crisis at any time but particularly not now when then the economy is in a relatively fragile state.

The LGFV problem could also have a potentially adverse impact on GDP growth in China. Earlier this year, *Bloomberg* reported that the financial problems facing the LGFVs could weigh down China's GDP growth in 2024 since it is likely to lead to less infrastructure investment by LGFVs,[24] but the *Bloomberg* report did not specify the size of any such potential drop in GDP. Since the Chinese economy is already facing strong headwinds, a LGFV-induced drop in GDP would not be welcome news by Chinese policymakers as they grapple with a sluggish post-COVID economic recovery, deflationary pressures in the economy, and continued troubles in the property market.

Nonetheless, it should be noted that, for more than a decade, observers have been cautioning about or even predicting an imminent LGFV debt crisis, and until now such a crisis has not yet materialized. But this moment may be different because LGFVs are currently facing a 'perfect storm,' as more fully discussed below, and will thus present Chinese policymakers with a supreme test of their ability to avert a serious LGFV debt crisis.

Recent debt servicing challenges for LGFVs

So far there have been no outright payment defaults by LGFVs on outstanding bonds, but there have been some payment defaults on other less significant debt obligations of LGFVs.[25] There have also been several instances of LGFVs making their debt service payments at the last minute. Moreover, certain LGFVs, particularly those in China's poorer, less economically developed regions such as the provinces of Guizhou, Yunnan, Gansu, and Inner Mongolia, have begun to explore debt restructuring and debt refinancing options with their banks and government officials in view of the financial difficulties that they have been facing.

For example, certain LGFVs have restructured their debt with banks so that debt with maturities of, say, ten years is stretched out to debt with a maturity of twenty or twenty-five years or longer,[26] accompanied possibly by lower interest rates and multi-year grace periods on the payment of principal. In addition, some outstanding LGFV debt is starting to be refinanced by new debt issued by the related local governments, so that off-balance sheet LGFV debt is taken onto the balance sheets of local

[20] Reuters, "Moody's Puts China on Downgrade Warning as Growth, Property Pressures Mount," December 5, 2023.

[21] Reuters, "Fitch Cuts China's Ratings Outlook on Growth Risks," April 10, 2024 ("[t]his does not mean that China will default any time soon, but it is possible to see credit polarization in some LGFVs (local government financing vehicles), especially as provincial governments see weaker fiscal health").

[22] See, e.g., "China's Debt-Laden Local Governments Pose Challenges to Economic Growth, Financial System," Reuters, March 10, 2023.

[23] Iori Kawate, "China Tries to Defuse Local Debt Risk with US$200bn Refinancing Tool," Asia Nikkei, September 3, 2023 (LGFV debt "equivalent to 53% of China's gross domestic product and 85% of GDP when combined with debts of local governments themselves").

[24] Tom Hancock, "China's Cleanup Efforts for LGFV Debt to Drag on Economy in 2024," Bloomberg, January 10, 2024.

[25] International Monetary Fund, "Local Government Finances After COVID and the Property Slump," 2024, 38 (" [t]he ongoing real estate slump and pandemic have delivered a combined shock to [local government] finances…..").

[26] Zhang Yukun and Cheng Siwei, "China's Local Governments Struggle with Hidden Debt," Nikkei Asia, May 8, 2023 (providing details of a restructuring of an LGFV in Guizhou province, Zunyi Road and Bridge Construction (Group), in which twenty-one banks agreed to extend the maturity on the LGFV debt to twenty years and to grant a grace period on principal payments for the first ten years).

governments, and this is something that is being encouraged by central government authorities.

Separately, certain local governments, due to their budgetary pressures, have fallen far behind in their wage payments to workers, in some cases by several months, and there have also been sharp cutbacks in services offered by certain local governments.[27] Although this is not strictly a problem of the LGFVs, it is emblematic of the financial difficulties facing local governments and helps explain why they do not have the necessary resources available to channel to LGFVs for the repayment of LGFV debt obligations.

Limited investment returns and other financial constraints facing LGFVs

A fundamental problem with LGFVs is that generally they generate truly negligible[28] and somewhat uncertain investment returns – returns that, crucially, are reported to be significantly lower than the borrowing costs of LGFVs.[29] In the past, when investment returns were not sufficient to service their debt, the LGFVs could rely on financial support from the related local governments.

Yet, as discussed more fully below, local governments no longer have such resources at their disposal to support LGFVs in servicing their debt due to sharply decreased revenues that local government have been receiving from land sales in the current troubled property market. Thus, LGFVs no longer have that extra cushion for servicing their outstanding debt.

One explanation for the low investment returns from LGFVs is that LGFVs focus on developing infrastructure that will provide public services at affordable prices (without regard to prospective investment returns), while a second explanation is an argument that the management of LGFVs simply make unwise investment decisions. A third explanation is that LGFVs make investment decisions strictly based on political considerations, again without regard to prospective investment returns. A fourth explanation is that the infrastructure projects being financed by LGFVs are considered long-term assets that generate returns over a lengthy period of time (such as 20 to 30 years), and high start-up costs for such projects can eat into returns in the early years of a project. This presents particular problems when LGFVs borrow in short-term debt since this creates a mismatch between a long-term asset and a short-term liability.

One area of immediate concern is that LGFVs are facing a wall of maturities in the coming years. In 2024 alone, LGFVs will face principal repayment obligations of approximately US$650bn (which represents a 13% increase over the amount of LGFV debt that fell due in 2023), according to *Bloomberg*.[30]

In addition, LGFVs are not maintaining healthy debt service coverage ratios which is an important metric in determining whether a borrower will be able to service its debt without difficulty. Indeed, a June 2023 report from the Rhodium Group indicated that "[n]early four fifths of LGFVs do not appear to have sufficient cash flows to cover interest payments."[31]

Another major area of concern stems from the fact that land sales by local governments have dropped precipitously in the last few years,[32] and this is closely connected in many ways to the recent slump, if not collapse, in the Chinese property market. With property developers in straitened circumstances and with several dozen property developers having defaulted on their debt in the last few years[33] as well as with property prices in China at severely depressed levels, local governments have not been able to find many willing buyers for land since so many Chinese property developers are on the sidelines in view of their current weakened financial condition.

This has had a deeply adverse impact on the ability of LGFVs to repay their debt. The proceeds from land sales have historically been a major source of revenue for local governments, and, with these revenues, local governments were able to use their budgets to help provide financial support to LGFVs for the repayment of their outstanding debt obligations. Investment returns from the LGFV projects themselves have been the other major source of funds for repaying LGFV debt, but, as discussed above, the flow of such investment returns from LGFV-financed projects has long been highly uncertain and is perhaps even more so in the current sluggish economic environment in China. Yet, without the financial support from local governments that they have received in the past, LGFVs have recently had a much-diminished capacity to repay their outstanding debt and hence the current financial difficulties of LGFVs.

Origins of the proliferation of LGFVs and the massive issuance of LGFV debt

In the Chinese system, local governments face certain major restrictions on their borrowing ability.[34] LGFVs, by contrast, have in the past generally not faced such restrictions on their ability to borrow. Until recently, LGFVs have been able to borrow from banks and issue bonds essentially without any significant limitations.

For local governments, borrowing through LGFVs is considered advantageous because such borrowing does not show up on their balance sheets. Rather, for local governments, LGFV borrowing

[27] Li Yuan, "China's Cities Are Buried in Debt, But They Keep Shoveling It On," *New York Times*, March 28, 2023.

[28] Han Shih Toh, "Debt on a Downward Spiral: China's LGFVs," Finance Asia, April 25, 2023 ("Given that typically, LGFVs generate returns on assets of less than 2%, they can barely meet a 3% interest rate. But many of these firms are actually borrowing at shadow bank interest rates as high as 10%.").

[29] PIMCO, "Local Government Financing Vehicles: A Growing Risk for China's Economy," September 1, 2023 (noting that LGFVs "fund infrastructure projects, which often fail to generate sufficient returns to cover debt payments, leaving many reliant on refinancing or government support to stay afloat").

[30] "China's LGFVs Has Record US$651bn Worth of Local Bonds Due in 2024," Bloomberg News, January 3, 2024.

[31] Allen Feng and Logan Wright, "Tapped Out," Rhodium Group, June 1, 2023 (available at https://rhg.com/research/tapped-out/).

[32] Iori Kawate, "China Tries to Defuse Local Debt Risk with US$200bn Refinancing Tool," Asia Nikkei, September 3, 2023 ("Revenue from [the sale of land use rights] was down 45% in the July-January period of [2023] compared with two years earlier").

[33] See, e.g., Joseph Wilkins, "Despite Country Garden's Last-Gasp Payment, China's Property Sector Remains in Crisis: Two-Thirds of Its Developers with Most Offshore Debt Are Defaulters," Business Insider, September 5, 2023 ("years-long crisis facing the nation's real-estate sector…..has seen 53 companies collapse in the space of little over two years").

[34] Qiu Lige, "A Way Out for 'Detroit' in China? — The Advantage and Feasibility of Starting Sub-National Bond Issuance in China," *PKU Transnational Law Review*, Vol. 1, Issue 2 (2013), 422 ("local governments in China have been barred from tapping the bond market since the 1994 PRC Budget Law, which banned direct sub-national bond issuance unless approved by the State Council or authorized by other laws").

Continued from p.25

is considered an 'off-balance sheet' item and thus, in Chinese government parlance, LGFV debt is for all intents and purposes considered a form of 'hidden debt.'[35]

In 1994, the Chinese government, under the leadership of Premier Zhu Rongji, realigned China's fiscal system so that more local government revenues would flow to the central government instead of remaining with local governments.[36] This created an incentive for local governments to make greater use of LGFVs as an off-balance sheet borrowing vehicle for funding expenses that their now-constrained budgets could not fund.

However, it was the global financial crisis of 2008-09 that provided a new, key impetus for the proliferation of LGFVs. At the time, the Chinese central government wanted to use new infrastructure construction and development as a means of stimulus for the Chinese economy so that the Chinese economy did not experience the same type of economic slowdown that much of the rest of the world was then experiencing. Ironically, during and after the global financial crisis, the Chinese government, leading a so-called 'socialist market' economy in a communist political system, was probably one of the most ardent practitioners of Keynesian economics among national governments.

China's central government looked in large part to the local governments to undertake this massive program of infrastructure construction and development. And the local governments in turn created multitudes of LGFVs that would be responsible for raising the finance for the development and construction of these infrastructure projects.

However, as the local governments in particular did not have the necessary funds in their budgets and were restricted by the central government in their borrowing activities, the LGFVs were in a sense largely on their own to raise the financing for these infrastructure projects. As a consequence, the LGFVs raised huge amounts of debt, financed through the issuance of bonds as well as through loans from banks, that was used to support this construction and development of infrastructure. LGFVs also relied upon high-interest rate products offered by 'shadow banks,' including so-called 'wealth management products,' particularly when access to financing from banks was not readily available.

In the 15 years since the global financial crisis, LGFVs have truly taken on a life of their own. The number of LGFVs in existence has increased very significantly, rising to thousands of LGFVs. As noted above, the amount of debt these LGFVs are carrying has skyrocketed in recent years into the trillions of dollars (nine trillion dollars, according to the IMF's estimate mentioned above).

[35] Yu Hairong, Cheng Siwei, Zhang Yuzzhe, and Han Wei, "China's Effort to Cut US$10tn of 'Hidden Debt' Faces Uphill Climb," Caixin, May 23, 2023 (China's State Council defined 'hidden debt' in 2018 as "any borrowing that is not part of on-budget government debt, but carries an explicit or implicit guarantee of repayment using fiscal funds from cities or provinces, or is backed by illegal guarantees").

[36] See, e.g., Di Lu, "China's Local Government Credit Dilemma," East Asia Forum, November 5, 2023 (available at https:// eastasiaforum.org/2023/11/03/chinas-local- government-credit-dilemma/) ("China's tax revenue sharing reform, orchestrated by then premier Zhu Rongji in 1994, restructured China's fiscal system to bolster central control of taxation, significantly diminishing local governments' share of tax revenues and weakening their fiscal strength"). See also Qiu Lige, *supra* note 34, at 426 (new system introduced in 19994 "reduced local governments' share of revenues" but "left their expenditure responsibilities unchanged" and thereby "...created a fiscal gap for local governments…").

For many years, China's central government has been trying to get a firm handle on the world of LGFVs. In fact, since the early 2010s, the central government has undertaken several national 'audits' for precisely the purpose of understanding the true scope of the LGFV debt problem. But it has presumably been challenging for the central government to get a comprehensive and accurate picture of the LGFV debt problem since LGFVs may not be completely open and transparent about their finances.

Options for addressing LGFV debt problems

China's central government is encouraging local governments and LGFVs to explore restructuring and refinancing options to address the debt problems of the LGFVs. The Chinese government is also restricting the amount of debt that LGFVs can issue, particularly LGFVs in weaker economic regions. In addition, the national government is also instructing LGFVs and the local governments in the economically distressed or weaker regions to cease further work on infrastructure projects that are not considered essential and to not undertake any new infrastructure projects.

Further, local governments are starting to conduct more extensive audits of LGFVs within their jurisdictions, and the central government plans to dispatch experts from various central government ministries and agencies to consult with officials of local governments where the local debt issues are most acute on how to address their financial challenges. Moreover, the central government has allowed provinces to issue approximately US$139bn of bonds that can be used to refinance outstanding LGFV debt. Yet, while that may be a welcome step, that amount of new bonds barely makes a dent in the overall multi-trillion dollar debt burden of LGFVs.

Fundamentally, however, Chinese authorities may wish to go beyond some of the measures now being discussed and instead consider more structural options outlined below for addressing the major debt travails facing LGFVs and avoiding future problems with LGFV debt.

First, as has been discussed by various analysts, the entire fiscal relationship between local governments and the central government probably needs to be re-examined. The objective would be to strengthen the financial position of local governments so that, for example, local governments would be able to retain more of the revenues that they raise through taxes and fees instead of reallocating a not insignificant portion of those revenues to the central government.

In addition, to the extent that local governments are responsible at the behest of the central government for certain expenditures designed to benefit their local populations but for which they are not reimbursed, such unfunded mandates should be re-evaluated.

Second, as to the debt restructuring of LGFV debt, that process could be handled on a less ad hoc, less localized basis. The central government might consider establishing a new national agency to take the lead on coordinating restructuring discussions between LGFVs and their creditors or at least provide a platform for such discussions to take place.

The Chinese government might look to a model developed by Japan in the early 2000s when it established a quasi-governmental agency, the Industrial Revitalization Corporation of Japan (IRCJ) that was led by Dr. Shinjiro Takagi. The basic purpose of ICRJ was to help restructure companies that were fundamentally viable but to liquidate companies that were that were overindebted and not viable over the long term (otherwise known as 'zombie companies').[37]

Third, the Chinese government might wish to consider how local infrastructure is financed generally: should it be solely or largely the responsibility of local governments as it is currently (with much of that financing provided by LGFVs), or should the central government play a more important role in financing such infrastructure investment?

This issue comes into sharper focus when one considers that the central government has, as noted above, from time to time directed local governments to undertake infrastructure investment and development as a matter of national fiscal policy in order to stimulate the Chinese economy. The Chinese government has done this particularly during periods of economic slowdown when it has used infrastructure spending as a countercyclical economic policy measure.

There are different modalities that China's central government might use to steer the financing of local infrastructure investment and development away from the local level to the national level. For instance, the Chinese government might consider establishing, on the one hand, a national infrastructure development bank which could support local infrastructure development (i.e., a potential domestic counterpart to the Chinese-sponsored Asian Infrastructure Investment Bank (AIIB)). Or it might consider, on the other hand, establishing a national financing agency dedicated to raising finance for local infrastructure development (which might potentially benefit from the credit rating of the national government).

Of course, the central government would presumably not want to become directly involved in the decision-making on the financing of thousands of individual infrastructure projects that local governments undertake across China as a whole. Nonetheless, any national financing mechanisms such as those discussed above could allocate blocs of financing (i.e., on-lend financing) to localities to undertake the development of a range of individual projects.

Furthermore, specifically with respect to a national infrastructure financing agency, the Chinese central government would want to ensure that any borrowings by the agency would not have the effect of overleveraging the Chinese government's balance sheet or otherwise adversely affecting the Chinese government's credit rating.

Fourth, the Chinese government and the Chinese Communist Party itself might revisit the criteria for the promotion of local government officials and/or local party cadres. Although there has been considerable controversy and debate surrounding this issue, it has been posited by some observers that one criterion used in this process is how much the local officials and/or party cadres have fostered economic growth (i.e., GDP growth) in their localities during their term of office, with the more growth supposedly leading to better career prospects for the local officials and/ or party cadres in question.[38]

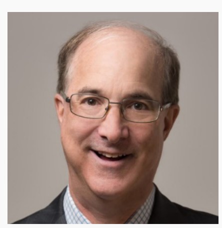
To the extent that this criterion for promotion based on GDP growth actually exists and is enforced by senior government/ party officials in practice, a lessened emphasis on this criterion for promotion might attenuate the urge by local officials and/or party cadres to undertake unnecessary infrastructure investment and development (as well as incurring excessive debt) as a way of increasing local GDP. In any event, whatever the relevant criteria for promotions, local officials and/or party cadres should not get any credit for infrastructure investments which are unproductive economically.[39]

Finally, the Chinese government might consider enacting a new bankruptcy law for municipalities to supplement China's existing bankruptcy law for corporations, namely the Enterprise Bankruptcy Law. China does not currently have a municipal bankruptcy law, but such a law is present in certain other jurisdictions, perhaps most notably in the US in the form of Chapter 9 of the US Bankruptcy Code. The LGFV debt crisis has shone a spotlight on the precarious finances of local governments across China, including municipalities in China.

A new Chinese bankruptcy law directed specifically at municipalities could be used as a last resort to provide a financially distressed municipality protection from its creditors while it works out a plan of adjustment of its debts with those creditors. It should not be overlooked, though, that Chapter 9 of the US Bankruptcy Code provides an important safeguard for the municipality to continue providing 'essential services' to its residents during the Chapter 9 bankruptcy proceeding.

Importantly, if creditors know that the municipality could end up in bankruptcy, they will be more careful in their lending decisions concerning municipalities since they will not be able to assume that the distressed municipality will be bailed out by a higher governmental authority. That, in turn, could help wring out of the system whatever moral hazard exists in relation to the lending of funds to municipalities.

ABOUT THE AUTHOR



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The author gratefully acknowledges the extremely insightful and constructive comments of James R. Kurth, Dan Guttman, and Shitong Qiao on an earlier draft of the article, as well as the excellent research assistance of Roman Shemakov. Of course, any and all errors in the article remain solely the responsibility of the author.

[37] Shinjiro Takagi, "Quasi-Governmental Special Purpose Vehicle to Restructure Ailing Business Corporations in Extraordinary Times—Proposal based on Japan's Experiences," *Norton Annual Review of International Insolvency* (2009), 181-182.

[38] Zhuo Chen, Mingzhi Hu, and Zhiyi Qiu, "Promotion Pressures of Local Leaders and Real Estate Investments: China and Leader Heterogeneity," *Journal of Risk and Financial Management*, August 2022 ("... regional gross domestic product (GDP) has been used both as a benchmark for judging local officials' policy decisions and as a [criterion] in determining promotions within the Communist Party").

[39] See, e.g., Donald Clarke, *supra* note 19, at 57 (citing "classic case of digging a hole and filling it up again").

NET WORKING CAPITAL: WHAT TO KNOW WHEN INVOLVED IN AN ACQUISITION

Harry Gruits
Stout

Today's macroeconomic and geopolitical landscape presents many factors for deal makers to consider when trying to evaluate an acquisition. Inflationary pressures, supply chain disruption, and other factors all create commercial, operational, and financial challenges. While the profitability and cash flow impact of these challenges may be addressed in a quality-of-earnings analysis, it is critical to ensure the current and future impacts of these challenges are addressed when assessing the "normal" level of working capital for purposes of setting the peg at closing and, ultimately, understanding what is required to operate the business.

Creative solutions such as working capital "collars" or adjustment caps can be applied to mitigate large working capital adjustments at closing, particularly when there is a heightened level of uncertainty; however, thorough due diligence should be performed to understand drivers, volatility, and requirements going forward.

The Importance of Net Working Capital

Net working capital (NWC) represents the money available to fund short-term operational obligations. It impacts many areas of the business, such as settling with vendors, securing inventory, and meeting payroll. Working capital can fluctuate significantly throughout the year due to seasonality, changes in customer demand, availability of supply, pricing, and unplanned events.

When considering an acquisition, working capital is typically a component of the purchase price with a dollar-for-dollar adjustment mechanism to settle the delta between the agreed-upon working capital target (or "peg") and the amount as of the closing date. While traditionally NWC is defined as current assets less current liabilities, it is generally more complex in a transaction, as it could include several adjustments. Examples include:

- **Definitional adjustments:** This could include adjustments consistent with a cash-free / debt-free transaction (e.g. cash, income taxes, and financing-related items)
- **Diligence adjustments:** This could relate to non-operating or non-recurring items, changes in accounting methodology, or other types of normalization items
- **Pro-forma adjustments:** This is recasting the historical NWC balances on an "as-if" basis by applying more current or relevant assumptions (e.g., retroactively adjusting NWC components for increases in pricing due to inflation)

Therefore, it is critical to understand the components of working capital and drivers of fluctuations to make sure the business has the levels it needs on day one without any disruptions or need for cash infusions. This is also critical to ensure the appropriate peg is established at closing with appropriate documentation included in the sale and purchase agreement to minimize post-closing adjustments and disputes.

What to Consider When Evaluating NWC

When evaluating NWC, the devil is in the details. Adjustments to determine the required level of NWC for the business and establishing the appropriate peg is typically not identifiable at a balance sheet summary level. Summary level accounts may include non-operating items or mask unusual trends in the business.

NWC components should be assessed at a detailed level (e.g., trial balance and sub-ledger) to ensure each account is considered, and, if necessary, adjusted when evaluating normalized NWC and determining the peg. Items excluded from NWC should be further assessed for debt-like treatment in the sale and purchase agreement.

Quality of Assets and Completeness of Liabilities

The acquisition target's accounting policies and procedures may not include a robust monthly closing ("hard-close") process, resulting in the potential misstatement of account balances at a given month-end. This tends to be more common with accounts requiring a higher level of subjectivity (e.g., bad debt or inventory reserves and accrued liabilities).

One should inquire with management as to the frequency of a hard-close accounting process to identify accounts that may require further analysis to assess the quality and completeness and may require adjustments for purposes of estimating the normalized NWC. This may include the following:

- Review the company's accounting and reporting manual to identify month vs. quarter vs. year-end differences, if available
- Review of accounts receivable and inventory aging to identify uncollectible accounts or obsolete inventory and adjust reserves accordingly
- Review of accrued liability account reconciliations to assess reasonableness of estimates and methodology

Notably, NWC requirements can shift significantly across periods for a variety of reasons:

- **Seasonality:** Businesses subject to seasonality can experience significant month-to-month fluctuations due to seasonal timing of sales and purchasing patterns.
- **Business expansion / contraction:** Growth or decline in the business can result in changes to NWC requirements (such as large customer wins or losses, new or discontinued products, and geographic expansion or contraction).
- **Macroeconomic factors:** Inflation and rising prices impact nearly every component of NWC, which can result in higher run-rates going forward. Supply chain disruption can also have impacts. Shipping lead times, scarcity of raw

Continued from p.29

materials, the war in Ukraine, and government shutdowns have all contributed to companies needing to reassess and reconfigure their supply chains. This has led to increased costs and changes in buying patterns to secure product, all of which impact NWC.

Establishing the Net Working Capital Peg Is More of an Art Than a Science

When establishing the NWC peg, the drivers, their recurrence, timing, and impact need to be assessed to ensure the right approach is taken. Best practices when performing this assessment include:

- **Understand the recent changes in the business** and how these impact NWC in the present and going forward. More recent net working capital trends may be more indicative of normalized levels going forward.
- **Calculate and analyze key NWC metrics**, such as days sales outstanding, day inventory on hand and days payable outstanding (DSO, DIOH, and DPO, respectively). These metrics can help identify problems and opportunities with the business' working capital management and help understand the timing of the business' cash flow cycle. These metrics can also be applied to the forecast of the business to understand future NWC needs when there is an expected growth or decline in the future (e.g., geographical expansion or contraction, plant openings, or closings).
- **Review the financial statements as a whole.** The income statement and balance sheet are linked and should be reviewed collectively to ensure the valuation of the business is comprehensive and aligned.

Defining Closing Net Working Capital in the Sale and Purchase Agreement

To avoid surprises and mitigate manipulation, it is best practice to include a tight definition documenting in detail how closing NWC will be calculated. From a buyer's perspective, this provides protection so the seller can't increase cash or decrease debt through the manipulation of NWC (e.g., accelerating collections, delayed payments to lenders).

When documenting a tight definition, it should explicitly address the accounts included and the accounting principles to be applied when calculating closing NWC.

Accounts included can be an exhibit in the sale and purchase agreement, which provides an illustrative calculation of NWC at a trial balance level (TB) with account numbers. This should align with how the peg was established along with adjustments, if any, to be included in the true-up mechanism. Accounting principles refer to the methodology being applied to the included accounts when calculating closing NWC. This could include 1) specific principles, policies, or procedures to be applied, 2) establishing consistency with a set of financial statements, or 3) defaulting to GAAP if not covered by the previous two options.

Including these elements in the definition should mitigate ambiguity of how closing NWC should be calculated and reduce the likelihood of a dispute.

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Adjustment Mechanism

As previously noted, a dollar-for-dollar adjustment mechanism to settle the delta between the agreed upon working capital target (or "peg") and the amount as of the closing date is documented in the sale and purchase agreement. If well documented, disputes can be mitigated, but if not, the adjustment can be significant and ultimately lead to disputes between the buyer and seller. Drivers of such adjustments could include the following:

- Lack of a tight definition, thereby allowing parties to manipulate net working capital
- Inadequate diligence performed when establishing the peg
- Seasonality in the business
- Growth or decline in the business
- Closing on a non-month end date (e.g., mid-month) where a "hard close" accounting process is not performed, and assumptions are required
- Unplanned events

To avoid unplanned large adjustments or surprises, an estimate of closing NWC is typically prepared around five days prior to closing. While this is an estimate, it should be prepared based on applying the definition of closing NWC and the accounting principles as documented in the sale and purchase agreement. The estimate can be reviewed by both buyer and seller ahead of closing to resolve any discrepancies and update the estimate or sale and purchase agreement as necessary.

There are various creative approaches that can be taken when defining the adjustment mechanism. However, these may serve in the interest of only one party, and the ability to obtain such an approach is typically tied to the negotiating power and deal acumen of each party. When applied, these items should be specifically documented in the sale and purchase agreement. Examples include:

- **Net working capital "collar":** This is an approach used to avoid adjustments for differences between the peg and closing NWC. If the difference between the peg and closing NWC is within the negotiated collar amount, then no adjustment is made. If the delta is outside the collar, then all or just the incremental delta could be subject to the mechanism (depending on what is negotiated).

- **“One-direction collar”:** If the buyer is concerned the seller will manipulate NWC leading up to closing, they may seek a “one-direction” collar whereby an adjustment is only made to the extent closing NWC is lower than the peg (in favor of the buyer).
- **NWC cap:** To avoid large adjustments or settlements, buyers and sellers may cap the adjustment to be no greater than a certain dollar amount, whether positive or negative.

Perform the Right Level of Due Diligence

In summary, there are many elements to consider when assessing the “normal” level of working capital for purposes of setting the peg at closing and understanding what is required to operate the business. Recent macroeconomic events have disrupted businesses and the net working capital requirements needed to operate.

Therefore, it is critical to perform the right level of due diligence to ensure NWC requirements are understood, and the right protections are included in the sale and purchase agreement to mitigate surprises at closing and going forward.

THIRD PARTY LITIGATION FINANCE AND ITS IMPACT ON THE BANKRUPTCY INDUSTRY

Ken Epstein, *Omni Bridgeway*
Marc Carmel, *McDonald Hopkins*

Third-party litigation funding is a multibillion-dollar U.S. industry in which investors help litigants and law firms pay legal fees and expenses in exchange for a return from a winning case or cases. It seems a natural fit in bankruptcy matters, with creditors vying for limited resources and liquidity-constrained debtors seeking a lifeline to preserve whatever value remains in their enterprises. So, what role does litigation finance play in today's bankruptcy world? And what role will litigation finance play in the future?

Litigation Finance's Historical Significance in Bankruptcy

To begin with, it helps to understand the size of the litigation finance market, which is small in comparison to the legal services market in the U.S. There are a few dozen commercial litigation funders globally, who together committed to invest an estimated $8.7 billion in commercial disputes over the last three calendar years.[1] It is now estimated that litigation finance companies, which include public companies, registered investment companies, and multi-strategy investment funds, control about $15.2 billion in investible domestic capital, with additional resources overseas.[2] While this number sounds impressive and has increased substantially in the past decade, it is a drop in the bucket when compared to the amounts litigants spent on legal fees and expenses every year in the U.S.

To date, most litigation finance money is put to work outside of the bankruptcy context. It is more commonly found in areas where litigation tends to be the most expensive, risky, long-lasting, and with the highest potential for damages. These factors make litigation finance an attractive option for individual and corporate plaintiffs and law firms seeking to externalize the cost and mitigate the unpredictability of their legal spend and are often attractive for patent, antitrust and non-bankruptcy commercial litigations with large-dollar stakes. These plaintiffs can preserve cash, lower their operating costs, and have greater pre-judgment profitability.

In comparison to the areas of litigation mentioned above, litigation finance in bankruptcy cases has been less prevalent over time. Although bankruptcies occur in all climates, historically low corporate default rates in recent years have limited the number of large-scale disputes and quality funding opportunities. Other challenging factors include the relatively rapid pacing of bankruptcy proceedings, which creates a mismatch with extensive diligence processes required by some litigation financing underwriters; a bankruptcy system that strongly encourages settlements and releases of causes of action; and vulnerabilities where resourceful existing creditors, including hedge funds, may use their leverage to direct value to themselves (and away from potential litigation finance-funded parties).

Litigation Finance's Growth with Distressed Companies and Bankruptcy

While litigation financing firms have not played a significant role with respect to bankruptcies and companies in financial distress to date, times *are* changing. Last year saw growth in high-profile cases, several of which are discussed below. Like rescue financing, litigation funding can be a critical lifeline for the preservation and creation of value. It continues to expand in the marketplace for entities in a variety of complicated circumstances.

Pre-Bankruptcy: Financially Distressed or Constrained Companies

Financial stresses related to litigation can have significant impacts on even the most well-capitalized companies, so the benefits of litigation financing for those in financial distress can be critical. Distressed companies that choose to use litigation financing may be faced with operationally material litigation costs, are typically unable to secure credit from traditional lenders, and often unable or unwilling to raise additional equity capital. Outsourcing legal expenses helps preserve liquidity and allows managers to reliably predict their cash flows, providing robust legal flexibility while smoothing out the inherent volatility of litigation. Without litigation funding, monthly legal bills can add up quickly and vary considerably depending on the stage of the case.

Recently, a financially distressed automotive business was able to obtain a commitment for litigation funding to pay the automotive business' legal fees and costs in a private transaction. The company's sales had been reduced to almost nothing due to the allegedly unlawful anti-competitive tactics of a larger competitor. The company had been unable to effectively seek redress and rebuild its business at the same time; however, it turned to litigation funding to preserve cash and help avoid having to file for bankruptcy, and it was successful.

Distressed companies can also use decisions about disclosure of litigation financing relationships to their strategic advantage. Having a litigation funder with an objective and knowledgeable viewpoint "in your corner" can be a powerful tool to drive meaningful settlements on the merits, often on an expedited timetable. While litigation is a distraction for any company, the time saved can be particularly valuable for a cash-constrained entity that needs to allocate maximum capital and management focus on satisfying investors and manufacturing, marketing, and selling its product. Some companies have even chosen to announce the presence of litigation financing to send a message to opposing parties. It *means* something to have a sophisticated litigation funder backing your claims with unknown millions in non-recourse financing -- and defendants recognize this.

Even those cases with strong merits but facing a prohibitively large imbalance of resources may take on a new character with the participation of litigation financing. For example, a litigation funding agreement was approved for a class action brought against Google and Meta for their alleged misconduct in on-line

[1] *2023 Litigation Finance Market Report*, Westfleet Advisors, April 1, 2024, https://www.westfleetadvisors.com/publications/2023-litigation-finance-market-report/.

[2] Ibid.

Continued from p.33

advertising.[3] The claim was brought by Crowsnest Pass Herald, a struggling Alberta newspaper with a limited circulation, on behalf of all similarly situated web-publishers. One can hardly imagine this small plaintiff taking on two of the most formidable legal opponents without assistance.

For those who opt *not* to disclose the presence of funding, the overwhelming majority of U.S. jurisprudence dictates that the arrangement is likely to be shielded from discovery and not provide public distraction (at least outside of a chapter 11 proceeding). The subject of disclosure of litigation finance agreements is nuanced and beyond the scope of this article.

Post-Bankruptcy: Litigation or Liquidating Trust Funding

Within the ecosystem of distress and bankruptcy, litigation funding is often used today by liquidating or litigation trustees who lack sufficient cash to fund administrative costs or pay for litigation. It is frequently the unsecured creditors that stand to benefit from litigation here. In some situations, affirmative litigation—where debtors or their successors are the plaintiff—may be the sole source of recovery. But turning litigation into cash requires an investment of capital to fund investigations and pay lawyers and litigation expenses. Absent funding, trustees are forced to find lawyers to work on full contingency (which is often difficult considering the type of litigation being pursued) or settle quickly at a material discount because the defendants will expect that the plaintiffs do not have sufficient funding to "go the distance" through trial and appeals. Litigation funding reduces the relative leverage of overpowered participants and evens the playing field for all parties.

Many (if not most) litigation trusts are governed by trust agreements negotiated as part of the plan process. They provide that litigation trustees—under the direction of a governing body—may commence and settle claims without the need for a court order. However, some litigation trustees seek the assurance of court approval. CAH Acquisition Company and certain of its affiliates—companies in bankruptcy in the Eastern District of North Carolina—provide an example.[4] The bankruptcy involves a rural hospital system that became insolvent as a result of fraudulent billing practices. The trustee (serving as a chapter 7 trustee and a litigation trustee, depending on the debtor) alleges that participants in the fraudulent scheme—including several executives of the debtors—used the debtors' critical access hospital designations to bill insurance companies for medical services performed at other facilities to receive higher reimbursement rates and distribute earnings to scheme participants as illegal kickbacks. The debtors have viable causes of action but did not have sufficient funds to pursue the litigation. After an extensive marketing process to secure litigation funding, the Bankruptcy Court presiding over the cases authorized the CAH entities to enter into a comprehensive litigation funding agreement. The funding provided is being used by the trustee to pursue claims against the debtors' former principals, as well as several laboratories and marketers, for their respective roles in the allegedly fraudulent billing schemes. Without litigation funding, the debtors' claims would likely have been undervalued or simply abandoned.

Available Throughout: DIP Funding, Working Capital and Claims Monetization

As the use of litigation funding continues to grow with distressed companies and bankruptcy participants, litigation finance companies (and, frankly, other lenders, shareholders and creditors) are now beginning to successfully experiment with law firms and debtors in more bespoke and creative ways.

Litigation finance has been used in several cases for debtor-in-possession (DIP) financing, working capital, and claims monetization. A recent example of DIP financing is the NS8 case involving a company that filed for chapter 11 after claimed "deception and fraud" of its co-founder and former CEO threw the operations into turmoil.[5] The debtor sought up to $10 million in DIP financing, with a portion specifically allocated to pursue claims related to malfeasance. The Chief Restructuring Officer, in its application to the court, stressed that "the Debtor's most valuable assets do not consist of inventory, accounts receivable, intellectual property or other assets associated with the operation of their business, but instead, are comprised of unliquidated litigation claims." One differentiating factor in this case is that the lender's collateral consisted of not just the future litigation recoveries, but recoveries from the estate more generally. In addition to situations where legal claims support DIP financing by lenders, there are several instances where legal claims support the funding of legal proceedings and working capital.[6]

The bankruptcy of *In re MLCJR LLC* (the Cox Oil case) in the Southern District of Texas, which occurred in late 2023, is another important example of the participation of litigation funders in the bankruptcy market.[7] The debtor, an oil and gas company, suffered damages before its bankruptcy when a cargo ship owned by another company veered off course and collided with one of Cox Oil's offshore drilling rigs. Here, an investment banker representing Cox Oil was able to separate and successfully market the company's valuable litigation assets to a universe of sophisticated litigation funding acquirers. Unlike the past, today's companies in bankruptcy have access to a mature marketplace of highly capitalized buyers who can calculate the market value of litigation assets, finance and acquire them in full, and provide immediate capital to the debtor. In this case, a well-resourced affiliate of Burford Capital was the leading bidder, which changed the tenor of negotiations between the original litigants and ultimately led to an advantageous settlement at an amount informed by the market-driven value of the asset.

[3] *Pass Herald Ltd. v. Google LLC*, T-589-22, CanLii 2024 FC 305 (Federal Court of Canada Feb.26, 2024).

[4] *In re: CAH Acquisition Company # 1, LLC*, d/b/a Washington County Hospital et al, No. 19-00730-5-JNC, LexMachina 5:19-bk-730 (Bankr. E.D.N.C. Feb. 19, 2019).

[5] *In re: Cyber Litigation Inc.*, No. 20-12702-CTG, LexMachina 1:20-bk-12702 (Bankr.D.Del. Oct. 27, 2020).

[6] *In re: Burtonsville Crossing LLC*, No. 21-10491-MCR, and *ElderHome Land, LLC*, No. 21-10492-MCR, LexMachina 0:21-bk-10492 (Bankr.D.Md. Jan. 5, 2021); *In re: Odyssey Contracting Corp.*, No. 17-35898, LexMachina 2:15-bk-22330 (Bankr.W.D.Pa.) (where a portion of the financing was made available to the debtor as working capital).

[7] *In re: MLCJR LLC*, No. 23-90324, LexMachina 4-23-bk-90324 (Bankr.S.D.Tex. May 14, 2023).

Claim monetization is the fastest growing use of proceeds for litigation finance clients.[8] There are examples of funders purchasing claims from litigation trusts with ongoing litigation, or litigation they have won, but is being appealed.[9] Some circuits have explicitly authorized the sale to third parties and others have been less clear. A recent decision from the United States Court of Appeals for the Fifth Circuit *In re South Coast Supply Co.* supports this trend. Here, the Fifth Circuit held that preference claims arising under section 547 of the Bankruptcy Code may be sold. The Fifth Circuit issued a thoroughly reasoned opinion that joined other circuits in authorizing the sale of preference claims.[10]

The Future Role of Litigation Funders in Bankruptcy

There is reason to believe that litigation finance will play an increasingly important role in the bankruptcy process, especially during the next economic downturn and tighter lending environment. For one, litigation funders are managing more investment capital than ever before and looking for places to invest, including the distressed market. Secondly, plaintiffs and law firms are better educated and have become more comfortable with litigation funding. Concerns that previously clouded the marketplace, like standardizing processes for confidential client communications when a funder is involved, or misplaced fears that a funder would look to exert control over the litigation, have largely been resolved.

Most users of litigation finance report a positive experience and would use it again.[11] And as the industry has built scale and a healthy track record of success, those lawyers who were once reluctant to recommend litigation finance to their clients are now embracing this financing tool to help win new business. When individuals and corporate clients are in financial distress and stop paying their lawyers on a timely basis, litigation funders are best suited to step in to provide a workable solution—the best alternative to pausing an important claim (or even abandoning it) while preserving much needed liquidity. Lastly, creditor-on-creditor violence through liability management transactions and otherwise is not a new phenomenon, but it seems more prevalent and fiercer than ever before.[12]

Perhaps most importantly, vendors, employees, and other unsecured creditors should have the means to assert their legal rights in court regardless of their financial resources. The existing dynamic gives the power to the prepetition lenders, or the DIP lenders, regardless of the value of the claims to be pursued. It remains rare that a bankruptcy court will grant standing to an unsecured creditor committee even when there is a conflict and appearance of potentially viable claims. Historically, there have been few options to solve for that asymmetry, particularly since these groups are relying on limited and competitive estate resources to conduct their investigation and prosecute claims. Under the existing dynamic, junior creditors trade away potentially valuable claims at the outset of the case without having an opportunity to vet them, much less prosecute them. Litigation finance has the potential to reposition that power dynamic.

Conclusion

Litigation finance has the potential to change the balance of power between creditors and debtors. Unsecured creditors are typically under water: their litigation claims may be the only potential source of recovery, litigation is expensive to monetize, and without cash, the value of litigation claims is significantly impaired. These factors combine to make it difficult for unsecured creditors to maximize value from a distribution of litigation assets without litigation funding.

Litigation finance's presence in the bankruptcy industry is in its early stages. However, given the overall size of capital that litigation funders control and how this capital is deployed across case types, its presence in the marketplace will continue to expand -- particularly as the market becomes more familiar with the process, funders grow comfortable with investing in the distressed debt market, and the pace of corporate filings increase in the next economic downturn. Forward-thinking firms are preparing for these changes as we speak, developing smart internal processes, updating guidance to clients, and establishing strong litigation financing relationships to meet coming opportunities without delay.

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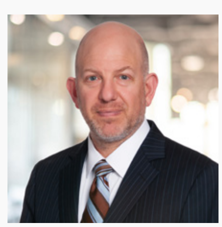

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[8] 2023 Litigation Finance Market Report, Westfleet Advisors, April 1, 2024.

[9] *In re: Magnesium Corp. et al*, No. 01-14312-MKV, LexMachina 1:16-cv-06844-AJN (S.D.N.Y. Oct. 7, 2016).

[10] *Capital Working Fund Capital, LLC as assignee of South* Coast Supply Company v. Remmert, No. 22-20536, LexMachina 4:18-CV-02867 (U.S.D.C. 5th Cir. Jan. 22, 2024).

[11] 2023 Annual Report, Burford Capital LLC, March 28, 2024, https://investors.burfordcapital.com/financials/annual-reports/default.aspx.

[12] Dan Roe, "Help, the Lenders Are Fighting Again: Creditor Violence Driving Demand in Bankruptcy, Litigation Practices," The American Lawyer, April 22, 2024, https://www.law.com/americanlawyer/2024/04/22/help-the-lenders-are-fighting-again-creditor-violence-driving-demand-in-bankruptcy-litigation-practices/.

CROSS-BORDER CARVE-OUTS: HOW TO PLAN FOR DATA SEPARATION

Eric Nelson, Gary Jacobs, Gopinath Tadapatri, and Jamal Al-Sheikhly
FTI Consulting

Are you planning a cross-border carve-out or interfacing with highly regulated industries, such as healthcare? Then beware, because a recent survey by TMF Group found that 34 percent of senior executives with buy-side experience at private equity firms said their most recent cross-border carveout failed to deliver on expectations, with 24 percent saying costly overruns impacted deal returns.[1] With sensitive data at risk and regulatory compliance requirements only increasing, companies must take proactive steps to ensure the success of these transactions. In this article, we unveil some key areas where careful planning is critical for success and discuss the complexities involved in these deals.

Whether you're a private equity firm, healthcare organization or global enterprise, these insights will help you navigate the carve-out process and avoid costly mistakes.

What Makes Data Highly Regulated?

Financial technology (fintech), healthcare and telecom companies must comply with multiple levels of regulation to protect customer data. In the United States, fintech companies follow the Gramm-Leach-Bliley Act (GLBA) and California Privacy Rights Act (CPRA) to govern the collection, usage and disclosure of individual financial information.[2] Healthcare companies adhere to the Health Insurance Portability and Accountability Act (HIPAA), while GDPR, LGPD, PIPEDA and other regulations apply in other countries.[3] In many cases, individual consent is required to handle sensitive data.

Telecom companies face similar regulations to those of healthcare companies. All companies must comply with antitrust laws, which prohibit sharing of competitor pricing information to prevent anti-competitive behavior. Compliance is crucial to avoid legal violations and protect customer data from breaches and misuse. Understanding the complex regulatory landscape is essential to maintaining a company's reputation and ensuring customers' privacy is maintained.

Identifying Data Impacts

It is essential to accurately ascertain the nature of assets being transferred in a carve-out and to implement appropriate measures to ensure compliance with relevant data privacy and sharing regulations.

Keeping all this in mind, we believe the following are four focus areas to consider as you dive deeper into your planning:

1. Data Privacy Considerations
2. Commercial Strategy
3. Business Application Separation
4. Operational Transition

1. Data Privacy Considerations

Regulated Data

Certain categories of data are regulated, meaning there are policies and laws governing secure and appropriate processing, control and sharing, where the right data assets go to the right place at the right time.

Sizable fines have been assessed for data breaches—the top 12 penalty amounts levied since 2019 add up to $5B.[4] Exhibit 1 on the next page presents several examples of the types of regulated data that must be accounted for and that are subject to various audits.

Unregulated Data

Unregulated data is company confidential, customer confidential, competitively sensitive (requires special handling on case-by-case basis) and could be audited by the customer. If unregulated data are shared without authorization, it can result in reputational harm. Exhibit 2 on page 39 presents examples of unregulated data.

Effective management of regulated and unregulated data requires comprehensive planning and coordination, as data separation policies have implications across multiple areas of the organization. Business functions are frequently reliant on IT systems' handling of data separation, and inadequate handling of such policies will negatively impact operations and customer experience. Therefore, it is crucial to transition the appropriate product and customer data in accordance with the target operating model.

2. Commercial Strategy

In the context of commercial strategy, the data strategy plays a crucial role, particularly when dealing with unregulated data. Data strategy involves developing a comprehensive plan for managing and utilizing data in the sale of products to customers. This includes considerations such as data separation with regard to pricing, discounting, and inter-company agreements, as well as establishing a charging and charge-back mechanism. The data strategy also encompasses ensuring data privacy and compliance with relevant regulations.

Moreover, the data strategy is essential when expanding sales into specific countries. It entails understanding the legal and regulatory requirements of operating in a new country, creating the necessary legal entity if it does not already exist, and addressing the implications of the tax structure. For example,

[1] "One-third of global carve-out deals fail to go to plan, says TMF Group study," Private Equity Wire, April 9, 2020, https://www.privateequitywire.co.uk/one-third-global-carve-out-deals-fail-go-plan-says-tmf-group-study/.

[2] Robb Hiscock, "Navigating the CPRA as a GLBA-compliant business," OneTrust, November 29, 2022, https://www.onetrust.com/blog/navigating-the-cpra-as-a-glba-compliant-business/.

[3] "HIPAA for Professionals," U.S. Department of Health and Human Services, February 3, 2022, https://www.hhs.gov/hipaa/for-professionals/index.html.

[4] Osman Husain, "The 25 Significant Data Breach Fines & Violations (2012-2023)," Enzuzo, February 27, 2023, https://www.enzuzo.com/blog/biggest-data-breach-fines.

Continued from p.37

Exhibit 1: Regulated Data Handling

TYPE OF DATA	DATA DESCRIPTION	SHARING RESTRICTIONS
PII (Personally Identifiable Information)[5]	GLB Act, GDPR (EU), CPRA, FCRA, Data Protection Act (UK), LGPD (Brazil), PIPEDA (Canada), APPi (Japan), APPs (Australia)[6]	SSN, driver's license, credit card numbers, passport
Medical or Health Records	HIPAA Act[7], GDPR[8]	Patient records, healthcare history, mental health records, test results
Educational Records	FERPA Act[9ww]	Students' educational records
Intellectual Property	IPE (USA)[10]	Trade secrets, patents, trademarks, etc.
Personal Financial Information	PCIDSS (USA),[11] LGPD (Brazil),[12] GDPR[13]	Bank accounts, credit card info, passwords, PINs, transaction records
Financial Accounting	U.S. GAAP, SEC[14]	Access to financial records such as assets, liabilities, P&L, revenue, expenses
Competitive Pricing	Antitrust Laws (various countries)	Competitive pricing for products and services
HR Data	GDPR[15], CCPA, FCRA[16], PIPEDA (Canada)[17]	Employee data must be protected and must comply by various laws
Gov't Data	Mandated by various governments[18]	Federal data (PII), defense & national security
Intermingled Data	NOA required	If data separation is not possible, will need clean room to view sensitive data

in Germany, companies must adhere to Works Council Section 79a, which protects employee data.[19]

Additionally, data strategy involves establishing the required bank accounts to support the operations, and implementing data separation practices to maintain the integrity and confidentiality of customer and pricing information.

[5] Peter Hu, "Understanding PII Laws and Regulations Worldwide," Strac, March 13, 2023, https://www.strac.io/blog/pii-laws-regulations-worldwide.
[6] Ibid.
[7] "Summary of the HIPAA Privacy Rule," U.S. Department of Health and Human Services, Oct 19, 2022, https://www.hhs.gov/hipaa/for-professionals/privacy/laws-regulations/index.html.
[8] "Data Protection in the EU," European Commission, https://commission.europa.eu/law/law-topic/data-protection/data-protection-eu_en.
[9] "What is FERPA?," U.S. Department of Education: Protecting Student Privacy, https://studentprivacy.ed.gov/faq/what-ferpa.
[10] "Intellectual Property Enforcement," U.S. Department of State, https://www.state.gov/intellectual-property-enforcement/.
[11] "PCI DSS Quick Reference Guide," PCI Security Standards Council, LLC, March 2022, https://listings.pcisecuritystandards.org/documents/PCI_DSS-QRG-v3_2_1.pdf.
[12] Brazilian General Data Protection Law, last updated October 2020, https://iapp.org/resources/article/brazilian-data-protection-law-lgpd-english-translation/.
[13] "Data Protection in the EU," European Commission.
[14] "US GAAP: Generally Accepted Accounting Principles," CFA Institute Research & Policy Center, October 2, 2023.
[15] "Data Protection in the EU," European Commission.
[16] "Fair Credit Reporting Act," Federal Trade Commission, https://www.ftc.gov/legal-library/browse/statutes/fair-credit-reporting-act.
[17] "Rules and Policies – Protecting PII – Privacy Act," U.S. General Services Administration.
[18] "PIPEDA," Office of the Privacy Commissioner of Canada, accessed April 25, 2024.
[19] "Co-determination at workplace level in Germany," DGB, December 2022, https://www.dgb.de/fileadmin/download_center/Brosch%C3%BCren_und_Flyer/Co-determination_at_workplace_level_in_Germany_-Englisch.pdf.

By having a well-defined data strategy within the overall commercial strategy, organizations can effectively manage data assets, ensure compliance and support decision-making processes related to pricing, customer segmentation, and cross-selling of goods and services.

Let's consider a situation where a company carves out its internet service business from a larger entity that provided bundled internet and cable TV services. After the carve-out, the newly established internet service business needs to bill customers separately for their internet usage while ensuring a smooth and unified billing experience.

In this case, the data strategy becomes crucial to enable accurate and efficient billing processes. The strategy involves implementing systems and processes to separate customer data, usage information and billing details specifically for the internet service business.

The data strategy would address key considerations such as creating distinct databases or data structures for internet-related customer information, designing new pricing models and rate structures specific to the internet service, and developing a billing system capable of generating separate invoices for internet usage.

Furthermore, the data and commercial strategies need to account for data migration from the existing system, ensuring data integrity during the transition, and establishing data privacy and security measures for the internet service customers. It will also involve updating customer communication channels to inform them about the changes in billing procedures and payment methods.

By carefully implementing a data strategy that focuses on the carve-out of the internet service business, the company can

Exhibit 2: Unregulated Data Handling

TYPE OF DATA	EXAMPLES OF DATA	INFO TO PROTECT
HR Data	Job performance, feedback, location	Consent required by law
Social Media	Data collected by various social media platforms	Consent required in some cases by law
Historical Financial Statements	Public companies already submit financial statements to regulators	Consent required
Operational Data	Data related to servicing existing customers	No confidential data can be shared
Commercial Agreements	Data related to doing business within commercial agreements	No pricing data can be shared by law
Transitional Service Agreement (TSA) Services	Data associated with applications under TSA	Will need additional NDA in most cases
Operational Reports	Operational reports not subject to data privacy regulations	Will require access separation in most cases

effectively manage the separation of billing processes while maintaining a unified experience for customers. This approach ensures accurate billing, improves customer satisfaction and retention, and supports the smooth operation of the newly established internet service business.

3. Business Application Separation

How does data privacy affect business application separation?

Data privacy guidelines and commercial agreements play a crucial role in determining the necessity for data separation and the establishment of new systems within business applications. This requirement varies depending on the industry and the specific nature of the business carve-out process.

For instance:

- Human Resources data must adhere to strict data privacy regulations dictated by local laws, necessitating its immediate separation on Day One. If for any reason HR data cannot be separated immediately, a third party must be put in place to handle this data post-Day One.
- Pricing and quoting systems should be segregated to prevent visibility of sensitive data by the other company, as mandated by antitrust laws. This ensures compliance and transparency in SalesOps.
- Customer data within customer-facing portals must be separated from the outset to safeguard the privacy of customer information, in accordance with data protection laws.
- Financial data, per SEC guidelines, must be isolated within the financial systems of each respective company after Day One.
- In situations where data is not regulated, separation of systems may not be feasible. This is primarily due to significant disparities between the technology, compatibility and functionality of the buyers' and sellers' system landscapes. This discrepancy poses challenges to the smooth operation of a carve-out. To address this, transitional service agreements (TSAs) are often established to maintain access to IT systems until the target architecture is defined and data migration is completed. Effective coordination between the buyer and seller is crucial to ensure operational continuity during this transitional period.

4. Operational Transition

After establishing a commercial strategy and evaluating its implications on IT systems, the operations team must promptly initiate an assessment of how these changes will affect access to business applications and existing processes. These effects can permeate throughout end-to-end business flows, encompassing the entire sales cycle and customer operations. In certain scenarios, it may be necessary to recreate automation or document manual workarounds as temporary measures.

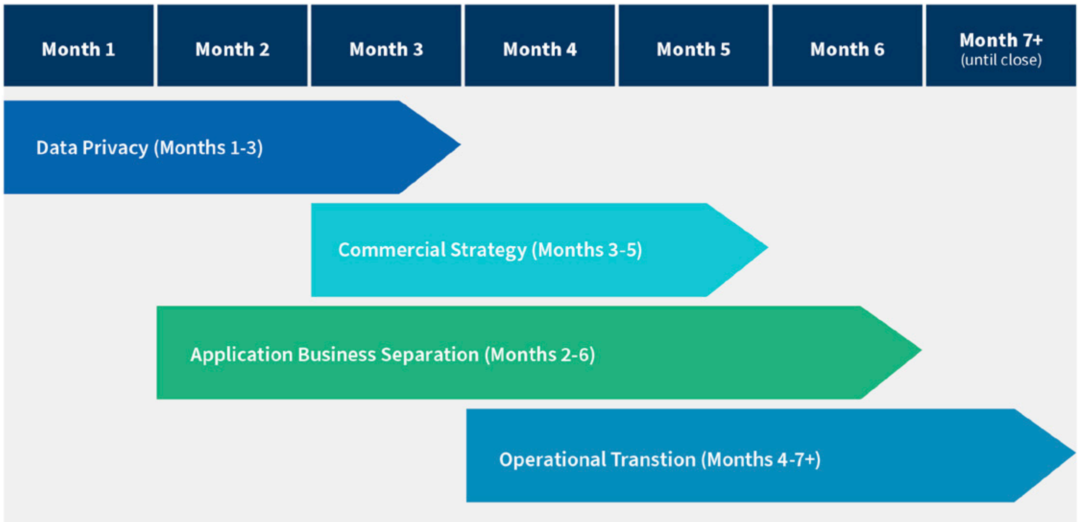
Additionally, any changes to IT systems might impact operational or financial reports, underscoring the need to identify these effects and diligently recreate and test the reports prior to Day One.

Equally vital is the assurance that these changes will not disrupt products or services already sold to customers, nor the operational flows associated with them. Any prospective modifications to these flows must undergo meticulous analysis, testing and documentation to preempt any adverse impact on business operations.

Sufficient time must be allocated for comprehensive end-to-end testing to ensure thorough examination of any changes in operational processes resulting from data segregation, with corresponding updates made to operational playbooks.

Continued from p.39

Exhibit 3: Suggested Timeline From Deals' Initial Signing Through Close (Can Vary by Industry)



This critical phase is one where many companies often encounter challenges and potential delays. To avoid such pitfalls, proactive measures should be taken.

First, it is essential to foster effective communication and collaboration between the commercial strategy, IT and operations teams. Regular meetings and discussions should be held to ensure a clear understanding of the strategy and its impact on IT systems and operations. This alignment will enable teams to anticipate potential issues and address them in a timely manner.

Second, establish a comprehensive project plan with clear milestones and deadlines with dependencies between cross-functional workstreams. This plan should outline the tasks and responsibilities of each team involved in assessing the impact of the changes. By adhering to a defined timeline, the company can prevent delays and ensure that all necessary actions are completed before the target date.

Third, invest in automated testing tools to significantly expedite the process. These tools can streamline the testing of access to business applications, operational flows, and the recreation and testing of reports. By automating these tasks, companies can save time and resources while increasing the accuracy and efficiency of the testing process.

Moreover, creating a dedicated cross-functional team specifically focused on managing the impacts and changes can be highly beneficial. This team should consist of representatives from IT, operations, and relevant business units. Their expertise and collaborative approach will help identify potential roadblocks, implement effective solutions and ensure a smooth transition without major disruptions.

Finally, engaging external consultants or experts with experience in similar projects will provide valuable insights and guidance. Their expertise will certainly help identify blind spots, offer best practices, and mitigate risks that will arise during this process.

By implementing these proactive measures, companies will be able to navigate this common challenge with greater ease, avoid unnecessary delays, and ensure a successful transition to the new commercial strategy while minimizing any adverse effects on business operations.

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Summary and Conclusions

Carving out a portion of a company is a complex process that requires careful planning and execution. It is crucial to have a clear understanding of the goals of the carve-out and the resources needed to achieve them. To successfully plan a carve-out, companies must consider four focus areas: data privacy, commercial strategy, business application separation and operational transition. Exhibit 3 on page 40 illustrates a suggested timeline from signing through closing.

Within these areas, there will be a significant amount of detail and many potential pitfalls, particularly when it comes to ensuring compliance and delivering the separation in a timely manner. Therefore, it is important to give due consideration to these areas to develop a clear strategy for the carve-out and ensure that the necessary resources and support are in place to execute it successfully.

To assist with the process, companies can benefit from working with experienced advisors or consultants who can provide valuable insights and expertise such as domain knowledge in privacy laws, offer expert advice during commercial negotiation, define business separation rules and guide teams during E2E Business Process testing. This will be especially helpful in navigating the complexities of data privacy regulations and developing a commercial strategy that aligns with the goals of the carve-out.

Overall, proper planning and execution of a carve-out is crucial to achieving success. By taking a comprehensive approach that considers all relevant focus areas, companies will increase their chances of achieving their goals and avoiding potential pitfalls.

THE LOOMING MATURITY WALL AND FUNDING GAP IN CORPORATE DEBT RESTRUCTURING: A CASE STUDY

Nataly Brown, Patrick M. Phillips, and Michael Barton, CIRA
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Introduction

During the pandemic, an unprecedented amount of countercyclical fiscal and monetary stimulus was provided to the US economy to address a steep and sudden recession. Congress provided over $1 trillion of fiscal stimulus through such programs as the $800 billion SBA Paycheck Protection Programs and the $230 billion Employee Retention Credit program. In addition, the Federal Reserve dramatically reduced the federal funds rate[1] and thus greatly decreased the cost of borrowing debt. As a result, companies were able to incur debt at record-low interest rates. Many companies and business owners took advantage of these very low interest rates and incurred large amounts of debt. Many of these loans will become due within the next few years.

We are thus seeing the effects of this “maturity wall” and “funding gap.”[2] In other words, a large amount of debt will come due in the next few years (the “maturity wall”) and companies will not be able to refinance their debt at the same interest rates or perhaps even to refinance for the same principal amount (the “funding gap”).

Multiple investment management firms and financial news providers have estimated that over $1.5 trillion in US commercial real estate debt will mature by 2025.[3] In addition, $3 trillion in corporate debt will need to be rolled over in coming years.[4]

The consensus is that replacing this debt is problematic as interest rates will be 4 to 5 percent higher over a longer period and creditors may not be willing to lend similar principal amounts. For example, a debt issued in 2020 of $900 million with a 4% interest rate will not be repeated in 2025; instead, a bank might be willing to make a loan for $350 million at a 7.5% interest rate. This leaves a $550 million funding gap that will still need to be paid off. Debtors may have to turn to private creditors or other alternatives who still may not lend a company enough funds to cover their outstanding debt.

This looming maturity wall is beginning to arrive now. The more quickly corporations can foresee and address the issues, the more maneuverability they will have in controlling the process and managing the tax cost of such transactions.

The fictional case below is intended to highlight the challenges corporations may face—as well as the relevant tax issues that may correlatively arise.

Case Study

Fabco, Inc., was formed in 2019 with $100 million of capitalization by its four founders.[5] They were able to raise an additional $50 million in an IPO during the same year. In February of 2020, Fabco opened its semiconductor fabrication factory that was considered the most automated in the world at that time. In April of 2020, the corporation closed on a $200 million debt financing with a 2.5% interest rate and a due date in 2025.

Due to shutdowns and supply chain issues during the pandemic, Fabco was unable to meet the large demand for its microchips during this time and thus lost out on a substantial amount of revenue. By 2023, the company had generated $300 million in losses. In addition, their microchips had become obsolete per “Moore’s Law”[6] and their order volume declined precipitously. Fabco then made the prudent business decision to close their factory. The company then focused all of its efforts on pursuing patent litigation related to infringements of its robotic automation and microchip design patents.

Fabco’s market capitalization decreased from $50 million in 2020 to $2 million in 2023. In 2024, Fabco issued a “clean” 10-K for the year ending December 31, 2023 and for their first quarter ending March 30, 2024. As such, their auditor did not issue a “going concern” opinion[7] based partially on the belief that they would prevail in their IP litigation. While Fabco’s debt was not publicly traded on an exchange, S&P Global (formerly IHS Markit) did reflect “indicative quotes”[8] for its debt. This indicative quote signaled that the $200 million of debt was currently “trading” at 40% of face value.

Fabco received an unsolicited offer from its lead senior secured creditor to modify its $200 million debt by extending the maturity date from 2025 to 2029, reducing the debt to an adjusted issue price of $50 million with 12% PIK interest,[9] and including “out of the money” warrants.[10] As such, if the IP litigation is successful, the creditors would have an equity “upside” based on the out of the money warrants.

Fabco’s board of directors reached out to professional advisors to determine if they should accept the offer. Fabco’s advisors noted that since the debt was publicly traded due to the indicative

[1] The federal funds rate almost went to 0%; for example, the rate was 0.05% in April of 2020, https://fred.stlouisfed.org/series/FEDFUNDS.

[2] Special acknowledgement to Joe Brusuelas, Chief Economist for RSM US LLP, for this terminology.

[3] Neil Callanan, “A $1.5 Trillion Wall of Debt is Looming for US Commercial Properties,” Bloomberg, April 8, 2023, https://www.bloomberg.com/news/articles/2023-04-08/a-1-5-trillion-wall-of-debt-is-looming-for-us-commercial-properties.

[4] “The logic of a Fed policy pause and then rate cuts in 2024,” rsmus.com, January 9, 2024, https://rsmus.com/insights/economics/the-logic-of-a-fed-policy-pause-and-then-rate-cuts-in-2024.html.

[5] This “Fab Four” should not be confused with the same appellation for the Beatles. :)

[6] In 1965, Gordon Moore, the co-founder of Intel, predicted that the number of transistors on an integrated chip would double between 12 and 24 months. After 50 years, “Moore’s Law” has generally still held true despite tremendous technological advances. As such, a microchip factory would become obsolete after a few years of operations.

[7] Going concern is a presumption that there is substantial doubt that an entity has the ability to continue.

[8] Indicative quote is a reasonable estimate of a current market price.

[9] PIK is payment-in-kind interest.

[10] “Out of the money” warrants have an exercise price higher than the current market price of the instrument.

quotes and was in excess of $100 million, the proposed debt transaction may be treated as a taxable exchange rather than as a non-taxable debt modification for federal income tax purposes.[11] This would result in $150 million of taxable debt income, otherwise known as cancellation of debt income (CODI).[12]

CODI is taxable to the extent Fabco was solvent immediately before the exchange and Fabco would have to pay tax on the gain to the extent of such solvency.[13] Fabco's advisors then considered whether any of the CODI could be excluded from taxable income due to insolvency. If a taxpayer is insolvent immediately before a CODI event, they may exclude the COD income, however only to the extent of such insolvency.[14] If insolvent, the tradeoff is that Fabco would be forced to reduce its tax attributes, such as net operating losses, by the amount of such excluded CODI.[15]

Fabco's advisors noted that multiple factors will prove to be a challenge to the argument that Fabco was insolvent immediately before the debt exchange:

(1) the company still has a positive market capitalization which may indicate that the fair market value of the assets exceeds its liabilities;

(2) the SEC 10-K filing did not reflect a "going concern" opinion; and

(3) Fabco did not book significant impairments to intangibles for GAAP purposes.

Thus, there is not a reasonable likelihood that Fabco would prevail with the IRS in taking a tax position that they were insolvent, to any extent, immediately prior to the debt exchange.[16]

Fabco then asked its advisors if they could avoid CODI by arranging for a related party to acquire its debt from the creditor at a discount. The advisors noted that section 108(e)(4) was enacted to prevent just such a tactic. That section provides that if a person or entity related to the debtor purchases debt from an unrelated creditor, the purchase is treated for federal tax purposes as if the debtor purchased the debt from the creditor. Therefore, the purchase would generate CODI to the extent of the discount.

With insolvency being difficult to prove, the advisors discussed three potential alternatives: (1) reflecting the taxable CODI on the company's 2024 tax returns; (2) pre-packaged bankruptcy; or (3) a Bankruptcy Code ("BK Code") section 363 asset sale.

Taxable CODI

In this alternative, Fabco would reflect $150 million of taxable COD income on their 2024 tax return. This taxable income could be offset dollar for dollar by the small projected 2024 loss relating to wind down and patent litigation costs. They could also use the net operating losses from 2019 through 2023, subject to the 80% taxable income limitation applicable to post 2017 net operating losses.[17]

Assuming $0 operating income or loss for 2024, before the $150 million taxable CODI, $120 million could be offset by the net operating losses from 2019-2023. This would result in $30 million of taxable income with a $7.5 million tax liability, assuming a 25% combined federal and state tax rate. In this scenario, the existing equity holders would continue to own the company in the short term. In the best-case scenario, if there is a substantial windfall from the litigation claims, the warrants issued to the creditor would produce a considerable amount of equity for them. In a worst-case scenario, if the litigation claims fail and the company would not be able to pay off the debt, inclusive of any PIK interest, Fabco would likely file a liquidating bankruptcy where the shareholders would receive no consideration and the creditors would receive the FMV of the net proceeds from selling the remaining corporate assets.

Pre-packaged bankruptcy

Fabco could also reject the current offer and negotiate terms for a pre-packaged bankruptcy with its creditors. In a prepackaged bankruptcy, the company and debtor agree on terms before the bankruptcy is filed.[18] This agreement must be voted upon by the shareholders before the company files for bankruptcy.[19] The goal of a prepackaged bankruptcy is to have a much shorter proceeding with a considerable reduction in time and professional fees.[20]

In Fabco's circumstance, the existing shareholders would probably not retain their equity as the creditors would likely receive equity in exchange for their outstanding debt. The shareholders could, however, take a section 165(g)(1) capital loss, having received nothing in exchange for their equity. This loss is available when a capital asset has become wholly worthless anytime during the taxable year and thus could result in a deduction as if it were a loss from a sale or exchange.[21]

As the creditors would likely own 100% of the equity upon the effective date of the bankruptcy plan of reorganization, the

[11] In other words, this would be treated as Internal Revenue Code (IRC) section 1001 taxable exchange rather than a modification of debt, as this constituted a significant modification of a debt instrument per IRC regulation section 1.1001-3. If the debt is >$100M and is deemed to be publicly traded (as is this debt instrument since there were indicative quotes) then there would be cancellation of indebtedness income equal to the difference between the adjusted issue price of the debt and the FMV of the debt if such modification occurred. As further described, such cancellation of debt income would be taxable to the extent the corporation was solvent immediately before the exchange.

[12] The actual determination of CODI would be more complex, and would include, for example, the NPV of the out the money warrants.

[13] IRC section 61(a)(11).

[14] IRC sections 108(a)(1)(B) and (a)(3).

[15] The order of attribute reduction is described in section IRC 108(b)(2). While CODI is excluded from taxable income to the extent of insolvency, the loss of tax attributes can result in greater tax liabilities in years after the CODI event as such tax attributes would not be available to offset future taxable income / federal income tax. As such, the taxpayer is provided a "fresh start" to extinguish debt without current federal income tax. However, federal income tax may thus be higher in later years due to the loss of such tax attributes.

[16] The burden of proof is with the taxpayer to prove insolvency, in whole or in part. This fact pattern is designed to put maximum stress on the determination of solvency / insolvency. While the creditor appears to be accepting consideration that is below the adjusted issue price of the debt, there are countervailing factors that make it difficult to assert the company is insolvent to any extent. It is possible a formal valuation might establish some level of insolvency.

[17] See https://www.irs.gov/newsroom/net-operating-losses.

[18] Bankruptcy Code section 1126.

[19] Procedural Guidelines for Prepackaged Chapter 11 Cases in the United States Bankruptcy Court for the Southern District of New York, https://www.nysb.uscourts.gov/sites/default/files/prepack.pdf.

[20] A prepackaged bankruptcy proceeding can be concluded in a period as short as one day.

[21] IRC section 165(g)(1) and IRC regulation section 1.165-5.

Continued from p.43

company could avail itself of special bankruptcy rules under section 382(l)(5) or (l)(6) which might preserve some of the company's net operating losses (NOLs) after emerging from bankruptcy. Section 382 was enacted to prevent a corporation from being acquired solely for the use of tax attributes, such as NOLs.[22] These special bankruptcy rules provide exceptions to the normal rules of section 382 that otherwise would place a substantial limitation on the ability of the loss corporation to utilize its tax attributes.[23] For Fabco, these losses might be available to offset a potential tax liability relating to any subsequent gains from the resolution of the IP litigation efforts and/or any sales of the IP.

Section 363 asset sale

Another alternative is that the company may enter into a bankruptcy filing and/or pursue a Bankruptcy Code section 363 asset sale.[24] In this case, the company would sell its assets and then satisfy its debt to the extent of the net proceeds from asset sale.[25] In a section 363 sale, the debtor auctions its assets to potential purchasers. The Bankruptcy Court selects the bidder that is considered the highest and/or best bidder. The debtor and bidder then negotiate an asset purchase agreement. Finally, the debtor will file a motion with the bankruptcy court seeking approval of the sale of the company's assets at a bankruptcy auction and approval of the bid procedures that would govern the process of the auction. For Fabco, the creditors would most likely receive the IP. However, in this case, it is possible that the creditor might accept the purchase of the IP by the founders, if they could mutually agree upon value. The creditors might accept such a sale of the IP to the founders if the founders believe there is a higher NPV for the IP claims than the creditors would. The effect of this bid procedure is intended to encourage competitive bidding to fully maximize the value of the assets.

Conclusion

In this hypothetical case study, Fabco was able to consider multiple alternatives to address their looming maturity wall. The first option was a taxable modification of its $200 million debt with correlative CODI issues. If the IP proceedings fail, the company may find itself in a liquidating bankruptcy procedure. The company also considered a prepackaged bankruptcy and/or a section 363 asset sale.

Companies that have debt coming due in the next few years should seek counsel from their tax advisor to address this looming maturity wall and funding gap. The earlier a company identifies impending refinancing issues and seeks professional advice, the more options it will likely have to control the process and the resulting tax consequences.

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[22] See, for example, T.D. 8531; 59 F.R. 12832-12840.

[23] IRC section 382(l)(5) provides that there is no section 382 limitation if certain creditors receive the equity of the corporation pursuant to a bankruptcy filing (though the net operating loss is reduced by interest paid to creditors during the change and prior 3 years). If IRC section 382(l)(5) does not apply or the taxpayer elects out of the provision, IRC section 382(l)(6) would apply. IRC section 382(l)(6) provides that the equity value of the corporation does not equal the pre-change value (the general rule) but rather equals the pre-change value *plus* the increase in value (if any) resulting from the surrender or cancellation of the creditor's claim in the transaction.

[24] Note that a BK Section 382 asset sale can also occur in conjunction with a prepackaged bankruptcy.

[25] BK Code section 363.

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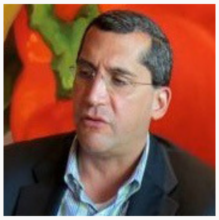

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NUANCE OR NECESSITY FOR CONFLICTS IN BANKRUPTCY CASES?* **

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Our thinking about conflicts of interest, especially in large chapter 11 cases involving a battle of BigLaw firms, has gone all catawampus. We are now seeing court decisions on section 327(a) employment applications[1] that, though they quite properly focus on disinterestedness[2] and the disclosures of connections required by Bankruptcy Rule 2014,[3] manage somehow to skip over the fact that, if we're talking about law firms seeking employment, the lawyers in those firms are bound by the ethics rules of the bars in which they hold membership. The law firms—and every lawyer in those firms—have to address the issues of conflicts with concurrent clients,[4] former clients,[5] or prospective clients.[6] I find myself increasingly frustrated with the behavior of certain applicants for employment who conveniently fail to address all of the issues raised by state ethics rules.

I know that those rules don't fit the practice of bankruptcy law, as seen by BigLaw, at least, very well. In my very first published article, I said: "[b]alancing two goals—giving the client the lawyer of his choice and avoiding a situation in which the lawyer is forced to argue both sides at once—is a difficult task in the bankruptcy context. The current ethics rules fulfill the second goal but often defeat the first."[7] I distinguished between two types of potential conflicts: first, potential conflicts that, once they morphed from being only potential conflicts to being actual ones, they *stayed* "actual" for the duration of a bankruptcy case,[8] and second, those potential conflicts that were issue-specific, dormant, and temporary.[9] These dormant, temporary, actual conflicts (DTACs) might occur or they might not, depending on what happened in the case, but if they occurred, they would occur only for one minor issue—then they would disappear. For DTACs, I suggested that the client could either consent to the dual representation[10] or use conflicts counsel, depending on the situation.[11]

That article wrestled with the idea that "normal" conflicts of interest rules really didn't fit the bankruptcy world, because in our world, the parties can shift alliances throughout a case.[12] I'm still right about the shifting alliances part, but somewhere along the line, conflicts analysis got worse. We seem to have stopped applying the state ethics rules in their full glory, rather than trying to see how they might fit within the realities of bankruptcy practice. And I understand why: the "fit" of those rules drives BigLaw crazy.[13] The rules just don't work for large law firms with a multitude of clients, some of whom will figure prominently in the case and some of whom may not appear at all. And big clients want BigLaw firms.

Here's the problem: some BigLaw firms are conflating the rules regarding employment in bankruptcy cases, the state ethics rules that apply to the lawyers in the firm, and the developing case law around advance waivers to seek employment in situations in which they should be conflicted out. To the extent that any law professor has any effect on the "real world,"[14] I blame myself for at least part of the catawampusness[15] of our thinking on conflicts of interest, and I'd be willing to take Orin Kerr up on his idea for a symposium issue in which professors recant their earlier articles.[16]

Two recent conflicts opinions with very different results have highlighted the challenges of parsing conflicts of interest. One of those opinions is the not-for-publication opinion in *In re* Invitae Corp.[17] The other is *In re* Enviva, Inc.[18] In *Invitae,* the court approved the employment of BigLaw Firm 1 as attorneys for the DIP; in *Enviva,* the court declined to approve the employment of BigLaw Firm 2. Let's explore the differences in those two cases.

In *Invitae,* prior to the petition, the debtors had entered into a transaction with a secured noteholder[19] that made the secured noteholder the debtors' largest secured creditor (with 79% of the debtors' debt).[20] BigLaw Firm 1 wasn't involved in that transaction at all, but it continues to represent the secured noteholder, though not in connection with the *Invitae* bankruptcy.[21] The Unsecured Creditors' Committee pointed out that the original transaction could be a central issue in the bankruptcy case and asked the Bankruptcy Court to limit BigLaw Firm 1's work to matters that did not involve the secured noteholder.[22] The United States Trustee went further, asking for the Court to deny the application to employ BigLaw Firm 1.[23]

The Court found that "such concurrent representation does not create a per se conflict that prohibits retention,"[24] observing that, although BigLaw Firm 1 was bound by Rule 1.7 (the concurrent conflicts ethics rule), the secured noteholder was represented by two other firms in the bankruptcy case. Moreover, "[BigLaw Firm 1] was not counsel to Debtors at the time of the Transaction, did not represent either party in the context of the Transaction, and [BigLaw Firm 1's] present representation of [the secured noteholder] pertains to matters wholly unrelated to the pending Chapter 11 bankruptcy...."[25] The Court concluded that "[BigLaw Firm 1's] zealous representation of [the secured noteholder] in other, unrelated matters does not present a significant risk that its representation of the Debtors in this bankruptcy case will be in any way impacted or limited—and Rule 1.7(a)(2) is not implicated."[26] Hmmm.

Let's think about the Court's point that, in the bankruptcy case, BigLaw Firm 1 didn't represent the secured noteholder. As a refresher, Rule 1.7 says:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
>
> > (1) the representation of one client will be directly adverse to another client; or
> >
> > (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client,

*This article was previously published as "Nuance or Necessity for Conflicts in Bankruptcy Cases?" (Special Feature: Professor Nancy Rapoport on Recent Disqualification Decisions), Creditor Rights Coalition, June 5, 2024, https://creditorcoalition.org/special-feature-professor-nancy-rapoport-on-recent-disqualification-decisions/. Republished with permission.

***Editor's note:* Due to the length and number of annotations to this article, these are presented as endnotes starting on page 49.

Continued from p.45

a former client or a third person or by a personal interest of the lawyer.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.[27]

Rule 1.7(a) doesn't say "shall not represent a client *in the same or a similar matter*." It says "shall not represent a client if the representation involves a concurrent conflict of interest." Then Rule 1.7(a) defines "concurrent conflict of interest" as direct adversity (e.g., plaintiff vs. defendant) or as "a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client ... or by a personal interest of the lawyer."[28] In other words, the definition of "concurrent conflict of interest" includes the situation in which the clients aren't going directly against each other but the lawyer for both clients might be tempted to pull his or her punches in favor of one client. The blanket prohibition includes an "out" in Rule 1.7(b), and part of that "out" involves informed consent by both clients, *if* subsections (1),(2), and (3) have also been met. We'll get back to informed consent in a bit, but first, let's return to the *Invitae* opinion itself.

To address the Committee's point that BigLaw Firm 1 was seeking to represent the Debtors while the firm concurrently represented the noteholder, the Court then focused on the "extensive and detailed waivers" to conclude that the secured noteholder had waived any conflict.[29] In essence, the Court held that BigLaw Firm 1 wasn't circumventing 11 U.S.C. § 327(a) because BigLaw Firm 1 drafted engagement letters for which BigLaw Firm 1's clients waived any potential conflict.[30]

Here's the language of the waiver:

Conflicts of Interest. As is customary for a law firm of the Firm's size, there are numerous business entities, with which Client currently has relationships, that the Firm has represented or currently represents in matters unrelated to Client.

Further, in undertaking the representation of Client, the Firm wants to be fair not only to Client's interests but also to those of the Firm's other clients. Because Client is engaged in activities (and may in the future engage in additional activities) in which its interests may diverge from those of the Firm's other clients, the possibility exists that one of the Firm's current or future clients may take positions adverse to Client (including litigation or other dispute resolution mechanisms) in a matter in which such other client may have retained the Firm or one of Client's adversaries may retain the Firm in a matter adverse to another entity or person.

In the event a present conflict of interest exists between Client and the Firm's other clients or in the event one arises in the future, Client agrees to waive any such conflict of interest or other objection that would preclude the Firm's representation of another client (a) in other current or future matters substantially unrelated to the Engagement or (b) other than during a Restructuring Case (as defined below), in other matters related to Client (such representation an "Allowed Adverse Representation"). By way of example, such Allowed Adverse Representations might take the form of, among other contexts: litigation (including arbitration, mediation and other forms of dispute resolution); transactional work (including consensual and non-consensual merger, acquisition, and takeover situations, financings, and commercial agreements); counseling (including advising direct adversaries and competitors); and restructuring (including bankruptcy, insolvency, financial distress, recapitalization, equity and debt workouts, and other transactions or adversarial adjudicative proceedings related to any of the foregoing and similar matters).

. . .

Restructuring Cases. If it becomes necessary for Client to commence a restructuring case under chapter 11 of the U.S. Bankruptcy Code (a "Restructuring Case"), the Firm's ongoing employment by Client will be subject to the approval of the court with jurisdiction over the petition. If necessary, the Firm will take steps necessary to prepare the disclosure materials required in connection with the Firm's retention as lead restructuring counsel. In the near term, the Firm will begin conflicts checks on potentially interested parties as provided by Client.

If necessary, the Firm will prepare a preliminary draft of a schedule describing the Firm's relationships with certain interested parties (the "Disclosure Schedule"). The Firm will give Client a draft of the Disclosure Schedule once it is available.[31]

An aside: the first part of the waiver (everything other than the part about Restructuring Cases) is pretty standard, though it's subject to the normal test of whether the waiver is based on informed consent.[32] It's the Restructuring Cases part of the waiver that is different. The language about Restructuring Cases reads to me as "the gloves are off," as a way of dealing with the "hot potato" rule.[33] The waiver has a one-two punch: (1) the Court has to approve us as counsel, so there's someone looking out for your interests, and (2) you already agreed to our representing the Debtors, even if that means that we'll be opposite you in "litigation (including arbitration, mediation and other forms of dispute resolution); transactional work (including consensual and non-consensual merger, acquisition, and takeover situations, financings, and commercial agreements); counseling (including advising direct adversaries and competitors); and restructuring (including bankruptcy, insolvency, financial distress, recapitalization, equity and debt workouts, and other transactions or adversarial adjudicative proceedings." That is one super-broad advance waiver, and the secured noteholder, sophisticated or not, might have been able to argue that BigLaw Firm 1 was too vague in its descriptions of what was being waived in advance.[34]

Observing that this particular secured noteholder was, in fact, sophisticated,[35] the Court also pointed out that the secured noteholder represented only 0.03% of its total billings in 2023 and even less in 2024.[36] As the Court explained, "[t]o be clear, the fact that [BigLaw Firm 1] bills such a high amount is not a commentary on their worthiness of retention; nor does it offer them a free pass to skirt the rules. Rather, case law instructs that the economic impact is a consideration that the Court should take into account in gauging material adversity."[37] Therefore, the economic impact factor favored the employment of BigLaw Firm 1.[38] As the Court put it, "[n]othing presented to date suggests that [BigLaw Firm 1] cannot zealously represent the debtor and the bankruptcy estate's interests."[39]

Then the Court discussed the argument that booting BigLaw Firm 1 off the case would "cause undue delay and significant additional expenses."[40] It puts the finger on the side of the scale that says that a debtor should be able to pick its counsel, no matter what.[41] That leaves the other side of the scale—a law firm's other concurrent clients—pretty high up in the air. Maybe those clients don't care, because they have other counsel. Maybe they do care, but they signed ironclad advance waivers. And maybe they didn't want to sign those waivers, but so many BigLaw firms are using them that they felt as though they had no other options.[42]

Finally, the Court considered the Committee's suggestion that BigLaw Firm 1 at least be prohibited from representing the Debtors on matters relating to the secured noteholder itself. The Court found that proposition

> unworkable. Simply put, the Court is loath to place such handcuffs on Debtors' counsel. [The secured noteholder] is the major secured creditor in this bankruptcy case—holding nearly 79% of the debt. Given [the secured noteholder]'s role, any attempt to limit [BigLaw Firm 1's] representation to work that does not impact [the secured noteholder] would be impractical, difficult to police, and engender further debate and contest. It is likely that even the most minimal task will affect [the secured noteholder]'s interests and any meaningful work undertaken nearly certainly will. The Court is unwilling to narrow the scope of [BigLaw Firm 1's] retention as requested by the Committee.[43]

The Court did not address the line of cases refusing to approve employment when the potential conflict was central to the case.[44]

The *Enviva* court, on the other hand, *did* address that line of cases:

> In the Court's view, this case is more analogous to *In re Project Orange Assocs., LLC,* 431 B.R. 363 (Bankr. S.D.N.Y. 2010). In *Project Orange,* proposed debtor's counsel represented GE, the debtor's largest unsecured creditor and the supplier of gas turbines critical to the debtor's operations. *Id.* at 365-66. Proposed debtor's counsel argued that it could use conflicts counsel for any issues related to GE. *Id.* at 366. The court rejected that suggestion, holding that it did not appear that proposed debtor's counsel could "'fairly and fully advise' in the negotiation and drafting of a plan when it may not even be able to advocate litigation against GE." *Id.* at 377.
>
> The Court ultimately denied the application to employ proposed debtor's counsel. *Id.* at 379 ("as [proposed counsel's] conflict is with the Debtor's largest unsecured creditor that is central to the issues in this case, the Court concludes that it is inappropriate to approve the retention application.") In this case too, the Court cannot see how [BigLaw Firm 2] could possibly negotiate a plan adversely to [the equity security holder]'s position. The employment of conflicts counsel can be useful for a discrete portion of a case, such as the prosecution of preference or fraudulent transfer claims, but it cannot be used as a substitute for general bankruptcy counsel's duties to negotiate a plan of reorganization. *In re WM Distribution, Inc.,* 571 B.R. 866, 873 (Bankr. D.N.M. 2017) ("use of conflicts counsel is not appropriate where the adverse interests of the debtors represented by the same general bankruptcy counsel are central to the reorganization efforts of either debtor or to other resolutions of the chapter 11 case or where the adverse interests are so extensive that each debtor should have its own independent general bankruptcy counsel.")[.][45]

In *Envira,* the Debtors had sought approval for interim DIP financing, with the financing to come from an ad hoc group.[46] The Court approved the interim financing but raised questions about "the Debtor[s'] proposal to pay $4.6 million of tax and other liabilities for a non-debtor entity known as Enviva Wilmington Holdings, LLC ('EWH'),"[47] and the Debtors withdrew that request.[48] The case involved three different types of concurrent conflicts that needed to be resolved: could BigLaw Firm 2 represent the Debtors and (simultaneously) (1) four members of the ad hoc group involved in the DIP financing,[49] (2) several of the Debtors' officers and directors who contended that, in various derivative lawsuits, they were entitled to indemnity from the Debtors (and who would stand to get 3.5% of the equity in any reorganized entities, based on a restructuring support agreement),[50] and (3) another investment group and its affiliates, which owned 4% of the Debtors' equity (and with which two members of the Debtors' board are affiliated)?[51] In particular, the same lawyers in the firm were doing work for both the debtors and that investment group, "thereby making any ethical walls impossible."[52]

The Debtors sought to employ BigLaw Firm 2, along with BigLaw Firm 3 as co-counsel.[53] As part of its employment application, BigLaw Firm 2 also disclosed that it represented a group of equity security holders in the Debtors.[54] The application did not include a discussion of any ethical walls.[55]

Of all of these concurrent conflicts, the Court found the concurrent conflict with the investor group to be the most troubling. That investor group represented about 0.8% of BigLaw Firm 2's billings—$14 million a year—but the client had consented to BigLaw Firm 2's representation of the Debtors and was planning to use its own lawyer in the bankruptcy.[56] The *Envira* court was,

Continued from p.47

in the end, troubled only by the last representation in this list.[57]

After the Court walked through the standards for employment and for Rule 2014,[58] it found that "[BigLaw Firm 2] was not deficient in its disclosure obligations in this case... [even with respect to the] 'late entrant' into the Debtors' debt structure...."[59] The Court also found that the concurrent representation of the officers and directors was permissible because the potential 3.5% of equity in the reorganized entities had not become ripe for a ruling.[60] Citing *In re* Harold & Williams Development Company,[61] the Court observed that "[a] court should then weigh, against the risks of any *potential* difficulties, the potential advantages to the bankruptcy estate of a dual appointment, such as savings of time and money spent on estate administration."[62] In other words, the Court deferred ruling on the issue of concurrent representation of the officers and directors until such time, if any, that the potential conflict changed into an actual issue.[63]

But representing that one investment group and the affiliates, along with the Debtors? That was a bridge too far for the Court:

> The Court finds that [BigLaw Firm 2's] simultaneous representation of [that group] renders [BigLaw Firm 2] not disinterested under Bankruptcy Code Section 327(a). [That group] has a 43% interest in the Debtors' common stock. It has two of the Debtors' thirteen directors' seats. [BigLaw Firm 2's] representation of [that group] is extensive [as it] is a $14 million-dollar-a-year client of the firm.[64]

The beauty of this opinion lies in part in its next paragraph: "[BigLaw Firm] argues that it only represents [that group] in unrelated matters, [that group] has consented to [BigLaw Firm's] representation of the Debtors in this case, and the Debtors have consented to [BigLaw Firm's] continuing representation of [that group]. While consent may satisfy certain State bar rules on conflicts,[65] it is not a substitute for disinterestedness under Section 327(a)."[66]

The Court listed all of the factors that it considered in denying the application for employment:

> This is not an academic concern. This is a case in which the Debtors have touted the RSAs as the basis for a stand-alone plan. It is not a case in which the Debtors seek approval for a Section 363 sale of substantially all their assets. The RSAs contemplate that existing equity holders will retain five percent (5%) of the equity in the reorganized entities. This will have to be negotiated with the Committee and the other constituents in the case. [BigLaw Firm 2] suggests that if this becomes a problem, it will look to its co-counsel, [BigLaw Firm 3], to negotiate [that group's] related provisions of the plan. A plan in a stand-alone reorganization case, though, is like a machine in which all of the parts depend on all of the other parts. Further, the allocation of equity in the reorganized entities is a zero-sum game – whatever old equity retains will come at the expense of the creditors unless the creditors are paid in full (or the plan is a consensual one). Even in the case of a "new value" plan, the creditors are entitled to challenge the sufficiency of any new value contribution and to demand that such contributions be market-tested. The Court in this case just does not see how [BigLaw Firm 2] can delegate this core function of Chapter 11 counsel to its co-counsel.[67]

The Court also distinguished this situation from the situation in *Invitae:*

> [T]he Court finds that there *is* an actual conflict of interest. [BigLaw Firm 2] cannot be expected to negotiate a Plan that contravenes the interests of its $14 million-dollar-a-year client. In *Invitae,* the proposed law firm billed the adverse party and client ... a total of $2.4 million from the inception of the relationship, and $1.8 million in 2023, representing 0.03% of the applicant's revenue for that year. *Id.* [*Invitae*] at *5. The court described this as "relatively de minimus" [sic] in the scheme of things. *Id.* In this case, [BigLaw Firm 2's] revenue from [that group] amounts to 1.4% of its annual revenue for 2023, or 46 times more than the percentage of annual revenue in *Invitae.* The Court does not view [BigLaw Firm 2's] revenues from [that group] to be *de minimus* [sic] in any sense of the term.[68]

There you have it: in *Invitae,* the troublesome other concurrent client was a tiny portion of BigLaw Firm 1's billings,[69] and it was a sophisticated client that had signed an advance waiver that specifically addressed restructuring situations, especially because that client had retained separate counsel in the bankruptcy case. Thus, it was fine for BigLaw Firm 1 to represent the Debtors and a major secured noteholder. But in *Envira,* the Court found that BigLaw Firm 2 couldn't represent the Debtors and still negotiate against its $14 million-a-year client in negotiating a plan. What gives?

In part, these questions are, as both courts recognize, extremely fact-specific. As long as the parties disclose what they're supposed to be disclosing under Rule 2014, a court can sift through the various factors and come to a reasoned decision. But three aspects of these cases bother me.

The first aspect concerns the perception that rulings such as *Invitae* are intended to signal that a court is friendly to debtors, or to BigLaw, or to case-placers in BigLaw, or to some other group. That perception may well not reflect reality,[70] especially because situations like these are (so far) the exceptions that prove the rule—many courts don't bend the Code or other statutes too far. But in my conversations with several practitioners, that perception is growing, and it's leading to a combination of cynicism and fatalism that can't possibly be good for the bankruptcy system.[71]

The second aspect concerns the short-ish shrift that Rule 1.7(b) gets in these discussions. In order to pass muster in a concurrent client situation, all four subsections have to be met, and subsection (1) relates directly to "it's only a small part of the firm's billings." In other words, having sophisticated clients who sign advance waivers won't survive Rule 1.7(b) unless the lawyer/law firm also can prove that it reasonably believes that it can represent both clients competently and diligently.

The burden shouldn't be on those objecting to employment to explain why a lawyer's belief "the lawyer will be able to provide competent and diligent representation to each affected client" isn't reasonable, but on the firm seeking approval of its employment to prove that its belief *is* reasonable.[72] The proportion of billings attributable to the client should be a factor in the court's consideration, but it shouldn't be the only factor, and it shouldn't be the factor weighted most heavily. Think of all of the factors that go into that one, difficult-to-verify number, including firm size and billing rates. Moreover, the larger the firm, the smaller the percentage of billings that will be attributable to each client, so this one metric rewards the Goliaths in the industry. As Professor Jonathan Lipson reminded me, "[t]he percentage-of-revenue test for potential conflicts seems to be an especially poor proxy because it will reward larger firms and punish smaller ones, and is indifferent to the nature of the work, the identities of the attorneys, and the economics of the matter(s) in question."[73]

The whole point about the concurrent conflicts ethics rule is that law firms owe two fiduciary duties to their current clients: the duty to keep confidential information confidential, and the duty of loyalty (the duty not to favor one client over another). *That's* the test—not an arithmetic comparison of proportionality. BigLaw Firm 1 happens to be incredibly profitable, so should it get a pass because it rakes in so much that no single client is going to represent a high percentage of its annual billings? The percentage of billings attributable to a client simply won't tell the whole story. Even a small client who is one of the top partners' favorite clients might encourage that partner (and therefore associates working for that partner) to protect that client's interests at the estate's expense.[74] Separate and apart from the disinterestedness requirement, court decisions should consider whether a firm that has two active clients who are parties in interest in a bankruptcy case should be representing both of them, neither of them, or only one of them. And because a court's decisions on conflicts depends on two things—how the applicant describes them and how the court perceives them—the significance of any conflicts review is extremely fact-specific.

The third aspect has to do with those pesky advance waivers and what they signal about BigLaw life these days. Go back and read the advance waiver that BigLaw Firm 1 requires its clients to sign. Then re-read note 42 in this essay, in which the Association of Corporate Counsel explains that, much of the time, even big institutional clients are unable to push back against those waivers.[75] Should we, as lawyers, be asking so much of our clients, especially with language that, in essence, treats one of the clients as a hot-potato[76] when it comes to future waivers of restructuring matters? Why are law firms asking for client permission to behave in such a manner,[77] and why are some courts letting them? At some point, shouldn't we go back to basic principles and start with the ethics rules, not the Code? Consider Professor Jonathan Seymour's point about bankruptcy judges not wanting to stand in the way of Pareto-optimal solutions:

> A judge that takes a narrower view of her authority and therefore stands in the way of an arrangement that key constituencies in the case argue is a necessary component of a reorganization may be accused by proponents of frustrating an outcome that could be Pareto superior, condemning the business instead to be sold off in parts in a liquidation sale that generates minimal value for any stakeholders. Particularly if the judge shares the problem-solving ethic of reorganization practice, her incentive is to grant approval rather than risk taking the blame for dooming the case.[78]

That perspective might explain a court's decision to look only to Section 327 and Rule 2014, rather than applying the ethics rules. In addition, not only do the ethics rules not fit bankruptcy practice (or family law practice) very well, they wreak havoc on the client base of the largest law firms. Yes, the rules don't fit. But have we gone too far? Are we getting to the point where BigLaw has significantly more leverage than its sophisticated clients have? I worry that, given how few of the BigLaw players are major players in large chapter 11s these days, soon just a few BigLaw firms will make the law and set the rules even when caselaw directly on point or a statute dictates a different result.[79]

The ethics rules don't fit well with any practice areas that involve constantly shifting alliances, such as bankruptcy law and family law, so I'm not recanting that part of my very first article. But my own work has given some ammo to law firms that want to take my theories farther than I intended, and for that, I blame myself.[80] Let's do a reset. We need to focus on fact-specific nuance here, and nuance applied to actual legal principles, rather than on focusing on the argument that BigLaw firms are, well, really big and thus just need special treatment because they're the only firms large enough to do the work.

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Many thanks to a few anonymous commenters, along with J. Scott Bovitz, Dan Kamensky, Jonathan Lipson, Aditi Paranjpye, Bill Rochelle, Joseph R. Tiano, Jr., and Jeff Van Niel, all of whom helped with an earlier draft of this essay.

ENDNOTES

[1] 11 U.S.C. § 327(a) states:

> Except as otherwise provided in this section, the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title.

[2] 11 U.S.C. § 101(14) defines "disinterested person" as:

> a person that—
>
> (A) is not a creditor, an equity security holder, or an insider;
>
> (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and
>
> (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.
>
> So to fit within section 327(a), the professional seeking employment must not "hold or represent an interest adverse to the estate" and must be disinterested.

[3] Bankruptcy Rule 2014(a) requires the professional seeking court approval of its employment to include certain disclosures in its application:

> An order approving the employment of attorneys, accountants, appraisers, auctioneers, agents, or other professionals pursuant to §327, §1103, or §1114 of the Code shall be made only on application of the trustee or committee.... The application shall state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee. The application shall be accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.

[4] *See* Model R. Pro. Conduct R. 1.7.

[5] *See* Model R. Pro. Conduct R. 1.9.

[6] *See* Model R. Pro. Conduct R. 1.18.

[7] Nancy B. Rapoport, *Turning and Turning in the Widening Gyre: The Problem of Potential Conflicts of Interest in Bankruptcy,* 26 Conn. L. Rev. 913, 975-76 (1994) [hereinafter *Turning & Turning*]. My buddy J. Scott Bovitz has teased me with the thought that I probably started publishing in elementary school, with less grandiose topics. Actually, back then, I did poetry.

[8] For example, another law firm client decides that its interests are best protected if the case is converted from chapter 11 to chapter 7. That type of conflict might not happen, but if it happens, it's not going away.

[9] For example, another law firm client decides that it wants to purchase an asset from the estate that the selfsame law firm is representing. That conflict is actual but will disappear after the purchase issue is resolved. For that type of conflict, the firm cannot represent both sides of the transaction. The potential purchaser will have to use another law firm for that transaction. *See* Model R. Pro. Conduct R. 1.7(a).

[10] Presumably with an ethical wall, though I didn't make that point clear in the article.

> [11] If the possibility that the potential conflict will become actual is remote and the harm of temporary withdrawal is minimal, then the client is likely to consent to simultaneous representation without hesitation. If the possibility of potential conflict becoming actual is remote but the harm of temporary withdrawal is great, the client must consider whether the harm outweighs the risk--especially because not every potential conflict will be a DTAC [dormant, temporary, actual conflict]. Some potential conflicts develop into actual and permanent conflicts, necessitating withdrawal for the remainder of the case. If, on the other hand, the harm of withdrawal is negligible, then even if the likelihood of a potential conflict becoming actual is high, the client should still be willing to consent to simultaneous representation (at least if the potential conflict will, at worst, become a DTAC). That way, unless and until a conflict becomes actual, the client still can use her own lawyer, whom she prefers to another second-choice lawyer. Obviously, if both the likelihood that an actual conflict will develop and the magnitude of harm from a temporary withdrawal are high, the client should think twice before consenting to simultaneous representation, and the lawyer should think three or four times before even broaching the possibility of representation with the client.

Id. at 986-87; *see also id.* at 990 ("The primary contribution of this theory is that it separates the question of whether the initially chosen lawyer should represent this client who selected her as counsel (typically asked at the beginning of the case) from the different question of whether that chosen lawyer should represent the client during the temporary conflict. The two-part test focuses on the overall benefit to the client from a particular lawyer's representation by acknowledging that temporary conflicts may preclude representation during a portion of a legal matter but may not necessarily preclude the resumption of that representation after the conflict is over."); *cf.* Nancy B. Rapoport, *Client-Focused Management of Expectations for Legal Fees in Large Chapter 11 Cases,* 28 Am. Bankr. Inst. L. Rev. 39, 51 n.43 (2020) ("I live for the day that someone, somewhere, will cite this article [*Turning & Turning*] for the proposition that appointing conflicts counsel is a good idea").

[12] *See Turning & Turning* at 914-15 ("In the arena of bankruptcy, however, a party's position is not set in stone. Although the roles of the various parties in interest in a bankruptcy case—the debtor, the trustee, the creditors' committee, the secured creditor, the unsecured creditor, a potential buyer, etc.—may not change over the course of a case, a particular party's allegiances may shift from faction to faction, depending on the specific issue involved. A party in interest may not be bothered at all by this position-shifting, as the changes in allegiance are all part of a

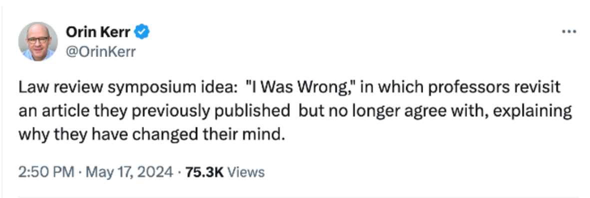
larger effort to protect the party's own interests. But a lawyer considering whether to represent a client has a problem to confront: whether she may take on the representation at all.") (footnotes omitted).

[13] I, too, am a creature of BigLaw, though it's been decades since I've set foot in my old firm's offices.

[14] There are law professors who truly are influential in the real world—I'm reasonably sure that my musings on conflicts of interest don't put me in that category.

[15] Not a word, but should be.

[16] *See* Orin Kerr, Tweet, X.COM (May 17, 2024):



[17] United States Bankruptcy Court, District of New Jersey, Case No. 24-11362-MBK (Doc. 500, May 16, 2024). It may not be for publication, but it's mentioned in *Enviva,* and I'm going to discuss it.

[18] United States Bankruptcy Court, Eastern District of Virginia, Case No. 24-10453-BFK (Doc. 653, May 30, 2024).

[19] And its affiliates.

[20] *Invitae* at 2.

[21] *Id.*

[22] *Id.* at 2-3.

[23] *Id.* at 3.

[24] *Id.* at 4.

[25] *Id.* at 5 (citations to record omitted).

[26] *Id.* at 5.

[27] *See* MODEL R. PRO. CONDUCT R. 1.7, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/rule_1_7_conflict_of_interest_current_clients/.

[28] *See id.* cmt. 8 ("Even where there is no direct adverseness, a conflict of interest exists if there is a significant risk that a lawyer's ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer's other responsibilities or interests.").

[29] *Invitae* at 6. The Court focused on Rule 1.7(b)(4) (the waiver provision), but it didn't focus on the fact that Rule 1.7(b) requires all four subsections to be met.

[30] *Id.* It's always handy to have a best friend who gives good comments on drafts of my articles, and my frequent co-author and bestie, Joe Tiano, has once again come through for me: "The court's conclusion mimics and affirms what the client explicitly did – that is, waive a conflict, no? It had to decide on different grounds than 1.7 or else it opened up the thorny issue of the efficacy of the advance waiver." Email from Joseph R. Tiano, Jr. to author (June 4, 2024) (on file with author). That is exactly what happened.

[31] *Id.* at 6-7. The way that I read this part of the waiver, the clients that sign it are basically telling their lawyers to do whatever they want in the event of a reorganization. That idea pushes Rule 1.7 past its breaking point. There are too many good lawyers and good law firms out there for the relatively few with the largest market share to be able to treat their clients this way, and I would like for clients that are presented with waivers of this type at least to consider reaching out to other law firms to see if those firms' waivers are as loose. *But see* n. 43, *infra,* and accompanying text.

[32] Everyone should read Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Co., 6 Cal.5th 59, 86 (2018) (for blanket advance waivers, "without full disclosure of existing conflicts known to the attorney, the client's consent is not informed for purposes of our ethics rules.").

[33] For a nice primer on the "hot potato" rule (as in "dropping a client like a hot potato"), see, e.g., Ronald E. Mallen, *§ 17:24. Defenses—Attorney-Client relationship—The "hot potato" rule and thrust-upon conflicts,* 2 LEGAL MALPRACTICE § 17:24 (2024 ed.).

[34] *See* Sheppard, Mullin, Richter & Hampton, LLP v. J-M Manufacturing Co., 6 Cal.5th 59, 86 (2018). When Bill Rochelle reviewed an earlier draft of this essay, he pointed out: "A client can perhaps give a binding advance waiver, but what about the debtor's creditors? How can creditors know for sure that the debtor's counsel will not favor a concurrent client." Email from Bill Rochelle to author (June 1, 2024) (on file with author).

[35] *Id.* at 8.

[36] *See id.* at 9.

[37] *Id.* at 9.

[38] *Id.*

[39] *Id.* at 10 (footnote omitted).

[40] *Id.* This argument is not too far off the mark from the argument that "we did good work, so don't punish us." *See, e.g.,* Jackson Walker LLP's Response in Opposition to the United States Trustee's Amended and Supplemental Motion For (1) Relief From Judgment Pursuant to Federal Rule of Civil Procedure 60(B)(6) and Federal Rule of Bankruptcy Procedure 9024 Approving the Retention and Compensation Applications of Jackson Walker LLP, (2) Sanctions, and (3) Related Relief, *In re* 4E Brands Northamerica, LLC, United States Bankruptcy Court, Southern District of Texas, Case No. 22-50009 (Doc. No. 692, May 22, 2024) at 72 ("The integrity of the bankruptcy process is paramount indeed, but integrity would not be restored by punishing a law firm that helped to effectively and efficiently shepherd its clients through chapter 11, consummating in each case a restructuring or other resolution that was—as a matter of law—in the best interests of the applicable estate.") (footnote omitted); Jackson Walker LLP's Supplemental Objection to Mr. Culberson's Motion For Relief From All Orders Approving All Applications For All Professional Fees and Reimbursement Expenses as to Jackson Walker, LLP and Motion to Disgorge Said Fees and Expenses and to Remove Professionals From This Matter, *In re* Sorrento Therapeutics, Inc., United States Bankruptcy Court, Southern District of Texas, Case No. 23-90085 (Doc. No. 2214, May 22, 2024) at 49 ("Even if this court considered such relief, disgorgement or the

Continued from p.51

denial of compensation to JW for services it performed—and continues to perform—on behalf of the Debtors in these Cases is entirely unwarranted. JW's services have provided a material and consistent benefit to the Debtors' estates, and no party has suffered any harm from JW's representation of the Debtors as local counsel in these Cases."). For a discussion of the whole David Jones-Liz Freeman-Jackson Walker mess, see, e.g., Nancy B. Rapoport, *Am I My Colleagues' Keeper When It Comes to Disclosing Connections?,* 40 Emory Bankr. Dev. J. 333 (2024); Nancy B. Rapoport, *Failing to See What's in Front of Our Eyes: The Effect of Cognitive Errors on Corporate Scandals,* 16 Wm. & Mary Bus. L. Rev. 1 (forthcoming 2025).

[41] Remember, I'm backing off of that more general statement. *See, e.g.,* nn. 10-16, *supra,* and accompanying text.

[42] The Association of Corporate Counsel had this to say about advance waivers:

> Not only does the rule advanced by Sheppard weaken this principle [lawyers as fiduciaries for their clients] by elevating an attorney's profits above the client's trust, it also ignores the practical reality that even sophisticated clients often have little bargaining power against a large law firm. New clients of a law firm are routinely presented with an advanced conflict waiver as a non-negotiable, take-it-or-leave-it option. This is particularly true for clients who may not have future matters with which to leverage. See W. Bradley Wendel, *Pushing the Boundaries of Informed Consent: Ethics in the Representation of Sophisticated Clients,* 47 U. Tol. L. Rev. 39, 42 (2015). And long-time clients may agree to an advance waiver because of the enormous cost and burden of moving the work to a new firm without the institutional knowledge of that client. Designed to protect law firm profits, these law firm practices persist because clients have limited bargaining power to negotiate these terms.

Application for Leave to File Amicus Curiae Brief and (proposed) Amicus Curiae Brief in Support of Association of Corporate Counsel in Support of Defendant and Respondent J-M Manufacturing Co. 2016 WL 11594703 (Cal.) (Appellate Brief), Supreme Court of California, at *12 (citation omitted).

[43] *Id.* at 10-11.

[44] *See, e.g., In re* Project Orange Assocs., LLC, 431 B.R. 363, 375 (Bankr. S.D.N.Y. 2010); *In re* WM Distribution, Inc., 571 B.R. 866, 873 (Bankr. D. N.M. 2017) (citing to Project Orange and observing that "[the] use of conflicts counsel is not appropriate where the adverse interests of the debtors represented by the same general bankruptcy counsel are central to the reorganization efforts of either debtor or to other resolutions of the chapter 11 case or where the adverse interests are so extensive that each debtor should have its own independent general bankruptcy counsel."). For a nice discussion of the *Project Orange* point that conflicts counsel can't cure all ills, see Gregory W. Fox, *Project Orange: Debtor's Counsel's Irreparable Conflict With Key Creditor Not Cured By Waiver,* 29-Sep. Am. Bankr. L.J. 30 (2010).

[45] *Enviva* at 14-15.

[46] *Id.* at 2.

[47] *Id.* The United States Trustee also raised questions about this proposal. *Id.* One of BigLaw Firm 2's clients is a member of EWH and thus would have "benefitted indirectly" from that then-dropped proposal. *Id.* at 3.

[48] *Id.*

[49] *Id.* at 5 (one of those clients came on board after BigLaw Firm 2 filed its employment application. *Id.*

[50] *Id.*

[51] *Id.* at 6.

[52] *Id.* Already exhausted at this list? Me, too.

[53] *Id.* at 4.

[54] *Id.*

[55] *Id.*

[56] *Id.* at 6-7. Also, BigLaw Firm 2 may have received some preferential payments, but we know how to take care of those, so let's leave that issue aside for the purposes of this essay.

[57] *Id.* at 8.

[58] For its discussion of Rule 2014, the Court cited to, among other cases, *In re Lewis Rd., LLC,* 2011 WL 6140747, at *7 (Bankr. E.D. Va. Dec. 9, 2011). *Id.* at 9. In particular, the Court quoted part of that case:

> Disclosures made pursuant to Rule 2014 "must be explicit enough for the court and other parties to gauge whether the person to be employed is not disinterested or holds an adverse interest." "[D]ebtors–in–Possession and their attorneys, whose employment is sought to be approved, [must] be meticulous in disclosing 'all connections' with the debtor and other parties in interest, and the failure to do so [justifies] a Court's taking significant punitive or corrective action." *Id.*

In re Lewis Rd., LLC, 2011 WL, at *8 (citations omitted). *See Envira* at 9.

[59] *Id.* at 10. In a footnote, the Court noted that it would have "preferred to know of [BigLaw Firm 2's] representation of [a particular client] at the first day hearing, where the Debtors proposed to pay $4.6 million in tax obligations for a non-debtor entity, EWH, in which [that client] is a member." *Id.* n. 7. The Court did not address the timing of disclosure about one of the four members of the ad hoc group, though. *See* n. 53, *supra,* and accompanying text.

[60] *Id.* at 11.

[61] 977 F.2d 906, 911 (4th Cir. 1992).

[62] *Id.* (emphasis in original).

[63] *Id.*

[64] *Id.* at 12 (citation to earlier part of opinion omitted).

[65] Author's note: Or not. *See* nn. 27-28, *supra,* and accompanying text.

[66] *Envira* at 12.

[67] *Id.* at 13-14 (citation omitted). The Court also noted the lack of an ethical wall as a potential corrective measure. *See id.* at 13.

[68] *Id.* at 15-16.

[69] As my buddy Jonathan Lipson put it in an email to me, "[a]s soon as you replace the "v." with "In re", the reference points

become unclear. I think that may explain why percentage-of-revenue is an attractive metric: it sounds concrete and objective. It is perhaps a cognitive substitute for the clarity of a traditional (if stylized) adversary environment." Email from Jonathan Lipson to author (June 3, 2024) (on file with author).

[70] For an aggressive tweet comparing the two cases, see Kevin Eckhardt, X.com (May 30, 2024, 12:27 PM).

[71] Joe Tiano has pointed out to me that forum-shopping in bankruptcy is different from forum-shopping in other types of matters: "The problem with bankruptcy is there is nowhere else to go with measurably different rules of engagement so it may feel more like pure judge/forum shopping than in other contexts where you may take jury composition or other procedural factors into account." Email from Joseph R. Tiano, Jr. to author (June 3, 2024) (on file with author).

[72] For a discussion about the idea that the ethics rules aren't being policed well in bankruptcy cases, see Daniel B. Kamensky, *The Rise of the Sponsor-in-Possession and Implications for Sponsor (Mis)Behavior,* 171 U. Pa. L. Rev. Online 19, 24 (2024) (referring to a trend indicating that "[s]ponsors [are avoiding] third-party independent scrutiny because of the failure of professional legal ethics to adequately police conflicts of interest in bankruptcy....").

[73] Comments from Jonathan Lipson to author on earlier draft (June 3, 2024) (on file with author).tt

[74] Bill Rochelle makes even a better point:

> I would place no reliance on the percentage that a client's billings represent....
>
> The client may be small, but it may be one of a hundred clients of the firm's biggest rainmaker. A bankruptcy lawyer would avoid pissing off the rainmaker's client, because it would get back to the rainmaker. Or, the bankruptcy lawyer might curry favor with the rainmaker by going easy on the rainmaker's client.

Email from Bill Rochelle to author (June 1, 2024) (on file with author).

[75] My buddy Joe Tiano is more skeptical than I am about the bargaining power of big institutional clients. "I doubt any law firm bullies Amazon or Ford or Apple or frankly any client paying a firm more than $5 million per year. I have no empirical evidence, just gut hunch." Email from Joseph R. Tiano, Jr. to author (June 4, 2024) (on file with author).

[76] *See* n. 33, *supra,* and accompanying text.

[77] Lawyers don't stop being fiduciaries just because some of their clients are dealing with a bankruptcy case.

[78] Jonathan M. Seymour, *Against Bankruptcy Exceptionalism,* 89 U. Chi. L. Rev. 1925, 1962 (2022).

[79] I'm waiting for the Association of Corporate Counsel to take hold of this issue and run with it. When even the biggest clients lack leverage, then we'll be even deeper into the "bankruptcy exceptionalism" against which Professor Seymour rails so eloquently.

[80] Though I'm just not that important. *See* n. 14, *supra.*

A LAYPERSON'S GUIDE TO THE OPTION PRICING MODEL

Everything You Wanted to Know, but Were Afraid to Ask

Travis W. Harms
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The option pricing model, or OPM, is one of the shiniest new tools in the valuation specialist's toolkit. While specialists have grown accustomed to working with the tool and have faith in the results of its use, many non-specialists remain wary, as the model—and its typical presentation—has all the trappings of a proverbial black box. The purpose of this whitepaper is to clarify the fundamental insights underlying the model and illustrate its application so that non-specialist users of valuation reports can gain greater comfort with the model. We will also address some qualitative concerns regarding use of the method in practice.

What Is the Option Pricing Model Used for?

First, a bit of ground-clearing. What does the OPM not do? The OPM is not a method for determining the value of a business enterprise. The method does not consider the value of the subject business enterprise's assets and liabilities, evaluate the present value of projected cash flows, or concern itself with a comparison of the subject business enterprise to similar businesses with observable market values.

The OPM becomes useful only after the value of the business enterprise has been determined through application of valuation methods under the asset-based, income and market approaches. The OPM is a tool for allocating the total equity value to individual ownership classes in a complex capital structure. For enterprises with a simple capital structure (i.e., a single class of common equity), the OPM is not necessary and should not be used. However, when the subject business enterprise features multiple classes of preferred and/or common equity with differing economic rights, the OPM can be a most effective tool for differentiating the value of the various ownership classes. Such complex capital structures are most frequently encountered in early-stage enterprises, which are commonly valued for equity compensation and portfolio fair value reporting.

What Is the Fundamental Insight Underlying the OPM?

The "Eureka!" moment behind the OPM is the recognition that the payoffs to complex securities with arcane features can be mimicked through an appropriately constructed portfolio of component securities (most commonly fractional call options or digital options with varying strike prices). As a result, what may seem on the surface to be an impossible valuation task can be mastered if the economic payoffs for a complex security are untangled and re-cast as a bundle of simple securities that can be more readily valued. The method holds out the promise of replacing subjective judgment with replicable analysis, which helps to explain why auditors favor the method.

Exhibit 1: Payoff Table—Simple Co.

Enterprise Value	Preferred Shareholders	Common Shareholders
$0	$0	$0
$100	$100	$0
$200	$200	$0
$300	$300	$0
$400	$400	$0
$500	$500	$0
$600	$500	$100
$700	$500	$200
$800	$500	$300
$900	$500	$400
$1,000	$500	$500

Consider a simple example. SimpleCo is capitalized with a single class of preferred shares and a single class of common shares. Upon liquidation or sale of SimpleCo, the preferred shareholders are entitled to receive $500, with the residual accruing to the common shareholders. The economic terms of the capital structure are summarized in Exhibit 1.

Two observations can be made from a brief study of Exhibit 1.

1. **Financial engineering does not create value.** In every possible state of the world, the sum of the payoffs to the preferred and common shareholders is equal to the equity value. Creative pie-slicing does not make the pie any bigger.
2. **The payoffs to the common shareholders have the same basic shape as a call option.** The holder of a call option receives no payoff when the stock price is less than or equal to the strike price. However, the call option holder participates dollar-for-dollar in appreciation above the strike price.

In light of these observations, we can express the value of the preferred and common share as shown in Exhibit 2.

By recasting the preferred and common equity classes into the component securities, the subjective judgment associated with selecting the appropriate yield on the preferred shares has been eliminated, as the value of the preferred shares is simply the excess of equity value over the value of a call option with a strike price of $500.

What Is a "Breakpoint"?

Moving to a more complex example will allow us to explain and define additional vocabulary terms from the OPM. Exhibit 3 on the next page summarizes the capital structure for ComplexCo.

Exhibit 2: Component Securities—Simple Co.

Enterprise Value	=	Preferred Value	+	Common Value
EV	=	*(EV - $500 Call)*	+	*$500 Call*

Continued from p.55

While this capital structure is still quite tame relative to many real-world counterparts, it is sufficiently complex to illustrate the fundamental tools used in OPM applications.

One could construct a payoff table similar to that in Exhibit 1. While certainly possible, doing so can become a bit cumbersome as the complexity of the capital structure increases. As a shortcut, valuation specialists identify the relevant "breakpoints" in the capital structure. In the OPM, a breakpoint is an equity value beyond which the marginal allocation of incremental value to the various equity classes changes. SimpleCo had a single breakpoint, while ComplexCo will prove to have four. We often see cases in which a dozen or more can be identified.

Breakpoints are identified starting with an equity value of $0. For ComplexCo, the Class A and Class B preferred shares participate on a pari passu basis, so the first breakpoint is the aggregate liquidation preference, or $2,500—the total "Net Proceeds" in Exhibit 4. Additional elements of Exhibit 4 will be explained as we proceed through the example.

For equity values from $0 to $2,500, the Class A preferred shareholders will receive 40% of value, and the Class B preferred shareholders will receive 60%. For equity values above $2,500, the marginal proceeds will be allocated differently, as shown in Exhibit 5. This change in allocation is what makes $2,500 a breakpoint in this example.

The next change in the allocation of proceeds will occur when the Class A Preferred shares convert to common. At common share values greater than $2.00 per share, the Class A Preferred shareholders will elect to convert, as their net proceeds from conversion will exceed the liquidation preference. As a result, the number of as-if converted shares increases, but the liquidation preference attributable to the Class A shares is forfeited. The corresponding breakpoint equity value is $5,500.

Breakpoint #3 corresponds to the common share price that will induce the Class B Preferred shareholders to convert to common shares ($5.00). In other words, the Class B Preferred shareholders will elect to convert, and be treated as common shareholders when the total equity value exceeds $11,500—see Exhibit 6.

As shown in Exhibit 7, Breakpoint #4 corresponds to the exercise of outstanding warrants. Note that while the warrants will be exercised at $10.00 per share, the warrant holders will pay $10.00 per share to do so, so the net proceeds to the warrants remains $0 at that point, and the equity value breakpoint is the aggregate "Net Proceeds."

Beyond the last breakpoint, marginal proceeds can be allocated according to an additional illustrative payoff schedule assuming some arbitrary share price in excess of the last breakpoint, as shown in Exhibit 8 (on page 58).

What Is a "Tranche"?

The next step in applying the OPM is to build a matrix that identifies the marginal allocation percentages between the various breakpoints. For purposes of the OPM, a "tranche" is the difference between two adjacent breakpoints. The marginal proceeds within a given tranche are allocated to the various equity classes in fixed proportions—see Exhibit 9 (on page 58).

The marginal tranche allocation matrix summarizes the relative allocation to the various equity classes within the respective tranches. The allocations were calculated in the corresponding

Exhibit 3: Capital Structure—Complex Co.

	Liquidation Preference	Liquidation Priority	Conversion/ Exercise Price	Fully-Diluted Shares	% of Total
Class A Preferred	$1,000	*Pari Passu*	$2.00	500	19.6%
Class B Preferred	1,500	*Pari Passu*	$5.00	300	11.8%
Common Shares	0	Residual	na	1,500	58.8%
Warrants	0	Residual	$10.00	250	9.8%
Total	**$2,500**			**2,550**	**100.0%**

Exhibit 4: Breakpoint #1—Class A & B Liquidation Preference

	Shares	Gross Proceeds	Exercise Price	Net Proceeds	% of Total	Marginal Proceeds	% of Total
Preference Claims							
Class A Preferred		$1,000	na	$1,000	40.0%	$1,000	40.0%
Class B Preferred		1,500	na	1,500	60.0%	1,500	60.0%
As-If Converted Shares	$0.00						
Class A Preferred	0	0	na	0	0.0%	0	0.0%
Class B Preferred	0	0	na	0	0.0%	0	0.0%
Common Shares	1,500	0	na	0	0.0%	0	0.0%
Warrants	0	0	0	0	0.0%	0	0.0%
Total	1,500	$2,500	$0	$2,500	100.0%	$2,500	100.0%

Exhibit 5: Breakpoint #2—Class A Converts to Common

	Shares	Gross Proceeds	Exercise Price	Net Proceeds	% of Total	Marginal Proceeds	% of Total
Preference Claims							
Class A Preferred		$0	na	$0	0.0%	($1,000)	-33.3%
Class B Preferred		1,500	na	1,500	27.3%	0	0.0%
As-If Converted Shares	$2.00						
Class A Preferred	500	1,000	na	1,000	18.2%	1,000	33.3%
Class B Preferred	0	0	na	0	0.0%	0	0.0%
Common Shares	1,500	3,000	na	3,000	54.5%	3,000	100.0%
Warrants	0	0	0	0	0.0%	0	0.0%
Total	2,000	$5,500	$0	$5,500	100.0%	$3,000	100.0%

Exhibit 6: Breakpoint #3—Class B Converts to Common

	Shares	Gross Proceeds	Exercise Price	Net Proceeds	% of Total	Marginal Proceeds	% of Total
Preference Claims							
Class A Preferred		$0	na	$0	0.0%	$0	0.0%
Class B Preferred		0	na	0	0.0%	(1,500)	-25.0%
As-If Converted Shares	$5.00						
Class A Preferred	500	2,500	na	2,500	21.7%	1,500	25.0%
Class B Preferred	300	1,500	na	1,500	13.0%	1,500	25.0%
Common Shares	1,500	7,500	na	7,500	65.2%	4,500	75.0%
Warrants	0	0	0	0	0.0%	0	0.0%
Total	2,300	$11,500	$0	$11,500	100.0%	$6,000	100.0%

Exhibit 7: Breakpoint #4—Warrants Exercise

	Shares	Gross Proceeds	Exercise Price	Net Proceeds	% of Total	Marginal Proceeds	% of Total
Preference Claims							
Class A Preferred		$0	na	$0	0.0%	$0	0.0%
Class B Preferred		0	na	0	0.0%	0	0.0%
As-If Converted Shares	$10.00						
Class A Preferred	500	5,000	na	5,000	21.7%	2,500	21.7%
Class B Preferred	300	3,000	na	3,000	13.0%	1,500	13.0%
Common Shares	1,500	15,000	na	15,000	65.2%	7,500	65.2%
Warrants	250	2,500	(2,500)	0	0.0%	0	0.0%
Total	2,550	$25,500	($2,500)	$23,000	100.0%	$11,500	100.0%

breakpoint tables. The illustrative upside scenario (Exhibit 8) allows us to confirm marginal allocation percentages for values in excess of the final breakpoint. Note that the marginal allocation percentages for the final tranche are equal to the proportion of total fully-diluted shares outstanding from each equity class.

The next step is to determine the value of each tranche. In doing so, we will work from right to left. Recall from our SimpleCo example that the portion of equity value in excess of a given amount can be calculated with reference to a call option on the underlying equity value with a corresponding strike price. In the case of ComplexCo, the value of the upside in excess of the final breakpoint ($23,000) is equal to the value of a call option having a strike price equal to that breakpoint value.

What about the value of the next tranche down? Following the same approach, the value of all of the upside beyond $11,500 is equal to the value of a call option on the underlying equity value having that strike price. The value of this call option represents the combined value of Tranche D and Tranche E. Since the value of Tranche E is known, the value of Tranche D can readily be calculated by subtraction. As shown in Exhibit 10 (page 58), the value of lower tranches is measured following the same procedure. Note that—in keeping with first observation above—the sum of the individual tranche values is equal to the equity

Continued from p.57

Exhibit 8: Illustrative Upside

	Shares	Gross Proceeds	Exercise Price	Net Proceeds	% of Total	Marginal Proceeds	% of Total
Preference Claims							
Class A Preferred		$0	na	$0	0.0%	$0	0.0%
Class B Preferred		0	na	0	0.0%	0	0.0%
As-If Converted Shares	$15.00						
Class A Preferred	500	7,500	na	7,500	21.0%	2,500	19.6%
Class B Preferred	300	4,500	na	4,500	12.6%	1,500	11.8%
Common Shares	1,500	22,500	na	22,500	62.9%	7,500	58.8%
Warrants	250	3,750	(2,500)	1,250	3.5%	1,250	9.8%
Total	2,550	$38,250	($2,500)	$35,750	100.0%	$12,750	100.0%

Exhibit 9: Marginal Tranche Allocation Matrix

	Tranche A	Tranche B	Tranche C	Tranche D	Tranche E
Upper Breakpoint	$2,500	$5,500	$11,500	$23,000	$35,750
Lower Breakpoint	$0	$2,500	$5,500	$11,500	$23,000
Tranche Width	$2,500	$3,000	$6,000	$11,500	$12,750
Marginal Allocations					
Class A Preferred	40.0%	0.0%	25.0%	21.7%	19.6%
Class B Preferred	60.0%	0.0%	0.0%	13.0%	11.8%
Common Shares	0.0%	100.0%	75.0%	65.2%	58.8%
Warrants	0.0%	0.0%	0.0%	0.0%	9.8%

% of Marginal Proceeds from Breakpoint payoff tables

Exhibit 10: Derivation of Tranche Values

	Tranche A	Tranche B	Tranche C	Tranche D	Tranche E
Stock price (S)	$17,500	$17,500	$17,500	$17,500	$17,500
Exercise price (K)	$0	$2,500	$5,500	$11,500	$23,000
Time to expiration (T)	4.0	4.0	4.0	4.0	4.0
Volatility (σ)	35.0%	35.0%	35.0%	35.0%	35.0%
Risk-free rate (r)	1.500%	1.500%	1.500%	1.500%	1.500%
Value of call options	**$17,500**	**$15,148**	**$12,426**	**$8,033**	**$3,514**
Tranche Values	**$2,352**	**$2,722**	**$4,393**	**$4,519**	**$3,514**

Calculated by subtraction

value. Financial engineering can create complexity, but does not create value.

Finally, the tranche values are apportioned to the individual equity classes in accordance with the percentages from the marginal tranche allocation matrix (Exhibit 9). As shown in Exhibit 11, the value of a particular equity class is the sum of the values of that class's respective allocations for each tranche.

The aggregate values are converted to per share amounts in Exhibit 12.

On a per share basis, the results conform to expectations regarding the relative value of the various classes. The higher liquidation preference of the Class B preferred shares causes those shares to be most valuable. The common shares, which do not have any liquidation preference, are worth less than either class of preferred shares. Finally, the strike price on the warrants reduces the value of those instruments relative to common shares.

Other Economic Features That Can Be Modeled in Option Pricing Models

The ComplexCo example included the most common economic rights (liquidation preferences, conversion features, exercise prices) found in equity instruments. The OPM can also accommodate dividends, to the extent they accumulate and affect liquidation preferences and/or conversion. Participation

Exhibit 11: Calculation of Equity Class Values

		Tranche A	Tranche B	Tranche C	Tranche D	Tranche E	Total
Tranche Values	A	$2,352	$2,722	$4,393	$4,519	$3,514	$17,500
Marginal Allocations							
Class A Preferred	B	40.0%	0.0%	25.0%	21.7%	19.6%	
Class B Preferred		60.0%	0.0%	0.0%	13.0%	11.8%	
Common Shares		0.0%	100.0%	75.0%	65.2%	58.8%	
Warrants		0.0%	0.0%	0.0%	0.0%	9.8%	
Marginal Values							
Class A Preferred	A x B	941	0	1,098	982	689	3,710
Class B Preferred		1,411	0	0	589	413	2,414
Common Shares		0	2,722	3,295	2,947	2,067	11,031
Warrants		0	0	0	0	344	344
Total		$2,352	$2,722	$4,393	$4,519	$3,514	$17,500

Calculated by addition

rights for preferred shares allow preferred shareholders to receive—in addition to their base liquidation preference—additional proceeds at liquidation on an as-if-converted basis, often up to some cap, expressed as a multiple of the liquidation preference. The mechanics of participation rights can vary modestly, but in any event can be directly modeled within the OPM framework.

More exotic, and less common, features of preferred shares include price or return hurdles that influence the allocation of proceeds to the equity holders. The OPM can also be accommodated to these features. So long as the feature can be reduced to a function of total equity value (i.e., for a given total equity value, there is one and only one possible allocation of proceeds to the various classes), the feature can be valued within the OPM framework.

Not all features can be reduced to a function of total equity value, however. The OPM cannot be adapted to directly value differential voting rights, price protection or ratchet provisions, drag-along and tag-along rights, or pre-emptive rights. Some notable recent late-stage rounds have featured complex anti-dilution provisions, including guaranteed minimum returns in the event of an IPO that go beyond the protections offered by traditional price ratchets. When such features are present, valuation specialists need to consider whether a discrete adjustment to the results of the OPM analysis should be made in measuring fair value.

Exhibit 12: Calculation of Per Share Values

	Total Value	Fully-Diluted Shares	Value per Share
Class A Preferred	$3,710	500	$7.42
Class B Preferred	$2,414	300	$8.05
Common Shares	$11,031	1,500	$7.35
Warrants	$344	250	$1.38

The OPM allocates the value of the existing capital structure, with the volatility parameter determining the potential changes in the value of the existing equity classes. Future issuances of additional equity are assumed to pull their own economic weight (i.e., neither contribute to, nor detract from, the value of the existing equity classes). As a result, there is no need to make assumptions in the OPM for the amount, timing, or pricing of future equity raises.

Assessing Reasonableness: Inputs

Beyond the formal elements of the capital structure that define breakpoints and tranche allocations, the required inputs to the OPM are the traditional Black-Scholes parameters. Exhibit 10 displayed the inputs used to allocate the value of ComplexCo.

The OPM inputs can be developed, and tested for reasonableness, in the same manner as in other applications of the Black-Scholes model.

- **Stock Price.** The stock price in the OPM is the total equity value of the subject business. The total equity value is derived through application of traditional valuation methods under the asset-based, income and market approaches. As will be discussed in a subsequent section, a known value for a particular component of the capital structure can be used to find the implied total equity value (the "back-solve" method).
- **Exercise Price.** The exercise prices in the OPM correspond to the equity value breakpoints identified in the formal analysis of the capital structure.
- **Time to Expiration.** In applying the OPM, one must assume a single point estimate for when liquidity will be achieved, either through dissolution, strategic sale, or IPO. While the actual time to expiration cannot be known with certainty, reasonable estimates can generally be made by reference to the subject company's life cycle stage, funding needs, and strategic outlook.

Continued from p.59

- **Volatility.** As with time to expiration, volatility cannot be directly observed. The most common starting point for volatility analysis is an examination of historical return volatility for a group of peer public companies. If reliable data is available, implied volatility from publicly traded options on the shares of such companies may also be consulted. Analysts adjust the observed peer volatility measures to take into account life cycle stage, remaining milestones, and other qualitative factors pertaining to the subject company.
- **Risk-free Rate.** The risk-free rate corresponds to the assumed time to expiration.

The most challenging assumptions to establish and support in application of the OPM are the time to expiration and volatility. As discussed in the following section, testing the sensitivity of the OPM output to variation in these inputs is a critical element of assessing reasonableness.

Assessing Reasonableness: Output

Report reviewers can quickly confirm the most basic mechanical integrity of an OPM through three easy preliminary checks: (1) the sum of the aggregate equity class allocations equals the total equity value of the subject company, (2) the sum of the fully-diluted shares used to calculate value per share equals that in the capitalization table, and (3) the rank order of the per share value conclusions is consistent with the liquidity preferences, conversion rights, and exercise prices pertinent to the various equity classes. These simple checks will not uncover all potential modeling errors, but they do eliminate a good portion of the most egregious potential pitfalls.

Beyond mere mechanical integrity, an additional step in assessing the reasonableness of the OPM output is to consider the sensitivity of the resulting allocation to changes in key inputs, principally time to expiration and volatility. Exhibit 13 provides such sensitivity analysis for ComplexCo.

We can make a few general observations from the sensitivity analysis in Exhibit 13.

1. Since the OPM is an allocation model, the total value of the equity classes is unaffected by changes in inputs. The only impact such changes can have is on the relative allocation to various classes. This is purely a zero-sum game; for one class to increase in value, one or more other classes must decrease in value.
2. The sensitivity results are easiest to interpret for the warrants. As the junior-most security in the capital structure, the sensitivity to changes in OPM inputs is unambiguous. Increases in time to expiration cause the allocation to warrants to increase, as do increases in volatility. Furthermore, because the warrants are at the bottom of the capital stack, the sensitivity of value to changes in inputs is magnified relative to other equity classes.
3. The Class B preferred shares benefit from downside protection, as the proximity of the conversion price ($5.00) to the current common share price increases the likelihood that the liquidation preference will preserve returns to the Class B preferred shareholders. The payoff to the Class B preferred shareholders is asymmetric since the upside is unlimited through the conversion feature, while the downside is constrained by the liquidation preference. As a result, assumptions that increase the dispersion of potential future outcomes (longer time to expiration and higher volatility) cause the value of the Class B preferred shares to increase.
4. The junior preferred shares (Class A) are directionally aligned with the common shares, although the fixed liquidation preference dampens volatility relative to the common shares. In cases of short times to expiration and low volatility, the per share value for Class A approaches that of the common as the likelihood that the current share price ($7.35) will fall below the Class A conversion price ($2.00) diminishes to a trivial level.
5. The sensitivity of the common shares, which are situated between the preferred classes and the warrants, is less predictable. In this case, the warrants have a parasitic relationship to the common shares, such that increases in the value of the warrants are accompanied by decreases in common share value. This relationship does not always obtain, however; the relative proportions of the instruments in the capital structure and the "moneyness" of the various

Exhibit 13: Sensitivity to OPM Inputs

	Volatility = 35%			Time to Expiration = 4 yrs		
	Changes in Time to Expiration			Changes in Volatility		
	2 yrs	4 yrs	6 yrs	20%	35%	50%
Total Value						
Class A Preferred	$3,744	$3,710	$3,696	$3,764	$3,710	$3,698
Class B Preferred	2,345	2,414	2,458	2,304	2,414	2,526
Common Shares	11,221	11,031	10,878	11,290	11,031	10,729
Warrants	189	344	467	142	344	546
Total	$17,500	$17,500	$17,500	$17,500	$17,500	$17,500
Per Share Value						
Class A Preferred	$7.49	$7.42	$7.39	$7.53	$7.42	$7.40
Class B Preferred	$7.82	$8.05	$8.19	$7.68	$8.05	$8.42
Common Shares	$7.48	$7.35	$7.25	$7.53	$7.35	$7.15
Warrants	$0.76	$1.38	$1.87	$0.57	$1.38	$2.19
Diff b/t Class B & Common	*$0.34*	*$0.69*	*$0.94*	*$0.15*	*$0.69*	*$1.27*

Exhibit 14: Seniority and Sensitivity to Volatility

Equity Classes Ranked by Seniority		
Class B Preferred		Most Senior
Class A Preferred	Muted sensitivity	
Common		
Warrants		Most Junior

capital structure components will determine the sensitivity of the common.

With reference to seniority, the equity classes at the "edges" of the capital structure are those that experience the greatest relative benefit from a skewed outcome. The most senior class benefits (on a relative basis) from the liquidation preference in a downside scenario, while the most junior class experiences the greatest marginal benefit from an upside scenario. Since the classes at the "edges" gain the most from skewed outcomes, they exhibit the greatest sensitivity to volatility and time factors, with the "interior" classes are less sensitive—Exhibit 14.

Strengths and Weaknesses Relative to PWERM

The primary analytical alternative to the OPM is the probability-weighted expected return method, or PWERM as it is affectionately known. Whereas the OPM is a continuous model, with potential future outcomes assumed to occur pursuant to a lognormal distribution, the PWERM is a discrete model which considers a finite number of analyst-selected potential outcomes and associated probabilities. In contrast to the OPM, the PWERM pulls double duty as both a valuation method and a means of simultaneously allocating the resulting value to the various equity classes.

Exhibit 15 summarizes a comparison of the two models along a variety of axes.

Reliability of Backsolve Application of OPM

The OPM is not a valuation method. However, if the value of any component of the capital structure is known – through either a contemporaneous primary issuance or secondary trade – the enterprise value corresponding to that value can be determined. Using the OPM to work backward from output to an indication of implied total equity value is known as the "backsolve" method.

As an example, consider the case of ComplexCo at the time the Class B preferred shares were issued at a price of $5.00 per share (one year prior to the valuation date in our Part 1 example). What was the implied total equity value of the company at that time? By starting with the known value of $5.00 per Class B preferred share, we can work backward, developing estimates for all the other assumptions, to determine the implied total equity value. In this case, we conclude that all assumptions are unchanged from Exhibit 10, with the exception of time to expiration, which is five years, instead of four. As shown in Exhibit 16, the resulting total equity value is $7,242 at the issuance date, compared to $17,500 at the later valuation date from our prior example.

This procedure is reasonable and appropriate in many circumstances. In our experience, however, it is important to keep in mind how the limitations of the OPM (primarily the lognormal distribution of outcomes) can distort the results of the analysis. When reading "backwards" from the value of a single equity class to the value of all equity, the effect of such distortions can be magnified. In our experience, the potential

Exhibit 15: Comparison of OPM and PWERM

	OPM	PWERM
Required Assumptions	In addition to the breakpoints and tranche allocations dictated by the capital structure terms, requires only five inputs.	Requires more assumptions than the OPM. Analyst must specify amount, timing and probability of future liquidity events as well as dilution from future financing
Sensitivity to Assumpti	As shown in Exhibit 13, sensitivity for many classes is somewhat muted. Since the OPM is only an allocation method, the impact of changes in inputs on allocation is generally tame compared to that in	Since the PWERM is both a valuation and allocation method, sensitivity to changes in inputs is potentially greater than with OPM.
Flexibility / Adaptability	Small number of required assumptions limits the flexibility and adaptability of the model. Cannot accomodate some common features of preferred shares such as mandatory conversion at IPO, IPO price guarantees and the like. The assumed lognormal distribution of	Can be readily adapted to unique features, such as price protection or ratchets. Offers the flexability to consider a range of potential future outcomes that more closely represent the market participant perspective than a lognormal distribution. Allows the analyst to consider outcomes at different
Transparency	Host of intermediate calculations and lack of familiarity with breakpoint analysis on the part of many report users contribute to	Generally intuitive, allocation of proceeds for each discrete scenario is readily checked for conformity to governing
Auditability	While not necessarily intuitive for non-specialists, small number of assumptions and translation of governing documents to formal structure of model is highly auditable.	While the required inputs correlate to assumptions that market participants actually make, convincing and documentable support for these estimates may prove elusive.

Continued from p.61

Exhibit 16: Backsolve Method Using the OPM

	Total Value	Fully-Diluted Shares	Value per Share
Class A Preferred	$1,618	500	$3.24
Class B Preferred	$1,500	300	$5.00
Common Shares	$4,089	1,500	$2.73
Warrants	$35	250	$0.14
Total	$7,242		

Exhibit 17: Reconciliation to Market Participant Perspective

TEV = $100 million Class B > $10.00	TEV = $100 million Class B = $10.00	TEV < $100 million Class B = $10.00
	per Term Sheet	
Consistent with OPM	Not Consistent with OPM	Consistent with OPM

magnitude of such distortion is greatest when the known value is for the most senior class.

Reconciling the OPM with Market Participant Perspectives

There is an irony at the heart of fair value measurement. Fair value is, by definition, a market participant concept. In other words, a "correct" fair value measurement will reflect the exit price for the subject asset among a group of relevant market participants. However, some techniques for measuring fair value are rarely, if ever, used by actual market participants.

In our experience working with market participants in early-stage companies, new financing rounds are generally priced through a two-step process: (1) negotiate the pre-money total equity value of the company, and (2) divide that figure by the fully-diluted share count. These market participants clearly understand that the economic rights associated with senior preferred shares are valuable. However, they do not develop or express a discrete estimate of that value. We suspect that there are at least two potential explanations for this. First, the economic rights that benefit the senior preferred shares may be the required "sweetener" to arrive at the headline total equity value. Second, in many early-stage companies, the actual benefit of a liquidation preference may be perceived as limited. Certainly, the scenario that would trigger payout of a liquidation preference, in lieu of participating as common shareholder following conversion, is sub-optimal. If the most likely outcomes are smashing success (in which case everyone converts and is treated equally) or abysmal failure (in which case being first in line to get nothing is not helpful), market participants may be less impressed by the economic rights accruing to the senior securities than the OPM would seem to be.

Assuming we are right, this perfectly rational behavior on the part of market participants can put those with the responsibility to measure fair value in a difficult spot. Consider a company that recently closed a $20 million Class B round, with customary liquidation preferences and conversion rights. The term sheet states that the pre-money equity value is $100 million. There are 10 million Class A preferred and common shares outstanding, and the issuance price for the Class B round is $10 per share.

As shown in Exhibit 17, there are three logical possibilities in this case. The only case that is inconsistent with the OPM is the one that reflects the actual, stated terms of the transaction.

There is no simple solution to this conundrum. However, to our mind it does underscore the appropriate posture toward analytical tools like the OPM. The fair value measurement tool should serve the market participant perspective; the market participant perspective should not be subordinated to the fair value measurement tool, no matter how insightful and "correct" it may be. As we have noted on our Financial Reporting Blog, Fidelity reports identical per share values for different equity classes of a given investee company. In doing so, one is effectively disregarding the differential economic rights of the various classes. Strictly speaking, such a conclusion is economically untenable. Yet, it likely mirrors how Fidelity, and other market participants, actually view value.

Conclusion

Use of the OPM in fair value measurement is growing. The model has many attractive attributes, including its precision, small number of assumptions, muted sensitivities, and auditability. However, the model is not necessarily appropriate in all circumstances. The underlying assumption of lognormality may not be appropriate for some companies and may limit the usefulness of the backsolve technique for determining implied total equity values. In our view, the model is best used in conjunction with the PWERM. Finally, as with all fair value measurement models, valuation specialists should carefully evaluate the degree to which the results of the model cohere with the market participant perspective.

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THE PURDUE DECISION[1]

Phil Anker, Martin Bienenstock, Bradford J. Sandler, Paul N. Silverstein, and Clifford J. White III

THE CONTRIBUTORS SPEAK UP*—*The Creditor Rights Coalition *asked its expert Contributors to weigh in on the Purdue decision. How will the decision affect bankruptcies going forward? How will bankruptcy courts deal with the complexity of tort cases? Will bankruptcy still provide a friendly forum for debtors looking to manage mass torts? How hard will it be for private equity sponsors to secure consensual releases against direct claims, and will it change sponsor behavior? Is forum shopping less likely? Read on to learn what to expect. Sign up to receive updates from the Creditor Rights Coalition at www. creditorcoalition.org.*[1]

Phil Anker

WilmerHale

My guess is that *Purdue* will have less of an impact in Chapter 11 cases not involving alleged mass tort liability than some might suspect. There are several reasons for my "prediction."

First, *Purdue*, of course, does not limit the ability of the debtor itself to obtain a discharge of its own liability or, perhaps more importantly, for third parties to settle with the bankruptcy estate and obtain a full release of estate causes of action against them. In my experience, sponsors and other controlling shareholders, as well as directors and officers, typically face more exposure to estate causes of action than to claims that truly belong to individual creditors. I have represented majority shareholders, former parents, and directors and officers of the debtor in cases where my clients faced substantial claims—sometimes in the hundreds of millions, if not billions, of dollars—but only by the bankruptcy estate, not by individual creditors. For example, a failed spinoff or leveraged buyout or recapitalization may lead to fraudulent transfer claims against the former parent or shareholders. Outside bankruptcy, creditors (indeed, only creditors) can typically bring such claims. But it is well established that, if the debtor company files for bankruptcy protection, the automatic stay bars creditors from pursuing such claims during the course of the bankruptcy case (absent relief from the stay which is not, in my experience, often granted for these purposes); instead, the bankruptcy estate has standing to do so, and it can (with court approval) settle the fraudulent transfer claims, precluding individual creditors from ever bringing their own claims seeking to "avoid" and recover the same transfers. Similarly, claims for breach of fiduciary duty against directors and officers, or controlling shareholders, are typically viewed as estate causes of action, at least where the underlying allegations concern supposed pre-petition stripping of assets from, or mismanagement of, the debtor. Same with lender liability claims (at least those that assert that the lender exercised undue control of the debtor/borrower, failed to honor a loan commitment, or took other improper actions that directly harmed the debtor/borrower) and, though the case law is not uniform, claims for alter ego liability.

None of this is to say that there are never cases where individual creditors assert claims against non-debtor third parties. Claims of securities or related fraud—that the directors and officers, or controlling shareholders, made misrepresentations to shareholders or creditors to cause them to invest in, or lend, to the now bankrupt debtor—may provide one example. Tortious interference or related claims asserting that one group of lenders or noteholders engaged in "creditor-on-creditor violence" that improperly advantaged them over other, similarly situated creditors may present another. But, at least in my career, those claims have not been as common or as big an economic driver as estate causes of action have been.

Second, even in cases where there are significant claims of individual creditors against non-debtors, Justice Gorsuch was very clear in his opinion for the majority in *Purdue* that the Court was not holding that *consensual* third-party releases were impermissible (or addressing whether a failure to opt out of a third-party release on a ballot for a plan could be deemed consent to grant the release). One of the principal strategies that I expect sponsors, directors and officers, and others facing potential claims by third parties to adopt after *Purdue* is to insist that the proceeds of any settlement they will fund can be made available under a plan only to those creditors that agree to release the potential defendants from any direct claims. In short, the sponsors, directors and officers and other potential "targets" will tell individual creditors in a class that they have a choice: either "opt in" to the settlement, and receive their ratable share of the settlement proceeds, but grant a full release, or "opt out," and retain their individual claims, but forgo any right to share in the settlement proceeds. Depending on the amount of the settlement and the strengths and weaknesses of any individual creditor claims, such a structure may incentivize most, if not all, creditors to opt into the settlement and grant the target a complete release.

Moreover, the potential defendants can adopt various mechanisms to "price" the risk that some creditors will decline to opt in to the settlement. For example, they can insist as a condition to their settlement that no more than a relatively small percentage of creditors opt out, and they can negotiate to reduce the dollar amount of the settlement for the exposure they retain to opt outs—just has been common in securities fraud and other class actions for decades.

Finally, unlike in mass tort cases where (as the name suggests) the number of creditors can be "massive," in my experience, there are often only a relatively modest number of holdouts in commercial cases with potential individual claims. By definition, it is easier to negotiate with a small, finite number of claimants than with a massive group, and business cases do not tend to present some of the negotiating difficulties that mass tort cases can (for example, claimants who, perhaps understandably, are less economically motivated and more angered by what they experienced, as well as potential future claims from individuals who have not even manifested any injury and whose claims may, therefore, have not yet accrued).

[1] This article was originally published by Creditor Rights Coalition, July 6, 2024, at https://creditorcoalition.org/contributors-speak-up-on-purdue-pharma/. Republished with permission.

Continued from p.63

All this said, I do not mean to suggest that *Purdue* will present no challenges to the resolution of commercial cases involving potential creditor claims against third parties. But Chapter 11 has enabled lots of companies in lots of different businesses to reorganize, as lawyers, financial advisors, other professionals and judges have innovated, and I do not expect that basic paradigm to change.

Martin Bienenstock

Proskauer Rose LLP

Now that the Supreme Court decided the Bankruptcy Code does not authorize nonconsensual non-debtor releases (coerced releases) in non-asbestos chapter 11 cases, what's next? To be sure, clever bankruptcy attorneys and jurists will experiment with workarounds, such as imposing requirements that holders of claims against non-debtor third parties engage in mediation before litigation if the claim may impact, directly or indirectly, the reorganized debtor. The balance of this discussion, however, is about the constitutional issues the Supreme Court did not mention, let alone decide. The constitutional issues impact the currently statutorily authorized coerced releases in asbestos chapter 11 cases in Bankruptcy Code section 524(g)(4)(A)(ii), and any future coerced releases Congress authorizes. The constitutional issues bar coerced releases on multiple grounds. Notably, the Supreme Court's majority opinion acknowledges constitutional constraints in its observation that Congress has "the power, consistent with the Constitution, to make policy judgments about the proper scope of a bankruptcy discharge." 219 L. Ed. 2d at 739.

One might wonder how there can be constitutional blockers to coerced releases issued in some circuits for several decades. I submit there are two main reasons. First, bankruptcy experts are as desensitized to discharges of claims as surgeons are desensitized to blood and internal organs. Second, most of us do not use our full powers of observation. My tenth grade lab teacher asked us to make lists of all the factual observations we could make about a simple wax candle. Most of us listed ten to twenty observations, but there were *over thirty* possible observations. So, let's identify the rights lost when a coerced release is imposed.

Most obviously, a coerced release deprives the creditor of the right to sue and obtain a judgment consistent with the common law. The Supreme Court has recognized that the right to sue is a fundamental right, without which all our liberty and property rights are unenforceable. Much jurisprudence suggests the people never granted the federal government the power to permanently deprive any person of the right to sue unless the beneficiary of the release exposes all its assets to satisfying claims.

Assuming the federal government can take a creditor's claim against a non-debtor for the public purpose of promoting reorganization, shouldn't the Fifth Amendment's just compensation requirement apply? When the government takes your house by eminent domain, you get a trial on the value of your house, and are entitled to be paid its full value. How can coerced releases legitimize the taking of a creditor's claim, without valuing the claim and without paying its full value?

Likewise, shouldn't the Fifth Amendment's due process requirement apply? The Supreme Court has long held due process requires that all a debtor's nonexempt assets be fairly distributed to its creditors. In *Purdue Pharma*, the non-debtor parties to be released appear to have been allowed to retain billions of dollars and to pay their personal creditors in full while their creditors who were also creditors of the chapter 11 debtor were fractionally paid.

Coerced releases deprive the Article III judicial branch from determining the claims eliminated by coerced releases and deprive the judicial branch from determining damages under the rules of the common law with a jury trial. That violates the separation of powers principle under which the judicial branch, and only the judicial branch, can adjudicate claims. It also violates the Seventh Amendment right to jury trial. The Supreme Court has many times ruled that violations of the separation of powers principle are not cured by the consent of the branch losing its powers.

But, hold the presses. The foregoing list of constitutional violations, by itself, does not mean coerced releases are illegal. The Supreme Court has long held legislation authorized by the United States Constitution can transgress the constitution. There are examples in the Bankruptcy Code. For instance, its preference provisions take away from a creditor money validly paid to the creditor in satisfaction of a valid debt, if the money was paid within 90 days before bankruptcy. That taking is to carry out the public purpose of equitably distributing the debtor's asset value. The Supreme Court has acknowledged the Fifth Amendment does not bar that taking.

So, the question becomes whether the bankruptcy power in Article I, Section 4, clause 8 of the Constitution authorizes coerced releases. If it does, the constitutional violations do not matter. But, it does not. The Supreme Court has ruled the bankruptcy power cannot deprive litigants of fundamental rights. And, when the Supreme Court was confronted with a district court enjoining nondebtor shareholders from objecting to their corporation's sale of railroad tracks to a reorganized debtor, the Supreme Court ruled the court lacked the power to do so. Some argue bankruptcy jurisdiction was narrower at the time, but suffice it to say it incorporated the power to decide rights of third parties.

Bradford J. Sandler

Pachulski Stang Ziehl & Jones

Recently, the U.S. Supreme Court issued its momentous ruling in the Purdue Pharma Chapter 11 case on the permissibility of nonconsensual third party releases.[2] The Supreme Court, in a 5-4 ruling, categorically held that "the bankruptcy code does not authorize a release and injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor

[2] *Harrington v. Pharma L.P.*, No. 23-124, 2024 U.S. LEXIS 2848 (U.S. June 27, 2024). Note that this opinion addressed non-consensual releases to non-debtors, and did not address consensual releases or releases of claims held by a debtors' bankruptcy estate.

without the consent of affected claimants." This is perhaps the most important and consequential bankruptcy decision issued in this millennium, if not longer, which will have ripple effects beyond mass tort cases and potentially impact many other larger Chapter 11 cases.

Plan / Settlement Background

Owned and controlled by the Sackler family, Purdue began marketing OxyContin, an opioid prescription pain reliever, in the mid-1990s. After Purdue earned billions of dollars, in 2007, one of its affiliates pleaded guilty to a federal felony for misbranding OxyContin as "less addictive" and "less subject to abuse." Thousands of lawsuits followed. The Sacklers proceeded to withdraw approximately $11 billion from Purdue—roughly 75% of the company's total assets—over the next decade and more, leaving the company in "a significantly weakened financial" state.

In 2019, Purdue filed for Chapter 11 bankruptcy protection, and the Sacklers initially proposed to return approximately $4.3 billion (spread out over a decade) to Purdue's bankruptcy estate; this proposed amount was later increased by the Sacklers to $5.5 - 6.0 billion. [3] In exchange, the Sacklers sought a judicial order releasing the family from all opioid-related claims and enjoining victims from bringing such claims against them in the future:

> The release sought to void not just current opioid-related claims against the family, but future ones as well. It sought to ban not just claims by creditors participating in the bankruptcy proceeding, but claims by anyone who might otherwise sue Purdue. It sought to extinguish not only claims for negligence, but also claims for fraud and willful misconduct…. And it proposed to end all these lawsuits without the consent of the opioid victims who brought them. To enforce this release, the Sacklers sought an injunction 'forever stay[ing], restrain[ing,] and enjoin[ing]' claims against them…. That injunction would not just prevent suits against the company's officers and directors but would run in favor of hundreds, if not thousands, of Sackler family members and entities under their control.[4]

While thousands of opioid claimants approved of the proposed exchange, together with the support of all 50 state Attorneys General, some parties, including the U.S. Trustee and certain U.S. states, opposed the relief, arguing that nonconsensual third-party releases are not permitted.[5] The bankruptcy court approved Purdue's proposed reorganization plan, including the broad, nonconsensual third party releases in favor of the Sacklers. The district court vacated that decision, holding that nothing in the law authorizes bankruptcy courts to extinguish claims against third parties like the Sacklers, absent the claimants' consent. A divided panel of the Second Circuit reversed the district court and revived the bankruptcy court's order approving a modified plan. After years of back-and-forth rulings in appeals, the Supreme Court finally decided in favor of the U.S. Trustee and the states.

The Majority Opinion

Justice Neil Gorsuch delivered the majority opinion of the Supreme Court, in which Justices Clarence Thomas, Samuel Alito, Amy Coney Barrett, and Ketanji Brown Jackson joined, making the following main points:

(i) The Bankruptcy Code does not authorize a release and related injunction that, as part of a plan of reorganization under Chapter 11, effectively seeks to discharge claims against a nondebtor without the consent of the affected claimants. Here, the Sacklers have not filed for bankruptcy or placed all their assets on the table for distribution to creditors, but they seek what essentially amounts to a discharge. No provision of the Bankruptcy Code authorizes that kind of relief.

(ii) The plan proponents' section 1123(b)(6) argument is baseless. Section 1123(b)(6) permits any term in a plan not expressly forbidden by the Bankruptcy Code so long as a judge deems it "appropriate." According to the plan proponents, because plan provisions like the Sackler discharge are not expressly prohibited under the Code, paragraph (6) necessarily permits them. To the contrary, according to the majority, "[w]hen faced with a catchall phrase like paragraph (6), courts do not necessarily afford it the broadest possible construction it can bear…. Instead, we generally appreciate that the catchall must be interpreted in light of its surrounding context and read to 'embrace only objects similar in nature' to the specific examples preceding it." In this case, each of the preceding paragraphs in section 1123(b) concerns the rights and responsibilities of the debtor; and they authorize a bankruptcy court to adjust claims without consent only to the extent such claims concern the debtor. Paragraph (6) cannot be read under the canon of *ejusdem generis* to endow a bankruptcy court with the "radically different" power to discharge the debts of a nondebtor without the consent of affected claimants.

(iii) Additionally, the Bankruptcy Code reserves discharges only for the debtor; the Code requires the debtor to submit all of the debtor's assets to the court; even a discharge is not "unbounded" because some claims are exempted from discharge; and section 524(g)(4)(A)(ii) is the only Code provision expressly authorizing nondebtor releases "but does so in only one context" (namely, plans dealing with asbestos claims). According to the majority, the Purdue plan "transgresses all these limits too."

(iv) Further, "every bankruptcy law cited by the parties and their amici—from 1800 until the enactment of the present bankruptcy code in 1978—generally reserved the benefits of discharge to the debtor who offered a 'fair and full surrender of [its] property.' … Had Congress meant to reshape traditional practice so profoundly in the present bankruptcy code, extending to courts the capacious new power the plan proponents claim, one might have expected it to say so expressly 'somewhere in the [c]ode itself.'"

[3] *Id.*, at *12-*13 ("As for individual victims harmed by the company's products, Purdue offered, with help from the Sacklers' anticipated contribution, to provide payments from a base amount of $3,500 up to a ceiling of $48,000 (for the most dire cases, and all before deductions for attorney's fees and other expenses)…. For those receiving more than the base amount, payments would come in installments spread over as many as 10 years.").

[4] *Id.* at *12.

[5] Notably, the majority addressed the fact that only a minority of opioid creditors actually voted on the plan, and it was that smaller group that largely affirmatively supported the plan. *Id.* at *13 ("Creditors were polled on the proposed plan. Though most who returned ballots supported it, fewer than 20% of eligible creditors participated…. Thousands of opioid victims voted against the plan too, and many pleaded with the bankruptcy court not to wipe out their claims against the Sacklers without their consent.").

Continued from p.65

(v) With respect to policy issues and implications, while both sides may have their points, "this Court is the wrong audience for such policy disputes. Our only proper task is to interpret and apply the law; and nothing in present law authorizes the Sackler discharge."

(vi) The majority painted its ruling as a narrow one, leaving for another day other important related issues including some continued grey areas:

> Nothing in what we have said should be construed to call into question consensual third-party releases offered in connection with a bankruptcy reorganization plan; those sorts of releases pose different questions and may rest on different legal grounds than the nonconsensual release at issue here…. Nor do we have occasion today to express a view on what qualifies as a consensual release or pass upon a plan that provides for the full satisfaction of claims against a third-party nondebtor. Additionally, because this case involves only a stayed reorganization plan, we do not address whether our reading of the bankruptcy code would justify unwinding reorganization plans that have already become effective and been substantially consummated.[6]

The Dissent

Joined by Chief Justice John G. Roberts, Jr., Sonia Sotomayor, and Elena Kagan, Justice Brett Kavanaugh "respectfully" dissented in a 54-page opinion (compared to the less than 20 pages for the Opinion of the Court), making a number of arguments including relying on section 1123(b)(6)'s catchall. Ultimately, however, Justice Kavanaugh focused more on the practical, equitable implications involving mass tort cases.

According to the dissent, the majority's decision was "wrong on the law and devastating for more than 100,000 opioid victims and their families." "Bankruptcy seeks to solve a collective-action problem and prevent a race to the courthouse by individual creditors who, if successful, could obtain all of a company's assets, leaving nothing for all the other creditors. The bankruptcy system works to preserve a bankrupt company's limited assets and to then fairly and equitably distribute those assets among the creditors—and in mass-tort bankruptcies, among the victims. To do so, the Bankruptcy Code vests bankruptcy courts with broad discretion to approve 'appropriate' plan provisions. 11 U. S. C. §1123(b)(6)."[7]

Justice Kavanaugh found that "the Bankruptcy Court exercised that discretion appropriately—indeed, admirably." It was, in his view, a "shining example of the bankruptcy system at work."[8] In making a categorical preclusion of nondebtor releases for "no good reason," he said that the majority "now throws out…a critical tool for bankruptcy courts to manage mass-tort bankruptcies like this one."[9]

Concluding his dissent, Justice Kavanaugh criticized the majority's opinion as "mak[ing] little sense legally, practically, or economically." Pointing to the Boy Scouts, the Catholic Church, the breast implants, and other mass tort cases, he stated that nondebtor releases "have been indispensable to solving that problem and ensuring fair and equitable victim recovery." Justice Kavanaugh suggested that the "Court's decision will lead to too much harm for too many people for Congress to sit by idly without at least carefully studying the issue." If the majority believed that $5.5 billion to $6 billion from the Sacklers was not enough, he argued that the Court "at most" should have remanded for the lower courts to decide "whether the releases were 'appropriate' under 11 U.S.C. § 1123(b)(6) (if anyone had raised that argument here, which they have not)."

Takeaways

The dissent, making statutory interpretation and other arguments, was trying to put a square peg into a round hole, primarily driven by practical and equitable concerns. Indeed, the Purdue Pharma ruling may severely hinder or at least delay, at more significant costs, acceptable settlements or other fair resolutions in mass tort and other bankruptcies. In short, mass tort bankruptcy cases and other complex bankruptcy cases will likely be considerably more expensive and protracted to get to a resolution, as any party not on board with providing a required release to a third party will have greater leverage. The ripple effect of the Purdue Pharma decision may extend beyond non-consensual third-party releases as the Supreme Court's Opinion, unlike the dissent, read 1123(b)(6) narrowly, and thus, how creative and far-reaching plan terms can be is now unknown and certainly will be tested in the lower courts.

Moreover, likely in the very near term, the next fight in chapter 11 bankruptcies will be over the form of consent required (by affected claimants), potentially leading to more bankruptcy litigation and further delays.[10] While various jurisdictions like the Second and Third Circuits have allowed for opt-in or opt-out "consensual" third party releases under chapter 11 plans, the U.S. Trustee, creditors' committees, and other affected creditors and parties in interest may raise more objections as to whether

[6] *Id.* at *31-*32.

[7] *Id.* at *33.

[8] As stated in the dissent, absent the Sackler releases and settlement payment under the chapter 11 plan, the bankruptcy court found the "most likely result" would be liquidation of a much smaller $1.8 billion estate, and in such a liquidation, the United States would recover first with its $2 billion superpriority claim, likely leaving the victims and other creditors with nothing.

[9] According to the dissent, "The Bankruptcy Code gives bankruptcy courts authority to approve non-debtor releases to solve the complex collective action problems that such cases present. As noted above, a Chapter 11 reorganization plan may release creditor claims against debtors. §1123(b)(1). And a plan may settle and release debtor claims against non-debtors. §1123(b)(3). In addition, the plan may also include 'any other appropriate provision not inconsistent with the applicable provisions of' the Code. §1123(b)(6). Section 1123(b)(6) provides ample flexibility for the reorganization plan to settle and release creditor claims against non-debtors who are closely related to the debtor." *Id.* at *50-*51.

[10] The form of consent required was not addressed by the Supreme Court. In addition, the Supreme Court left open the issue of what may happen if parties in interest attempt to question the propriety of nonconsensual third party releases in some previously-confirmed plans. Presumably, in such cases, the plan proponents will attempt to argue that the applicable plan has been consummated and any new attempt to undo the release should be equitably mooted. The success of this potential argument, no doubt, will be determined by the lower courts.

such plan release provisions are truly consensual.[11] To the extent that all victims of mass tort have to be solicited, the already expensive cost of solicitation will skyrocket. Beyond the added cost of solicitation, there are practical challenges of soliciting all class members, including identifying and locating them and protecting their often desired confidentiality (in terms of service, proof of service, etc.). Many class members may not be easily located, and even if located, they may not want their identity to be known, at least not in the bankruptcy court; however, under the Purdue Pharma ruling, the Supreme Court has put their identity at issue due to the requirement of obtaining their affirmative consent to any proposed third party release.

While much of the focus has been on mass tort, all significant bankruptcy cases will be impacted. Prepackaged bankruptcy cases will be much more challenging if the plan sponsors want releases from all parties in interest, including employees, unions, vendors, and shareholders. Obtaining consent from these creditors, who generally ride through a prepack, could materially risk business operations. In addition, aggressive shareholders could seek to organize a class action seeking to disrupt the prepack by refusing to grant a desired, if not required, release to the plan sponsors, as they likely would be slated to get no recovery in a prepack. The shareholders could then use the threat of a failed prepack as leverage to generate value, making the success of the prepack not only more tenuous but also more expensive. Unions that may not like the intended treatment of their collective bargaining agreements under a proposed plan may also attempt to disrupt operations as well as the prepack itself, leading to riskier and more expensive restructuring plans. Even employees who potentially have employee-related claims, such as those arising under the WARN Act, will have more leverage. Suffice it to say, the more parties in interest, the more challenging it will be to efficiently and successfully confirm a speedy prepackaged bankruptcy plan in which the plan sponsors want or desire a release from third parties, which means that the planning for any prepack will not only be more expensive, but the planning process will need to start earlier for maximizing the likelihood of success.

In order to incentivize voting creditors to consent to the non-debtor releases, it is likely Plan Sponsors will more frequently use a carrot-and-stick approach to procure consensual releases, such as increasing the use of death traps[12] and other negative consequences for not providing consent, leading to two practical options: one, non-debtor parties will offer to pay more consideration to obtain consent by all parties in interest, or two, because money is fungible and obtaining consent from all parties may be impractical, if not impossible, pay less consideration (be it upfront or via a death trap if there is a failure to obtain full consent) and use the "savings" as a defense fund for potential future litigation. In the first situation, the "hold out" creditors win; in the second situation, the "hold out" creditors lose, and may lose substantially as the consideration that may desperately be needed, such as in many mass tort cases for victims, would not be forthcoming, if at all, for likely many, many years down the road.

Any non-debtor party that pays additional consideration for consent likely will (and should) want assurances that the consent and the attendant "settlement" is approved, not only by the bankruptcy court, but also, in the case of class action settlements, by the court in which the class action is asserted. This additional procedural step, which likely will become a standard condition precedent to the effective date of any mass tort plan with consensual non-debtor releases, will further delay and complicate bankruptcy cases, causing them to be more expensive and uncertain.

Bankruptcy courts and case participants may be able to work out some clearer guidelines or principles relating to consensual third party releases in particular, but such matters will take time to be fleshed out in chapter 11 bankruptcies. As these issues get resolved in the lower courts, such as what form of consent is required (e.g., opt-in, opt-out, etc.), restructuring advisors will need to be keenly focused on plan treatment, solicitation strategy, and forum selection (as different jurisdictions will determine the boundaries of consent) to maximize the likelihood of successful chapter 11s seeking third party releases. Regardless of the merits of the majority opinion in Purdue Pharma, it seems likely, and is unfortunate, that a substantial price will have to be paid by innocent mass-tort victims as the implications of the Purdue Pharma ruling develop over time through the judicial system.

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[11] Post-Purdue, several bankruptcy courts have considered what type of consent is required, and there is a split of authority, with some requiring "opt-in" and others approving "opt-out" to indicate consent. For example, in the *Ebix, Inc*. Chapter 11 case (*In re Ebix, Inc*., No. 23-80004 (Bankr. N.D. Tex. August 2, 2024)), Judge Scott W. Everett ruled in an oral decision that the proposed opt-out third-party releases in the debtors' plan were nonconsensual, in violation of *Purdue Pharma*. According to Judge Everett, although *Ebix* gave parties a chance to affirmatively opt-out of the releases (either on a ballot or through other documents) and exclude themselves from the third-party releases, the mere opportunity to opt-out was not sufficient to prove the waivers were consensual: He stated at the confirmation hearing, "Silence does not equal the consent of the affected claimants." Similarly, in the *Red Lobster* Chapter 11 case (*In re Red Lobster Management LLC et al*., No. 24-bk-02486 (Bankr. M.D. FL)), Judge Grace E. Robson held during the disclosure statement hearing on July 26, 2024, that consent must be indicated by opting-in to a release. However, other courts have taken the opposite approach and held that the opportunity to opt-out of releases, but not doing so, is sufficient to show consent to the releases. In *Bowflex* (*In re Bowflex, Inc. et al*., No. 24-12364 (Bankr. D.N.J. August 19, 2024)), Judge Andrew B. Altenburg, overruled an objection by the United States Trustee and held that the plan's clear and conspicuous notice of opting out of non-debtor releases was acceptable and that it is incumbent on parties to act to protect their rights (in other words, silence does equal consent, which is more closely related to the common law principle of *qui tacet consentire videtur*, he who is silent is taken to agree). Similarly, Judge Christopher Lopez held in *Robertshaw* (*In re Robertshaw US Holding Corp. et al*., No. 24-90052 (Bankr. S.D. Tex. August 16, 2024)) that *Purdue* had no impact on the pre-*Purdue* precedent of allowing opt-out nondebtor releases as consensual. Ultimately, bankruptcy courts around the United States will need to determine whether an opt-in or opt-out method of consent is appropriate, and, depending on the underlying facts of the situation, the permissible method of consent may likely become another one of the many driving factors determining the chosen, if not desired, Chapter 11 venue.

[12] Deathtrap plan provisions commonly provide the impaired voting class receives a distribution, or an increased distribution, in exchange for the class's acceptance of the plan, but receives no distribution, or only the distribution to which the class is minimally entitled, if the class votes to reject the plan. A number of courts have found deathtrap provisions are permissible where the incentive is consideration beyond a creditor's existing rights and all creditors in the affected class are offered the same opportunity, but impermissible where the incentive is the threat of stripping existing rights. Post-Purdue Pharma, debtors may more commonly propose similar plan provisions varying the treatment of the claim based on whether the creditor provides the relevant third party release

Continued from p.67

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As widely reported, on June 27th the Supreme Court majority in Harrington v. Purdue Pharma L.P. ("*Purdue*"), in a concise opinion, held that no authority exists in the text of the Bankruptcy Code, in the non-asbestos context, for non-consensual release of non-debtors.

Before providing a high level discussion of some of the likely implications of the Supreme Court's *Purdue* decision, a few general observations. The Second Circuit's approval of non-consensual third party releases under Purdue's Chapter 11 plan was based on the satisfaction of several enumerated factors, one of the most important of which was the requirement that such releases be *overwhelmingly* supported by opioid claimants. Such overwhelming support by claimants was found by both the Bankruptcy Court and the Second Circuit: "The claimants voted overwhelmingly to approve" the Plan with "[o]ver 95% of the personal injury claims voting to accept". "[T]he main challenge is not by creditors, but by the [United States] Trustee—a government entity without a financial stake in the litigation." The Supreme Court majority, however, was swayed by a contrary view:

> Though most who returned [Plan] ballots supported it, fewer than 20% of eligible creditors participated . . . *Thousands of opioid victims voted against the plan too, and many pleaded with the bankruptcy court not to wipe out their claims against the Sacklers without their consent* …. (Emphasis added.)

Consistent with the Second Circuit, the Supreme Court's minority, which viewed the majority opinion as "devastating" to opioid claimants, described Purdue's Chapter 11 plan as, in fact, overwhelmingly supported by opioid claimants:

> The Plan . . . guaranteed substantial and equitable compensation to Purdue's many victims and creditors . . . and provided significant funding for thousands of state and local governments to prevent and treat opioid addiction. . . . Not surprisingly, therefore, *virtually all of the opioid victims and creditors in this case fervently support approval of Purdue's bankruptcy reorganization plan. And all 50 State Attorney Generals have signed on to the plan — a rare consensus*. The only relevant exceptions to the near universal desire for plan approval are a small group of Canadian creditors and one individual [the United States Trustee]. (Emphasis added.)

It appears clear that the Supreme Court's majority and minority were each swayed by their perceived views of the *Purdue* plan's treatment of opioid claimants. The minority opinion saw the majority's result as providing nothing good for opioid claimants anytime soon. The Supreme Court's majority agreed with the United States Trustee that the Sacklers' legal exposure absent a release "may induce the Sackler's to negotiate <u>consensual</u> releases on terms more favorable to opioid victims. . . . and there may be a better deal on the horizon." Interestingly, the Supreme Court's minority refers to the United States Trustee as "one lone individual" whose actions "remain mystifying" and said "that the U.S. Trustee does not speak for the victims of the opioid crisis and is indeed thwarting the opioid victim's efforts at a fair and equitable recovery. . . ."

<u>What the Majority Opinion Did Not Address</u>

The final Section IV of the majority's opinion, which reads like a supplemental after-thought, was particularly careful to emphasize the limits of its decision. Specifically, the majority declined to offer any view regarding the effect of its opinion on: (a) already effective and substantially consummated Chapter 11 plans in other cases, (b) plans that provide for consensual, as opposed to non-consensual, releases and (c) plans that purport to pay claimants in full. The Supreme Court's *Purdue* decision also affects neither derivative claims (i.e., claims that are held or owned by the debtor but asserted by third parties) nor cases involving asbestos claims, which are governed by Section 524(g) of the Bankruptcy Code.

Rather than debating myriad interesting matters including the merits of the statutory construction principles construing Section 1123(a)(6) of the Bankruptcy Code (or even whether, as speculated by some that the Supreme Court's minority opinion was to be the majority until one Justice flipped at the last moment), below is a high level discussion of some of the practical implications of *Purdue* on future mass tort cases.

<u>Effect of Remand on Purdue Chapter 11</u>

Ultimately, Purdue will resolve its opioid claims and the Sacklers will pay billions over time to move on. There may be trailing litigation given that not all claims will be released. But such litigation, if pursued, would be protracted and expensive to prosecute. Purdue has already moved for a further stay of all litigation to enable the parties to mediate a resolution consistent with the Supreme Court's ruling. It remains to be seen whether the Sacklers will pay more or less than offered in exchange for full releases. It likewise remains to be seen whether opioid claimants and the states will receive a better or worse recovery, particularly given the delays in payments. To the extent some plaintiffs wish to pursue actions against the Sacklers, at the end of the day the results or fruits of such actions will likely not be material.

<u>Effect of the Supreme Court's Ruling on Other Mass Tort Cases</u>

As the tail of the majority opinion indicated, "because [Purdue] involves only a stayed reorganization plan we do not address whether our reading of the bankruptcy code would justify unwinding reorganization plans that have already become effective and been substantially consummated." It should be clear that substantially consummated plans will not be disturbed.

It appears that the Third Circuit deferred ruling on the *Boy Scouts* plan confirmation appeal pending the Supreme Court's ruling in *Purdue*. The *Boy Scouts* Chapter 11 plan went effective, was partially consummated, but was not stayed notwithstanding the appeal of the plan confirmation order. There will no doubt be arguments both that the *Boy Scouts* plan has not been substantially consummated, and arguments to the contrary. The very strong likelihood is that the *Boy Scouts* plan and trusts established and funded by insurance carriers will not be disturbed on equitable (or other) mootness grounds.

What Is a Consensual Third Party Release; Opt-In, Opt-Out, Etc.

Part IV of the majority opinion states that consensual third party releases are not affected by its decision: "Nor do we have occasion today to express a view on what constitutes a consensual release. . . ." Consensual releases have long been used particularly in courts in Circuits, such as the Fifth, which prohibited non-consensual third part releases. In the Fifth and other Circuits, creditors are typically given the opportunity to opt out of such releases. Disclosure statements are supposed to make such opt-out rights clear. If a creditor does not specifically opt out, the release is deemed consensual in the Fifth Circuit and some other courts. In such courts, when a creditor does nothing, i.e., doesn't vote to accept or reject a plan and doesn't opt out of giving a third party release, such silence is deemed consent. Other courts, including some in the Third Circuit, have required an affirmative opt-in, or specific consent to a third party release for it to be deemed consensual. It remains to be seen whether the opt-out mechanism will continue to be deemed sufficient for a consensual release and in which districts; but it would appear that bankruptcy courts in the Fifth Circuit may now be viewed as more favorable for mass tort cases given long standing precedent there for the required opt-out mechanism.

What Is a Paid in Full Release?

Part IV of the majority opinion states that it was not "pass[ing] upon" the propriety of a plan that "provides for the full satisfaction of claims against a third-party non-debtor." If paid in full meant cash payment in the full allowed amount of a claim on the plan effective date it would be very simple and a non-issue. But that's not the case. Typically, a paid in full release is predicated on expert testimony which establishes to the court's satisfaction that the trust or other vehicle established to pay allowed claims in full is, or will be, fully funded and that all anticipated claims will eventually be paid in full under the claims resolution process promptly after allowance. In a scenario where a court concludes, based on the evidentiary record, that claimants would be paid in full, does such plan, in fact, provide for the full satisfaction of claims against a third-party non-debtor? Plainly, a claimant can only be paid once; but affected claimants will argue that a judicial determination that such claimant would ultimately be paid in full does not necessarily make it so.

Petition Date Injunctions Extending the Automatic Stay to Non Debtors

The Supreme Court's *Purdue* decision forbidding non-consensual third party releases does not mean that Chapter 11 will no longer be used to resolve mass tort claims (in non-asbestos contexts). Even though *Purdue's* prohibition on non-consensual third party releases likely increases claimants' leverage over non-debtors, the bankruptcy bar, which has pockets of extreme creativity, will work around *Purdue's* prohibition of non-consensual third party releases and achieve largely global resolutions. For example, upon filing of the petition, the debtor will typically obtain, in a mass tort or similar case, an order extending the automatic stay to non-debtor third parties such as officers and directors, controlling stockholders and others who arguably are liable to certain of the debtor's creditors. Nothing in *Purdue* suggests that such "provisional injunctions" would not be issued by bankruptcy courts, particularly where debtors will now likely maintain, from the start, that any plan for the debtor would have consensual or full pay third party releases. The leverage such injunctions provide the debtor in a mass tort context is very meaningful, and it is an integral step towards a consensual or global resolution.

Post-Confirmation Channeling Injunctions or the Like

Similarly, "gatekeeping provisions" which can be used in mass tort and other cases are likewise not barred by *Purdue*. A "gatekeeping provision" is not a release. It is an injunction preventing lawsuits against non-debtors, unless the designated court determines there is a colorable claim. Properly framed, a "gatekeeper" provision in a plan is a tool that likely will be used by debtors to attempt to "control" non-releasing claimants who seek to pursue litigation against non-debtors that are funding plans and are seeking to maximize the scope of consensual releases.

Channeling or similar post-petition injunctions, but now without non-consensual third party releases, may likewise still be in the debtor's toolbox to maximize the extent of consensual releases. Channeling injunctions were originally created under Section 524(g) of the Bankruptcy Code to allow debtors in asbestos cases to resolve all known and future claims by funneling such claims into a settlement trust. Those injunctions involved a non-consensual release of third parties. In non-asbestos cases, courts have enjoined lawsuits by known and future claimants against settling insurers and "channeled" all such claims into claims resolution processes and procedures. In addition to using so-called channeling injunctions to establish trusts funded by insurance proceeds, the goal of such injunctions is to avoid piecemeal litigation in multiple forums. It is likely that while a channeling injunction will not limit the potential recovery amount of non-releasing claimants, future mass tort debtors will likely attempt to channel the litigation into, for example, a centralized and "organized" process but with an option for the claimant to opt out. It would appear that the *Takata* injunction precedent should be a starting point in formulating such a path or process.

Derivative Claims

As indicated, the *Purdue* decision only affects non-consensual third party releases of claims directly owned by the claimant/plaintiff. *Purdue* does not affect derivative claims, which belong to the debtor, not the claimant. For example, in many circuits, a claim based on a liability theory of "piercing the corporate veil" is owned by, and belongs to, the debtor, not the claimant or creditor. Nothing in *Purdue* has any effect on a debtor releasing or in any way compromising a claim it owns. A *direct* claim for negligence, malfeasance or the like against a non-debtor third party, however, belongs to the claimant. A non-consensual release of such claim is plainly affected by *Purdue*. We can likely expect future mass tort or similar debtors to argue that many claims against non-debtors actually belong to the Debtor, and thus are derivative claims that can be released by the debtor without the claimant's consent.

Exculpation

Purdue raises many other considerations for issues going forward. For example, to address a few, *Purdue* should have no effect on

Continued from p.69

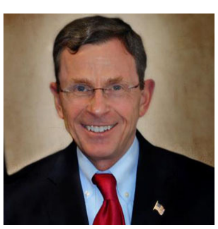
exculpations that are typically provided under Chapter 11 plans to protect estate fiduciaries against alleged claims relating to post-petition acts and omissions committed in connection with administering and/or prosecuting the debtor's reorganization. A plan exculpation is not a release and the rationale for such exculpations is generally that estate fiduciaries should not be subject to litigation in connection with their post-petition actions in connection with, or in furtherance of, the debtor's reorganization, absent unusual circumstances. Legitimate debate can be had over whether exculpations cover gross negligence or willful misconduct or just merely negligence. But, in any event, *Purdue* has no bearing on such exculpations.

Chapter 15 Considerations

Finally, for those who try to look under every rock to determine the full scope of *Purdue*, *Purdue's* effect in the Chapter 15 context may pique the curiosity of some. In some countries, including England, non-consensual third-party releases are allowed. Suppose a foreign company files a reorganization or insolvency proceeding in its local jurisdiction and the foreign debtor's creditors include some U.S. citizens with claims against the foreign debtor's controlling shareholders, which also include some U.S. citizens. Suppose the foreign debtor seeks recognition of its reorganization under Chapter 15 of the Bankruptcy Code so that it can be enforced in the U.S. with the U.S. non-debtors defendants getting releases from U.S. claimants without their consent? Will the U.S. bankruptcy court recognize such foreign proceeding's non-consensual third party releases, or will such releases be viewed by the Chapter 15 court as "manifestly inconsistent" with U.S. law or public policy? Manifestly inconsistent is a very high bar.

Conclusion

The Supreme Court's *Purdue* opinion, from the majority's succinct and simplistic approach to the minority's emphatic and lengthy dissent, is interesting. Perhaps the commentators who suggested that the minority opinion was intended to be the majority until a last-minute Justice switch are correct. But it doesn't really matter. Mass tort and similar cases will continue to be filed under Chapter 11 when such relief is warranted and other alternatives are not sufficient. The "guardrails" imposed by the *Purdue* majority on creative debtors' (and courts') ability to use non-consensual third party releases to get to a desired, reasonable and seemingly fair result will be more difficult but nonetheless achievable notwithstanding that mass tort claimants may now be seen to have more leverage in the process.



Clifford J. White III

Justice Neil Gorsuch's majority decision in *Purdue Pharma* was crisp, straight-forward, and to the point. The majority decided that "nothing in present law authorizes the Sackler discharge." The majority found that "the Sacklers seek to pay less than the code ordinarily requires and receive more than it normally permits." In response to the dissenting justices' policy arguments in favor of non-consenting third-party releases, Justice Gorsuch wrote that "we are the wrong audience" because "if a policy decision like that is to be made, it is for Congress to make."

The majority appropriately did not go beyond the issues before it and expressly noted it was not opining on what constitutes consent or whether offending chapter 11 plans that have been substantially consummated should be unwound. It is not hard to contemplate other issues that may be raised in the aftermath of the *Purdue* decision.

Here is my top ten list of issues and actions that may arise from the decision:

1. Purdue Pharma will negotiate a better plan that respects the rights of victims to sue the Sacklers. In fact, immediately after the court decision was handed down, the Sackler family issued a statement saying they were ready to negotiate again. That was a predictable response, if also a far cry from what Purdue's lawyers and the Sacklers declared many times in stentorian tones during the bankruptcy court proceedings. After the court just said no to similarly objectionable relief in the *Asena* and *Aero* cases,[13] it did not take long for new settlements, inside or outside of bankruptcy, to be completed. Future mass tort bankruptcy cases will require consent and hold-outs who want their day in court will receive the due process and other rights to which they are legally entitled.

2. Chapter 11 practice will be chastened by the court's decision and start adhering more closely to the confines of the Bankruptcy Code. Justice Gorsuch's reasoning puts practitioners on notice. The teaching of the majority decision is not confined to mass torts cases or even to releases. Numerous chapter 11 practices, such as 24-hour bankruptcies and other corporate-debtor-friendly innovations adopted by magnate bankruptcy courts should finally be subject to closer scrutiny. The high court rejected the view that "everything not expressly prohibited is permitted."

3. There will be one less reason to forum and judge shop. Magnate districts tend to take the most liberties with the Code, including on non-consensual third-party releases. Even in the Fifth Circuit, where such releases were prohibited before *Purdue*, an end-run was tried. (Recall Bankruptcy Judge Jones's mediated settlement in the *Tehum Care Services* case which was later rejected after the Jones scandal was revealed.) The high court ruling on releases should make end-runs harder as well.

4. Mass tort cases in bankruptcy may become more victim-friendly and less lawyer-friendly. Mass tort cases will still be filed in bankruptcy courts. For many cases, bankruptcy will still provide an efficient forum in which to carry out negotiations. But there will be rules. Neither parties nor the courts will be able to make it up as they go along. Parent companies and affiliates will not skate through as if they had filed their own bankruptcy cases. Releases will be confined to derivative claims and probably claims based on certain conduct by certain parties during the case. Maybe victims will be treated better, as well. It is worth remembering that victims under the *Purdue* plan would have gotten, in the aggregate, less money than the professionals. Also, as pointed out by Justice Gorsuch, tort lawyers would have

[13] In *Ascena*, the district court on appeal strongly rejected the non-consensual releases. Within a few weeks, a new plan without involuntary releases was successfully proposed. In *Aero*, the bankruptcy court dismissed the case on grounds that the debtor did not qualify for bankruptcy relief and the debtor settled with tort claimants in an amount many times higher than the offer described in bankruptcy court.

gotten a slice of the payments and the bigger payments would have stretched out over 10 years.

5. Congress just may act. Given concerns already expressed in both the business and class action lawyer communities, Congress may begin to study proposals for governing mass torts in bankruptcy, maybe even this year. Although the debate may start with trying to find a way to create a section 524(g) asbestos approach for other mass torts, additional related proposals may quickly emerge, such as: *venue and judge-shopping reform; policing the integrity of post-confirmation trusts*, including through stricter audits and claims reviews; and *controls on attorney fees* that unjustifiably erode victim compensation. Constitutional protections surely will hem in overly-creative solutions and even prompt reforms of asbestos bankruptcies as well.

6. Consent will be better defined by the courts or Congress. The Supreme Court expressly avoided this issue and thereby implicitly recognized that additional "knowing and informed consent" requires further consideration. Currently, there is far too much inconsistency between, and even within, districts on what constitutes consent. The biggest issue is opt-in or opt-out. Some judges approve opt-outs on grounds that failure to sign a statement opting out constitutes knowing and confirmed consent. That is particularly dubious in mass tort cases in which providing adequate notice is a huge challenge. Watch the Purdue and Sackler professionals try to create a loophole as big as a Mack truck in defining consent. Over time, I think most courts will require a signed "opt-in" form before taking away the property right to sue.

7. Equitable mootness and related issues will receive more attention. The Supreme Court also recognized that issues may arise concerning unwinding plans already confirmed. The *Boy Scouts* case is already on appeal. This and other cases will help raise and resolve related controversies, including by ending the equitable mootness doctrine which too often insulates bankruptcy court decisions from effective Article III court review.

8. There are Constitutional issues galore that must be sorted out. This applies both to litigation in court and any Congressional legislation to allow non-consensual releases. The right to due process and a jury trial are just two. Martin Bienenstock and others did a masterful job identifying these issues in *amicus* briefs filed in *Purdue* in the Supreme Court.

9. Courts will need to settle issues over the definition of derivative vs. direct claims. This may be the key factual and legal issue over which future third-party release controversies revolve. Derivative claims can be settled by the estate; direct claims cannot. As pointed out by the majority, the dissent tried to morph the definition of derivative claim (generally understood to mean a claim owned by the debtor) into any non-debtor claim in which the debtor's conduct is a "legally relevant factor." Justice Gorsuch rejected that contrivance, but it would not be hard to imagine aggressive debtor and tort lawyers trying to muddy the waters again.

10. The U.S. Trustee Program should be emboldened to appeal more often. The USTP won two cases in the Supreme Court this term, including in *Purdue Pharma*, as well as the *FTX* case in the Third Circuit vindicating the statutory provision making examiners mandatory under certain circumstances. (In total, the USTP pursues or defends upwards of 100 appeals per year.) One of the best ways the Program brings value to the bankruptcy system is to raise issues for judicial resolution. And bankruptcy courts are not the courts of last resort. I will never forget the judge in *Purdue* excoriating the USTP for its objection to the releases just struck down by the Supreme Court: he said DOJ's action to hold up the settlement was "reprehensible." Fortunately, he did not have the last word.

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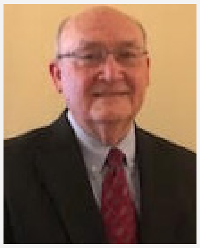

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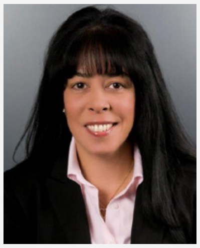

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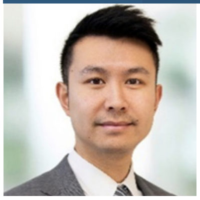

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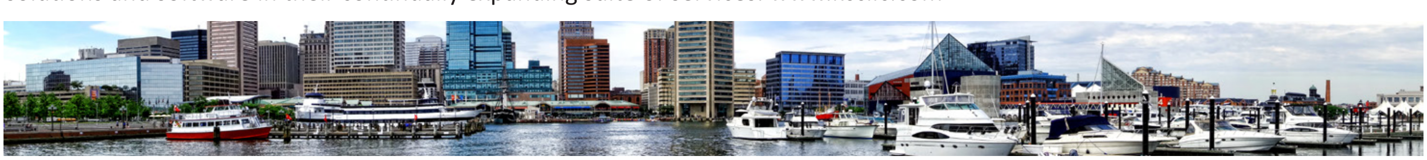

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