

# AIRA *Journal*

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**Will Interest Rate Cuts Drive a Debt Capital Markets Boom?**

**Intensive Care: A Pulse Check on the Healthcare Industry**

**Inside Disney's Star CEO Wars**

**A Robust Portfolio Valuation Process as Defense to Increasing Inquiries**

**Valuation Dynamics of Secondary Transactions**

**Commercial Real Estate's Maturity Wall Is Unprecedented—Is It Disastrous?**

**Unlocking the Value of Distressed Assets Through M&A**

**Mr. Market Miscalculates**

**From Worthless to Worthwhile: Maximizing Value for Insolvent Controlled Foreign Corporations**

**Four Tips for Drafting Earnouts to Avoid Disputes**

**Implications of the Constant Growth Perpetuity Model for Calculation of Terminal Value**



**Save  
the  
Date**

AIRA/NYIC Luncheon Program, January 22, 2025, NYC  
Wharton Restructuring and Distressed Investing Conference,  
February 21, 2025, NYC  
VALCON 2025, May 14-15, 2025, Las Vegas





## Annual AIRA/NYIC Luncheon Program

Wednesday, January 22, 2025 (11:00 AM - 2:00 PM) (EST) New York, NY

This event will feature two insightful panel discussions:

**Panel 1: Mergers & Acquisitions: The Good, the Bad and the Ugly**

Eric Welchko, President, Harney Capital

**Panel 2: 2025 Industries Outlook**

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# 41<sup>ST</sup> BRC

ANNUAL

Bankruptcy & Restructuring Conference

Returns to  
*Newport Beach, CA*  
June 4-7, 2025

More information on BRC 2025 coming Q1 to [www.aira.org](http://www.aira.org)!

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## From the Executive Director's Desk



**James M. Lukenda, CIRA**

AIRA

Since the late 2010s, *AIRA Journal* has been edited and composed by an incredibly dedicated and talented team. Led by Managing Editor, **Valda Newton**, Publications Chair, **Michael Lastowski**,

recently retired from Duane Morris, Co-editors **David Bart**, CIRA, CDBV, Baker Tilly, US, LLP (retired) and **Boris Steffen**, CDBV, Province, Inc., and Creative Director, **Michael Stull**, AIRA's signature quarterly publication provides informative and timely material to our membership, furthering AIRA's educational mandate.

As time goes on, change happens. And so it is with a touch of sadness I report to the membership that this journal is the last to bear Valda's name beside the title Managing Editor on the publication banner. When I became Executive Director in January 2020, Valda advised me she was considering retirement. I feel incredibly fortunate and so too should the membership that Valda continued to consider retirement for almost five years. But the time has finally come, consideration is now action and Valda is officially retiring from AIRA at the end of 2024.



Like her husband, Grant, Valda has been an integral part of AIRA. My association with AIRA goes back to 1989 and Valda has always been here. Whether assisting with conferences, helping members, or editing AIRA content, AIRA owes much to Valda for the success of our organization. Having honed her editorial skills on Grant's classic text, *Bankruptcy and Insolvency Accounting*, and other books, articles, and educational materials, Valda has

provided a level of editorial oversight to *AIRA Journal* and many of AIRA's other publications that is likely the envy of any other business publication.

On behalf of *AIRA Journal* leadership: Valda, thank you for your years of service and more importantly, friendship. We will miss your wise counsel.

And so, where does that leave us?

Working with Valda and the rest of the editorial leadership on this edition of the journal is our new Managing Editor, **Alexandra Mahnken**, CIRA, CDBV.

Alexa has been a member of AIRA for many years. She became a CIRA in 2008 and earned her CDBV in 2017. Alexa has taught CIRA certification classes and volunteered her time to assist me in revamping the CIRA curriculum.

She served as a member of AIRA's Board of Directors from 2023 to 2024. Alexa's professional experience includes financial advisory, bankruptcy litigation and commercial disputes, fraud

investigations, and C-level interim management of troubled companies. I worked with Alexa at Huron Consulting. There, beside her skills as a reorganization and turnaround consultant, she impressed me with her attention to effective communication and William Strunk's *Elements of Style*, to quote Google, "the book that generations of writers have relied upon for timeless advice on grammar, diction, syntax, and other essentials." Asked if there was anything I should mention in this letter, Alexa said to convey she welcomes our readers' input on topics of interest and any other comments about *AIRA Journal*.

With the hand-off from Valda to Alexa now complete, once again, a collection of informative, well edited articles follows. Please read, enjoy, and learn.

—Jim

### 2024-2025 COURSE SCHEDULE

# CIRA

Part:	Dates:	Location:
3	Dec 10-17, 2024	Online
1	Feb 04-12, 2025	Online
2	Apr 15-23, 2025	Online
3	May 05-08, 2025	Online
1	Jun 02-03, 2025	Newport Beach, CA
2	Jul 08-16, 2025	Online
3	Sep 03-11, 2025	Online
1	Oct 07-15, 2025	Online
2	Nov 05-13, 2025	Online
3	Dec 09-16, 2025	Online

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for more information and registration



## Resident Scholar Column

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



### Bankruptcy Busters LEADERSHIP AMONG BANKRUPTCY & RESTRUCTURING PROFESSIONALS

#### Introduction

"The greatest leaders you will ever meet are working for you right now!" Those remarks, from one of my most compassionate and devoted mentors, continue to resonate. She was fond of warning that one should not confuse leadership with authority or power. Many people in authority lack the qualities of leadership, while many people without authority possess those qualities. I have little doubt that there are those where the mantle of good leadership is worn comfortably, almost naturally. There are also those, most of us, who must work for it, where the qualities of leadership are forged in the fires of life.

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*"Don't ever think that leaders are different from the rest of us. They aren't... What distinguishes a leader from a non-leader is not position or office or role but rather a basic attitude to life. Others wait for something to happen; leaders help make something happen. While others curse the darkness, a leader lights a light."*

— Rabbi Jonathan Sacks, *Lessons in Leadership*

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Much work has been devoted to the meaning of leadership, the qualities or attributes of good leaders, cultural aspects of successful leadership, developing leadership skills, and mentoring successful leaders. While it is easy to fall into the trap of quoting hackneyed truisms, there are so many valuable works to choose from across an array of cultures and time. It is this richness in sources that caused me to question what I could add to this discussion, other than an introduction to great works on the subject. I'd like to share with you my favorite authors on the topic.<sup>1</sup> Each provides true wisdom that speaks to me. I hope they speak to you too.

I have not been entrusted with the key to deciphering a deeper understanding of leadership, particularly in our profession, and I am doubtful, in general, whether a leadership process for the many can spring from any one person. So, in addition to relying on my favorite authors, I asked around our profession over many years.

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<sup>1</sup> My favorite books (in my preferred order): Rabbi Jonathan Sacks, *Lessons in Leadership*; Robert K. Greenleaf, *Servant Leadership: A Journey into the Nature of Legitimate Power and Greatness*; Ronald Heifetz and Marty Linsky, *Leadership on the Line*; James MacGregor Burns, *Leadership*; Simon Sinek, *Start with Why: How Great Leaders Inspire Everyone to Take Action*; Daniel Kahneman, *Thinking Fast and Slow*; Seth Godin, *Tribes*; Mark C. Crowley, *Lead from the Heart*.

It is what I received from these two sources that I share with you now.

#### Humility as a Habit of the Heart

So where do we begin? Let's start with a nonobvious attribute of leadership often shared with me by the leaders in our profession. Humility.<sup>2</sup> Several colleagues shared that this quality served as the foundation of leadership. Genuine humility. It embraces the powerful observation that great leaders lead by example. The power of example cannot be overstated. To lead is to listen, a deeply spiritual act. Knowing is a form of listening. It is nurtured through respect for intellectual diversity and dedication to listen to those of lesser social or professional stature or the powerless, as well as the great and the powerful. High ideas indeed. They mean nothing, however, until they are nurtured into habits of the heart.

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*"Don't assume, because you are intelligent, able, and well-motivated, that you are open to communication, that you know how to listen."* — Robert K. Greenleaf, *Servant Leadership: A Journey Into the Nature of Legitimate Power and Greatness*

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How do we accomplish that? Again, I turn to my mentors and colleagues. First, one should recognize their own limitations and be open to learning from others, listening to others. All have something to teach. Be open to and invite feedback. Be genuine; those who work with you will know when you are not. Asking for feedback invites a dialogue and signals a willingness to learn from others. Second, lead with a sense of service and not entitlement.<sup>3</sup> There is a world of difference between power and influence. Humility is not a sign of weakness, a reduction in power; rather, humility is a virtue that builds trust, and with trust, one earns influence and strength. Third, at its zenith, humility reflects confidence. Confidence, which in Latin means having "faith together," does not ensure success; it does, however, ensure overcoming setbacks, together. Finally, humility is a guardrail to prevent a fundamental flaw in many of our leaders, that is, moving faster than the group can follow. Leaders exhibit a willingness to go no faster than the people you lead can bear.

#### Moral Responsibility

Many have written on the ethical dimensions of leadership. At the core of this concept rests the importance of responsibility. Here, I would like to add a finer point to the meaning of responsibility in leadership. Think of three scales of responsibility,<sup>4</sup> or lack thereof:

1. Personal—"It wasn't me!"
2. Organizational—"It wasn't us!"
3. Moral—"Why should I care about the welfare of anyone else?"

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<sup>2</sup> Ronald Heifetz and Marty Linsky, *Leadership on the Line* (Harvard Business School Press, 2002); Robert K. Greenleaf, *Servant Leadership: A Journey into the Nature of Legitimate Power and Greatness* (Paulist Press, 1977).

<sup>3</sup> Robert K. Greenleaf, *Servant Leadership*.

<sup>4</sup> Rabbi Jonathan Sacks, *Lessons in Leadership* (Maggid, 2015).

Leadership is not about power or glory or status.<sup>5</sup> The best among us in our profession teach by example that leadership is about serving others, be they our clients in a difficult situation, who we have a duty to represent, or our coworkers, who we have a duty to lead. It is these senses of duty that should guide us and our actions.<sup>6</sup> While leaders must often delegate tasks, they do not delegate responsibility. Leadership is a “profound moral responsibility”<sup>7</sup> that transcends common understandings of professional responsibility.<sup>8</sup> Leadership is not only being able to admit to flaws and failures in yourself and those for whom you are responsible, but also owning those flaws and failures and making efforts to correct them.

## Leading Human Beings

Leaders **lead** people. Granted, that statement may be a truism. Bear with me. Leaders must have the courage to live with unpopularity. They must manage human beings with all the unique complexity that comes with that great adventure.

*“Power wielders may treat people as things. Leaders may not.”*

— James MacGregor Burns, *Leadership*

A leader must manage conflicts with confidence and often state what someone must hear and not necessarily what someone would like to hear.<sup>9</sup>

*“People do not resist change, per se. People resist loss. You appear dangerous to people when you question their values, beliefs, or habits of a lifetime. You place yourself on the line when you tell people what they need to hear rather than what they want to hear. Although you may see with clarity and passion a promising future of progress and gain, people will see with equal passion the losses you are asking them to sustain.”*

— Ronald A. Heifetz and Marty Linsky, *Leadership on the Line*

Great leaders work on managing these conflicts in their own identity, that is, they manage in a manner genuine to them.<sup>10</sup> The burdens of leadership could lead to resistance, hostility, and isolation.<sup>11</sup> It is in these precise moments that leaders must be themselves. Nothing more or less will do.

One cannot understate the calm that comes with genuine and ample praise in these interpersonal areas of tension. Here, our mentors in leadership reminded me that by praise, they do not mean platitudes. They mean focused praise, specific to person and time and place, reflecting a positive quality in those you lead and a treasured ability to “show them their strength.”<sup>12</sup>

<sup>5</sup> Ibid.

<sup>6</sup> Ibid.

<sup>7</sup> Ronald Heifetz and Marty Linsky, *Leadership on the Line*.

<sup>8</sup> James MacGregor Burns, *Leadership* (Harper Perennial Political Classics, 2010); Rabbi Jonathan Sacks, *Lessons*.

<sup>9</sup> Ronald Heifetz and Marty Linsky, *Leadership on the Line*.

<sup>10</sup> Rabbi Jonathan Sacks, *Lessons*.

<sup>11</sup> Ronald Heifetz and Marty Linsky, *Leadership on the Line*.

<sup>12</sup> Ibid.; Rabbi Jonathan Sacks, *Lessons*.

## Shared Purpose

Leaders, according to our seasoned colleagues, strive to present and answer the question “why.”<sup>13</sup> Why are we doing this? What purpose does our work serve? How does one fit into the overall picture?

Shared purpose is a process and needs reinforcement at most every critical stage in our profession. A leader reinforces that shared purpose across the team. Leaders frame the reality for the team by regularly defining, and updating, the engagement space, specifying and refining the tactical and strategic goals, articulating tradeoffs, and reminding the group where they are and where they seek to be.<sup>14</sup>

*“Working hard for something we don’t care about is called stress. Working hard for something we love is called passion.”*

— Simon Sinek, *Start with Why: How Great Leaders Inspire Everyone to Take Action*

## Succession

To paraphrase an aphorism, the best time to pick a successor was ten years ago, the second-best time is now.

## Conclusion

My discussions with our mentors within the Association of Insolvency & Restructuring Advisors over many years cannot serve as fodder for a comprehensive framework for understanding the complexities of leadership. My goal was more modest: what insight into the development of leadership traits would they have to offer the next generation? The common themes emphasized the importance of humility, moral responsibility, appreciating the complexity of human beings, and framing shared purpose and vision in leadership. Our mentors remind us that leadership is not merely a position of power but a profound moral responsibility. By embodying these values, leaders can inspire others, build trust, and create a lasting positive impact on their communities, organizations, and themselves.

*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 and finance for lawyers; admiralty and maritime commerce; American Indian law; archaeology; bankruptcy and business reorganization; board governance and business ethics; business valuations; corporate finance; counterterrorism, intelligence, and national security; forensic investigations; Islamic law and finance; mergers and acquisitions; remedies; and statistics and the law.

<sup>13</sup> Simon Sinek, *Start with Why: How Great Leaders Inspire Everyone to Take Action* (Penguin Publishing Group, 2017).

<sup>14</sup> Rabbi Jonathan Sacks, *Lessons*.



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# THE VALUATION OF PRIVATE DEBT<sup>1</sup>

**Boris J. Steffen, CDBV**

*Province, LLC*

## Introduction

The market for private debt refers to lending, characteristically in the form of floating rate loans, that are negotiated directly between the borrower and lender, often an asset manager.<sup>2</sup> A segment of the \$12 trillion alternatives market, excluding real estate, the private debt market has grown to approximately \$1.6 trillion in assets under management globally according to March 2023 Preqin data, and is comparable in size with certain widely followed U.S. high yield bond and leveraged loan indices. Driving this growth has been the demand by borrowers for certainty in pricing and transaction execution, long-term, partner-like relationships, customized funding, and smaller transaction sizes. With private debt extended in North America at around \$698 billion, an amount equivalent to around 25 percent of commercial and industrial loans outstanding in the U.S., this growth is expected to continue. However, the private debt market is complex, not appropriate for all investors, and not exempt from the effects of adverse changes in the economic environment. In valuing a private debt instrument, it is therefore important to measure how much of the opportunity and related risks are reflected in the price of the issue.

## Taxonomy of the Asset Class

Corporate direct lending comprises the largest and perhaps most important segment of the private debt class.<sup>3</sup> As a core investment strategy, it most closely matches the characteristics of private debt in that it is cash paying, spans a broad variety of borrowers and industries, bears floating rates that mitigate interest rate risk, makes use of covenant provisions to insure security of principal, and provides the opportunity for liquidity through relatively short terms to maturity. If underwritten appropriately, its risk is primarily related to the beta characteristics of private debt, as its returns are a byproduct of the broad drivers of the asset class, such as in an index.

Enhanced private debt strategies include litigation finance, reinsurance, royalties, infrastructure debt, real estate debt, asset-backed lending, rescue finance, venture debt, structured CLO debt, and mezzanine debt. Returns from enhanced strategies are expected to be higher than core strategies, by as much as 3-5% depending on the strategy and asset managers. Accordingly, the risk is alpha driven and more dependent on the size of the manager's allocations to certain credits, industries, and sub-strategies.

<sup>1</sup> This article was originally published in ABI Journal, Vol. XLIII, No. 7, July 2024. Reprinted with permission.

<sup>2</sup> Blackrock Investment Institute, *Investment perspectives: Mega forces—Future of finance*, October 2023, 7, <https://www.blackrock.com/corporate/literature/whitepaper/bii-investment-perspectives-october-2023.pdf>.

<sup>3</sup> Stephen L. Nesbitt, *Private Debt: Yield, Safety, and the Emergence of Alternative Lending*, 2nd ed. (Hoboken: John Wiley & Sons, 2023), 61-62.

## Market Participants<sup>4</sup>

Direct loans are most often underwritten and held by asset managers who raise capital from private investors rather than bank deposits. While regulated by the SEC, they are not subject to the same regulations as commercial banks. The investor pool served by asset managers is in the main comprised of institutional investors, including insurers, pensions, endowment funds, and foundations. On the flip side, retail investors are served by publicly traded business development companies.

There are roughly 250 asset managers that invest in direct middle market loans in the United States, an increase from 180 in 2019. Many entered the market during or shortly after the global financial crisis of 2008–2009, recruiting staff from banks that filed for bankruptcy, such as Bear Stearns and Lehman Brothers, or non-banks which cut back on their participation, such as GE Capital, which through its subsidiary Antares was once the largest nonbank lender. Much of this growth is attributable to private equity, with sponsors backing approximately 75 percent of direct loans currently. While as compared to asset managers, banks have a significant advantage by having a lower cost of funds in the form of deposits, this advantage is counterbalanced by regulations that require higher capital requirements, restrictions on the type of loans they may make and the level of leverage they can offer to borrowers.

## The Fair Value of Debt

“The fair value of debt reflects the price at which the debt instrument would transact between market participants transacting in the debt in an orderly transaction at the measurement date.”<sup>5</sup> Factors implicit to the fair value of debt may include its contractual terms, including coupon rate of interest, time to maturity, amortization and prepayments, change of control provisions and conversion rights. Other than its contractual terms, factors bearing on the fair value of debt may also include the financial performance of the company, information regarding the prospects of the issuer known to market participants, and the debt's expected cash flows and market yield taking into account the riskiness of the debt and contemporaneous market conditions.

In certain cases, proxies for the fair value of debt may be used to infer the value of equity. However, these proxies may not be indicative of the fair value of the subject debt, or the value of debt appropriately used to value equity. These measures include par value, or notional value of the debt; face value, equal to par value plus accrued paid-in-kind interest; book value, equal to par value less any original issue discount, including debt issue discounts, which accrete to par value over the time to maturity; payoff amount, the value of the debt that would be owed if repaid on the valuation date; and trade prices, matrix prices, and indicative broker quotes.

<sup>4</sup> Ibid., 3.

<sup>5</sup> American Institute of Certified Public Accountants, Private Equity and Venture Capital Task Force, *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies, Accounting and Valuation Guide* (2024), 6.02.



## Relationship between Fair Value and Market Interest

The fair value of debt is not necessarily equal to its face value. For instance, the fair value of a bond may be lower than face value if the rate of interest paid by the bond is below the market interest rate.<sup>6</sup> This can occur due to general market conditions and/or credit issues specific to the company. Conversely, for the same reasons, the fair value of the bond may be higher than face value where the bond provides for interest above the market rate.<sup>7</sup>

## The Fair Value of Private Debt

The Financial Accounting Standards Board (FASB) provides a framework for use in determining the fair value of private debt.<sup>8</sup> FASB Accounting Standards Codification (ASC) 820 defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” For purposes of determining the process to be used to determine fair value, ASC 820 defines three categories of assets: Level 1, Level 2 and Level 3. Level 1 is comprised of liquid assets that are valued using quoted prices in active markets. Included in this category are listed equities, derivatives, mutual funds, and others having mark-to-market pricing systems such as that of a central exchange. Level 2 assets in general trade in inactive markets and are valued using quotes from market participants rather than real-time transactions on central exchanges. Examples include credit default swaps and corporate debt, which may be priced using the average of indicative quotes from multiple broker dealers. The majority of derivative instruments are also considered Level 2 despite the fact that their value may be available from a central exchange. Level 3 assets, such as direct corporate loans, are not traded or trade infrequently; consequently, their value cannot be determined from market actions or inputs. Rather, they are valued using valuation models that incorporate significant assumptions.

## Methodologies

The four main approaches to valuing private debt are the (i) income approach using yield analysis, (ii) net recovery approach, (iii) liquidation approach, and (iv) broker quotes.<sup>9</sup> The method selected depends on the availability of broker quotes and extent to which the enterprise value or collateralized assets of the borrower cover its debt positions. If the subject debt is fully covered, but broker quotes and trading activity are not observable or considered reliable, then the income approach, using a yield analysis to benchmark the credit risk of the instrument, may be used. If the subject debt is non-performing, irrecoverable or partially recoverable, either the recovery or liquidation approach would be used. The three main questions that are typically asked in considering the appropriate methodology are (i) is it

reasonable to assume 100 percent of interest and principal will be recovered, (ii) what cash flows are expected, and (iii) at what discount rate should the expected cash flows be discounted. A rule of thumb is that if the implied Yield to Maturity (YTM) is greater than 20 percent, the market does not expect a full recovery, in which case it would not be appropriate to use an income approach.

## Income Approach Using Yield Analysis

The three elements of the income approach using yield analysis method are the projected cash flows, discount rate and calculation of present value. The first step is to create a schedule of cash flows the subject debt is expected to generate over the estimated remaining holding period based on the terms and conditions specified in the credit documentation, including coupon payments, payment frequency and day count convention.<sup>10</sup> The cash flows are then discounted to present value using a cost of debt commensurate with the risk of realizing the cash flows.

For non-traded, private debt,<sup>11</sup> where the subject debt has a credit rating, the firm’s cost of debt may be estimated based on the YTM of bonds of other companies having identical or similar maturities and credit ratings using matrix pricing. In cases where there is no credit rating, a synthetic credit rating may be developed by comparing a company’s interest coverage and or leverage ratios with the range of ratios reported by a credit rating agency for each credit rating class. This credit rating may then be compared to the YTM on bonds with a similar maturity to estimate a cost of debt for use as a discount rate. It may also be feasible to determine a credit spread based on the credit rating and maturity of the subject debt and then add the spread to the benchmark risk-free rate to estimate the cost of the debt. The cost of debt may then be used to discount the cash flow to present value as of the valuation date.

## Net Recovery Approach

In cases where the Enterprise Value (EV) Coverage analysis shows that the subject debt is not performing or expected to be fully recovered in accordance with its contractual terms though secured by a going concern, fair value may be estimated using the net recovery approach.<sup>12</sup> The net recovery approach is implemented applying a waterfall to the enterprise value of the company. The value of the EV or collateral value may be measured using either the guideline company, guideline transaction or discounted cash flow method. A recovery waterfall is then applied to the estimated EV or collateral value, with fair value determined based on the portion of EV or collateral coverage allocable to its position in the capital structure.

<sup>6</sup> Ibid., 6.05.

<sup>7</sup> Ibid., 6.06.

<sup>8</sup> Nesbitt, 18-19.

<sup>9</sup> European Leverage Finance Association and Houlihan Lokey, *Technical Guide for Valuation of Private Debt Investments*, February 2022, 12, <https://cdn.hl.com/pdf/2022/elfa-diligence-technical-guide-for-valuation-of-private-debt-investments-.pdf>.

<sup>10</sup> Ibid., 13.

<sup>11</sup> Michelle R. Clayman, Martin S. Fridson, and George H. Troughton, *Corporate Finance: Economic Foundations and Financial Modeling*, 3<sup>rd</sup> ed., CFA Institute Investment Series (Wiley, 2022.) 262-3; Aswath Damodaran, *Investment Valuation: Tool and Techniques for Determining the Value of Any Asset*, 3<sup>rd</sup> ed. (Wiley, 2012), 212-13.

<sup>12</sup> European Leverage Finance Association and Houlihan Lokey, *Technical Guide*, 17.

## Liquidation Approach

When a firm has entered bankruptcy or is no longer considered to be a going concern, the fair value of its debt may be estimated using the liquidation approach.<sup>13</sup> In this approach, assets are appraised using assumptions reflecting distress, such as liquidation discounts and the fire-sale of assets in a forced sale. As a result, fair value is reduced to reflect the time and costs of liquidation, in addition to the uncertainty of conducting a forced sale.

## Broker Quotes

Broker quotes may be considered in the estimation of fair value, particularly if found to be reliable. Factors that go into this determination include, but are not limited to, the proximity of the quote to the valuation date, the volume of trades, the validity of the source of the data, and whether a known transaction occurred between related parties such as co-investors. In cases where the broker quote is found to be unreliable, or the debt is not traded, consideration should be given to whether the loan is non-performing.

## Concluding Thoughts

Initially used to finance small transactions or firms having negligible or negative EBITDA, the market for private debt has grown significantly over the past decade. Driven by borrower

<sup>13</sup> Ibid., 18.

preferences for customized financing terms, investor desire for yield and diversification, public market deal sizes exceeding the debt capacity of many middle market firms, and a contraction in available bank credit, this growth is expected to continue. The lack of transparency and liquidity inherent to the market remain key risks, however. Borrowers tend to be smaller, privately held, more highly leveraged and unrated by credit agencies. Notwithstanding, the returns available from an investment in private debt can be attractive provided that these risks are calibrated and accounted for in evaluating the fair value of the instrument.

### ABOUT THE AUTHOR



**Boris J. Steffen, CPA, ASA,  
ABV, CDBV, CGMA**  
Province, LLC

Mr. Steffen is a Managing Director in the Corporate Restructuring practice of Province, LLC. With over 30 years' experience as a financial advisor and expert witness in transactions totaling over \$200 billion, Mr. Steffen has served as a Financial Advisor to the Unsecured Creditors' Committees of cases including Wesco Aircraft, Revlon, Purdue Pharma, Thrasio, Ascena Retail Group and Eagle Hospitality Trust. He also served as a Financial Advisor to the Committee of Opioid Related Creditors in Mallinckrodt PLC, Opioid Claimant Committee in Endo International plc, and as a Financial Advisor to the Special Committee of the Board of Managers in Intelsat Envision Holdings, LLC.

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# WILL IMPENDING INTEREST RATE CUTS DRIVE A DEBT CAPITAL MARKETS BOOM IN 2025 AND BEYOND?

**Angela Giles**

*Hilco Corporate Finance, LLC*

As we end the year and look to 2025, the likelihood of further interest rate cuts later this year raises the question of whether we will see a boom in debt capital markets. To explore this possibility, we need to consider how interest rates impact debt capital markets, examine historical precedents, and assess current economic conditions.

## How Much Do Interest Rates Drive Debt Capital Markets?

Interest rates significantly influence debt capital markets. When rates rise, borrowing becomes more expensive, leading companies to defer raising debt capital. It's only logical that refinancing existing low-cost debt with higher-cost debt is financially unwise. Higher interest rates mean increased debt service payments, straining a company's cash flow. Importantly, however, some companies may find themselves needing to refinance maturing debt despite higher rates. In these cases, banks and non-bank lenders often opt for amending and extending loan terms, especially for companies with performing loans. This arrangement benefits both parties. Companies maintain their existing debt facilities at the same rates, while lenders earn fees for the amendments and continue to receive interest income without deploying new, higher-cost capital. Additionally, performing loans require lower reserve requirements for banks, creating a win-win situation.

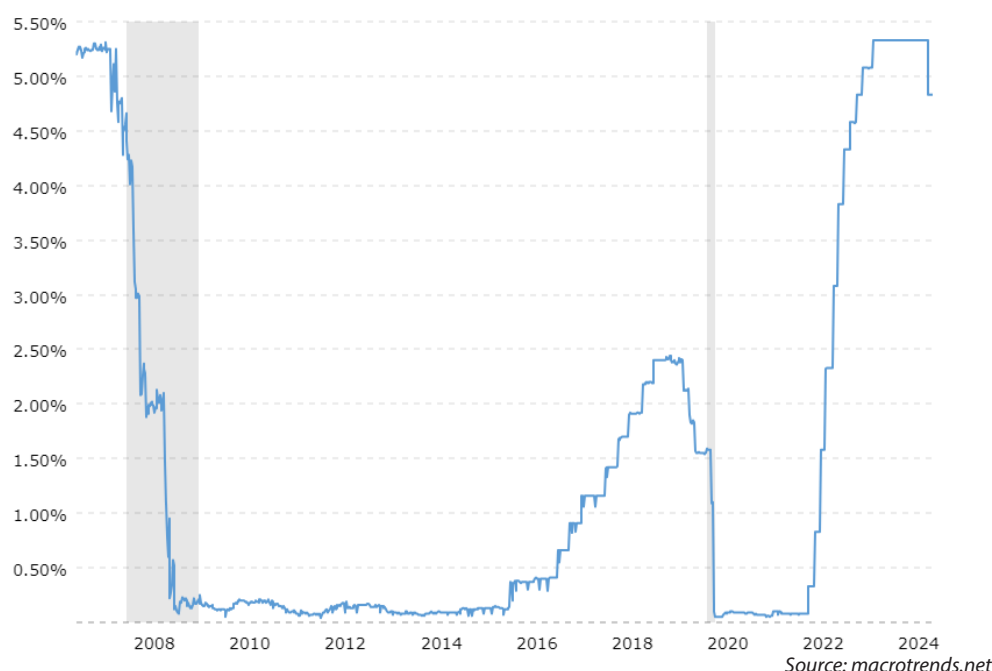
## A Historical Perspective: The Post-Great Recession Era

To understand how interest rates might impact future debt capital markets, it is helpful to look at recent events. Following the Great Recession of 2008-2009, for example, the U.S. economy was in turmoil due to massive losses in mortgage-backed securities. In response, the Federal Reserve slashed interest rates to near zero through unprecedented monetary policy measures, including ten rate cuts (Exhibit 1). However, the recovery was slow, and debt capital market activity was subdued. Regulated lenders, bolstered by funds from the Troubled Asset Relief Program (TARP), were hesitant to deploy capital. TARP aimed to stabilize the financial system and promote economic growth, but despite these efforts, lending remained cautious immediately following the crisis. The reluctance to lend during this period underscores how deep economic disruptions can overshadow low-interest rates in spurring debt capital market activity.

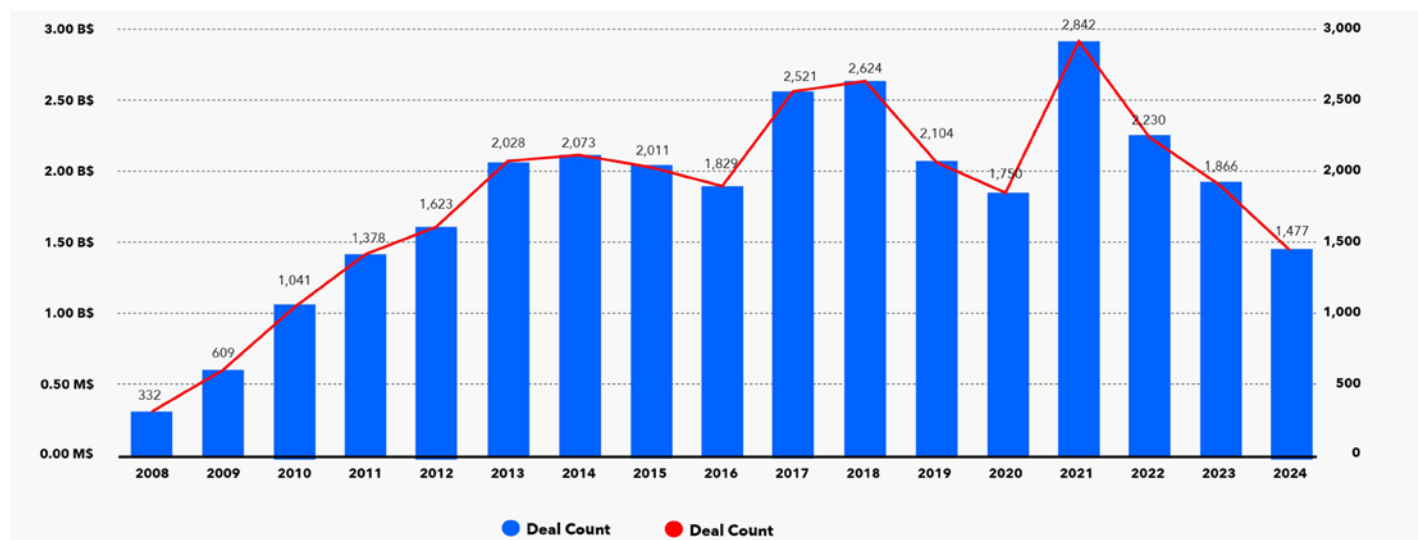
## The COVID-19 Years and the Aftermath

The COVID-19 pandemic in 2020 dramatically disrupted global financial markets. Equity markets plummeted but rebounded quickly, yet deal activity came to a halt during the lockdowns. As the world adjusted to the new normal with vaccines and government stimulus, the Federal Reserve continued to cut

**Exhibit 1: Federal Funds Rate—2008-2024**





**Exhibit 2: Debt Deal Count—2008-2024**

Source: Pitchbook Data, Inc.

rates to nearly zero, igniting a surge in deal volume during 2021 (see Exhibit 2). This was driven by pent-up demand from 2020, increased consumer goods spending from home (with access to travel and events limited), and a wave of refinancings. Company valuations soared during this period, and the low-interest environment spurred mergers and acquisitions (M&A), resulting in a true boom in deal activity. This recovery, however, faced challenges including supply chain issues, labor market tightness driven by the “Great Resignation,” and inflationary pressures. The Federal Reserve responded with a series of interest rate hikes from late 2022 through 2023 that were intended to combat inflation. A byproduct of those actions was the resulting cooling off in deal activity.

## Present Day Forward

Through mid-2024, the Federal Reserve had held rates steady but hinted at potential cuts in the near future. Multiple rate cuts had been originally expected to begin in the first half of 2024. With inflation remaining above the Fed’s 2% target, those anticipated cuts will likely occur in the latter half of 2024 instead, and as of September 2024, have already begun. This leaves many companies in a dilemma right now. Those needing capital are being forced to navigate a high-interest environment while others wait on the sidelines. Banks continue to amend and extend loans for performing borrowers, but non-performing loans are seeing increased restructurings and bankruptcy filings (Exhibit 3), particularly in consumer discretionary sectors like restaurants and retail. On the private equity side, firms are being forced to hold investments longer than intended, as they are challenged to exit at favorable valuations right now amid high debt costs.

Looking ahead, if the Fed begins cutting rates meaningfully, we might witness a gradual uptick in deal activity. Companies that postponed raising debt capital will likely re-enter the market as borrowing becomes more affordable and less burdensome on liquidity. However, the extent of this potential boom will depend on various factors beyond interest rates, including political stability, international relations, and broader economic conditions.

## Implications for the 2025 Economy

Though the economy remains in a state of flux as of this writing, balancing between slowed but persistent inflation and the promise of lower interest rates, companies are cautiously optimistic but remain wary of immediate economic challenges. That said, historical precedent and current trends suggest that the following sectors may see deal activity increases in the months ahead:

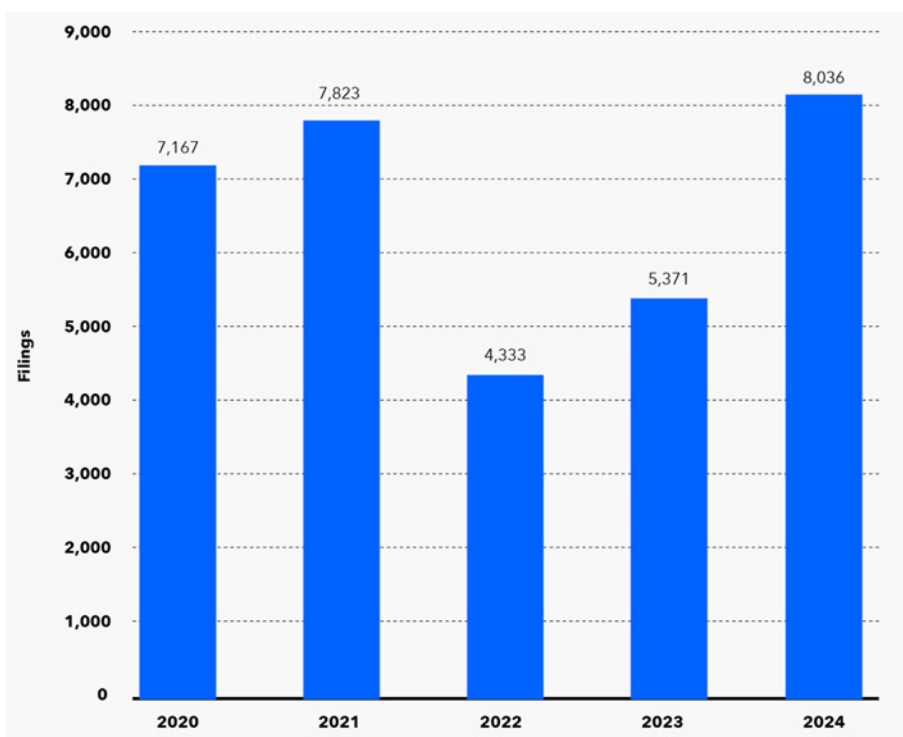
**Technology**—With cheaper access to capital, tech companies are likely to pursue acquisitions to accelerate innovation, expand market share, and integrate emerging technologies like artificial intelligence, cloud computing, and cybersecurity solutions. Historical precedents, such as the surge in tech deals post-2008 financial crisis when rates were near zero, suggest a similar trend could emerge in 2025.

**Healthcare**—Lower interest rates reduce the cost of financing large acquisitions, enabling pharmaceutical companies and healthcare providers to pursue strategic deals aimed at expanding their product pipelines, improving service delivery, and achieving economies of scale. The COVID-19 pandemic underscored the importance of robust healthcare infrastructure, and companies are likely to continue consolidating to enhance their capabilities and resilience.

**Consumer Goods**—Businesses in the sector have often utilized consolidation as a means of enhancing brand portfolios, expanding distribution networks, and leveraging synergies and efficiencies. In the aftermath of the Great Recession, for example, numerous consumer goods companies engaged in significant M&A to optimize their operations and capture new markets. With declining rates, companies may also focus on acquiring innovative, younger brands that appeal to evolving consumer preferences including sustainability and customization.

**Industrials**—Cheaper capital can facilitate investments in advanced manufacturing technologies, sustainable practices, and expansion into new geographies. Industrial M&A activity tends to rise with lower interest rates as companies seek to

**Exhibit 3: Chapter 11 Cases Filed, 2020-2024 (12-month periods ending March 31)**



Source: USCourts.gov

enhance operational efficiencies and reduce costs through strategic acquisitions.

**Private Equity**—A more conducive borrowing environment will enable PE firms to pursue larger and more numerous deals, focusing on businesses across sectors that demonstrate high growth potential and opportunities for operational improvement. While the private equity boom post-2008, driven by low interest rates and abundant capital, may be indicative of what we could start to see take place at some point in 2025 or 2026, this is a different market and time. Among other areas, we are likely to observe notable focus from PE firms on investment in businesses with proven traction in artificial intelligence development, on businesses now leveraging AI and machine learning technologies, and those ripe for adopting these to gain competitive advantage.

**Real Estate and REITs**—Lower interest rates reduce the cost of capital for acquisitions and development projects, making it an opportune time for consolidation in commercial and residential real estate. Historical trends post-recession suggest aggressive deal interest as companies seek to capitalize on lower financing costs to acquire appealing properties and portfolios. Commercial real estate deals are likely to be among those that will be most highly scrutinized as investors weigh the potential return on office properties relative to the likelihood of continued remote and hybrid work trends, as well as a property's potential for office to residential conversion.

## Concluding Thoughts

The charts herein support a correlation between debt deal activity and interest rates. Over the same historical period, we see an increase in the number of debt deals completed when interest rates are lower. Conversely, we see the number of debt

deal activity decrease over time as interest rates rise. While other outside factors inevitably factor into deal activity levels, a strong correlation between interest rates and deal activity is unquestionably evident. It is, therefore, reasonable to expect that we will see deal activity pick up now that the Fed's expected rate cuts have begun. As rates continue to decrease over time, we should also expect to see a greater increase in debt deal activity.

Lastly, it should be emphasized that the relationship between interest rates and debt capital markets is highly complex, influenced historically by myriad economic, geopolitical, and other factors, including increasingly larger debt funds that continue to achieve record-level fundraising dollars ready to finance M&A activity. While impending rate cuts could drive a potential boom in debt capital markets in 2025 and beyond, the impact that these factors might have on such a development remains uncertain. As companies and investors navigate the current economic landscape, they must remain agile, prepared to adapt to both opportunities and challenges that arise.

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Angela Giles is a Director in Investment Banking at Hilco Corporate Finance. Her expertise includes executing M&A sell-side transactions, raising capital, and structuring leveraged finance transactions for private equity and middle market clients. Prior to joining Hilco Corporate Finance, Angela helped to raise over \$1 billion in private debt funds from institutional investors in a capital markets role at GE Capital. She has also held positions in leveraged finance and investment banking at Capital Source, Bank of America, and Merrill Lynch.

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# INTENSIVE CARE: A PULSE CHECK ON THE HEALTHCARE INDUSTRY\*

Steven Wang, CIRA

BDO USA

As economic conditions continue to stabilize in the healthcare industry from the volatility of the past few years, more healthcare entities are transitioning from recovery to growth mode. According to a recent 2024 Healthcare CFO Outlook Survey, 79 percent of chief financial officers (CFOs) reported that their profitability improved in 2023.<sup>1</sup> However, while this article mainly focuses on healthcare service providers (e.g., hospitals, ambulatory surgery centers, senior care facilities, etc.), this outlook might not turn out to be as rosy for the industry as a whole.

Industry-wide obstacles such as stagnant reimbursement rates and increasing operating expenses remain persistent and are pushing operating such margins to razor-thin levels, leaving little to no room for error. In fact, 2023 saw healthcare companies account for a disproportionate share of leveraged loan defaults: despite healthcare companies representing only 12.5 percent of issuers, they represented more than 20 percent of default value.<sup>2</sup> In addition, the number of large healthcare chapter 11 cases increased by 72 percent in 2023, with 79 new chapter 11 cases compared to just 46 in 2022.<sup>3</sup>

## Symptoms: Signs of Distress

As leadership continues to navigate the complex healthcare landscape, there are signs of financial distress that should be watched closely. Spotting these symptoms early requires a thorough understanding of the entity's financial and operational conditions, and identifying these symptoms could pave the way for prompt corrective actions and present an opportunity to avert an existential crisis down the line.

There are several financial metrics and operational key performance indicators (KPIs) that should remain in focus. Reporting of these metrics are typically covenants required by lenders or bondholders as part of the credit agreement or bond documents. Deterioration in these metrics—either compared to historical periods or industry benchmarks—often raises concerns about the entity's financial health.

Some financial metrics, including days of cash-on-hand, debt-service-coverage ratio, operating-margin ratio, and days in

\* This article was originally published in *ABI Journal*, Vol. XLIII, No. 7, July 2024.

<sup>1</sup> "2024 BDO Healthcare CFO Outlook Survey," BDO USA, Feb. 13, 2024, available at [insights.bdo.com/2024-BDO-Healthcare-CFO-Outlook-Survey](https://insights.bdo.com/2024-BDO-Healthcare-CFO-Outlook-Survey) (unless otherwise specified, all links in this article were last visited on May 21, 2024).

<sup>2</sup> "Q4 2023 Health Care Services Report," Pitchbook, Feb. 8, 2024, available at [pitchbook.com/news/reports/q4-2023-healthcare-services-report](https://pitchbook.com/news/reports/q4-2023-healthcare-services-report).

<sup>3</sup> "Record Bankruptcy Filings in the Health Care Sector in 2023," Gibbins Advisors Research Report, Jan. 25, 2024, available at [gibbinsadvisors.com/record-bankruptcy-filings-in-the-healthcare-sector-in-2023](https://gibbinsadvisors.com/record-bankruptcy-filings-in-the-healthcare-sector-in-2023).

accounts receivable (AR), can reveal a great deal about the entity's liquidity situation. For example, an increase in days in AR, if not managed on a timely basis, could result in a depletion of operating cash, which is the backbone of the business for maintaining its day-to-day activities. Depending on the entity type, such operational indicators as occupancy rate and in-patient days offer great insights to management that allow them to make informed decisions, address inefficiencies, and improve quality of care.

## Diagnosis: Root Cause of Financial Issues

There are several factors contributing to the margin decline and financial distress of healthcare entities. Over the past few years, reimbursement rates have not kept up with the cost of healthcare. While costs are on the rise, payors continue to reduce reimbursement rates for several services.

In November 2023, the Centers for Medicare & Medicaid Services finalized a 3.4 percent decrease in the conversion factor in the physician fee schedule, representing an overall payment rate cut of 1.25 percent for 2024 compared to 2023.<sup>4</sup> These low and unstable reimbursement rates have been a contributing factor to a number of recent hospital closures across different regions.<sup>5</sup>

There have been positive trends in prior-authorization requirements from some payors, with the aim of reducing the administrative burden and expediting patient care and services. For example, Blue Cross Blue Shield of Massachusetts removed more than 14,000 prior-authorization requirements for homecare services effective early 2024,<sup>6</sup> and other insurers have made similar announcements regarding reductions in requirements.

Despite these advancements, the challenge of high claim denials persists, with a significant percentage of health system leaders reporting an uptick in the rate of claims denials over the past year.<sup>7</sup> The process of appealing these denials imposes further delays in payments and adds pressure to the revenue cycle. A recent industry survey highlighted that health systems are incurring almost \$20 billion annually in costs associated with contesting denied claims. Furthermore, only a little more than half of these denials were successfully overturned and paid by commercial insurers after going through several rounds of appeals.<sup>8</sup>

Specific plans, such as Medicare Advantage (MA), can also pose significant challenges to a healthcare entity's liquidity. MA enrollments have been growing at a steady pace, with an

<sup>4</sup> "Calendar Year 2024 Medicare Physician Fee Schedule Final Rule," Ctrs. for Medicare & Medicaid Servs. Press Release, Nov. 2, 2023, available at [cms.gov/newsroom/fact-sheets/calendar-year-cy-2024-medicare-physician-fee-schedule-final-rule](https://cms.gov/newsroom/fact-sheets/calendar-year-cy-2024-medicare-physician-fee-schedule-final-rule).

<sup>5</sup> Madeline Ashley & Alan Condon, "The Reasons Behind 14 Hospital Closures," Becker's Hosp. CFO Report, Dec. 14, 2023, available at [beckershospitalreview.com/finance/the-reasons-behind-14-hospital-closures.html](https://beckershospitalreview.com/finance/the-reasons-behind-14-hospital-closures.html).

<sup>6</sup> "Blue Cross Blue Shield of Massachusetts Removes Prior Authorization Requirements for Home Care Services," Blue Cross Blue Shield of Massachusetts Newsroom, Nov. 6, 2023, available at [newsroom.bluecrossma.com/2023-11-06-blue-cross-blue-shield-of-massachusetts-removes-prior-authorization-requirements-for-home-care-services](https://newsroom.bluecrossma.com/2023-11-06-blue-cross-blue-shield-of-massachusetts-removes-prior-authorization-requirements-for-home-care-services).

<sup>7</sup> "2023 State of Health Care Performance Improvement: Signs of Stabilization Emerge," Kaufman Hall, (October 2023), available at [kaufmanhall.com/sites/default/files/2023-10/KH-Report\\_2023-State-Healthcare-Performance-Improvement.pdf](https://kaufmanhall.com/sites/default/files/2023-10/KH-Report_2023-State-Healthcare-Performance-Improvement.pdf).

<sup>8</sup> Ibid.

expected enrollment of 33.8 million in 2024.<sup>9</sup> This represents more than half of the total eligible Medicare population. However, several providers have announced their plans to go out of network with MA due to several concerns, including continued reimbursement decreases, excessive coverage denials, and burdensome paperwork requirements.

For example, Scripps Health opted to discontinue MA plans in January 2024 for its integrated medical groups. Scripps' president and CEO Chris Van Gorder suggested that the San Diego, CA-based health system incurred an annual loss of \$75 million on MA contracts in 2023.<sup>10</sup> In fact, 16 percent of health systems intend to stop accepting one or more MA plans in the next two years, and another 45 percent are also considering doing so, although no final decisions have been made, according to the Healthcare Financial Management Association's 2024 Health System CFO Pain Points Study.<sup>11</sup>

Operating expenses have also increased at a rate that exceeds revenue and patient volume growth during the past few years. Labor costs, representing more than 50 percent of total costs in a typical healthcare setting (and up to 70 percent if external contractors are used), continue to erode margins. Staffing shortages, especially in nursing, remain one of the top concerns for management since COVID-19. Managing staff turnover and retention requires an understanding of the current market dynamics. Other factors such as high drug and supply costs fueled by inflation also contribute to the financial distress of a healthcare entity.

Unexpected external events, such as cyberattacks, often send shockwaves through the whole industry and can delay the financial recovery of health systems. Ransomware attacks can expose more than personal health information. In some cases, billing and collections processes might also be disrupted, leaving providers unable to submit claims or receive payments and claim information. Cash-posting might not be finalized until the data between the claims and the cash deposited can be matched. As a result, companies hoping to regain access to collections and liquidity could experience lengthy delays that could create significant uncertainties and financial risks for healthcare providers.

Noncompliance with regulatory requirements and union contract terms could also lead to costly penalties and serve as another root cause of financial distress. For example, hospitals might be ordered to pay millions of dollars in fines for understaffing nurses and violating the safe-staffing ratio. In addition, risks arising from changes in laws should not be overlooked. Although the Federal No Surprises Act, introduced in 2022, is still facing legal challenges, it has the potential to eliminate pricing levers for some providers over out-of-network billing for emergency

care services. Healthcare leaders need to assess the financial implications of these events and come up with game plans to proactively monitor and mitigate risks.

## Treatment Plan: What Management Can Do

How can management tackle liquidity constraints and financial issues? Cash is king in any distressed scenario, and leadership should have a tight grip on overall liquidity. Tools such as a 13-week cash-flow analysis offer an overview of the entity's short-term cash-flow situation. To improve cash inflow, such operational KPIs as the net-collection rate should be reviewed regularly. Sufficient resources must be allocated to manage payor relations and focus on revenue-cycle functions, specifically collection efforts. In some cases, special operating groups can be set up to negotiate with payors and accelerate cash collections from aging ARs.

In addition to expanding collection efforts, more than one-third of healthcare CFOs are also planning continued strategic cost reductions, including labor cost containment, based on the 2024 BDO Healthcare CFO Outlook Survey. Healthcare entities are coming up with out-of-the-box solutions. For example, Urbana, IL-based Carle Health has introduced voluntary separation to employees in order to contain costs and plan for growth.<sup>12</sup> Somerville, MA-based Mass General Brigham is offering its employees buyouts to meet its workforce needs.<sup>13</sup>

To get ahead of the ever-increasing competition in today's labor market, management can focus on retention by optimizing employment packages and perks. Various programs and initiatives can be designed to support the workforce, improve employee loyalty, and address turnover. For example, Chicago, IL-based CommonSpirit Health recently launched a multidisciplinary residency program for nursing that aims to mitigate the turnover risk in the first year for new nursing grads.<sup>14</sup> The program provides nursing orientation and is designed to enhance the workforce transition experience through education, support, and mentorship.

Other cost-optimization mechanisms should also be deployed, such as exploring alternative suppliers and renegotiating anesthesia and other services contracts. Based on the 2024 BDO Healthcare CFO Outlook Survey, nearly half of healthcare CFOs expect to increase investment in technology implementation in 2024, and a staggering 98 percent suggested that they are piloting generative artificial intelligence over the next 12 months.

The importance of technology investment and system upgrades cannot be overstated. Operating an outdated system leaves the organization vulnerable to cyberattacks, thus putting valuable financial resources and sensitive patient data at risk. In today's consumer-centric environment, healthcare is no exception, as

<sup>9</sup> "Medicare Advantage and Medicare Prescription Drug Programs to Remain Stable in 2024," Ctrs. for Medicare & Medicaid Servs. Press Release, Sept. 26, 2023, available at [cms.gov/newsroom/press-releases/medicare-advantage-and-medicare-prescription-drug-programs-remain-stable-2024](https://cms.gov/newsroom/press-releases/medicare-advantage-and-medicare-prescription-drug-programs-remain-stable-2024).

<sup>10</sup> Alan Condon, "Scripps CEO Concerned Further Losses Will Risk Borrowing Ability," Becker's Hosp. CFO Report, Sept. 29, 2023, available at [beckershospitalreview.com/finance/scripps-ceo-concerned-further-losses-will-risk-borrowing-ability.html](https://beckershospitalreview.com/finance/scripps-ceo-concerned-further-losses-will-risk-borrowing-ability.html) (subscription required to view article).

<sup>11</sup> "HFMA Health System CFO Pain Points 2024: Margin Challenges and Opportunities for Vendors," Eliciting Insights, available at [hfma.org/wp-content/uploads/2024/03/Overview-2024-CFO-Pain-Points-Study.pdf](https://hfma.org/wp-content/uploads/2024/03/Overview-2024-CFO-Pain-Points-Study.pdf).

<sup>12</sup> Tim Shelley, "Carle Offers Voluntary Separation Agreements to Non-Patient-Facing Employees, Citing Ongoing Financial Challenges in Health Care," NPR Illinois, Nov. 2, 2023, available at [nprillinois.org/illinois/2023-11-02/carle-offers-voluntary-separation-agreements-to-non-patient-facing-employees-citing-ongoing-financial-challenges-in-health-care](https://nprillinois.org/illinois/2023-11-02/carle-offers-voluntary-separation-agreements-to-non-patient-facing-employees-citing-ongoing-financial-challenges-in-health-care).

<sup>13</sup> Mackenzie Bean, "Mass General Brigham Offers Buyouts for Digital Staff," Becker's Hosp. Review, Nov. 10, 2023, available at [beckershospitalreview.com/workforce/mass-general-brigham-offers-buy-outs-for-digital-staff.html](https://beckershospitalreview.com/workforce/mass-general-brigham-offers-buy-outs-for-digital-staff.html) (subscription required to view article).

<sup>14</sup> "CommonSpirit Health National Nurse Residency Program," CommonSpirit Health, available at [commonspirit.careers/Nursing-New-Grad-Residency](https://commonspirit.careers/Nursing-New-Grad-Residency).

prospective patients have certain expectations regarding the patient experience. By investing in a patient portal that is easy to use, healthcare entities can enhance patient interaction at the first point of contact, which in turn boosts the patient consult-to-treatment conversion rate, improves efficiency, and prevents revenue leakage. Investment in the mid-revenue cycle will drive the accuracy of coding, charge capture, and clinical-documentation integrity, all of which directly impact cash collections and net revenue.

On top of operational levers that management can pull, there are various strategic options available to some. For example: Are there any additional revenue streams to explore? Can a sale-leaseback transaction be contemplated for additional liquidity? Is anyone in the market interested in consolidation, partnership, or joint venture? Is there any appetite for a carve-out or divestiture, such as a parcel of land or a vacant medical office building? Is there any interest in pursuing private equity or venture capital funding?

## Concluding Thoughts

Chapter 11 remains an effective tool for entities to seek protection and undertake reorganization and restructuring. A Section 363 sale might also provide satisfactory results to the parties involved. While assessing these alternatives, management should always consider the stakeholders at play and the communities it serves.

### ABOUT THE AUTHOR



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# INSIDE DISNEY'S STAR CEO WARS

**Kurt Moeller**  
FTI Consulting, Inc.

Epic battles are the stock in trade for The Walt Disney Company ("Disney"), and not just on the big screen. Over the past 40 years, Disney has faced three waves of shareholder activism, with the first two resulting in its CEO being replaced. The most recent fight, which culminated in Disney's annual meeting on April 3, 2024, left CEO Bob Iger intact.

How did Iger avoid replacement? His exceptional ability to persuade others gained him substantial goodwill from the financial press, the Disney "family," and investors—groups that criticized Disney's previous leaders.<sup>1</sup> His public commitment to step down in 2026 perhaps dispelled concerns that he would linger as an "Imperial" CEO.<sup>2</sup> At the same time, in today's clouded media industry landscape, it is unclear who Iger's immediate successor would be.

## 1984: The Shareholder Force Awakens

The media environment, and Disney itself, were both much simpler when the company encountered shareholder activism in 1984. Walt Disney's son-in-law, Ron Miller, was in his second year as CEO. Disney released three or four movies each year, mostly in the family genre.<sup>3</sup> Miller recognized Disney's need to evolve and had begun to move the company into edgier movies, such as the 1984 hit film *Splash*, which marked the launch of the Touchstone Pictures banner.<sup>4</sup>

However, equity investors viewed Disney as undervalued and undermanaged. On two separate occasions in the spring and summer of 1984, an investor accumulated a large block of Disney shares and hinted at seeking control.<sup>5</sup> Director Stanley Gold, counsel for fellow director Roy Disney, Walt's nephew, and the Bass family, who were shareholders and had Board representation, led the charge to remove Miller as CEO.<sup>6</sup> That September, Disney's Board replaced Miller with Paramount Pictures President Michael Eisner.<sup>7</sup>

Under Eisner's leadership, Disney had two distinct periods. The company initially thrived in the first of these periods, from

<sup>1</sup> Alex Weprin, "Bob Iger's Invincible Era Is Over," *The Hollywood Reporter*, March 27, 2024, <https://www.hollywoodreporter.com/business/business-news/bob-iger-disney-nelson-peltz-shareholder-meeting-1235860938/>.

<sup>2</sup> Reuters, "Here's when Bob Iger plans to step down as Disney CEO," *The New York Post*, November 29, 2023, <https://nypost.com/2023/11/29/business/bob-iger-to-step-down-as-disney-ceo-at-the-end-of-2026/>.

<sup>3</sup> "Complete List of Walt Disney Movies," [imdb.com](https://www.imdb.com/list/ls033609554/?sort=release_date%2Casc), last accessed July 31, 2024, [https://www.imdb.com/list/ls033609554/?sort=release\\_date%2Casc](https://www.imdb.com/list/ls033609554/?sort=release_date%2Casc).

<sup>4</sup> John Taylor, *Storming the Magic Kingdom* (New York: Knopf, 1987).

<sup>5</sup> Thomas C. Hayes, "Disney's Chief is Forced Out," *The New York Times*, September 8, 1984, <https://www.nytimes.com/1984/09/08/business/disney-s-chief-is-forced-out.html>.

<sup>6</sup> John Taylor, *Storming*.

<sup>7</sup> Thomas C. Hayes, "New Disney Team's Strategy," *The New York Times*, September 24, 1984, <https://www.nytimes.com/1984/09/24/business/new-disney-team-s-strategy.html>.

1984 to 1996, when it greatly increased its movie production, expanded the types of movies it made, revitalized its animated division, and released a string of blockbuster films.<sup>8</sup> Disney's shares skyrocketed as shown in the following table.

**Table 1: Disney TSR with Michael Eisner as CEO (year ended 9/30)**

	1984 – 1996	1996 – 2003	2003 – 2005	1984 – 2005
Disney	1750.2%	0.8%	21.8%	2170.8%
S&P 500	508.8%	60.9%	27.8%	1151.6%

Source: Bloomberg

The second period of Eisner's tenure, from 1996 to 2005, was a different story from the first, with executive turnover, fewer popular animated films (e.g., *The Emperor's New Groove*), a lack of exciting new characters, and a sluggish share price.<sup>9</sup> At the time, Disney was partnering with Pixar, whose successful animated films and new characters had become increasingly critical to Disney. However, in early 2004, Pixar decided to end the partnership.<sup>10</sup>

## 2004: Attack of the Disney Family

A month earlier, in December 2003, Roy Disney and Stanley Gold had left Disney's Board and called for Eisner's removal as CEO and Chairman.<sup>11</sup> They ran a "Vote No" campaign, asking shareholders to withhold their votes on Eisner and three other directors.<sup>12</sup> Their criticisms included a value-destructive acquisition, excessive executive compensation, and high executive turnover.<sup>13</sup>

As the campaign progressed, Eisner seemed to lack a reservoir of goodwill among the media or investors. He "resembles an aging caudillo hanging on to power long past the flower of his youth," wrote one prominent financial journalist.<sup>14</sup> "He's a lightning rod," a Wall Street stock analyst said.<sup>15</sup> Large public pension fund CalPERS said Eisner should resign as Chairman and later, as CEO.<sup>16</sup>

Both Institutional Shareholder Services (ISS) and Glass Lewis recommended that shareholders withhold votes on Eisner as a

<sup>8</sup> Chris Pallant, *Demystifying Disney: A History of Disney Feature Animation*, 89 (Continuum Publishing), last accessed August 1, 2024, <https://books.google.com/books?id=zOC0AwAAQBAJ&pg=PA89&v=onepage&q&f=false>.

<sup>9</sup> Associated Press, "Roy Disney, ally quit Disney board," *NBC News*, December 1, 2003, <https://www.nbcnews.com/id/wnba3606492>.

<sup>10</sup> Bruce Orwall and Nick Wingfield, "The End: Pixar Breaks Up With Distribution Partner Disney," *The Wall Street Journal*, January 30, 2004, <https://www.wsj.com/articles/SB107541081328315628>.

<sup>11</sup> *Ibid.*

<sup>12</sup> Roy E. Disney and Stanley P. Gold, "An Open Letter To Our Fellow Disney Shareholders," January 27, 2004, <https://www.sec.gov/Archives/edgar/data/1001039/000089534504000026/px14a6g.txt>.

<sup>13</sup> *Ibid.*

<sup>14</sup> Roger Lowenstein, "The rise and fall of Disney's Michael Eisner," *The Ledger*, February 14, 2004, <https://www.theledger.com/story/news/2004/02/15/the-rise-and-fall-of-disneys-michael-eisner/26741228007/>.

<sup>15</sup> Michael McCarthy, "Disney strips chairmanship from Eisner," *USA Today*, March 3, 2004, [https://usatoday30.usatoday.com/money/media/2004-03-03-disney-shareholder-meeting\\_x.htm](https://usatoday30.usatoday.com/money/media/2004-03-03-disney-shareholder-meeting_x.htm).

<sup>16</sup> Paul R. LaMonica, "Eisner out as Disney chair," *CNN/Money*, March 4, 2004, <https://money.cnn.com/2004/03/03/news/companies/disney/>.

director.<sup>17</sup> Forty-three percent of votes were withheld for Eisner at Disney's March 2004 annual meeting, leading to his removal as Chairman.<sup>18</sup> Undeterred, Eisner continued as CEO.<sup>19</sup> However, in March 2005, he agreed to step down, with Iger becoming CEO on October 2, 2005.<sup>20</sup>

## 2024: The Return of Bob Iger

Like Eisner, Iger's tenure also began well. Disney purchased Pixar Films (2006), Marvel Entertainment (2009), and Lucasfilm (2012), and the newly acquired franchises contributed to Disney dominating the box office, producing one hit movie after another.<sup>21</sup> Disney's shares soared again.

Iger's successful first decade evolved into a second decade filled with challenges, in a much less favorable media environment. (Interestingly, both Eisner and Iger ran into difficulties after 10-12 years.) Many American households no longer subscribe to cable TV, hurting ESPN, while COVID-19 restrictions reduced industrywide theme park attendance and box office revenues, the latter of which remained lower after restrictions were lifted. Disney feuded with Florida Governor Ron DeSantis.<sup>22</sup> Conservative activists criticized Disney for adopting a "woke" agenda, with Iger seeming to agree.<sup>23</sup> These factors have combined to result in Disney shares struggling in recent years, leading up to the 2024 shareholder meeting (Table 2).

**Table 2: Disney TSR under Bob Iger's Leadership\***

	9/30/2005 – 9/30/2015	9/30/2015 – 3/31/2024	9/30/2005 – 3/31/2024
Disney	388.9%	28.1%	526.4%
S&P 500	93.0%	219.4%	516.6%

Source: Bloomberg

\*Iger was CEO from October 2, 2005, through February 23, 2020, and has been CEO since November 20, 2022. From February 24, 2020, through December 31, 2021, he was Executive Chairman.

<sup>17</sup> Gary Gentile, "2nd Proxy Firm Says Vote 'No' On Eisner," *The Ledger*, February 26, 2004, <https://www.theledger.com/story/news/2004/02/26/2nd-proxy-firm-says-vote-no-on-eisner/26102084007/>.

<sup>18</sup> David Teather, "Disney shareholders force Eisner out of chairman's role," *The Guardian*, March 4, 2004, <https://www.theguardian.com/business/2004/mar/04/usnews.citynews>.

<sup>19</sup> Frank Ahrens, "Disney Chooses Successor to Chief Executive Eisner," *Washington Post*, March 13, 2005, <https://www.washingtonpost.com/wp-dyn/articles/A32493-2005Mar13.html>.

<sup>20</sup> Ibid.

<sup>21</sup> Meriah Doty, "Disney Becomes First Studio to Top \$3 Billion at Domestic Box Office," *The Wrap*, January 3, 2017, <https://www.thewrap.com/disney-becomes-first-studio-top-3-billion-domestic-box-office/>.

<sup>22</sup> Kimberly Leonard, "The Disney-DeSantis détente is here," *Politico*, March 27, 2024, <https://www.politico.com/news/2024/03/27/disney-world-desantis-fight-00149320>.

<sup>23</sup> Lucia Moses and Madeline Berg, "Bob Iger says 'woke' Disney is not over, but it may not silence his critics," *Business Insider*, April 24, 2024, <https://www.businessinsider.com/bob-iger-woke-disney-is-over-not-silence-his-critics-2024-4#:~:text=Some%20criticize%20the%20company%20for,the%20recent%20%22Little%20Mermaid.%22;Jill%20Goldsmith,%20Bob%20Iger%20On%20Succession,Nelson%20Peltz,Elon%20Musk%20%26%20%22Woke%22%20Content%20Day%20After%20Disney%20Wins%20Proxy%20Battle,Deadline, April 4, 2024, https://deadline.com/2024/04/bob-iger-disney-succession-nelson-peltz-elon-musk-woke-content-1235875760/>.

As Disney faced these issues, Iger postponed his departure as CEO several times, and potential successors left the company.<sup>24</sup> Iger stepped down as CEO in February 2020 to become Executive Chairman, but he returned as CEO in November 2022 after discontent with successor Bob Chapek.<sup>25</sup>

Since 2022, multiple shareholder activists have sought changes at Disney. However, after publicly suggesting improvements at Disney, Third Point settled with the company that September.<sup>26</sup> Trian Partners took steps toward a proxy fight in late 2022 but ended its campaign in February 2023.<sup>27</sup>

Between February 2023 and October 2023, Disney shares fell 25%, leading Trian to resume its campaign.<sup>28</sup> For Disney's 2024 annual meeting, Trian nominated two candidates: Trian founder Nelson Peltz and ex-Disney CFO Jay Rasulo; fellow activist Blackwells Capital nominated three directors.<sup>29</sup> Neither major proxy advisor recommended for any of Blackwells' nominees, and its nominees received only 2% of votes cast.<sup>30</sup>

Trian's criticisms echoed those in 2003, including a value-destructive acquisition and high executive compensation, and also cited a lack of succession planning.<sup>31</sup> In its defense, Disney touted ongoing cost reductions and heavily criticized Peltz and Rasulo.<sup>32</sup>

Trian attempted to replace two directors, but not Iger, who declared that he would step down as CEO when his contract

<sup>24</sup> Ben Fritz, "Disney's Iger Isn't About to Let Go as CEO," *The Wall Street Journal*, May 16, 2017, [https://www.wsj.com/articles/disneys-iger-isnt-about-to-let-go-as-ceo-1494945084?mod=article\\_inline](https://www.wsj.com/articles/disneys-iger-isnt-about-to-let-go-as-ceo-1494945084?mod=article_inline); Ben Fritz, "Disney Extends CEO Bob Iger's Contract Until 2018," *The Wall Street Journal*, October 2, 2014, [https://www.wsj.com/articles/disney-extends-bob-igers-contract-until-2018-1412273135?mod=article\\_inline](https://www.wsj.com/articles/disney-extends-bob-igers-contract-until-2018-1412273135?mod=article_inline).

<sup>25</sup> Joe Flint, Robbie Whelan, Erich Schwartzel, Emily Glazer and Jessica Toonkel, "Bob Iger vs. Bob Chapek: Inside the Disney coup," *The Wall Street Journal*, December 17, 2022, [https://www.wsj.com/articles/bob-iger-bob-chapek-disney-coup-11671236928?mod=article\\_inline](https://www.wsj.com/articles/bob-iger-bob-chapek-disney-coup-11671236928?mod=article_inline).

<sup>26</sup> Lillian Rizzo, "Disney reaches deal with activist investor Third Point, will add former Meta executive to its board," *CNBC.com*, September 30, 2022, <https://www.cnbc.com/2022/09/30/disney-reaches-deal-with-activist-investor-third-point-will-add-former-meta-executive-to-its-board.html>.

<sup>27</sup> Lillian Rizzo, "Activist investor Nelson Peltz declares Disney proxy fight is over after Iger unveils restructuring," *CNBC.com*, February 9, 2023, <https://www.cnbc.com/2023/02/09/activist-investor-nelson-peltz-declares-disney-proxy-fight-is-over-after-iger-unveils-restructuring.html>.

<sup>28</sup> Source: FactSet; Lauren Thomas and Robbie Whelan, "Nelson Peltz boosts Disney Stake, Seeks Board Seats," *The Wall Street Journal*, October 8, 2023, <https://www.wsj.com/business/media/nelson-peltz-boosts-disney-stake-seeks-board-seats-77b2c589>.

<sup>29</sup> Reuters, "Disney wins ValueAct, Blackwells backing in boardroom fight with Trian," *CNBC*, January 3, 2024, <https://www.cnbc.com/2024/01/03/disney-secures-valueact-support-in-looming-proxy-battle-with-peltz.html>.

<sup>30</sup> The Walt Disney Company, "The Walt Disney Company Comments on ISS Recommendation," March 21, 2024, <https://thewaltdisneycompany.com/the-walt-disney-company-comments-on-iss-recommendation-2/>; The Walt Disney Company, Form 8-K, April 9, 2024, <https://www.sec.gov/ix?doc=/Archives/edgar/data/1744489/000095015724000595/form8-k.htm>.

<sup>31</sup> The Walt Disney Company, "Restore the Magic at the Walt Disney Company," March 2024, <https://www.sec.gov/Archives/edgar/data/1345471/000090266424002190/p24-1119exhibit1.htm>.

<sup>32</sup> Eileen AJ Connolly, "Disney Slams Activist Investor Nelson Peltz Nominee's 'Track Record of Value Destruction,'" *TheWrap*, February 27, 2024, <https://www.thewrap.com/disney-slams-activist-investor-nelson-peltz-nominees-value-destruction/>; Meg James, "Disney slams proxy fight rival Nelson Peltz in political-style ad," *Los Angeles Times*, March 11, 2024, <https://www.latimes.com/entertainment-arts/business/story/2024-03-11/disney-slams-proxy-fight-rival-nelson-peltz-in-political-styled-ad>.

ended in 2026.<sup>33</sup> Media reports identified four internal Disney contenders, each of whom seemed to have strong knowledge of their segment, but less experience in other Disney segments.<sup>34</sup> The tough environment for media conglomerates in the post-cable TV, post-COVID-19 world made it difficult to identify potential outside candidates. In previous situations, Eisner's track record at Paramount and Iger's experience at Disney rendered them somewhat natural choices as Disney's next CEO.

Despite Trian not targeting Iger, the media often portrayed its campaign as Peltz against Iger. "Bob Iger v Nelson Peltz: The Rematch," blared an *Economist* magazine headline.<sup>35</sup> *Fortune* magazine called Peltz's campaign a "personal vendetta against the iconic CEO."<sup>36</sup>

Unlike 20 years earlier, this time the business press portrayed Disney's CEO favorably. Bloomberg Businessweek called Iger a "legendary CEO (who) came out of retirement to save the company."<sup>37</sup> MarketWatch said he "appears to be making good progress in his turnaround efforts at the Magic Kingdom, and is now getting his hands dirty to fix the content problem at its studios."<sup>38</sup>

The extended Disney "family," including the grandchildren of Walt Disney and Roy Disney, plus Disney shareholder George Lucas, the creator of *Star Wars*, all backed its CEO and Board.<sup>39</sup> ISS recommended for Trian, while Glass Lewis supported Disney.<sup>40</sup> Shareholders Neuberger & Berman and CalPERS backed Trian, while BlackRock and T. Rowe Price supported the company.<sup>41</sup>

<sup>33</sup> Ashley Carter, "Disney CEO Bob Iger says he will 'definitely' step down at the end of 2026," *Spectrum News* 13, November 29, 2023, <https://mynews13.com/fl/orlando/news/2023/11/29/disney-ceo-bob-iger-says-he-will-definitely-step-down-in-2026>.

<sup>34</sup> Toni Ferrigno, "Reports Indicate Four Disney Executives Are Top Picks to Succeed Bob Iger as CEO," *WDW News Today*, March 14, 2024, <https://wdwnt.com/2024/03/reports-indicate-four-disney-executives-are-top-picks-to-succeed-bob-iger-as-ceo/>.

<sup>35</sup> "Bob Iger v Nelson Peltz: The Rematch," *The Economist*, November 9, 2023, <https://www.economist.com/business/2023/11/09/the-bob-iger-v-nelson-peltz-rematch>.

<sup>36</sup> Jeffrey Sonnenfeld and Steven Tian, "The wizard vs. the illusionist: Bob Iger faces another challenge as ex-Disney employees join activist investor Nelson Peltz in a personal vendetta against the iconic CEO," *Fortune*, November 7, 2023, <https://fortune.com/2023/11/07/wizard-illusionist-bob-iger-challenge-disney-employees-activist-investor-nelson-peltz-personal-vendetta-iconic-ceo-sonnenfeld-tian/>.

<sup>37</sup> Thomas Buckley, "Has Bob Iger Lost the Magic?," *Bloomberg Businessweek*, October 10, 2023, <https://www.bloomberg.com/news/features/2023-10-10/has-bob-iger-lost-the-magic-inside-disney-ceo-s-billion-dollar-crisis>.

<sup>38</sup> Therese Poletti, "Opinion: Disney CEO Bob Iger is getting his hands dirty as he focuses on studio woes—will be it enough?," *MarketWatch*, November 11, 2023, <https://www.marketwatch.com/story/disney-ceo-bob-iger-is-getting-his-hands-dirty-as-he-focuses-on-studio-woes-will-be-it-enough-703ae645>.

<sup>39</sup> Robbie Whelan, "Disney Family Rebukes Nelson Peltz, Praises Bob Iger in Shareholder Letter," *The Wall Street Journal*, February 29, 2024, [https://www.wsj.com/business/media/disney-family-rebukes-nelson-peltz-praises-bob-iger-in-shareholder-letters-a524cbd2?mod=article\\_inline](https://www.wsj.com/business/media/disney-family-rebukes-nelson-peltz-praises-bob-iger-in-shareholder-letters-a524cbd2?mod=article_inline); Sarah Krouse, Robbie Whelan, and Lauren Thomas, "Disney, Trian Blitz Shareholders for Votes in Last Stretch of Proxy Fight," *The Wall Street Journal*, March 28, 2024, [https://www.wsj.com/business/deals/disney-trian-blitz-shareholders-for-votes-in-last-stretch-of-proxy-fight-64e025c3?mod=Searchresults\\_pos9&page=1](https://www.wsj.com/business/deals/disney-trian-blitz-shareholders-for-votes-in-last-stretch-of-proxy-fight-64e025c3?mod=Searchresults_pos9&page=1).

<sup>40</sup> Alana Pipe and Stephanie Stamm, "The Battle Lines in the War Over Disney's Board," *The Wall Street Journal*, April 1, 2024, [https://www.wsj.com/business/media/the-battle-lines-in-the-war-over-disneys-board-5c8f84c3?mod=Searchresults\\_pos13&page=1](https://www.wsj.com/business/media/the-battle-lines-in-the-war-over-disneys-board-5c8f84c3?mod=Searchresults_pos13&page=1).

<sup>41</sup> Ibid.

## A New Hope at the House of the Mouse

Why were there such contrasting opinions of Disney's CEOs during these last two shareholder activism campaigns? The differing media environment could be one reason; shareholders may prefer a trusted hand in today's turbulence. Personal likability and charm also seem to have played a large role. Eisner "apparently didn't realize how many people in Hollywood felt so bitterly betrayed by him," one journalist wrote.<sup>42</sup> By contrast, *The Hollywood Reporter* described Iger as having Marvel superhero-like powers of persuasion.<sup>43</sup>

Trian's campaign ended with Disney shareholders electing all company nominees; its most popular nominee, Peltz, received only 31% of votes cast.<sup>44</sup> Such results do not appear to have weakened Iger. They leave him free to figure out how to unlock the value of Disney's many strong assets. While Iger has spent many years leading Disney, it may be the decisions during his last two years that largely shape how investors remember his tenure.

## Are You Prepared for the Phantom Menace of Shareholder Activists?

What lessons can CEOs take from the Disney experience? Activists are drawn to companies by a variety of perceived vulnerabilities, upon which they can agitate with other shareholders to push for changes. FTI Consulting's quarterly Activism Vulnerability Report<sup>45</sup> shows how our quantitative screener ranks industries' vulnerability to activism.

Disney's high profile makes it an attractive target for activists looking to make a splash, but its many great brands and its longer-term track record of generating strong shareholder returns help fend off attacks. For other companies facing shareholder activists, or even the potential for activists, the recent contest provides some key takeaways:

- **Get ready for the sequel**—Winning a battle doesn't mean the war is over. Third Point and Trian both agitated for change the previous year before winding down those campaigns. However, a subsequent drop in Disney's share price re-energized Trian. Just because an activist campaign went away does not mean that it or others will not be back soon.
- **Be wary of the dark side**—How "celebrity" CEOs like Iger are viewed personally can play a significant role in proxy contests such as this. For Iger, his likability and persuasiveness were substantial advantages. However, other high-profile CEOs may be perceived less favorably, leading shareholders to be more receptive to an activist.

<sup>42</sup> David Lieberman, "Eisner at Center of 'Disney War,'" *USA Today*, February 24, 2005, <https://forums.wdwmagic.com/threads/disney-war-review.51600/>.

<sup>43</sup> Alex Weprin, "Bob Iger's Invincible Era is Over," *The Hollywood Reporter*, March 27, 2024, <https://www.hollywoodreporter.com/business/business-news/bob-iger-disney-nelson-peltz-shareholder-meeting-1235860938/>.

<sup>44</sup> The Walt Disney Company, Form 8-K, April 9, 2024, <https://www.sec.gov/ix?doc=/Archives/edgar/data/1744489/000095015724000595/form8-k.htm>.

<sup>45</sup> <https://www.fticonsulting.com/insights/reports/activism-vulnerability-report>.



- **Build alliances**—Disney was able to convince other shareholders, including a well-known activist, to publicly back it. This can be helpful in convincing proxy advisors and undecided shareholders to support the company. Winning a battle doesn't have to be all-or-nothing.

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

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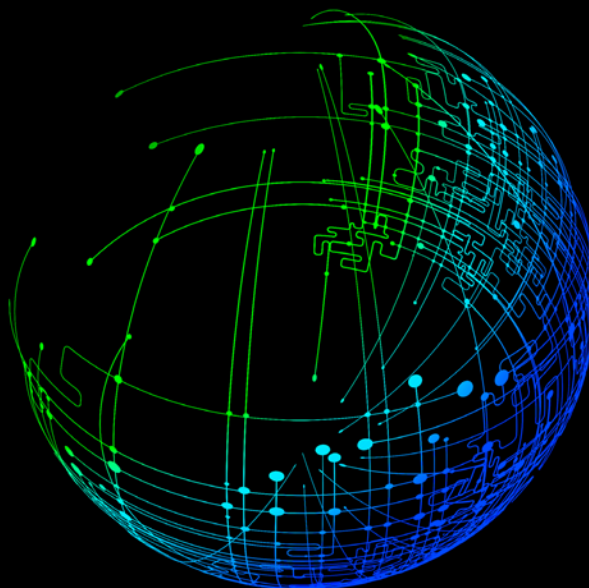
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# A ROBUST PORTFOLIO VALUATION PROCESS AS DEFENSE TO INCREASING INQUIRIES

Steve Nebb and Ricardo Armendariz — Kroll

*Valuations are now more critical than ever, given the current market uncertainties, growing concerns about transaction values, and increased scrutiny by investors, regulators, and auditors. A robust valuation process is crucial. Further, for early-stage valuations, a Calibrated Market Approach often provides the support needed.*

## Market Environment: Growing Concerns About Valuations Amidst Increased Scrutiny

Limited financing events, delayed exits, and the need for critical capital leading to down rounds or dilutive financings are putting more pressure on a Fund Manager's valuation process. Estimating and supporting fair value is a growing challenge as the securities held by investors are increasingly complex.

Given the dramatic rise in the number and value of illiquid securities held by Fund Managers, pensions, and even retail investors, the scrutiny and attention to fair value reporting standards by investors and regulators has sharpened dramatically. It is imperative that reported fair values be accurate and supported by a well-defined, well-documented, and consistently applied valuation policy that complies with the relevant reporting standards.

## Valuation Challenges for Early-Stage and High-Growth Companies

A steady flow of financing events and the ability to calibrate valuation assumptions to these transactions has allowed the venture capital industry to enjoy a long period of relatively easy and objective supporting information for a Fund Manager's valuations. However, with increased scrutiny, the specialization of disruptive business models and limited information coming from transactions, valuations now require much more judgment and supportive documentation.

Valuation challenges for early-stage and high-growth companies include:

- Recognizing changes in performance in terms of fair value
- The value of liquidation preferences and protective rights
- The compression of multiples over time due to growth
- Implementing best practices for supporting and documenting valuation analyses.

## A Calibrated Market Approach Often Provides the Support Needed for Early-Stage Valuations

Recognizing that many early-stage investments are valued based on milestone-based progress and efficient cash-burn management, companies that are starting to generate revenue may rely on a Market Approach to estimate value. However, because revenue is still at a nascent stage (often with significant year-over-year growth), the implied multiples are typically not meaningful when compared to the publicly-traded peer group, and thus selecting multiples in a traditional Market Approach framework will be challenging. Likewise, relying on either the

initial transaction multiple or the latest calibrated multiple may not be appropriate given that, when there is significant growth in the metric (e.g., revenue), the implied multiples typically decrease over time in a process known as "compression." Indeed, as the investment achieves the forecasted growth, the expected future growth rates at subsequent valuation dates decrease over time, and so do the implied multiples as a result. As such, when the calibrated multiple is materially different than the observed market multiples, the representative multiple for the company is expected to converge toward the market multiples over time.

To overcome these obstacles, a Calibrated Market Approach may be utilized. In a Calibrated Market Approach framework, the initial implied transaction multiple (or the latest calibrated multiple) is adjusted with the following factors:

**Multiple compression adjustment:** Reflects the compression that multiples experience over time when there is significant growth in the valuation metric. This effect can be quantified based on its underlying value drivers:

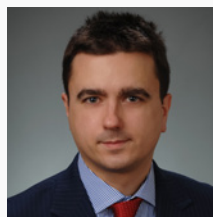
- The rate at which the reference valuation metric grows
- The rate at which the enterprise value (EV) accretes value (which, in turn, is based on the underlying rate of return adjusted by the impact of the cash flow generated between the calibration and the valuation date).

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## Exhibit 1: Illustrative Example of Calibrated Market Approach

Calibration Date		0.0% change in market multiples	Valuation Date	
Median multiple peer group <i>Transaction date</i>	5.0x (LTM revenue)		Median multiple peer group <i>Valuation date</i>	5.0x (LTM revenue)
Implied transaction multiple for Portfolio Company	10.0x (LTM revenue)	-25.0% multiple adjustment	Selected (calibrated) multiple for Portfolio Company	7.5x (LTM revenue)
Premium over peers	100%		Premium over peers	50.0%
LTM revenue	\$100		LTM revenue	\$150
Enterprise Value	\$1,000		Enterprise Value	\$1,125
Components of the Multiple Adjustment				
Market adjustment	0%		Change in market multiples	0%
			Correlation factor	0.5
Company-specific adjustment	-5%		Due to lower future growth prospects relative to the calibration date	
Multiple compression	-20%		Reflects metric growth and accretion in EV	
<b>Total multiple adjustment</b>	<b>-25%</b>			

**Company-specific adjustment:** Reflects changes in the financial outlook and risk profile of the portfolio company as of the valuation date relative to the calibration date. For instance, if the outlook at the valuation date is less favorable than that at the calibration date, a negative adjustment to the multiple may be applied. The selection of a company-specific adjustment can be quantitative and/or qualitative based on the following value drivers:

- Level of achievement of the budget initially estimated
- Changes in future growth rates relative to those estimated as of the calibration date
- Changes in future free cash flow margins (e.g., changes in margins, tax rates, capex, and/or working capital requirements) relative to those initially estimated
- Changes in the risk assessment of the investment
- Data on secondary activity and anticipated financing rounds.

**Market adjustment:** Reflects the change in the multiples of comparable companies from the calibration date to the valuation date. A correlation factor between 0 and 1 is often applied to the observed market movement. Given the private nature and early-stage status of VC-backed portfolio companies, their valuations typically do not move in sync with the public peers. An illustrative example is provided in Exhibit 1.

Accurate estimates of fair value resulting from a well-documented and consistently applied valuation policy are required for all leading entities investing in alternative assets. Generally, third-party valuations enhance transparency and consistency, reduce potential conflicts of interest, mitigate risk and, ultimately, enhance credibility. The benefits of third-party valuations are summarized in Exhibit 2.

## Concluding Thoughts

In conclusion, a robust, well-documented valuation process is essential in today's market environment, where scrutiny

from investors, auditors, and regulators is at an all-time high. Given the increasing complexity of securities and the challenges specific to early-stage and high-growth companies, methods like the Calibrated Market Approach are invaluable. As the financial landscape continues to evolve, fund managers who emphasize accuracy, transparency, and consistent valuation practices will be better positioned to navigate market uncertainties and deliver reliable, defensible valuations that align with industry standards and expectations. ■

## Exhibit 2: Benefits of Third-Party Valuations

<b>Technical Excellence</b>	Market and Industry Knowledge
	Technical depth on full spectrum of illiquid securities
	Ensures valuation best practices are followed
	Thought leadership
<b>Process-related</b>	Deep understanding of the audit process
	Reduce strain on internal resources
	Ensures consistency across investments
	Improves documentation
<b>Risk-related</b>	Reduces perceived conflicts of interest
	Independence
	Transparency
	Mitigates overall risk
<b>Other</b>	Provides benchmarks for fund raising
	Boosts investor confidence
	Enhances credibility
	Values may be used for other transactions



# VALUATION DYNAMICS OF SECONDARY TRANSACTIONS

**John Czapla**

*Valuation Research Corporation*

The transaction market for secondary limited partnership (LP) fund interests experienced material growth in recent years, aligning with the overall growth of private capital markets. This market, characterized by its opaque and often illiquid nature, involves buying and selling LP stakes in private equity funds, private credit funds, and various hedge funds, often at material discounts to reported fund net asset values (NAVs) or equity values from an LP perspective. The reporting of specific discounted secondary fund LP transaction values relationship to general partner (GP) reported NAVs, theoretically at fair value, has received increased media coverage recently.

## Why Does the Secondary Market Exist?

Most private fund structures are closed end, committed capital, illiquid fund structures whereby limited partners (LPs), or equity investors, commit capital that is drawn down over an investment period of one to two years and agree to receive a return of and return on capital over the contractual life of the fund, often ten or more years. The effective monetization period may be shorter, depending on the GP's ability and desire to monetize equity or debt assets, but it is not guaranteed.

The growth of the secondary market for LP interests is a product of the growing number of private fund LPs' need for immediate liquidity and, thus, desire to sell their LP investment before the fund's intended and contractual hold period. However, this liquidity can be costly, with LP sellers often incurring material discounts of as much as 10 to 30 percent of the reported NAV of their LP interest. Hence, these markets ultimately provide liquidity to selling investors and simultaneously create attractive potential returns for opportunistic buyers of LP interests.

These discounts are also leading to increased negative press for fund managers and their boards of directors that determine the reported fair value of their investments and for third-party valuation providers that help them determine the appropriate fair values by calling into question the accuracy of such fair value estimates. If interests in such funds are traded at material discounts to fund NAV, is this an indication that the fair values for the underlying assets are marked too high? We will explain below why this is not necessarily, or not likely, the case.

To understand why secondary transactions are currently gaining press attention, it is essential first to understand what they are and what the underlying issues are when transacted.

## What Are Secondary Transactions?

A secondary transaction involves the sale of any security after its original primary market issuance: bonds, public equities, broadly syndicated bank loans, and private equity and debt instruments issued by individual companies are all traded in secondary markets. For this discussion, however, we are focusing solely on transactions where a buyer acquires an LP stake in a fund from one of the current LPs and the resulting value dynamics, which

are a significant aspect of these transactions, often resulting in discounts to the NAV. Understanding these valuation dynamics is crucial to all stakeholders.

## Typical Scenario: NAV and Fair Value Assessments

Typically, the NAV of a fund is defined as the sum of the fair value (FV) of its assets minus the book value (BV) of its liabilities. Accounting guidelines such as ASC 820 (U.S. GAAP) and IFRS 13 (International standards) set forth guidelines that Fund GPs determine and report the FV of the assets in their issued financial statements. The definition of FV in these standards specifies an orderly market scenario where neither buyer nor seller is in distress, and all relevant information is equally available. Publicly traded investments are stated at reported market values; however, private or illiquid investments need to be estimated. Fund managers often use third-party valuation firms to help estimate the FV of their illiquid investments to ensure objectivity and better prepare for regulatory compliance and potential regulatory scrutiny.

For private equity funds, generally, the underlying assets are valued based on an assumption of an orderly exit, such as a sale or IPO, managed by the GPs. This is also true for private credit funds, where investors receive their investment back when funds are wound down in an orderly fashion at the end of their fund lives. Investors, or LPs in debt or equity funds, are expected to hold their fund equity investments until such orderly exits of the fund assets occur. Indeed, LPs that allocate capital to private securities do so with the recognition that their investment is less liquid than public market securities, and they expect a higher return on investment to compensate them for locking up their money. Therefore, the valuations of the underlying fund assets do not typically account for minority or illiquidity discounts, and in turn, the underlying fund NAVs also do not contemplate these discounts.

## Discounts in Secondary Market Transactions

Despite the rigorous valuation processes, secondary market transactions often occur at significant discounts to the reported NAV. These discounts can range from 10 to 30 percent and are influenced by several factors:

- 1. Cost of liquidity for LP investors**—The secondary market is more characterized by opportunistic buyers and forced or distressed sellers than by liquid, orderly buyer-seller transactions. Liquidity needs can significantly impact the valuation of LP stakes, especially when sellers face pressure to liquidate quickly.
- 2. Market perception and volatility**—The market's perception of the underlying asset values and the volatility associated with different types of funds (e.g., venture capital=more risky, as opposed to large-cap buyout=less risky) plays a crucial role. More volatile or risky assets generally trade at higher discounts.
- 3. Dividend yield and outlook**—For credit funds, recurring dividend expectations and their comparison to market comps affect valuations. Equity funds are less influenced by this factor as they typically do not distribute regular dividends.

4. **Exit time frames and expectations**—The expected time frame for distributions and exits, particularly in private equity, can impact the secondary market value. Longer expected hold periods can lead to larger discounts.
5. **Leverage and risk profile**—The leverage used by the fund and the associated risk can also influence the discount. Higher leverage might lead to higher perceived risk and, therefore, larger discounts.

## Regulatory Oversight and Accurate Valuations

Speculation that the NAV may be overstated is less likely to be the cause of LP stakes trading at a discount in the secondary market, thanks to stringent oversight and fair value reporting standards. Auditors and regulators play a crucial role in ensuring the accuracy of these valuations. ASC 820 and IFRS 13 are accounting standards mandating fair value reporting, while regulatory bodies like the SEC oversee most private funds (particularly those with assets under management (AUM) exceeding \$150 million, as stipulated by the Dodd-Frank Act.) Although the courts recently overturned the SEC's attempt to regulate private funds further through the Private Fund Advisers Rule, oversight remains robust through SEC Rule 2a-5, which mandates stringent controls over publicly traded funds' valuation processes, controls, and documentation. Competitively, many private fund managers have adopted many of the 2a-5 mandates as best practices for their respective investors.

## Case Studies of Secondary Market Valuations

Some observers have highlighted instances of significant immediate markups in secondary transactions that bring into sharp relief the disparities between secondary LP interest purchase prices and reported NAVs. For example, *The Wall Street Journal* reported<sup>1</sup> that a leading investment manager's private assets fund recorded a 39 percent gain on fund LP investments bought at a substantial discount, marking them up to the GP-provided NAV within a day. Similarly, another private market investment firm<sup>2</sup> reported spectacular gains on LP stakes purchased in the secondary market, marking them up significantly upon acquisition.

Critics argue that the true market value of an asset is what a buyer is willing to pay; thus, secondary market prices might be a more accurate reflection of fair value. However, GPs and valuation firms often defend the higher NAV valuations, citing rigorous valuation processes and the assumptions of orderly market conditions.

## Implications for Investors and Valuers

The discrepancies between secondary market prices for LP stakes and fund-reported NAVs underscore the need to consider various factors influencing valuations carefully. Investors in the

<sup>1</sup> Laura Cooper and Ben Dummett, "This Can't Go On for Much Longer: Private Equity's Deal Lament," *The Wall Street Journal*, Dec. 31, 2023. Available at <https://www.wsj.com/finance/investing/this-cant-go-on-for-much-longer-private-equitys-deal-lament-493a4bbb>.

<sup>2</sup> Jonathan Weil, "Funds Are Booking Big One-Day Windfalls Buying Private-Equity Stakes," *The Wall Street Journal*, June 7, 2024. Available at <https://www.wsj.com/finance/investing/funds-are-booking-big-one-day-windfalls-buying-private-equity-stakes-664f3423>.

secondary market should be aware that discounts may reflect not just the liquidity needs of the seller but also differences in market conditions and assumptions about asset exits.

Accordingly, internal and third-party valuation professionals and auditors must recognize the distinct market contexts and dynamics when assessing reported LP interest values, or NAVs, per GP financial reporting and those reported in the secondary markets. The NAV reported by GPs under ASC 820 or IFRS 13 for financial reporting assumes orderly market exits for the underlying assets; therefore, these GP-determined NAVs reflect the assumption of orderly market transactions underlying LPs' interests in that fund. However, a fund buying LP interests in the secondary market at steep discounts to GP-reported NAV needs to assess and document if the purchased interest reflected an orderly or distressed trade, i.e., the seller was under duress or highly motivated to sell quickly. If the trade was deemed distressed, per ASC 820 and IFRS 13 fair value mandates, the fund should not use the lower distressed trade value and should continue using the orderly market NAVs reported by the GP. However, this treatment will often reflect a controversial Day 2 gain by the buying fund, which needs to support and document carefully the differences between GP-reported NAV and the lower NAV implied by a secondary market trade for the fund's board of directors (which is responsible for final valuations), its auditors, and regulators.

## Conclusion

The valuation dynamics of secondary LP transactions are complex and influenced by numerous factors. While NAV provides a theoretical fair value under orderly conditions, secondary market prices often reflect the practical realities of liquidity needs of minority fund investors and market perceptions of these LP interests, which are not necessarily reflective of orderly market trades and, thus, the fair value of the underlying fund assets. We would argue that the secondary LP interest discounts to NAV are more reflective of the minority position and the liquidity needs of the sellers. Understanding these dynamics is essential for both buyers and sellers in the secondary market and those responsible for valuing and auditing these investments. ■

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# COMMERCIAL REAL ESTATE'S DEBT MATURITY WALL IS UNPRECEDENTED—IS IT DISASTROUS?

William Russo, Andrew Manley, and Ian Mackie

BRG

Between now and 2028, the commercial real estate (CRE) sector will see more than \$2.8 trillion in debt<sup>1</sup> come due as mortgage loans and extensions made prior to and during the COVID-19 pandemic run their course. This is on top of the \$541 billion in debt that matured last year—the highest amount ever in a single year.<sup>2</sup>

The vast scale of that debt, the current state of real estate capital markets, and certain asset-specific idiosyncrasies are prompting speculation around whether parts of the industry are headed for a disaster. The situation echoes the 2008 financial crisis—the last time a CRE debt maturity wall loomed—further stoking fears about how (or whether) borrowers will be able to refinance and potential downstream economic effects.

To understand the seriousness of the current debt wall, it is important to reflect on how the situation took shape and differs from what came before. Several key factors—including interest rates, collateral availability, and consumer behaviors—will play a consequential role in shaping what comes next.

Most important, borrowers (and their lenders) facing this challenging refinancing environment are not without options. Here is what they should know.

## Why This Debt Maturity Wall Is Different

This is not the first debt maturity wall or wide-reaching challenge the industry has faced. Prominent examples include the 2008 financial crisis and the savings and loan crisis of the early 1990s, which was caused by the outsized leveraging of the 1980s commercial construction boom.<sup>3</sup> However, this moment does have some important differences.

### *The trend in capital costs and availability is different.*

Capital costs generally compressed starting in the early to mid-1990s. Although the approach to resolving nonperforming loans differed during the previous two crises, falling interest rates and steady value recovery enhanced the functioning of real estate capital markets and enabled borrowers and lenders to transact. Because capital costs compressed and asset values recovered, borrowers were more capable of servicing and ultimately refinancing debt. As a result, loan extensions led to positive outcomes, which created a tailwind effect for transactions.

<sup>1</sup> Emily Yu, "CRE Mortgage Maturities & Debt Outstanding: \$2.81 Trillion Coming Due by 2028," Trepp, Dec. 21, 2023, <https://www.trepp.com/trepp-talk/cre-mortgage-maturities-debt-outstanding-2.81-trillion-coming-due-by-2028>.

<sup>2</sup> Peter Grant, "The Bill Is Coming Due on a Record Amount of Commercial Real Estate Debt," *The Wall Street Journal*, Jan. 16, 2024, <https://www.wsj.com/real-estate/commercial/the-bill-is-coming-due-on-a-record-amount-of-commercial-real-estate-debt-451ec8cb>.

<sup>3</sup> C. Alan Garner, Federal Reserve Bank of Kansas City, *Economic Review*, Third Quarter 2008, <https://www.kansascityfed.org/documents/1116/2008-1s%20Commercial%20Real%20Estate%20Reliving%20the%201980s%20and%20Early%201990s%3F.pdf>.

The rapid run-up of interest rates since 2022 has created the opposite situation. Although the Federal Reserve is expected to continue to relax rates in 2025, over the past two years the industry has faced the fastest and most substantial interest rate hikes since the 1980s. Even with rate relaxation, the prevailing rate environment likely will remain elevated—in many cases by a factor of more than two.

All things being equal, the obvious effects of this situation will be two-fold: It will diminish borrowers' ability to meet debt-service requirements (i.e., coverage) and will apply downward pressure on available loan proceeds. This will likely be intensified by valuation pressures, which will impact different asset classes in different ways.

### *RE capital markets are not functioning efficiently.*

A dearth of CRE sales since the COVID-19 pandemic has rendered price discovery difficult. As borrowers and lenders struggle to find valuation data points, we can expect a more intensive focus on existing or in-place cash flow in the underwriting of real estate loans and valuation of assets. Additionally, this focus will likely contribute to reduced loan proceeds as lenders' appetites for underwriting prospective cash flows will probably remain muted until market clarity improves.

History suggests that price discovery will again become possible as transaction volume normalizes. However, fundamental shifts in the functionality and usage of certain asset classes will likely have a more enduring impact. This is especially true of the hardest-hit asset types, like retail and office, where tenant demand has become extremely difficult to underwrite.

### *The CRE sector is grappling with post-pandemic cultural shifts.*

This occurs namely in declining demand for office space and shifting retail formats. Technology is the clear catalyst behind these trends, as remote work and online shopping have become commonplace. Unfortunately, solutions are not nearly as obvious; this has intensified questions about the reliability of cash flows.

COVID-19 did not *cause* these changes. Rather, COVID-19 *accelerated* existing trends as the sudden closure of offices pushed companies to use technology tools widely to maintain productivity. The average office space per employee had been shrinking for years,<sup>4</sup> well before 2020, suggesting that a full return to occupancy may be unlikely even as the pandemic recedes in the rear-view mirror.

<sup>4</sup> "Space Matters: Key Office Trends and Metrics for U.S. Occupiers," cushmanwakefield.com, 2018, [https://www.cushmanwakefield.com/-/media/cw/americas/united-states/insights/research-report-pdfs/2018/space\\_matters\\_gos\\_report\\_interactive.pdf](https://www.cushmanwakefield.com/-/media/cw/americas/united-states/insights/research-report-pdfs/2018/space_matters_gos_report_interactive.pdf).

It is worth noting, however, that asset classes within CRE are not all facing the same circumstances. Some have benefitted from the same technological changes that have negatively impacted office and retail sectors. In particular, industrial warehouse and distribution space saw advantages from online retailing and the resulting need for efficient distribution networks to promote rapid delivery of goods.

Geography and age also play a part. Older buildings can face greater valuation pressure as tenants migrate or “trade up” to superior-quality assets. The same can be said for geographic markets; superior and more desirable locations will benefit from tenant migration to quality, while less desirable locations will continue to diminish.

In addition, in the UK and EU, borrowers with older buildings may face even more valuation issues than those with newer CRE assets thanks to stronger environmental, social, and governance (ESG) building regulations,<sup>5</sup> particularly around energy efficiency.<sup>6</sup> These requirements—typically involving expensive refurbishments to older properties<sup>7</sup>—are coming into effect as many borrowers are exploring refinancing options, heightening their risk profile, and raising refinancing costs on top of these other challenges.

## What This Could Mean for CRE

Do these unique circumstances spell disaster for CRE, borrowers, lenders, and the broader economy? Short answer: probably not on a universal basis, but that doesn’t mean there won’t be challenges ahead.

The past 12 months have offered some startling examples of value deterioration in office space assets. They include a Washington, DC, office that sold for less than one-third of its loan value,<sup>8</sup> as well as the tallest office building in Fort Worth, whose lender bought it back at a foreclosure auction for under 10 percent of its earlier sale price.<sup>9</sup> Similar examples are likely to follow as borrowers and lenders are unable to “amend and extend” loans any further.

Yet a flood of distressed asset sales has not happened. This suggests that for the few borrowers that default, many more successfully negotiate with lenders behind the scenes. If this persists over the next few years, as the post-pandemic readjustment and financial recovery stabilize, then the debt maturity wall may prove to be more of a rolling hill.

Of course, it’s too early to say definitively how the CRE debt situation will evolve. The magnitude and direction of interest

<sup>5</sup> Vincent Bryant, “Research Flags Rising ESG Risk for Real Estate,” RICS, July 22, 2022, <https://www3.rics.org/uk/en/journals/property-journal/research-flags-rising-esg-risk-for-real-estate.html>.

<sup>6</sup> “UK Real Estate Horizon Scanning 2022: ESG and the Real Estate Sector – Where Are We and What’s Hot?” Linklaters.com, 2022, <https://www.linklaters.com/en/insights/publications/year-review-year-to-come/2021-2022/legal-topics/uk-real-estate-horizon-scanning-2022/esg-and-the-real-estate-sector>.

<sup>7</sup> Flora Harley, “What Does ‘Good’ ESG in UK Real Estate Look Like?” Knight Frank, July 5, 2023, <https://www.knightfrank.com/research/article/2023-07-05-what-does-good-esg-in-uk-real-estate-look-like>.

<sup>8</sup> Keith Loria, “Eagle Cliff Buys DC Office Building at Foreclosure Sale for \$30M,” Dec. 22, 2023, [commercialobserver.com, https://commercialobserver.com/2023/12/eagle-cliff-buys-dc-office-building-at-foreclosure-sale-for-30m/](https://commercialobserver.com/2023/12/eagle-cliff-buys-dc-office-building-at-foreclosure-sale-for-30m/).

<sup>9</sup> “Pinnacle Bank Buys Back Fort Worth Office Tower for \$12 per sf,” TRD.com, May 9, 2024, <https://therealdeal.com/texas/fort-worth/2024/05/09/pinnacle-bank-buys-back-fort-worth-office-tower-for-12-per-sf/>.

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rates rising or falling will have a significant impact on capital costs, available loan proceeds, and financing transactions in general. Changing habits of consumers, employers, and employees may have a more enduring effect.

## Options When Facing CRE Debt Maturity

Borrowers and lenders facing maturing CRE loans typically have three options available:

1. **Refinance or Extend:** Refinancing is by far the preferred option for both borrowers and lenders. Extension is a viable strategy if value and/or market recovery will permit a future repayment. Yet refinancing or extending at a higher interest rate can prove challenging, especially if it results in reduced proceeds.

Lenders may demand a “cash-in re-fi” where the borrower must inject additional capital to balance valuation shortfalls to refinance or extend a loan. This may be a difficult ask for borrowers who are pessimistic about the future value of their asset and fear wasting further capital—or for those who don’t have the money. Negotiating is also more difficult when multiple lenders are involved.

2. **Sell the Asset:** Though a less common option to date, this may be the most attractive choice for borrowers either unable or unwilling to front additional capital to refinance a loan. It may mean that the borrower will make nothing—or possibly lose capital. In severe cases, the lender may suffer a principal loss. In the absence of more viable alternatives,



however, this may be the best option for both borrower and lender.

Buyers with capital to spend, however, could snap up deals. In fact, opportunistic funds in search of distressed debt or assets are becoming increasingly prevalent.

3. **Foreclosure:** This tends to be the option of last resort. Lenders have learned that taking ownership of and managing collateral is too much of a burden and requires expertise that does not typically exist in-house. This is particularly true for small and regional banks. Still, foreclosures may result if borrowers and lenders are too far apart on better options.

Whether it proves to be a wall or a speed bump, CRE's maturing debt situation differs meaningfully from what has come before, with expanding capital costs, inefficient capital markets, and profound cultural change creating a unique moment for the sector. The challenges may be significant, but current signs are not pointing toward disaster—and borrowers have tools at their disposal to weather what comes next. ■

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# UNLOCKING THE VALUE OF DISTRESSED ASSETS THROUGH M&A

**Pilar Tarry, CIRA, Brian Maloney, and John Tetnowski**

*AlixPartners, LLP*

*Combining an M&A mindset with a turnaround approach creates higher valuations of distressed assets and greater efficiency in a sale scenario.*

Every cloud has a silver lining. In a distressed scenario, when temperatures rise and the sense of urgency peaks, it is imperative to remember that all assets—even distressed ones—can be valuable to the right buyer. For companies considering alternatives such as 363 sales and distressed asset carve-out transactions, the need to optimize the opportunity for the benefit of stakeholders is critical.

Both the rumor on the street and respondents to AlixPartners' recent *2024 Turnaround and Transformation Survey*<sup>1</sup> suggest that distressed deal activity is on the rise. Roughly 65% of over 7,000 global respondents expect distressed M&A to increase year-over-year, and 32% anticipate current levels to continue. Bringing a value creation lens to a distressed deal can help to maximize value for the seller and drive more favorable resolutions with creditors, equity holders, and other key stakeholders.

In an environment buzzing with M&A activity, here's how advisors can help clients create additional value and navigate special situations:

## Being Management's Lifeline

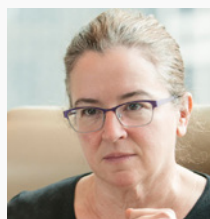
It is important to understand the emotions that course through the veins of senior executives in the throes of these processes. Even veteran leadership teams with M&A experience can get overwhelmed managing a sale against a backdrop of corporate distress. The authors have found it highly effective to offer comfort through industry insight, functional expertise, and real-time, on-the-ground support, helping leaders run the business, manage their financial projections, address tightness in liquidity, respond to buyer diligence, and plan a thoughtful separation (to name just a few). In the lead-up to a sale, maintaining a focus on value creation can be difficult given the many priorities competing for attention, and the often-aggressive timeline needed to do so. As advisors, we help management stay focused on maximizing the opportunity at hand and help guide the company through the accelerated pace of work that transactions require.

## Using the Diligence to Sharpen the Story

The stakes are always high when management presents to prospective buyers, but the pressure in a distressed transaction is even greater. The usual niche pool of buyers arrives on the scene armed with a healthy dose of skepticism, and the overhang of

<sup>1</sup> A pdf of the full report is available at <https://www.alixpartners.com/insights/turnaround-transformation-survey-2024/>.

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challenging market dynamics. Execution-related difficulties or publicized setbacks can put leadership teams on the back foot. Fortunately, preparation can go a long way toward yielding better outcomes.

It is important that advisors:

- Engage with buyers to understand their investment thesis, identify where their concerns lie, and optimize their time at working sessions.
- Align with subject matter experts to prioritize requests, focus on difference-making items for the sale process, and ensure that operational priorities do not suffer.
- Partner with management to make sure they have whatever they need—be it as simple as a list of focused talking points, or as elaborate as a one-on-one coaching session with a specialist—to bring the best of themselves and their organization to bear.

## Focus on the Prize

When the objective is value creation, the distractions that often come with a restructuring must be managed and minimized such that no opportunity to improve the business is overlooked. To accomplish this, advisors can take an active role by helping management to articulate their vision for the post-sale organization, evangelizing the benefits of the sale to employees, and helping to strike the right tone throughout the process.

Harnessing positivity is critical. By reminding the organization of the opportunities that can arise during times of transition, seeking thoughtful input from employees at the front line, and looking critically at the status quo, management teams can leverage the sale process to craft a new roadmap for the future, and unlock value for prospective buyers who are willing to listen.

In a recent transaction, AlixPartners enabled management to put together a supply chain optimization plan with clear EBITDA benefit. Aligning management with this plan and talking to it during the sale process allowed the buyer to see additional bottom-line value in the company, ultimately driving the sale process forward. In a distressed scenario, finding ways to increase valuation can make the difference between a successful, actionable outcome and a total stalemate.

## Isolating the Opportunity

The unique circumstances of a distressed sale—especially those in which previously consolidated business units are being sold piecemeal—can open even more doors for value creation. Advisors and leadership teams that fully assess the good, the bad, and the ugly about the operations, organization structure, and current staffing—and thoughtfully articulate a path for improvement—do themselves a great service in the eyes of potential buyers, who will be seeking a partner that is both future-minded and capable of driving change.

Creating value is hard. Switching from a label of **distressed** to **valuable** can be even harder. But with the right focus—and a collaborative team—the hard things are made much easier. ■



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# MR. MARKET MISCALCULATES

**Howard Marks**

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*This article was originally created as a memo to the author's clients and can be viewed at [oaktreecapital.com/insights/memo/mr-market-miscalculates](https://oaktreecapital.com/insights/memo/mr-market-miscalculates).*

In his book *The Intelligent Investor*, first published in 1949, Benjamin Graham, who was Warren Buffett's teacher at Columbia Business School, introduced a fellow he called Mr. Market:

Imagine that in some private business you own a small share that cost you \$1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.

Of course, Graham intended Mr. Market as a metaphor for the market as a whole. Given Mr. Market's inconsistent behavior, the prices he assigns to stocks each day can diverge—sometimes wildly—from their fair value. When he's overenthusiastic, you can sell to him at prices that are intrinsically too high. And when he's overly fearful, you can buy from him at prices that are fundamentally too low. **Thus, his miscalculations provide profit opportunities to investors interested in taking advantage of them.**

There's a great deal to be said about investors' foibles, and I've shared much of it over the years. But the rapid market decline we saw in the first week of August—along with the rapid rebound—compels me to pull together what I've said previously on the subject, along with some priceless investing cartoons from my collection, and add a few new observations.

To set the scene, let's review recent events. As a result of the COVID-19 pandemic, soaring inflation, and the U.S. Federal Reserve's rapid interest rate increases, 2022 was one of the worst years ever for the combination of stocks and bonds. Sentiment reached its low around the middle of 2022, with investors depressed by the universally negative outlook: "We have inflation, and that's bad. And the rate increases to fight it are sure to bring on a recession, and that's bad." Investors could think of few positives.

Then the mood lightened and, late in 2022, investors coalesced around a positive narrative: the slow economic growth would cause inflation to decline, and that would permit the Fed to start lowering rates in 2023, leading to economic vigor and market gains. A significant stock market rally began and continued nearly

uninterrupted until this month [August 2024]. Although the rate cuts anticipated in 2022 and 2023 still haven't materialized,<sup>1</sup> optimism has been in the ascendency in the stock market. The S&P 500 stock index rose by 54% (not counting dividends) in the 21 months which ended on July 31, 2024. That day, Fed Chair Jerome Powell confirmed that the Fed was moving closer to a rate cut, and things appeared to be on track for economic growth and further stock market appreciation.

But that same day, the Bank of Japan announced its biggest increase in its short-term interest rate in over 17 years (to a whopping 0.25%! ). This shocked the Japanese stock market, to which people had been warming for over a year. In addition, and importantly, the announcement played havoc with investors who had engaged in "the carry trade." For years, Japan's infinitesimal—and often negative—interest rates have meant that people could borrow cheaply in Japan and invest the borrowed funds in any number of assets, there and elsewhere, that promised to return more, for a "positive carry" (aka "free money"). This led to the establishment of highly levered positions. It seems odd that a quarter-point increase in interest rates could require some of these positions to be unwound. But it did, leading to motivated selling in a variety of asset classes as those who had engaged in the practice moved to cut their leverage.

Starting the next day, the U.S. announced mixed economic news. On August 1, we learned that the Manufacturing Purchasing Managers' Index had dipped, and initial jobless claims had risen. On the other hand, corporate profit margins continued to look good, and gains in productivity surprised to the upside. A day later, we learned that employment gains had moderated, with hiring rising less than had been expected. The unemployment rate stood at 4.3% at the end of July, up from a low of 3.4% in April 2023. This was still very low by historical standards, but, according to the suddenly popular "Sahm Rule" (don't complain to me; I'd never heard of it either), since 1970, an increase in the three-month average unemployment rate of 0.5 percentage points or more from the low of the prior 12 months has never occurred without the economy already being in recession. Around the same time, Warren Buffett's Berkshire Hathaway announced that it had sold off a good part of its massive holding of Apple shares.

In all, this news constituted a triple whammy. The resulting flip-flop from optimism to pessimism set off a significant stock market rout. The S&P 500 fell on three consecutive trading days—August 1, 2, and 5—by a total of 6.1%. The replay of the mistakes I've witnessed for decades was so obvious that I can't resist cataloging them below.

## What's Behind the Market's Volatility?

On the first two days of August, I was in Brazil, where people often asked me to explain the sudden collapse. I referred them to my 2016 memo "On the Couch"<sup>2</sup>:

<sup>1</sup> Update: there were subsequently rate decreases in September and November 2024.

<sup>2</sup> "On the Couch," 2016, <https://www.oaktreecapital.com/docs/default-source/memos/on-the-couch.pdf>.

**[The memo's] key observation was that in the real world, things fluctuate between 'pretty good' and 'not so hot,' but in investing, perception often swings from 'flawless' to 'hopeless.'**

That says about 80% of what you need to know on the subject.

If reality changes so little, why do estimates of value (that's what security prices are supposed to be) change so much? The answer has a lot to do with changes in mood. I wrote over 33 years ago, in only my second memo:

The mood swings of the securities markets resemble the movement of a pendulum. . . . between euphoria and depression, between celebrating positive developments and obsessing over negatives, and thus between overpriced and underpriced. This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at a "happy medium."<sup>3</sup>

Mood swings do a lot to alter investors' perception of events, causing prices to fluctuate madly. When prices collapse as they did at the start of this month [August 2024], it's not because conditions have suddenly *become* bad. Rather, they become *perceived* as bad. Several factors contribute to this process:

- heightened awareness of things on one side of the emotional ledger,
- a tendency to overlook things on the other side, and
- similarly, a tendency to interpret things in a way that fits the prevailing narrative.

**What this means is that in good times, investors obsess about the positives, ignore the negatives, and interpret things favorably. Then, when the pendulum swings, they do the opposite, with dramatic effects.**

One important idea underpinning economics is the theory of rational expectations, described by *Investopedia* as follows:

The rational expectations theory . . . posits that individuals base their decisions on three primary factors: their human rationality, the information available to them, and their past experiences.

If security prices were really the result of the rational, dispassionate evaluation of data, presumably one piece of negative information would move the market down a little, and the next such piece would move it down a bit more, and so forth. But instead, we see that an optimistic market is capable of ignoring individual pieces of bad news until a critical mass of bad news builds up, at which time a tipping point is reached, the optimists surrender, and a rout begins. Rudiger Dornbush's great quote about economics is highly applicable here: ". . . things take longer to happen than you think they will, and then they happen

faster than you thought they could." Or as my partner Sheldon Stone says, "The air goes out of the balloon much faster than it went in."

The non-linear nature of this process suggests something very different from rationality is at work. In particular, as in many other aspects of life, cognitive dissonance plays a big part in investors' psyches. **The human brain is wired to ignore or reject incoming data that is at odds with prior beliefs, and investors are particularly good at this.**

While we're on the subject of irrationality, I've been waiting for an opportunity to share this screenshot from June 13, 2022 [below].

This was a tough day in the markets: interest rates were rising thanks to the actions of the Fed and other central banks, and asset prices were under significant pressure as a result. But take a look at the table. Every country's equity index was down significantly. Every currency was down relative to the dollar. Every commodity was down. Only one thing was up: bond yields . . . meaning bond prices were down, too. Wasn't there one asset or country whose value didn't decline that day? What about gold, which is supposed to do well in difficult times? My point here is that, during big market moves, no

one performs rational analysis or makes distinctions. They just throw out the baby with the bathwater, primarily because of psychological swings. As the old saying goes, **"in times of crisis, all correlations go to 1."**

Further, the data in the table exhibit an additional phenomenon that's often present during extreme moves: contagion. Something goes wrong in the U.S. market. European investors take that as a sign of trouble, so they sell. Asian investors detect that something negative is afoot, so they sell overnight. And when U.S. investors come in the next morning, they're spooked by the negative developments in Asia, which confirm their pessimistic inclinations, so they sell. This is a lot like the game of telephone we played when I was little: the message may be miscommunicated as it's passed down the chain, but it still encourages ill-founded actions.

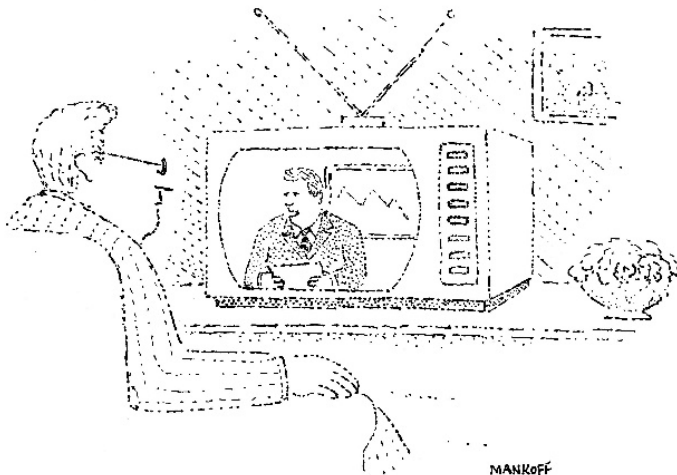
When psychology is swinging radically, meaningless statements can be given weight. Thus, during the three-day decline [in August 2024], it was observed that foreigners sold more Japanese stocks than they bought, and investors reacted as if this meant something. But if foreigners sold on balance, Japanese

Indices	
Hang Seng	▼ -3.39% at 21,068
Nikkei 225	▼ -3.01% at 26,987
S&P 500	▼ -2.91% at 3,901
Eurofirst 300	▼ -2.04% at 1,624
Nasdaq 100	▼ -3.56% at 11,833
FTSE 100	▼ -1.78% at 7,188
Currencies	
€ / \$	▼ -0.52% at 1.0460
\$ / ¥	▲ +0.11% at 134.5300
£ / \$	▼ -0.94% at 1.2198
€ / £	▲ +0.42% at 0.8572
Commodities	
Brent Crude	▼ -1.74% at 119.89
WTI Crude Oil	▼ -1.81% at 118.48
Comex Gold	▼ -0.82% at 1,856.20
Copper	▼ -0.91% at 4.26
Natural Gas	▼ -1.19% at 8.75
10-year bond yields	
US	▲ 0.062 at 3.219
UK	▲ 0.031 at 2.474
Japan	0 at 0.255
Bund	▲ 0.038 at 1.536

<sup>3</sup> "First Quarter Performance," April 1991, [https://www.oaktreecapital.com/docs/default-source/memos/1991-04-11-first-quarter-client-performance.pdf?sfvrsn=d7bd0f65\\_2](https://www.oaktreecapital.com/docs/default-source/memos/1991-04-11-first-quarter-client-performance.pdf?sfvrsn=d7bd0f65_2).

investors must have bought on balance. Should either of these phenomena be treated as more significant than the other? If so, which one?

Further complicating things in terms of rational analysis is the fact that most developments in the investment world can be interpreted both positively and negatively, depending on the prevailing mood.



*"On Wall Street today, news of lower interest rates sent the stock market up, but then the expectation that these rates would be inflationary sent the market down, until the realization that lower rates might stimulate the sluggish economy pushed the market up, before it ultimately went down on fears that an overheated economy would lead to a reimposition of higher interest rates."*

CartoonStock.com

Another classic cartoon sums up this ambiguity in fewer words. It's highly applicable to the market tremor that inspired this memo.



*"Everything that was good for the market yesterday is no good for it today."*

One more source of miscalculation is investors' tendency toward optimism and wishful thinking. Investors in general—and equity investors in particular—must, by definition, be optimists. Who other than people with positive expectations (and/or a strong desire for increased wealth) would be willing to part with money today based on the possibility of getting back more in the future?

Charlie Munger, Warren Buffett's late partner, routinely quoted the ancient Greek statesman Demosthenes, who said, **"Nothing is easier than self-deceit. For what each man wishes, that he also believes to be true."** One great example is "Goldilocks thinking":

the belief that the economy will be neither strong enough to bring on inflation nor weak enough to lapse into recession. Things sometimes work out that way—as may be the case right now—but not nearly as often as investors posit. Expectations that incline toward the positive encourage aggressive behavior on the part of investors. And if this behavior is rewarded in good times, still more aggressiveness usually ensues. **Rarely do investors realize that (a) there can be a limit to the run of good news or (b) an upswing can be so strong as to be excessive, rendering a downswing inevitable.**

For years, I quoted Buffett as having warned investors to temper their enthusiasm: "When investors lose track of the fact that corporate profits grow at 7% on average, they tend to get into trouble." In other words, if corporate profit growth averages 7%, shouldn't investors begin to worry if stocks appreciate by 20% a year for a while (as they did throughout the 1990s)? I thought it was such a good quote that I asked Buffett when he said it. **Unfortunately, he answered that he hadn't. But I still think it's an important warning.**

That inaccurate recollection reminds me of John Kenneth Galbraith's trenchant reference to one of the most important causes of financial euphoria: "the extreme brevity of the financial memory." It's this trait that allows optimistic investors to engage in aggressive behavior, untroubled by knowledge of what such behavior led to in the past. Further, it makes it easy for investors to forget past errors and invest blithely on the basis of the newest miraculous development.

Finally, the investment world might be less unstable if there were immutable rules—like the one governing gravity—that could be counted on to always produce the same results. **But there are no such rules, since markets aren't built on natural laws, but rather the shifting sands of investor psychology.**

For example, there's a long-running adage that says we should "buy on rumor and sell on news." That is, the introduction of favorable expectations is a buy signal, because expectations often continue to rise. That ends when the news arrives, however, because the impetus for gains has been realized and no further good news remains to take the market higher. But in the carefree environment of a month ago [July 2024], I told my partner Bruce Karsh that maybe the prevailing attitude had become "buy on rumor and buy on news." In other words, investors were acting as though it was always a good time to buy. Rationally, one shouldn't price in the possibility of a favorable event twice: both when the possibility of the event is introduced and when the event occurs. But euphoria can get the better of people.

Another example of the absence of meaningful guidelines can be seen in this excerpt from one of the oldest clippings in my file:

A continuing pattern of consolidation and group rotation suggests that increasing emphasis should be placed on buying stocks on relative weakness and selling them on relative strength. This would be a marked contrast to some earlier periods where emphasizing relative strength proved to be effective.<sup>4</sup>

**In short, sometimes the things that have gone up the most should be expected to continue to go up the most, and sometimes the**

<sup>4</sup> Loeb, Rhoades & Co., 1976.



things that have gone up the least should be expected to go up the most. To which many of you might respond “duh.” Bottom line: there are few effective rules for investors to follow. Superior investing always comes down to skillful analysis and superior insight, not adherence to formulas and guidelines.

***Volatile psychology, skewed perception, overreaction, cognitive dissonance, rapid-fire contagion, irrationality, wishful thinking, forgetfulness, and the lack of dependable principles. That's quite a laundry list of ills.***

Together, they constitute the main cause of extreme market highs and lows and are responsible for the volatile swings between them. Ben Graham said that, in the long run, the market is a weighing machine that assesses the merit of each asset and assigns an appropriate price. But in the short term, it's merely a voting machine, and the investor sentiment that moves it swings wildly, incorporating little rationality and assigning daily prices that often reflect little in terms of intelligence.

Rather than try to reinvent the wheel, I'll repeat some of what I've said in two past memos:

Especially during downdrafts, many investors impute intelligence to the market and look to it to tell them what's going on and what to do about it. This is one of the biggest mistakes you can make. **As Ben Graham pointed out, the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You just can't take it too seriously.** Market participants have limited insight into what's really happening in terms of fundamentals, and any intelligence that could be behind their buys and sells is obscured by their emotional swings. It would be wrong to interpret the recent worldwide drop as meaning the market “knows” tough times lay ahead.<sup>5</sup>

My bottom line is that markets don't assess intrinsic value from day to day, and certainly they don't do a good job during crises. Thus, market price movements don't say much about fundamentals. **Even in the best of times, when investors are driven by fundamentals rather than psychology, markets show what the participants think value is, rather than what value really is.** Value is something the market doesn't know any more about than the average investor. **And advice from the average investor obviously can't help you be an above average investor.**<sup>6</sup>

Fundamentals—the outlook for an economy, company or asset—don't change much from day to day. **As a result, daily price changes are mostly about (a) changes in market psychology and thus (b) changes in who wants to own something or un-own something.** These two statements become increasingly valid the

more daily prices fluctuate. Big fluctuations show that psychology is changing radically.<sup>7</sup>

**The market fluctuates at the whim of its most volatile participants: those who are willing (a) to buy at a big premium to the former price when the news is good and enthusiasm is riding high and (b) to sell at a big discount from the former price when the news is bad and pessimism is rampant.** Thus, as I wrote in “On the Couch,” every once in a while, the market needs a trip to the shrink.

It's important to note that, as my partner John Frank points out, in comparison to the total number who own each company, it takes relatively few people to drive prices up during bubbles or down during crashes. When shares in a company that was worth \$10 billion a month ago trade at prices implying a valuation of \$12 billion or \$8 billion, it doesn't mean the whole company would change hands at these prices; just a tiny sliver. **Regardless, a few emotional investors can move prices much more than should be the case.**

The worst thing you can do is join in when other investors go off on these irrational jags. It's far better to watch with bemusement from the sidelines, buttressed by an understanding of how markets work. **But better still to see Mr. Market's overreactions for what they are and accommodate him, selling to him when he's eager to buy regardless of how high the price is, and buying from him when he desperately wants out.** Here's how Ben Graham followed the introduction of Mr. Market that I included on [page 33]:

If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of your \$1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.

In other words, it's the primary job of the investor to take note when prices stray from intrinsic value and figure out how to act in response. Emotion? No. Analysis? Yes.

<sup>7</sup> Ibid.

<sup>5</sup> “It's Not Easy,” September 2015, [https://www.oaktreecapital.com/docs/default-source/memos/1991-04-11-first-quarter-client-performance.pdf?sfvrsn=d7bd0f65\\_2](https://www.oaktreecapital.com/docs/default-source/memos/1991-04-11-first-quarter-client-performance.pdf?sfvrsn=d7bd0f65_2).

<sup>6</sup> “What Does the Market Know?,” January 2016, <https://www.oaktreecapital.com/docs/default-source/memos/what-does-the-market-know.pdf>.

## ABOUT THE AUTHOR



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Since the formation of Oaktree in 1995, Howard Marks has been responsible for ensuring the firm's adherence to its core investment philosophy, communicating closely with clients concerning products and strategies, and contributing his experience to big-picture decisions relating to investments and corporate direction. Previously, he was with The TCW Group, Inc. and Citicorp Investment Management. Mr. Marks holds a BS degree cum laude from the Wharton School of the University of Pennsylvania and an MBA from the Booth School of Business of the University of Chicago. He is a CFA charterholder.



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# FROM WORTHLESS TO WORTHWHILE: MAXIMIZING VALUE FOR INSOLVENT CONTROLLED FOREIGN CORPORATIONS

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## Introduction

Navigating the labyrinth of worthless stock and bad debt deductions can be particularly challenging when applied to financially distressed controlled foreign corporations (“CFCs”). This article provides a high-level overview of the relevant U.S. federal tax law, particularly in the international context. It explores the mechanics and implications of claiming worthless stock deductions under section 165(g)<sup>1</sup> and bad debt deductions under section 166 as they relate to CFCs. Additionally, the article examines the treatment of Subpart F income and the impact of the Global Intangible Low-Taxed Income (“GILTI”) regime introduced by the Tax Cuts and Jobs Act of 2017 (“TCJA”), highlighting the multifaceted nature of these tax rules and their significant implications for U.S. shareholders of financially distressed CFCs.

## Controlled Foreign Corporations

A controlled foreign corporation (CFC) is defined under section 957 as any foreign corporation in which more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of the stock, is owned by U.S. shareholders on any day during the taxable year of the foreign corporation.

U.S. shareholders of a CFC are generally required to file Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations. This form mandates the reporting of detailed information about the CFC, including its financial statements, ownership structure, and transactions between the CFC and its U.S. shareholders. Additionally, it requires the disclosure of CFC items that may be reflected as income for the U.S. shareholder.

## Subpart F Income

The Subpart F rules, introduced in 1962, prevent U.S. shareholders from deferring tax on certain types of “movable” income, such as dividends, interest, rents, and royalties, by earning income through CFCs in low tax jurisdictions. Under these rules, U.S. shareholders must include their pro rata share of the CFC’s earnings in their current-year income, regardless of whether the income is actually distributed. This inclusion increases<sup>2</sup> the shareholder’s basis in the CFC stock, which is then reduced<sup>3</sup> when the previously taxed income is distributed, preventing double taxation.

<sup>1</sup> All section references are to the Internal Revenue Code of 1986 (the “Code”), as amended, or to underlying regulations.

<sup>2</sup> Section 961(a).

<sup>3</sup> Section 961(b).

## GILTI

GILTI is one of the largest post-TCJA anti-abuse principles to prevent offshoring of profits to low tax jurisdictions.

GILTI requires U.S. shareholders owning at least 10% of a CFC<sup>4</sup> to include their pro rata share of the CFC’s GILTI in their current income. GILTI is calculated as the net CFC tested income (gross income minus certain exclusions and deductions) minus the net deemed tangible income return (10% of the shareholder’s pro rata share of the adjusted tax basis of tangible depreciable property, reduced by allocable interest expense).

U.S. corporate shareholders can generally deduct up to 50% of their GILTI inclusion pursuant to section 250<sup>5</sup>, reducing the effective tax rate to 10.5%.<sup>6</sup> They can also claim an indirect foreign tax credit for 80% of the foreign taxes paid by the CFCs on GILTI. However, these benefits are generally not available to individuals.<sup>7</sup>

For U.S. shareholders with multiple CFCs, GILTI is calculated on an aggregate basis, netting tested income and losses across all CFCs. If the net result is a loss, the GILTI inclusion is zero. Similarly, a U.S. federal consolidated return group is treated as a single taxpayer for GILTI purposes, netting tested income and losses across the group.

## CFC Stock Basis Adjustments

The rules for determining the tax basis in the stock of a CFC have evolved with the enactment of the TCJA. Despite some differences between the pre- and post-TCJA regimes, certain factors consistently increase the tax basis under both systems, including capital contributions<sup>8</sup> and Subpart F income.<sup>9</sup> In general, distributions of previously taxed earnings and profits (“PTEP”) under the post-TCJA regime, and previously taxed income (“PTI”)

<sup>4</sup> Note that section 957 requires that 50% of the vote or value of a foreign corporation is required to be owned by U.S. shareholders on any day of the taxable year of the foreign corporation to be treated as a CFC. The GILTI rules thus apply to any 10% shareholder of a foreign corporation that meets the section 957 CFC definition.

<sup>5</sup> Note that the section 250 deduction is computed after net operating losses (“NOLs”). If the section 250 deduction is reduced or eliminated due to NOL deductions, the unused section 250 deduction cannot be carried forward. In other words, the section 250 deduction must be used in the year of the GILTI (and/or other inclusions) or is otherwise lost.

<sup>6</sup> The deduction will be reduced for tax years beginning after Dec. 31, 2025, from 50% to 37.5%. This change effectively increases the GILTI inclusion rate for domestic corporations from 10.5% to 13.125%, assuming the corporate tax rate remains at 21%.

<sup>7</sup> Note that these benefits would be available to individuals and trusts that make a section 962 election.

<sup>8</sup> Note that issuances of U.S. parent stock to a CFC relating to employee stock option plans are included in capital contributions.

<sup>9</sup> Defined in section 951(a) and discussed above.



## CFC Tax Basis Calculation (in USD)

	Pre-TCJA				Post-TCJA				
	2014	2015	2016	2017	2018	2019	2020	2021	2022
Initial Basis	\$10,000								
Capital Contributions		\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000	\$5,000
Deemed Capital Contributions (Stock options)		1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Section 965(a) Inclusion Plus GILTI				50,000	10,000	10,000	10,000	10,000	10,000
Plus Subpart F		2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000
Reclass of I/C			-	-	-	-	-	-	-
Distributions (negative)		(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)	(1,500)
Current Year Change in Basis		6,500	6,500	56,500	16,500	16,500	16,500	16,500	16,500
Adjusted U.S. Tax Basis EOY	\$ -	\$6,500	\$13,000	\$69,500	\$86,000	\$102,500	\$119,000	\$135,500	\$152,000

under the pre-TCJA regime, decrease the tax basis in CFC stock, but not below zero.<sup>10</sup>

Before the TCJA, the U.S. followed a worldwide system for CFC taxation, allowing U.S. shareholders to defer U.S. taxation on CFC profits until those profits were repatriated to the U.S. This system often resulted in the long-term offshoring of profits.<sup>11</sup> The TCJA introduced a hybrid-territorial system, requiring U.S. shareholders to include CFC income as current income,<sup>12</sup> thereby eliminating the long-term offshoring allowed under the pre-TCJA regime.<sup>13</sup>

The TCJA also introduced the one-time section 965(a) inclusion as well as the GILTI provisions. Section 965(a) mandated a one-time inclusion in income for U.S. shareholders of CFCs, based on the accumulated post-1986 deferred foreign earnings, which increases the tax basis in the CFC stock.<sup>14</sup> As discussed above, the GILTI regime under section 951A requires U.S. shareholders to include their share of the CFC's GILTI in their gross income, also resulting in a basis adjustment to prevent double taxation.

Above is an example of a CFC tax basis calculation, with most amounts held constant from year to year to highlight the changes and similarities between the pre- and post-TCJA calculations. Note that the section 965(a) inclusion occurred in the 2017 tax year.

<sup>10</sup> Section 959 provides that such distributions are excluded from taxable income of the U.S. recipient. This is intended to prevent double taxation in most cases. The U.S. Treasury is in the process of drafting regulations that will attempt to prevent double taxation in certain cases where double taxation remains.

<sup>11</sup> The U.S. enacted a tax holiday in 2004 that reduced the tax rate on repatriated cash from 35% to 5.25%. This resulted in \$362 billion of cash being repatriated in that year. Martin A. Sullivan, *Corporate Tax Reform: Taxing Profits in the 21st Century*, 83, ISBN 143023928X.

<sup>12</sup> U.S. shareholders may be eligible for a 100% dividends-received deduction, subject to certain limitations. Note that high-taxed GILTI is excluded from income.

<sup>13</sup> Note the Organization for Economic Co-operation and Development ("OECD") has proposed a "global minimum tax" of 15% for large corporations, with an effective date of 2024. The global minimum tax is based on a two-pillar approach. Pillar One relates to where taxes will be paid. Pillar Two relates to how the global minimum taxes will be paid.

<sup>14</sup> While the 965(a) inclusion could have been paid in installments in tax years beginning in 2017, the increase to basis would have occurred in 2017, regardless of when the payments were actually made.

## CFCs in Financial Distress

### Creditor Considerations

#### Worthless Stock Deduction

Section 165(g) generally provides that if a security (including a share of stock in corporation) becomes worthless during a taxable year—such loss shall be treated as a loss from the sale or exchange, on the last taxable day of the year. Section 165(b) states that the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

For example, assume a U.S. shareholder owns shares in a CFC with an adjusted basis of \$100 and the CFC becomes wholly worthless during the year. The U.S. shareholder would thus be entitled to a \$100 capital loss.

Section 165(g)(3) provides an exception to capital loss treatment by allowing a domestic corporation an ordinary loss on the disposition of an affiliated corporation. To qualify as an affiliated corporation, the U.S. corporation must directly own 80% of the vote and 80% of the value of the subsidiary.<sup>15,16</sup>

In addition, section 165(g)(3) generally requires that more than 90 percent of the aggregate of the subsidiary's gross receipts for all taxable years have been from sources other than royalties, rents, dividends, interest, annuities, and gains from sales or exchanges of stocks and securities.

As such, if a controlled foreign corporation (CFC) becomes wholly worthless, the U.S. shareholder can claim a capital loss deduction equal to its adjusted basis in the stock of the CFC under section 165(g). However, if the requirements of section 165(g)(3) are met, they can instead claim an ordinary loss. Based on the previous example, if the requirements of section 165(g)(3) are met, the U.S. shareholder would have a \$100 ordinary deduction (rather than capital loss).

<sup>15</sup> As defined in section 1504(a)(2).

<sup>16</sup> Note that Treas. Reg. Sec. 1.165-5(d)(2)(ii) provides an anti-abuse rule that states: "None of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under section 165(g)(3)."

As section 165(g)(3) requires direct ownership, the provision is not available if the worthless stock deduction was not taken with respect to a first-tier CFC. Alternatively, if a solvent intermediary CFC could be liquidated – then section 165(g)(3) treatment might be available. However, the transaction would also be subject to the Treas. Reg. Sec. 1.165-5(d)(2)(ii) anti-abuse rules.<sup>17</sup>

### *Bad Debt Deduction*

Section 166(a)(1) allows for a deduction for any debt that becomes *wholly* worthless during the year. The amount deductible equals the adjusted basis of the debt.<sup>18</sup> Under certain circumstances, section 166(a)(2) provides for partially worthless debt deductions.

For example, assume a CFC owes its U.S. shareholder debt with an adjusted basis of \$100. It is determined that the debt has become wholly worthless in 2024. As such, the U.S. shareholder can take a \$100 bad debt deduction.

## **Debtor CFC Considerations**

### *Cancellation of Debt Income*

While the shareholder creditor may take a bad debt deduction or worthless stock deduction, the debtor generally would have correlative cancellation of debt income (“CODI”). Section 61(a)(11) provides that CODI is included in taxable income. For example, assume a corporation borrows \$100 from a creditor. The corporation increases an asset (cash) and has a corresponding increase to its liabilities (note payable). If the creditor forgives \$100 of the loan,<sup>19</sup> then the corporation has been relieved of \$100 of liabilities, and thus would reflect \$100 of CODI.

Since CODI is included in taxable income<sup>20</sup> and CFCs are treated as domestic corporations for purposes of calculating gross income under Treas. Reg. Sec. 1.952-2(a)(1), taxable CODI is likely includable in the calculation of GILTI as section 951A(c)(2)(A) tested income. However, to the extent available,<sup>21</sup> the section 250 deduction could offset up to 50% of such GILTI income.

There are two important exceptions to this rule. To the extent the debtor is insolvent, section 108(a)(1)(B) provides that such CODI is excluded by the amount of insolvency immediately before the debt discharge. In the prior example, if the debtor is insolvent by \$40 immediately before the debt discharge, \$40 of the CODI would be excluded from taxable income (and \$60 would be taxable to the debtor).<sup>22</sup>

Another prominent exclusion is the bankruptcy exclusion, in which CODI is excluded if the discharge occurs in a “title 11 case.”<sup>23</sup> The term “title 11 case” means a case under the Bankruptcy Code, e.g., Chapter 7, Chapter 11, or Chapter 15, if the taxpayer is under the jurisdiction of the court; and the discharge of indebtedness is granted by the court or pursuant

to a plan approved by the court.<sup>24</sup> In circumstances where a debt cancellation occurs during the bankruptcy process, but not pursuant to a court order, the bankruptcy exclusion does not apply. If the debt discharge occurs pursuant to a plan approved by the court, the level of insolvency of the debtor is irrelevant to the amount of the exclusion. In other words, the burden of proof is on the taxpayer to establish the amount of insolvency outside of a title 11 bankruptcy case. One benefit of a title 11 bankruptcy filing is the absence of the requirement for the taxpayer to establish the amount of insolvency.

Generally, where an exclusion (i.e., bankruptcy or insolvency) applies, a tax attribute reduction is required under Section 108(b), which provides mechanical ordering rules. The mechanics of the attribute reduction resulting from excluded CODI is beyond the scope of this article; however, while not entirely clear, it appears logical that tax basis in assets of a CFC would be reduced to the extent that CODI is excluded due to insolvency or U.S. title 11 bankruptcy.<sup>25</sup>

Attribute reduction generally has the effect of providing the debtor with a “fresh start”—such that the CODI is excluded from taxable income (due to insolvency or bankruptcy) after the determination of tax for the year in which debt is cancelled.<sup>26</sup> The cost of reducing attributes is that future income and taxes would likely be increased. For a CFC, the loss of basis in assets would have the effect of reducing depreciation deductions, which would have the effect of increasing tested income and thus the GILTI inclusion to the U.S. shareholder.

### *Revenue Ruling 2003-125*

Revenue Ruling 2003-125<sup>27</sup> clarifies the tax consequences when a U.S. shareholder converts a CFC to a disregarded entity. Specifically, the ruling addresses the conditions under which a shareholder can claim a worthless security deduction under section 165(g)(3), with regards to a CFC.

In Situation 2 of the ruling, P, a domestic corporation, owned all equity interests in FS, a foreign subsidiary. On July 1, 2003, P filed a valid Form 8832 to change FS’s classification from a corporation to a disregarded entity. At the close of the day before the election, the fair market value of FS’s assets, including intangible assets such as goodwill and going concern value, did not exceed its liabilities (meaning, FS’s stock was worthless). Consequently, P did not receive any payment for its FS stock in the deemed liquidation. The deemed liquidation is an identifiable event that fixes P’s loss, allowing a worthless security deduction under section 165(g)(3) for the 2003 tax year.

The ruling clarified that when a U.S. shareholder owns an insolvent CFC, changing the classification of the CFC to a disregarded entity can result in a section 165(g)(3) worthless stock deduction. Additionally, the creditors of the former CFC

<sup>17</sup> Ibid.

<sup>18</sup> Treas. Reg. Sec. 1.166-1.

<sup>19</sup> The creditor would presumably take a bad debt deduction.

<sup>20</sup> In a 1997 Private Letter Ruling, the IRS stated that a CFC’s CODI would not ordinarily be considered Subpart F income as CODI is specifically enumerated as its own type of income under Section 61(a)(11): LTR 9729011 (Apr. 11, 1997).

<sup>21</sup> As discussed above, the section 250 deduction is calculated after the NOL deduction.

<sup>22</sup> Note that insolvency is a factual issue that may be challenged by the IRS.

<sup>23</sup> Section 108(a)(1)(A).

<sup>24</sup> Section 108(d)(2).

<sup>25</sup> Corporations are eligible to file a U.S. bankruptcy case if they have some nexus to the U.S., per Bankruptcy Code section 109(a). Foreign corporations commonly file U.S. Bankruptcy cases when there are U.S. creditors.

<sup>26</sup> See section 108(b)(4). For example, if tax basis in the assets of a CFC was reduced in the 2024 tax year, depreciation relating to such assets would be available in the determination of tax for 2024. However, to the extent that basis in such assets were reduced in the 2024 tax year, such basis would not be available to be depreciated beginning the first day of the 2025 tax year.

<sup>27</sup> Rev. Rul. 2003-125, 2003-2 C.B. 1243.

may be entitled to a deduction for a wholly or partially worthless debt under section 166.

This ruling provides a clear pathway for U.S. shareholders of CFCs to recognize losses on worthless stock and claim appropriate deductions, thereby offering tax relief in situations where the CFC's liabilities exceed its assets.

## Conclusion

Navigating the tax consequences for financially distressed CFCs is complex, particularly under the post-TCJA international tax rules. Understanding the relevant provisions such as section 165(g)(3) for worthless stock deductions and section 166 for bad debt deductions is crucial. Effective tax planning can help U.S. shareholders manage the tax implications of their investments in financially distressed CFCs.

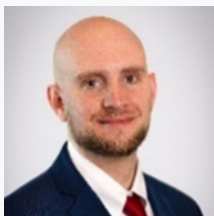
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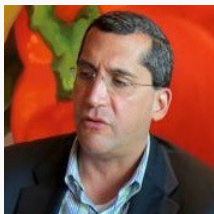
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# FOUR TIPS FOR DRAFTING EARNOUTS TO AVOID DISPUTES

Michael McMahon, Tijana Brien, and Bobby Earles

Cooley LLP

Amid a somewhat sluggish mergers and acquisitions market, and as buyers seek to scoop up companies at a discount while sellers long for the sky-high valuations of 2020 and 2021, the earnout is having a moment.

In broad terms, an earnout provision is one in which a buyer agrees to pay additional consideration to a seller, after closing, if certain milestones or requirements are achieved.

The use of an earnout provision is often a way to bridge a valuation gap between buyers and sellers who otherwise want to move forward with a transaction. Earnouts have the potential to be conceptual wins for both parties.

The earnout returns value to the seller if the target company performs at or above expectations. It also protects downside for buyers including by incentivizing seller stakeholders to remain involved with the business post-closing and hedging against uncertainties — like future growth potential, market conditions and whether regulatory approvals will be obtained.

In addition, earnouts allow buyers to somewhat de-risk transactions. For example, if the target claims it will achieve certain growth, e.g., three times earnings before interest, taxes, depreciation and amortization, or EBITDA, over a particular time horizon, such as two years — then the buyer can pay an amount at closing based on a more conservative growth profile, and if the target delivers on its promises, pay future consideration based on the actual growth to the business, a win for both sides.

While earnout provisions have been a staple of life sciences deals for many years, 2023 saw a dramatic uptick in the use of earnout provisions in non-life sciences deals, as recently reported by the SRS Acquiom 2024 M&A Deal Terms Study.<sup>1</sup>

Of the deals SRS analyzed, 33% included earnouts, up from 21% in 2022 and 18% in 2021. The use of earnout provisions in less traditional settings also has garnered media attention.

In May 2023, the Washington Commanders grabbed headlines<sup>2</sup> for allegedly using an earnout provision in a contract between Dan Snyder, owner of the Commanders, and the Josh Harris Group, which acquired the Commanders.

In this rumored deal, if the Commanders franchise hits specified financial benchmarks, Snyder may be entitled to receive additional payouts. As The Washington Post reported,<sup>3</sup> this type of earnout payment structure is extremely rare in sports franchise sales; nevertheless, it is an example of the earnout's versatility.

Predictably, as earnouts have become more prevalent, the number of post-closing disputes over earnouts also has increased.

<sup>1</sup> <https://www.srsacquiom.com/our-insights/deal-terms-study/>.

<sup>2</sup> <https://bleacherreport.com/articles/10076456-nfl-rumors-daniel-snyder-to-receive-earnout-deferred-payment-from-commanders-sale>.

<sup>3</sup> <https://www.washingtonpost.com/sports/2023/05/17/josh-harris-deal-earnout-commanders/>

For example, based on the admittedly inexact science of searching court dockets, Bloomberg<sup>4</sup> reported that, in the first quarter of 2023, the number of earnout disputes filed in the Delaware Court of Chancery quadrupled compared to the number of similar disputes filed during the same period in the prior year.

Because many earnout disputes are decided in private proceedings by subject matter experts engaged by the parties, it is likely that the occurrence of disputes is considerably greater than these numbers suggest.

## Avoiding Common Pitfalls in Earnout Provisions

Although an earnout can help to bridge the valuation gap between buyers and sellers, in many cases, earnouts may simply delay an inevitable dispute.

Indeed, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery astutely observed 15 years ago in the *Airborne Health Inc. v. Squid Soap* decision, that “an earn-out often converts today’s disagreement over price into tomorrow’s litigation over the outcome.”<sup>5</sup>

Not much has changed in the intervening decade and a half. If not given appropriate care and attention, earnout provisions can lead to insurmountable differences in interpretation on whether the earnout metrics have been met.

Further complicating matters, earnout disputes are often referred to independent subject matter experts chosen by the parties, and not courts. This is typically intended as a means of efficiently expediting resolution, but disputes often arise regarding the dispute resolution process itself. Accordingly, buyers and sellers alike should exercise caution when drafting earnout provisions.

Below, we provide a few considerations.

### 1 Use clear and unambiguous terms

Clear drafting of the earnout terms is crucial. Often, earnouts are crafted with bespoke terms that leave much room for subjective interpretation.

Parties should give considerable thought to how key terms and phrases are defined, and they should set clear metrics and goals that ideally can be objectively measured — including EBITDA or net revenue targets, sales targets, regulatory approvals, and study or clinical trial completion.

An illustrative example, such as an EBITDA calculation for an earnout based on achievement of certain EBITDA metrics,

<sup>4</sup> Abena Opong-Fosu, “Earnouts Are Showing Up in More M&A Deals — and Lawsuits,” Bloomberg Law, June 23, 2023. <https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-earnouts-are-showing-up-in-more-m-a-deals-and-lawsuits>.

<sup>5</sup> *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126, 132 (Del. Ch. 2009).

appended to the agreement also can provide helpful clarity for demonstrating how the parties intended the earnout to function.

Additionally, parties should plainly spell out timing mechanisms, such as for when regulatory or financial milestones must be reached, and what rights, if any, sellers have to access information buyers used to prepare earnout statements or make business decisions that affect the earnout.

Given that earnouts often tend to be crafted for specific deals, situations and parties, drafters should take care not to repurpose earnout terms from other deals without careful consideration.

## 2 Explicitly define methods to measure “efforts” provisions

Drafters should clarify whether the buyer has an obligation to operate the acquired business in such a way as to maximize the earnout opportunity for the benefit of the seller. However, inclusion of so-called best efforts or commercially reasonable efforts clause, without further detail or definition, can lead to uncertainty.

In the Delaware Chancery’s 2022 decision in *Menn v. ConMed Corp.*, for example, the contract between the buyer and seller included a “commercial best efforts” provision.<sup>6</sup> While some “commercial best efforts” clauses contain what is called a contractual yardstick — a method to measure the efforts — the contract in *Menn* lacked any express standard by which to gauge the buyer’s efforts.

The court turned to other sources of interpretation for best efforts and found that, in that context, “commercial best efforts” required “a party to do essentially everything in its power to fulfill its obligation.”

The *Menn* case should serve as a warning to buyers to build guardrails into earnout provisions around how they will be expected to manage the business post-closing, such as whether they must retain certain employees; continue past practices, including discounts and training; and fund future improvements or development.

## 3 Set strict timelines for resolving disputes

Parties to a deal often build dispute resolution provisions directly into the earnout with the hope of quickly and cheaply resolving disputes and avoiding costly in-court litigation. While alternative dispute resolution, such as referring disputes to a subject matter expert, can be efficient, that is not always the case.

To avoid these pitfalls, earnout provisions should set clear, strict timelines by which a dispute should be resolved. For example, if the parties want the dispute resolved within 90 days from the time it arises, the agreement should say so.

Otherwise, it is not uncommon for parties to take months to simply agree upon and engage the private subject matter expert to adjudicate the matter, and that timeline can drag on for longer if there are conflicts to work around.

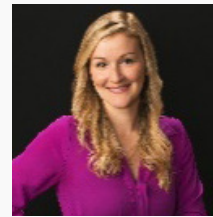
<sup>6</sup> *Menn v. ConMed Corp.*, No. CV 2017-0137-KSJM, 2022 WL 2387802 (Del. Ch. June 30, 2022), judgment entered, (Del. Ch. 2022).

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Even once the process gets rolling, there may be many more months of costly submissions, rebuttals, and perhaps even oral argument or evidentiary proceedings. If the parties want, need or intend the process to be completed faster, they should say so.

Similarly, the earnout provision should state exactly what triggers escalation of the dispute; the parties should not have to litigate over whether a dispute is ripe for referral to the expert or court.

## 4 Clearly define what types of disputes will go to an expert

If the parties plan on sending any disputes to a subject matter expert, like an independent accountant, they should clearly spell out who the expert will be and who the backup will be if that individual or firm is conflicted.

The provision also should make clear what sorts of disputes the expert has jurisdiction over.

Take, for example, the 2022 *Bus Air LLC v. Woods* decision in the U.S. District Court for the District of Delaware.<sup>7</sup> There, the buyer and seller questioned whether there was an agreement to submit to arbitration in the case of an earnout dispute.

<sup>7</sup> *Bus Air, LLC v. Woods*, No. CV 19-1435-RGA-CJB, 2022 WL 2666001 (D. Del. July 11, 2022).



The seller brought counterclaims relating to the earnout, and the buyer moved to compel arbitration. The court denied the buyer's motion and found the parties had not clearly expressed their intent in the purchase agreement to arbitrate all earnout disputes.

Parties can avoid this uncertainty by addressing specifically the types and scope of disputes an expert will have jurisdiction over, and which disputes otherwise must go to court.

For example, if an accounting expert will only be able to resolve disputes over revenue calculations relating to the earnout but will not have authority to resolve other disputes between the parties, such as whether the buyer used commercial best efforts to run the business, the agreement should state clearly that the expert will be serving as an expert and not an arbitrator.

## Conclusion

With care and precision, earnout provisions can be effective tools and help buyers and sellers agree to a deal value — or account for situations where the future performance of the target is simply uncertain.

Before using an earnout provision, however, the parties need to consider the potential for a later dispute. Many such disputes can be avoided with patience and careful drafting, and thus often there is no need to put off to tomorrow what can be resolved today. ■

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# PRACTICAL VALUATION TIPS: IMPLICATIONS OF THE CONSTANT GROWTH PERPETUITY MODEL FOR CALCULATION OF TERMINAL VALUE

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## Introduction

The Discounted Cash Flow (“DCF”) model is often referred to as the fundamental valuation model and is widely used to value companies and their equity. An important component of the DCF model is the terminal value, also known as continuing value or residual value, that often accounts for 50% or more of the DCF value. A typical approach for estimating the terminal value is the application of the Constant Growth Perpetuity Model. Some practitioners use market multiples as a shortcut for the Constant Growth Perpetuity Model. This article focuses on the constant growth condition required by the application of the Constant Growth Perpetuity Model and its implications for the proper calculation of terminal value in the context of a real-world example.

## The Discounted Cash Flow Model

The value of the firm in the DCF model is equal to the present value of all expected future free cash flows (“FCF”)<sup>1</sup> discounted at the risk-adjusted discount rate,  $r$ . Since a company can have indefinite life, the DCF model discounts a company’s FCF to infinity. The DCF model to measure the value of the firm at the end of period zero,  $V_{F,0}$ , is:<sup>2</sup>

$$V_{F,0} = \frac{FCF_1}{(1+r)^1} + \frac{FCF_2}{(1+r)^2} + \dots + \frac{FCF_\infty}{(1+r)^\infty} = \sum_{t=1}^{\infty} \frac{FCF_t}{(1+r)^t}$$

This model of infinite FCF is implemented by forecasting the company’s FCF for a finite period of  $C$  years, typically 5 to 10 years, and then measuring the terminal value,  $TV_{F,C}$ , as of the end of Year  $C$ :<sup>3</sup>

$$V_{F,0} = \sum_{t=1}^C \frac{FCF_t}{(1+r)^t} + \frac{TV_{F,C}}{(1+r)^C}$$

<sup>1</sup> Free cash flows are the cash flows generated by the company after the collection of its revenues, payment of its expenses, and after making its investments, including investments in working capital. They are the cash flows the company would generate if it was entirely financed with equity. We use the word “free” to describe these cash flows not because they were costless to generate, but because the company is “free” (or able) to distribute these flows to its investors without interfering with the execution of its strategy. Robert W. Holthausen and Mark E. Zmijewski, *Corporate Valuation: Theory, Evidence & Practice*, 2<sup>nd</sup> Ed. (Cambridge Business Publishers, 2020), 11.

<sup>2</sup> Ibid., 12.

<sup>3</sup> Ibid.

## The Discounted Dividend Model

The Discounted Dividend Model (“DDM”) values a company’s stock (as opposed to the value of the entity) under the assumption that the fair value of the stock equals the sum of all future dividends,  $DIV_t$ , discounted back to the present at the risk-adjusted discount rate,  $r$ :<sup>4</sup>

$$V_{E,0} = \frac{DIV_1}{(1+r)^1} + \frac{DIV_2}{(1+r)^2} + \dots + \frac{DIV_\infty}{(1+r)^\infty} = \sum_{t=1}^{\infty} \frac{DIV_t}{(1+r)^t}$$

Similarly, the DDM model can be represented as:<sup>5</sup>

$$V_{E,0} = \sum_{t=1}^C \frac{DIV_t}{(1+r)^t} + \frac{TV_{E,C}}{(1+r)^C}$$

## The Constant Growth Perpetuity Model

A common way to measure a company’s terminal value is to assume the company’s free cash flows grow at a constant rate,  $g$ , after the continuing value date,  $C$ , and that the discount rate remains constant as well. This assumption is called a constant growth perpetuity assumption. As long as the growth rate is constant and less than the constant discount rate, the infinite series present value calculation summarizes to the constant growth perpetuity formula (Gordon Growth Model) that was originally derived for a constant growth dividend series and can be applied to both the DCF and DDM models:<sup>6</sup>

$$TV_{F,C} = FCF_{C+1} \times \frac{1}{(r-g)} = \frac{FCF_{C+1}}{(r-g)}$$

$$TV_{E,C} = DIV_{C+1} \times \frac{1}{(r-g)} = \frac{DIV_{C+1}}{(r-g)}$$

The Constant Growth Perpetuity Model is applied when a company reaches a steady state. In other words, when the company generates constant economic returns on its investments and meets the basic assumptions for the constant growth perpetuity model: expected FCF/dividend in period  $C$  is positive, growth rate is constant, discount rate is constant, the growth rate

<sup>4</sup> Ibid., 226.

<sup>5</sup> Ibid.

<sup>6</sup> Myron J. Gordon, *The Investment, Financing, and Valuation of the Corporation* (Illinois: Richard D. Irwin, 1962); Holthausen and Zmijewski, Chapter 6.1.

is less than the discount rate. A steady state company generates constant economic returns on its investments when:<sup>7</sup>

- Company's existing investments as of the terminal value date earn constant returns.
- Company's new investment is a constant proportion of its free cash flow generated from its existing assets and earns a constant return.
- It is likely that the company's steady state economic rate of return approaches its cost of capital; in other words, little, if any, additional value is created from new investments.

These assumptions do not change the conclusion that the constant growth rate can be negative or zero or positive.

## A Real-World Example: DDM Valuation of a Bank Company

The following is an example of a DDM valuation of a bank stock. The model forecasts bank's net income over a six-year horizon.

<sup>7</sup> Holthausen and Zmijewski, 255.

The bank is required to maintain CET1 ratio<sup>8</sup> of 11.5% and distributes all earnings in excess of the targeted equity capital as a dividend. The cost of equity is 12%. The terminal value is estimated based on a price to earnings (P/E) multiple of 8.0x calculated at the end of Year 5 based on Year 6 net income. Based on these assumptions, the undiscounted DDM value is \$18,134 million or \$11,775 million in present value. Based on 300 million shares, the DDM value per share is \$39.25. The DDM model is presented in Exhibit 1 below.

The estimated terminal value using 8.0x PE multiple is \$10,976 million. Is this a reasonable estimate? Well, let's examine the assumptions implied by the Constant Growth Perpetuity Model. Notice that the company's net income, risk-weighted assets, and capital distribution (dividend) are projected to grow at a constant growth rate of 7.0%, 5.0%, and 7.6%, respectively in Years 5 and 6. Is this an indication of a steady state?

<sup>8</sup> The Common Equity Tier 1 (CET1) ratio is a measure of a bank's capital strength and ability to withstand financial distress. It is calculated as the ratio of core capital to the bank's risk-weighted assets. CFI, "Common Equity Tier 1 (CET1)," <https://corporatefinanceinstitute.com/resources/wealth-management/common-equity-tier-1-cet1/>.

### Exhibit 1: Base DDM Model

(\$ in millions, except per share data)	Formula	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Total
Bank Net Income	[ a ]	\$ 1,200	\$ 1,100	\$ 1,120	\$ 1,198	\$ 1,282	\$ 1,372	
YoY Growth					7.0%	7.0%	7.0%	
Risk-Weighted Assets (RWA)	[ b ]	47,958	48,639	49,241	51,703	54,288	57,003	
YoY Growth					5.0%	5.0%	5.0%	
Target Common Equity Tier 1 (CET1) Ratio	[ c ]	11.5%	11.5%	11.5%	11.5%	11.5%	11.5%	
Required Common Equity	[ d ] = [ b ] x [ c ]	5,515	5,593	5,663	5,946	6,243	6,555	
Beginning of Period Equity	[ e ]	7,500	5,515	5,593	5,663	5,946	6,243	
Plus: Net Income	[ f ] = [ a ]	1,200	1,100	1,120	1,198	1,282	1,372	
Less: Capital Distribution	[ g ] = [ h ] - [ e ] - [ f ]	(3,185)	(1,022)	(1,051)	(915)	(985)	(1,060)	
End of Period Equity	[ h ] = [ d ]	5,515	5,593	5,663	5,946	6,243	6,555	
Capital Distribution (Dividend)	[ i ] = -[ g ]	3,185	1,022	1,051	915	985	1,060	
YoY Growth						7.6%	7.6%	
Terminal Value (TV)	[ j ]					\$10,976		
Capital Distribution (Dividend) incl. TV	[ k ] = [ j ] + [ i ]	\$ 3,185	\$ 1,022	\$ 1,051	\$ 915	\$11,961		\$18,134

### Implied Valuation

#### Assumptions:

Discount Rate (r)	[ l ]	12.0%	DDM Value per Share	[ p ] = [ n ] / [ o ]	\$ 39.25
Terminal PE Multiple	[ m ]	8.0 x			
DDM Value	[ n ] = NPV Sum [ k ]	\$11,775	Implied Perpetual Growth Rate (g)	[ q ]	2.3%
Shares Outstanding (million)	[ o ]	300.0			

Notes: [ j ] — Calculated based on Terminal PE multiple of 8.0x and Year 6 net income of \$1,372. [ j ] = \$1,372 x 8.0 = \$10,976.

[ n ] — Assumes end of the period discounting.

[ q ] — Calculated based on Constant-Growth Perpetuity Model using Year 6 distribution of \$1,060 million, terminal value of \$10,976 million, and 12% discount rate. [ q ] = (10,976 x 12% - 1,060)/10,976 = 2.3%.

Let's examine the perpetual growth rate implied by the estimated terminal value of \$10,976 million. Based on the Year 6 capital distribution of \$1,060 million and the discount rate of 12%, one can calculate the implied perpetual growth rate of 2.3%. While this seems reasonable for a constant growth rate, notice that it is much lower than the observed 7.6% capital distribution growth rate. **This is an indication of likely undervaluation based on a low P/E multiple.**

## Correcting the DDM Valuation: A Steady State Projection

Extending the projections for another year using the constant growth rate of 2.3% such that net income, risk-adjusted assets, and capital distributions (or stated alternatively, the income statement, balance sheet, and cash flow statement) grow at the same steady state constant growth rate results in a normalized

capital distribution of \$1,251 in Year 7 and a terminal value of \$12,951 million at the end of Year 6. Based on these assumptions, the undiscounted DDM value is \$21,168 million or \$12,645 million in present value. Based on 300 million shares, the DDM value per share is \$42.15. Indeed, allowing for the steady state assumptions to hold when using the Constant Growth Perpetual Model, results in higher valuation, \$42.15 vs. \$39.25, and higher implied terminal P/E multiple of 9.2x vs. 8.0x. The revised DDM model is presented below in Exhibit 2.

## Testing the Steady State Projections

Once a company is in a steady state, extending the forecast horizon and adding more years of cash flows to the DDM model does not affect the valuation. To test the revised DDM valuation, we can extend the forecast by another year, Year 8 (Normalized), using the same 2.3% perpetual growth rate.

**Exhibit 2: Revised DDM Model**

(\$ in millions, except per share data)	Formula	Years 1-5	Year 6	Year 7 Normalized	Total
Bank Net Income	[ a ]		\$ 1,372	\$ 1,404	
YoY Growth			7.0%	2.3%	
Risk-Weighted Assets (RWA)	[ b ]		57,003	58,339	
YoY Growth			5.0%	2.3%	
Target Common Equity Tier 1 (CET1) Ratio	[ c ]		11.5%	11.5%	
Required Common Equity	[ d ] = [ b ] x [ c ]		6,555	6,709	
Beginning of Period Equity	[ e ]		6,243	6,555	
Plus: Net Income	[ f ] = [ a ]		1,372	1,404	
Less: Capital Distribution	[ g ] = [ h ] - [ e ] - [ f ]		(1,060)	(1,251)	
End of Period Equity	[ h ] = [ d ]		6,555	6,709	
Capital Distribution (Dividend)	[ i ] = -[ g ]		1,060	1,251	
YoY Growth			7.6%	18.0%	
Terminal Value (TV)	[ j ]		<b>\$12,951</b>		
Capital Distribution (Dividend) incl. TV	[ k ] = [ j ] + [ i ]	7,158	<b>\$14,011</b>		<b>\$21,168</b>
<b>Implied Valuation</b>					
Assumptions:					
Discount Rate (r)	[ l ]		12.0%		
Perpetual Growth Rate (g)	[ m ]		2.3%		
DDM Value	[ n ] = NPV Sum [ k ]		<b>\$12,645</b>		
Shares Outstanding (million)	[ o ]		300.0		
DDM Value per Share	[ p ] = [ n ] / [ o ]		<b>\$42.15</b>		
Implied Terminal PE Multiple	[ q ]		<b>9.2 x</b>		

Notes: [ j ] — Calculated based on Constant-Growth Perpetuity Model using Year 7 (Normalized) distribution of \$1,251 million, 2.3% perpetual growth rate, and 12% discount rate. [ k ] = \$1,251 / (12%-2.3%) = \$12,951  
[ n ] — Assumes end of the period discounting.  
[ q ] — Calculated based on terminal value of \$12,951 million divided by Year 7 (Normalized) net income of \$1,404. [ q ] = 12,951/1,404 = 9.2 x.



Based on the capital distribution of \$1,280 million in Year 8 (Normalized), the new terminal value at the end of Year 7 (Normalized) is \$13,255 million. The undiscounted DDM value is \$22,723 million, which is \$1,554 million higher than the undiscounted DDM value of \$21,168 million using a 7-year horizon. However, the present value DDM valuation remains unchanged at \$12,645 million and so does the per share value of \$42.15.

The extended revised DDM model is presented below in Exhibit 3.

#### ABOUT THE AUTHOR



#### Pavel Nikolov

Charles River Associates (CRA)

Pavel is a Principal at CRA with more than 18 years of experience in litigation support and consulting. He has an extensive background in financial analysis, valuation, solvency, and damages. His litigation and regulatory experience include matters related to fraudulent conveyance, bankruptcy, breach of fiduciary duty, insider trading, theft of trade secrets, alleged misstatements and omissions by management, various business combinations, and post-merger disputes. Pavel has worked with leading testifying and consulting experts. His experience spans many industries, including insurance, financial services, advertising and publishing, aviation transportation, computer hardware, manufacturing, automotive, real estate, travel and entertainment, utilities, private equity, and venture capital.

#### Exhibit 3: Extended Revised DDM Model

(\$ in millions, except per share data)	Formula	Years 1-6	Year 7 Normalized	Year 8 Normalized	Total
Bank Net Income	[ a ]		\$ 1,404	\$ 1,437	
YoY Growth			2.3%	2.3%	
Risk-Weighted Assets (RWA)	[ b ]	No Change	58,339	59,706	
YoY Growth			2.3%	2.3%	
Target Common Equity Tier 1 (CET1) Ratio	[ c ]		11.5%	11.5%	
Required Common Equity	[ d ] = [ b ] x [ c ]		6,709	6,866	
Beginning of Period Equity	[ e ]		6,555	6,709	
Plus: Net Income	[ f ] = [ a ]		1,404	1,437	
Less: Capital Distribution	[ g ] = [ h ] - [ e ] - [ f ]		(1,251)	(1,280)	
End of Period Equity	[ h ] = [ d ]		6,709	6,866	
Capital Distribution (Dividend)	[ i ] = -[ g ]		1,251	1,280	
YoY Growth			18.0%	2.3%	
Terminal Value (TV)	[ j ]		<b>\$ 13,255</b>		
Capital Distribution (Dividend) incl. TV	[ k ] = [ j ] + [ i ]	8,217	<b>\$ 14,505</b>		<b>\$ 22,723</b>

#### Implied Valuation

Assumptions:

Discount Rate (r)	[ l ]	12.0%
Perpetual Growth Rate (g)	[ m ]	2.3%
DDM Value	[ n ] = NPV Sum [ k ]	<b>\$12,645</b>
Shares Outstanding (million)	[ o ]	300.0
DDM Value per Share	[ p ] = [ n ] / [ o ]	<b>\$42.15</b>
Implied Terminal PE Multiple	[ q ]	<b>9.2 x</b>

No  
Change

Notes: [ j ] — Calculated based on Constant-Growth Perpetuity Model using Year 8 (Normalized) distribution of \$1,280 million, 2.3% perpetual growth rate, and 12% discount rate. [ k ] = \$1,280 / (12%-2.3%) = \$13,255.

[ n ] — Assumes end of the period discounting.

[ q ] — Calculated based on terminal value of \$13,255 million divided by Year 8 (Normalized) net income of \$1,437. [ q ] = \$13,255 / 1,437 = 9.2 x.

# 23<sup>RD</sup> ANNUAL ADVANCED RESTRUCTURING & PLAN OF REORGANIZATION CONFERENCE



Over 90 people attended the 23rd Annual Advanced Restructuring and POR Conference on November 18, 2024. We thank CohnReznick for hosting, and the Co-Chairs and Planning Committee for creating an exciting and relevant day.

Jim Lukenda, Executive Director, opened the conference, followed by comments from the Co-Chairs of the conference, Sheryl Guigliano (pictured below), Ruskin Moscou Faltischek, and Boris Steffen, CDBV, Province, and AIRA Board of Directors President-Elect.



The morning began with “The ABCs of ABCs, Receiverships, and Other Bankruptcy Alternatives.” This panel, moderated by Deborah Kovsky-Apap (pictured left), Troutman Pepper, provided an overview of options beyond traditional bankruptcy proceedings, including ABCs and

federal and state receiverships.

The second panel “The Private Credit Market, Structure, Strategies and Valuation,” moderated by Boris Steffen, discussed the structure of the private credit market and how it differs from other debt markets. This issue’s article “The Valuation of Private Debt,” is based in part on this presentation.



Jamie Sprayregen (pictured left), Vice Chairman, Hilco Global and founder of Kirkland and Ellis’ worldwide Restructuring Group, gave the Keynote Presentation at lunch, “Liability Management in the Current Era and at the Dawn of the American Republic.” A self-described history buff, Mr. Sprayregen included a

comparison of liability management today to circumstances just after the American Revolution, over two hundred years ago. As he noted, “there’s nothing new under the sun,” even in finance.

Lunch was sponsored by C Street Advisory Group, LLC and Ruskin Moscou Faltischek. After lunch, Clifford J. White III, Former Director, United States Trustee Program/DOJ moderated a panel, “The Impact of Purdue.”

*AIRA Journal*

Board Member Ira Herman moderated an ethics panel, “What You Must Do When Your Client Lies to You.” The panel had a lively debate over a hypothetical case in which a client had been less than forthcoming with counsel.

The final panel, always a hallmark session of the conference, “2024 - The Year in Review from the Perspectives of Judges and Attorneys,” included Hon. Philip Bentley, Judge, U.S. Bankruptcy Court, SDNY, Hon. Thomas M. Horan, Judge, U.S. Bankruptcy Court, D. Del., and Hon. Michael B. Kaplan, Judge, U.S. Bankruptcy Court, D. N.J. The panelists reviewed the significant decisions of the past year.



The session closed with a cocktail hour, during which the 2024 Judicial Service Award was presented to our honoree the Honorable Robert E. Grossman (pictured left), U.S. Bankruptcy Court, EDNY. Judge Grossman was appointed as a U.S. Bankruptcy Judge for the Eastern District of New York in April 2008, and currently is also serving as a visiting Judge in the Southern

District of New York. He recently announced his retirement from the bench, effective 2025.

The next issue will have articles on some of the conference topics. Conference materials are available at <https://aira.org/conference/event/nypor24/materials>.



*AIRA Board Member Kevin Clancy and Nicole Vecchio, both of CohnReznick, the location sponsor.*

*AIRA Board Member Mike Sullivan, Deloitte, and Jim Lukenda, AIRA Executive Director*



## HARNEY PARTNERS ANNOUNCES LAUNCH OF HARNEY CAPITAL TO PROVIDE INVESTMENT BANKING SOLUTIONS

CHICAGO, IL, Sept. 2, 2024—Harney Partners is pleased to announce the formation of Harney Capital, a national boutique investment banking firm providing comprehensive capital and M&A solutions designed for private and closely-held middle market companies.



Harney Capital is a collaboration inspired by the leaders at Harney Partners, a corporate advisory firm with a 30-year track record, along with 20-year investment banking veteran Eric Welchko (left), who will lead the new firm. While Harney Capital and Harney Partners will operate independently, they will maintain a strategic affiliation to enable shared advisory services and expertise.

“We are thrilled to fill a critical need for middle market companies that are navigating the complex capital market landscape and provide them access to services typically reserved for much larger companies,” said Eric Welchko, President of Harney Capital. “Our strategic affiliation with Harney Partners enables us to provide our clients with seasoned veterans who have spent their careers solving complex corporate finance problems with world-class solutions.”

For more information see: <https://harneycapital.com> and <https://harneypartners.com>.

## J.S. HELD LAUNCHES STRATEGIC ADVISORY PRACTICE WITH ACQUISITION OF STAPLETON GROUP

JERICO, NY, Oct. 10, 2024 – Global consulting firm J.S. Held acquired Stapleton Group and announced the creation of the Strategic Advisory practice. The Stapleton Group acquisition further strengthens J.S. Held’s restructuring capabilities, spanning bankruptcy, receiverships, turnarounds, ABCs, and other financial advisory services.

Founded in 2008, Stapleton Group is a full-service team of fiduciaries, financial advisors, turnaround experts, receivers, chief restructuring officers, and asset managers. The team has earned a strong reputation for helping companies overcome challenging situations, maximizing the recovery of capital for creditors and investors, and helping to resolve disputes between shareholders.

“We look forward to introducing the Stapleton Group experts to our clients, who will find our expanded geographic footprint and service offerings attractive,” noted Senior Managing Director and new practice leader Michael Jacoby.

“The addition of the Stapleton team further strengthens our expertise across many sectors, including agribusiness, real estate, construction, energy and power, manufacturing, retail, telecom,

transportation, and others,” added new J.S. Held President and COO Lee Spirer.

For more information see [www.jsheld.com](http://www.jsheld.com).

## STRETTO ACQUIRES CHAPTER 11 DOCKETS

IRVINE, CA., Oct. 22, 2024 – Stretto has further expanded its comprehensive suite of solutions by acquiring Chapter 11 Dockets, a precedent research database and system designed by corporate restructuring attorneys for corporate restructuring attorneys.

“Stretto remains on the forefront of bringing new efficiencies and solutions to its corporate restructuring clients. We could not be more pleased to bring on board the leading precedent research provider to meet this goal,” stated James Le, Stretto’s President and Chief Operating Officer. “We look forward to combining forces and continuing our shared commitment to serving the corporate bankruptcy community.”

Chapter 11 Dockets provides a full suite of products and services designed specifically for the needs of corporate bankruptcy professionals. The platform currently serves professionals in large Chapter 11 cases. Its research database contains more than 5.5 million pleadings from over 4,000 of the nation’s largest Chapter 11 cases, with a comprehensive catalog of documents dating back to the origination of electronic filing. The platform also provides bankruptcy case filing alerts, custom key bankruptcy event reports, and a daily newsletter of new current reports (Form 8-K filings with Securities and Exchange Commission).

Randall Reese, founder of Chapter 11 Dockets, commented, “As both Chapter 11 Dockets and Stretto were founded by former corporate restructuring attorneys, we share the same vision and dedication to bringing optimized services to industry professionals.”



## SUBMIT MEMBER NEWS OR A PRESS RELEASE

One of AIRA’s objectives is to provide accurate and timely information to apprise members of professional developments, important events, and resources. The AIRA encourages AIRA members and industry professionals to submit Member News and Press Releases for publication in the AIRA Journal.

For more information on how to submit a press release or news item visit [www.aira.org/journal](http://www.aira.org/journal)



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

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