AIRA Journal

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WHAT'S INSIDE

Save the Date

VALCON 2025, May 14-15, 2025, Las Vegas, NV
AIRA's 41st Bankruptcy & Restructuring Conference (BRC)
June 4-7, 2025, Newport Beach, CA

More information on BRC 2025 coming in March 2025 to www.aira.org!

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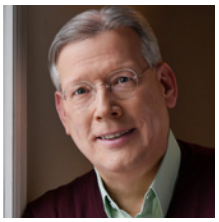
From the Executive Director's Desk



James M. Lukenda, CIRA
AIRA

For two years now, AIRA has been a member of a consortium of professional organizations focused on increasing the scope of the draw to our chosen area of practice. **The Bankruptcy Inclusion, Diversity, Equity, and Accessibility (IDEA) Consortium** is a network of organizations whose purpose is to centralize opportunities and resources offered by the member organizations in an effort to achieve the goal of increasing diversity in the bankruptcy restructuring community. AIRA finds itself in good company with ABA Business Law Section, ABI, American College of Bankruptcy, ACT12, IWIRC, JBTAPO, NABT, NACBA, NACTT, NAFER, NCBJ, TMA, WorkOUT, and until recent events, the Department of Justice, as an ex officio member.

It is astounding that the current political environment has taken a principle – equal access to opportunities – and turned it into a reason not to engage, but rather to terminate the livelihood of individuals acknowledging the fairness and benefits of the concept.

By sharing information, the Consortium seeks to make individuals who may not see themselves currently reflected in the bankruptcy and restructuring community aware of the career opportunities and resources that exist.

The ability of the Consortium to accomplish these goals depends on the participation of the member organizations' own membership. So, how might AIRA members assist?

- Alert your recruiting and HR departments to the Consortium website: www.bankruptcyidea.org and the ability to use the website for hiring.
- Add your firm job openings to the Consortium Job Board (free!) for any job in the bankruptcy and restructuring industry.
- Contribute bankruptcy and restructuring articles or other resource documents to the IDEA website.
- Add your IDEA and other relevant events to the Consortium calendar.
- Search for subject matter experts in the Consortium Speaker Network database.

One of the Consortium's Access and Careers Committee projects is the production of vignettes under the title: *What It's Like to Be an Insolvency Professional*. On the Career page of the Consortium website, men and women from the various member organizations speak to their experience as insolvency professionals. Speaking for AIRA and from the financial advisor's perspective is **Kirsten Turnbull, CIRA**, a senior vice president at Alix Partners. My thanks go out to Kirsten and **AIRA board member and Distinguished Fellow, Denise Lorenzo, CIRA,** for arranging Kirsten's participation. A second phase of vignettes is under production for insolvency professionals to discuss tips on preparing for and interviewing for jobs in the profession. **Abhi Gupta, CIRA**, a Huron managing director, and **Cathy Shi**, a director with EY-Parthenon, are participating for AIRA in this effort. Again, my thanks to them.

Our organizations are looking for the next generation of participants and leaders. Participating in the Consortium's efforts can be an effective way to reach those communities ignored or excluded in the past.

Once again, a collection of informative and well edited articles follows. Please read, enjoy, and learn.

– Jim

IDEA
the Bankruptcy
INCLUSION, DIVERSITY, EQUITY & ACCESSIBILITY
consortium

AlixPartners CIRA Awards

Each year, AIRA recognizes the CIRA candidates who attained the highest cumulative scores on the CIRA exams. Since 2018, the CIRA Awards have been sponsored by AlixPartners.

At AIRA's annual meeting in June, in Newport Beach, CA, we will honor these individuals who attained the highest cumulative scores in 2024:

CONGRATULATIONS

1st Freda (Qifei) Yuan, *AlixPartners, LLP*

2nd Zachary Brant, *Ankura Consulting LLC*

3rd Warren Su, *Alvarez & Marsal*

AIRA
Distinguished Fellows Program

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

Purpose of Distinguished Fellows Program

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

Nomination Process

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

- Submission of completed forms by any AIRA member, and
- Approval by AIRA's Board of Directors.

AIRA members who meet the following criteria are eligible to be nominated. At the time of nomination, a nominee must:

- Be an AIRA member in good standing for at least 10 years, and
- Have made contributions to the art and science of corporate restructuring and to the AIRA that may be deemed outstanding by AIRA's Board of Directors.

Recognition of Fellows

Upon approval, new Distinguished Fellows will be inducted at the AIRA Annual Conference or at AIRA's New York Plan of Reorganization Conference, and their designation will be included on AIRA's website.

Additional information about AIRA's Distinguished Fellows Program and nomination forms are available at www.aira.org.

ARTIFICIAL INTELLIGENCE – A PRIMER

Hoyoung Pak, Angela Zutavern, Catherine Brien, Luca Ridolfi, and Greg Adams

AlixPartners, LLP

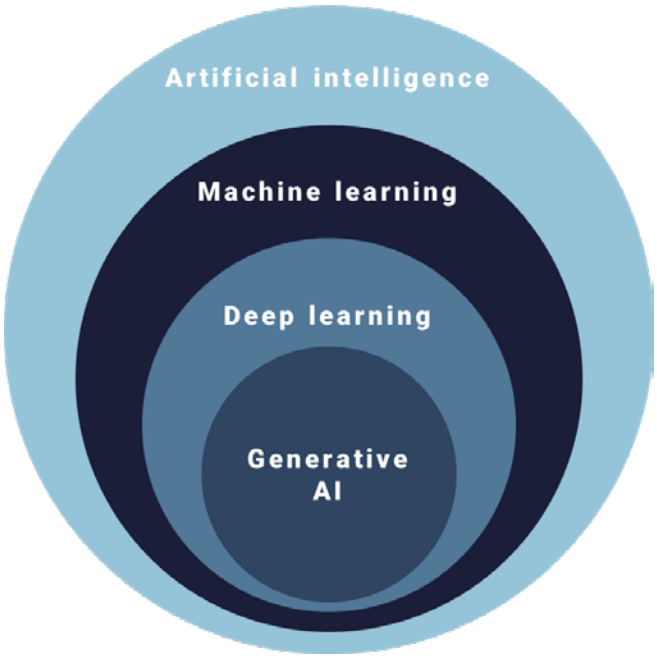
Understanding how AI works can no longer reside solely with the tech team.

AI is profoundly reshaping the very fabric of business operations and competition. These technologies offer unprecedented opportunities for optimizing efficiency, fostering innovation, and driving sustainable growth.

Today, it's a strategic imperative for CEOs and other senior leaders to fully grasp the terminology, the attributes, and how the technologies work together. This is the only way to make the right investments, ask the right questions, and ultimately unlock AI's full potential for the organization.

While many technical explanations on AI exist, we are sharing our answers to the most common questions we get asked by C-suite executives to help you understand the technology in practical business terms.

What is artificial intelligence (AI), and how do machine learning (ML), neural networks, deep learning (DL), and generative AI (GenAI) relate to it?



Artificial intelligence (AI) is an umbrella term, dating back to 1956 and referring to machines capable of performing tasks that typically require human intelligence, encompassing all the other technologies in this primer.

Machine learning (ML) is a subset of AI that focuses on creating algorithms and models that enable computers to learn and improve their performance on a specific task without being explicitly programmed. These models are trained on large datasets, allowing them to identify patterns, make predictions, or take actions based on the input data.

Neural networks are a type of machine learning model that can automatically learn and extract complex patterns from raw data. They consist of interconnected layers that transform the input data, allowing the network to learn increasingly abstract and sophisticated features. Traditional machine learning algorithms require carefully structuring and specifying the features used to train the models; neural networks, on the other hand, demand less from how features are structured in the data but generally require more data and intensive processing.

Deep learning (DL) is a further specialization within ML, utilizing neural networks with many layers (hence "deep") to find patterns in vast volumes of data. DL is computationally intensive, typically running on expensive graphical processors (GPUs), and is useful for computer vision (detecting and classifying objects in images) and natural language processing.

Generative AI (GenAI) uses both ML and DL to create content – such as text, images, videos, and music – that resembles human-generated content. It learns from a vast dataset of existing content to generate new, original creations.

What is the difference between ML and the traditional approach to building models?

In traditional statistical models, experts explicitly specify the functional relationship between features and the target being predicted or explained. A traditional model is expressed as an equation, such as yi = a + b*xi + errori, and algorithms will calculate values for the parameters, in this case a and b, that satisfy an objective, such as minimizing the total error from the model.

Traditional Model	Machine Learning Model
Example output	
Equation, such as: Spend = $212 + 0.13 * Age	Complex instructions, such as: Spend = *{$15 when age < 0; $17 when age >0 & age < 1.5;...; $355 when age > 98;}*
Virtues	
Easily implemented in spreadsheets or simple code Easier to interpret	Excellent predictive powers
Drawbacks	
Lower predictive power Sensitivity to model specification, requiring modeler to have statistical and subject matter expertise	Larger data requirements Need computer scripts to generate new predictions "Black box" complex instruction set makes interpretation difficult

By contrast, machine learning models do not require specifying the precise functional relationship between features and the target being predicted. Instead of a simple statistical equation, a machine learning model produces a complex set of instructions yielding specific predictions for y depending on values or ranges of values for x.

Traditional models are more constrained but generally require less data. And because the output is an equation, traditional models can often generate predictions in a spreadsheet or a single line of computer code. Machine learning models, on the other hand, require larger volumes of data. ML models tend to produce more accurate predictions than traditional statistical models, but the model is expressed in hundreds or thousands of lines of computational instructions, which cannot be easily interpreted by humans or expressed in a spreadsheet.

How can ML and GenAI drive business value?

ML and GenAI can drive business value in several ways:

Automation and efficiency: ML algorithms can automate complex, time-consuming tasks, from data entry and analysis to customer service inquiries, increasing operational efficiency and reducing costs.

Improved decision making: By analyzing vast amounts of data, ML models can uncover insights and patterns not easily visible to humans, supporting better business decisions. Predictive analytics can spot and even forecast market trends, customer behavior, and potential risks, allowing companies to act proactively rather than reactively. These insights can help businesses optimize inventory, allocate resources, and make proactive decisions.

Personalization at scale: ML and GenAI enable businesses to offer personalized experiences to customers by analyzing their behavior and preferences. This can range from personalized marketing messages to customized product recommendations, improving customer satisfaction, loyalty, and lifetime value.

Innovation and new products/services: GenAI can generate new ideas and designs, from creating new product concepts to optimizing existing ones. For example, it can simulate how a new product might perform or generate creative marketing content, speeding up the innovation process.

Fraud detection and risk management: ML algorithms can identify patterns and anomalies in data that may indicate fraudulent activities or potential risks. This can help businesses mitigate financial losses, protect customer data, and maintain regulatory compliance.

By leveraging ML and GenAI to drive automation, improve decision-making, enhance customer experiences, innovate, predict future trends, and manage risks, businesses can gain a competitive edge, optimize operations, and unlock new growth opportunities.

Senior leaders play an important role here, which is to ensure that AI projects align with a company's value proposition and advance its strategy. A low-cost producer will want to emphasize automation and efficiency; a company whose value proposition centers on customer experience will have different priorities and should pursue different projects.

The primary tasks of ML can be broadly categorized into several key areas, each with distinct applications that drive business value:

Clustering: Grouping data points based on similarities. Businesses use clustering for market segmentation, targeting marketing efforts more effectively, or identifying patterns in customer behavior.

Classification: Predicting a discrete outcome or state, such as purchasing or contracting {purchase, no purchase}, churning {churn, no churn}, outcome {success, fail} or performance group {high, medium, low}.

Regression: Predicting continuous values. Regression analyses can forecast sales, demand, inventory levels, and market trends, enabling better resource planning and market positioning.

What are the primary tasks of ML, and how do they apply to business operations?

	 Clustering	 Classification	 Regression	 Anomaly detection	 Natural language processing
Objective	**Group similar items**	**Determine propensities**	**Predict outcome of a continuous variable**	**Find outliers**	**Translate/process language**
Business applications	Customer segmentation	Customer acquisition/retention	Price optimization	Predictive maintenance	Reputation monitoring
	Employee segmentation	Labor productivity and automation	Financial/ demand forecasting	Fraud detection	Sentiment analysis
	Store segmentation	Lead scoring	Cash forecasting	Quality control	Language translation
	Product segmentation	Credit risk assessment	Energy consumption forecasting	Cybersecurity threat detection	ChatGPT

Anomaly detection: Identifying unusual data points. This task is vital for fraud detection in financial transactions, network security, and monitoring industrial equipment or processes for unusual patterns that could indicate problems.

Natural language processing (NLP): Understanding, interpreting, and generating human language. NLP applications include chatbots for customer service, sentiment analysis to gauge customer satisfaction, and automated content creation or summarization.

Other tasks include:

Recommendation systems: Suggesting items users might like based on their history or similar users' actions. This is crucial for personalized marketing, improving customer engagement, and increasing sales through targeted recommendations.

Computer vision: Interpreting visual information, including facial recognition. In business, computer vision is used for quality control in manufacturing, retail analytics through customer movement tracking, and healthcare for diagnostic imaging analysis.

Content creation: GenAI can generate text, images, videos, and music that mimic human-like creativity. Businesses use this capability for creating marketing content, developing new product designs, or generating stock images and videos, significantly reducing the time and cost associated with traditional content creation.

Data synthesis: GenAI can create synthetic data sets that mirror real-world data, which is invaluable for training ML models where actual data may be scarce or sensitive. This is particularly useful in fields like healthcare for research and development without compromising patient privacy.

Personalization at scale: By generating content tailored to individual preferences, GenAI can personalize marketing messages, product recommendations, or even customize products and services for each customer, enhancing the customer experience and engagement.

Automation of creative processes: From drafting emails to writing code or automating the design of digital and physical products, GenAI streamlines creative processes.

Simulation and modeling: GenAI can generate realistic scenarios and simulations, useful for training, forecasting, and decision-making. Businesses can simulate different outcomes to aid in strategic planning.

Interactive customer service: With the ability to understand and generate human-like responses, GenAI can power chatbots and virtual assistants, providing personalized customer support, enhancing satisfaction, and reducing operational costs.

When is AI not the best tool for the job?

While AI can be a powerful tool in various business contexts, there are situations where it may not be the best choice. Here are a few examples:

Small datasets: AI, particularly machine learning, relies on large amounts of quality data to train models effectively. If the business problem involves a small dataset, traditional statistical methods or human expertise might be more appropriate.

Interpretability and transparency: Some AI models, such as deep neural networks, can be complex and operate as "black boxes." If the business requires clear explanations for decision-making processes, such as in legal or medical contexts, AI models that lack interpretability may not be suitable.

What are the core capabilities of GenAI, and how do they apply to business applications?

GenAI capabilities	Description
Comprehension	**Understand and interpret** information from various sources (text, code, images, data)
Analysis	**Analyze** data to identify patterns, trends, relationships in data
Synthesis	**Integrate information and insights** from various sources to form a perspective
Creation (including personalization)	**Generate tailored content, recommendations, visualizations** - including personalized message/offerings
Recommendation	**Provide actionable advice, strategies, or decision options** based on insights from previous stages
Interaction	**Communicate with users to refine and adapt insights and recommendations**

High-stakes decisions: When decisions have significant consequences, such as in life-or-death situations or major financial investments, relying solely on AI might not be advisable. Human oversight, expertise, and judgment should be involved to ensure responsible and ethical decision-making.

Creative and subjective tasks: AI excels at pattern recognition and automation but may struggle with tasks that require creativity, emotional intelligence, or subjective judgment. For example, while AI can assist in generating ideas or providing insights, tasks like developing marketing strategies, product design, or managing complex human relationships often benefit from human intuition and creativity.

Insufficient ROI: Implementing AI solutions can be resource-intensive, requiring investments in data collection, infrastructure, and talent. If the expected benefits do not justify the costs, or if alternative solutions can achieve similar results more efficiently, AI may not be the best choice.

What are the different ways that ML algorithms learn?

ML learns in two basic ways:

1. In **"supervised learning,"** the goal is to make accurate predictions or decisions, and each model can be assessed by its accuracy. For instance, predicting next quarter's revenue, or how many units will be sold next week, or whether particular individuals will make a purchase in the next month are all tasks for supervised learning.

2. In **"unsupervised learning,"** the goal is typically to find descriptive patterns in the data. Unsupervised learning is less about accuracy or being right and more about generating useful, sensible results. A common unsupervised learning task is to group similar observations, such as in customer segmentation models, market basket analysis, or mapping employees into common work functions.

There are variations and hybrids. One interesting hybrid is "reinforcement learning" where the algorithm, or agent, learns to make decisions by performing actions and receiving feedback in the form of rewards or penalties. Through an iterative trial and error process, the algorithm gets progressively better at obtaining rewards.

Why do people say that AI is a "black box"? And should I be worried about it?

The "black box" nature of ML and GenAI refers to the difficulty in understanding how these models make decisions or generate outputs, due to their complex and often opaque algorithms. This can pose challenges in terms of trust, accountability, and compliance.

To address this, there is a growing field of explainable AI (XAI) that aims to make the decision-making processes of AI systems more transparent and understandable. Additionally, collaboration between data scientists and business leaders can help in developing clearer guidelines and explanations for AI behaviors. Regularly reviewing and auditing AI models for fairness, bias, and accuracy also contributes to demystifying the black box, ensuring responsible and ethical AI use.

What are the ethical considerations in using ML and GenAI, and how can businesses address them?

Ethical considerations in using ML and GenAI span several key areas, reflecting the importance of responsible development and deployment:

Bias and fairness: ML algorithms can perpetuate biases present in their training data, leading to unfair outcomes. Businesses must ensure diverse data sets and regularly audit algorithms for bias, adjusting as necessary.

Transparency and explainability: The "black box" nature of some ML and GenAI systems can obscure how decisions are made, challenging accountability. Promoting transparency and developing explainable AI systems helps stakeholders understand and trust AI-driven decisions.

Privacy: ML and GenAI often require vast amounts of data, raising concerns about data privacy and security. Implementing robust data protection measures and adhering to privacy regulations are essential for maintaining user trust.

Security: AI systems can be targets for malicious attacks, potentially leading to the manipulation of algorithm behavior. Strengthening security protocols and regularly assessing vulnerabilities are crucial to safeguarding these technologies.

Intellectual property: With GenAI's ability to generate content, questions arise about copyright and ownership. Developing policies that respect intellectual property rights while encouraging innovation is important.

Addressing these ethical considerations involves a multidisciplinary approach, incorporating legal, technical, and ethical expertise. By proactively engaging with these issues, businesses can lead in the responsible use of ML and GenAI, fostering trust and promoting a positive societal impact.

ABOUT THE AUTHORS

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Hoyoung is the Global Co-Leader of the AI & Data Practice Group at AlixPartners. He has extensive experience in both management consulting and industry executive roles, applying AI to the Private Equity, Consumer, Retail, and TMT industries. He has extensive experience leveraging AI/ML to enhance decision-making and capture value through growth and cost reduction initiatives. Prior to joining AlixPartners, Hoyoung was Chief Operating Officer (COO) at a global design and packaging graphics firm. There, he drove an enterprise-wide transformation using a combination of process improvement and AI/ML.

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Greg is a Partner in the Detroit office of AlixPartners. He helps clients grow by developing and administering AI & machine learning solutions. As a recognized machine learning expert with over 20 years' experience, Greg builds and implements practical AI solutions that result in immediate ROI. Greg has extensive experience in AI-based pricing algorithms; customer lifetime value (CLV); propensity models for customer retention, engagement, and acquisition; clustering and segmentation; product recommendation engines; forecasting; survival analyses; anomaly detection; multi-armed bandit testing; propensity score matching; and conjoint analysis.

WHY CUSTOMIZATION IS KEY TO SOLVING GENERATIVE ARTIFICIAL INTELLIGENCE HALLUCINATIONS

Craig Muir
Solomon Partners

The Future of Human Interaction with Technology

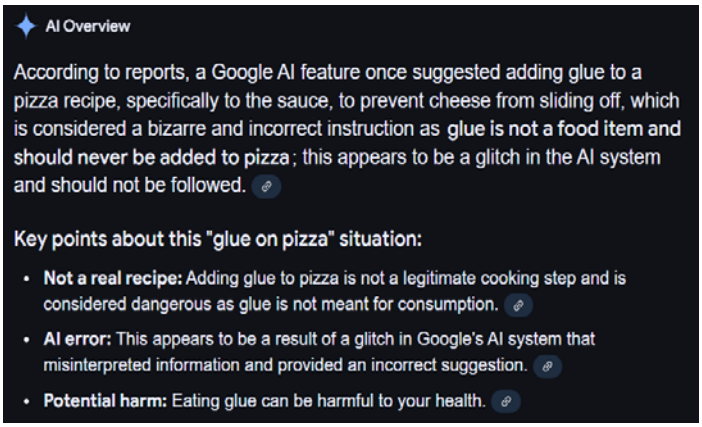
Generative AI is a fast-evolving artificial intelligence technology capable of producing a variety of new content, including code, images, music, text, and more. Generative AI models, whether in the form of AI-generated search results or chatbots that converse fluently with users, will continue to alter how we interact with technology.

However, as those systems become more pervasive, their limitations are increasingly obvious, particularly when they are called upon to answer queries in specialized domains. Examples can be found across generative AI models, including errors in Google's AI Overviews as well as inaccuracies encountered by businesses using ChatGPT.

The Inherent Flaws of Generalized AI Models

Google's AI Overviews, a feature designed to offer concise summaries of search results, has been a prime example of how even cutting-edge AI can falter. Users have reported baffling outputs, such as advice to add glue to pizza recipes or inaccuracies regarding historical figures like President Andrew Johnson.

Google's Correction to the "Glue on Pizza" Situation



These errors reveal a fundamental issue with large language models: they are optimized to predict the next word in a sequence, not to validate the accuracy of the information they provide. Despite using techniques like Retrieval-Augmented Generation ("RAG"), which allows the AI to consult external sources of specialized data, mistakes still occur when the system misinterprets or combines data from conflicting sources. The same pattern emerges in other fields.

The Wall Street Journal describes how organizations, from the PGA Tour to agricultural firms, have encountered similar issues.[1] While AI models may be trained on vast amounts of general data, they often fail when faced with domain-specific questions. In one notable example, ChatGPT confused Tiger Woods' 15 major wins with his 82 PGA Tour victories—a significant error for anyone familiar with golf.

The Role of Retrieval-Augmented Generation

Generative AI users across sectors have turned to RAG to mitigate such errors. The RAG technique enhances generative AI models by allowing them to pull in authoritative information from specialized databases or documents before generating responses. In theory, this should make the models more accurate, yet, as these examples show, RAG can still fail.

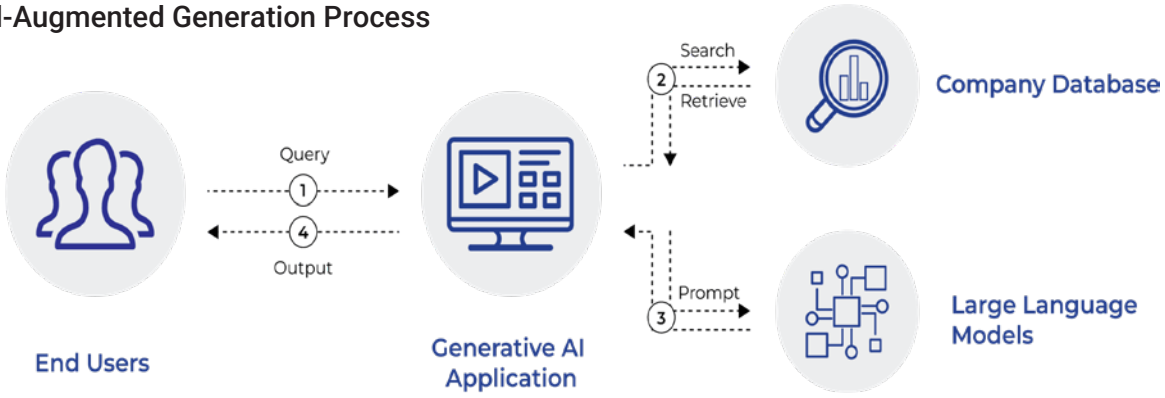
In the case of Google's glue-laden pizza recipe, the AI retrieved data from a joke post that was deemed relevant by the system but clearly was not correct. *The Wall Street Journal* describes how RAG is being used by various industries, including agriculture and finance, to improve AI performance. However, while RAG can increase accuracy by 20%-40%, it is far from perfect. The approach requires high-quality, domain-specific data, and even then, it is not immune to generating errors.

Customization Is Critical

Given these challenges, businesses are increasingly realizing that off-the-shelf AI models are not enough. To achieve higher accuracy, many companies are fine-tuning or custom-building models with their own proprietary data. For instance, the PGA Tour has begun incorporating a 190-page rulebook into its AI systems to ensure that the model understands the nuances of the sport. This approach allows AI to move beyond generalization and deliver more contextually relevant responses.

[1] Ryan Knutson, "AI Doesn't Know Much About Golf, or Farming, or Mortgages," Wall Street Journal, Dec. 14, 2024.

Retrieval-Augmented Generation Process



However, fine-tuning is not a simple fix. It requires significant investment, in terms of both financial resources and specialized talent. Even then, these models may still fall short of complete accuracy, particularly in high-stakes fields like agriculture or legal services, where a small mistake could have significant repercussions.

Conclusion

The key to the future lies in striking a balance between generalization and specificity. While generalized models like ChatGPT work well for general conversations and information gathering, they are still inadequate for serious, domain-specific questions. As businesses and technology firms figure out these limitations, several paths forward seem to be emerging: using RAG for higher levels of accuracy, fine-tuning existing models with more specialized data, and, in some cases, even building custom models from scratch. With these, the price of customization can be high, but for industries in need of precision and reliability, it might be the only way to make sure AI delivers on its promise. As AI continues to improve, so too will demand increase for more tailored and precise systems, furthering the bounds of what these models can do.

ABOUT THE AUTHOR

Craig Muir
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Craig Muir is a Partner and Head of Software, Data & Analytics in the Technology group at Solomon Partners, an investment bank headquartered in New York City. Craig has over two decades of corporate finance experience, and has advised on critical sell-side, buyside, capital raises, strategic partnerships, and other transactions. Prior to joining Solomon Partners, he was a Managing Director in the Technology group at Houlihan Lokey and a member of the Data & Analytics team. Prior to that, Craig Muir was a Managing Director at Quayle Munro where he was instrumental in developing their Technology practice.

GEN AI Applications for Bankruptcy Cases and Court Documents

Stretto is applying AI to the world of corporate bankruptcy with Stretto Conductor, an AI-powered platform designed specifically for bankruptcy case management and communications.

Stretto Conductor uses retrieval-augmented generation ("RAG") technology specifically engineered for the complexities of bankruptcy law. Stretto's AI platform overcomes common challenges associated with AI platforms including:

- Naive retrieval: Traditional AI systems often struggle to understand the nuanced context of legal documents, returning irrelevant results based on simple keyword matching. Stretto Conductor employs advanced contextual understanding to deliver precisely relevant information.
- Inapplicable authority: Many AI platforms cannot distinguish between controlling and non-controlling legal precedents or differentiate between jurisdictions. Stretto Conductor is trained to recognize and prioritize relevant jurisdictional authority and current precedents, filtering out inapplicable citations.
- Reasoning errors: Stretto Conductor's specialized legal reasoning framework ensures accurate interpretation of bankruptcy concepts and relationships between parties, claims, and proceedings.

Stretto Conductor's capabilities include:

- Real-time retrieval, analysis, and summarization of complex legal documents, across all judicial districts. Unlike traditional databases that simply store and retrieve documents, Conductor actively analyzes relationships between filings, identifies key legal arguments, and provides intelligent summaries of complex procedural histories.
- Automated citation generation links responses to the specific location(s) within the responsive pleading(s) and relevant bankruptcy rules, ensuring response verifiability, addressing a common criticism of AI legal tools that can generate "hallucinated" case citations or precedents.
- Secure document-handling processes only non-redacted filed documents. The platform automatically identifies and excludes sensitive redacted information, ensuring compliance with privacy requirements while maintaining the integrity of public record analysis.

OPERATIONAL RESTRUCTURING: A STRATEGIC IMPERATIVE

Rani Bou Hamdan and Karim Labban
Ankura

Introduction

In today's rapidly evolving economic landscape, businesses are navigating challenging shifts in the operating environment. From geopolitical tensions and the resultant supply chain disruptions to technological advancement and sustainability agendas, these market dynamics have exposed underlying vulnerabilities of certain companies, pressing the need for a strategic response to ensure business continuity.

To effectively address these challenges, managers must embrace a holistic approach to business restructuring. At the heart of successful restructuring lie two pivotal aspects: financial and operational.

Financial restructuring is primarily concerned with stabilizing the company's financial position ("fixing the balance sheet") and recapitalizing the business.

However, this alone is not sufficient for continued success. ***Operational restructuring,*** the focal point of this article, is equally crucial as it involves "fixing the P&L" to drive sustained business recovery and growth.

From Quick Wins to Lasting Change: The Roadmap for Operational Restructuring

As businesses grapple with these complex challenges in the operating environment, a well-structured roadmap becomes indispensable.

In the short to medium term, the focus is on designing a turnaround plan with clearly defined performance improvement initiatives that deliver quick wins, before stabilizing operations. The core question then becomes identifying which turnaround initiatives should be prioritized, and which ones offer the highest return on investment, considering direct and indirect benefits, as well as ripple effects on the wider business. The operational turnaround plan should be examined through a financial lens to enable informed decision-making. A cost-benefit analysis is thus essential for informed decision-making and strategic clarity; without financial alignment, the company risks running blind.

These tactical changes provide companies with the necessary breathing space to reassess and realign business objectives. However, true resilience and growth require embracing a longer-term vision. This involves embarking on an operational transformation journey, that is, implementing strategic shifts that fundamentally alter how a business operates. These changes are designed for sustained performance improvement, ensuring that the organization is agile and adaptable. Whether it is redesigning business models or adopting new technologies, strategic initiatives are integral to fostering a culture of continuous improvement and building a long-lasting competitive advantage.

Strategic Pillars for Effective Operational Restructuring

"Increase revenue and cut cost!"

In today's highly competitive business environment, the mantra "increase revenue and cut cost," often the subject of consulting humor, is more intricate than it appears.

Thriving amidst economic challenges may require businesses to embark on a dual journey simultaneously — growing revenue and optimizing cost. This requires rethinking:

- ***The value proposition*** of the company, that is, whether the business is still creating value and thus able to sustain and grow revenue, in light of changing market dynamics; and
- ***The modus operandi*** or the way the business operates, that is, whether the cost structure is optimized to be commensurate with revenue levels.

Revenue Growth

In substance, this requires ensuring that the underlying business model remains robust considering the prevailing market dynamics, to grow sales value. Without a viable business model, companies cannot survive, let alone thrive in the competitive landscape. An understanding of customer needs within each of the target markets is

required for the products or services to meet those needs effectively.

As such, a market assessment is essential for companies aiming to expand geographically, tap into new customer segments, or diversify their product base. Growth can be achieved through upselling and/or cross-selling to existing customers by diversifying the product base, or by selling existing products to a new customer base.

Management must consider key questions to make this vision a reality: How will this growth be achieved — can the company accomplish this independently, or are strategic partnerships needed?

Price optimization is another essential element when exploring revenue growth opportunities. By employing dynamic pricing strategies that adjust based on market demand, competitor actions, and customer behavior, companies can maximize revenue potential. Value-based pricing for instance, which aligns prices with the perceived value to customers and their "willingness to buy," can also enhance profitability and strengthen customer relationships.

That said, developing growth strategies involves not only redesigning routes to market but also aligning the operating model to achieve the vision and realize growth.

Cost Optimization

The art of doing more with less revolves around the operating model and involves implementing lean management techniques for companies to streamline operations and optimize cost bases. This is typically done through agile utilization of the main resources that drive cost, including capital and human.

Capital optimization involves strategic management of fixed assets, machinery, and equipment to enhance operational flexibility and efficiency. For capital-intensive businesses, the degree of operating leverage is impacted by the business's ability to operate an "asset-light" model, without compromising operational requirements.

When it comes to human resources, a multi-disciplinary workforce may be essential for fostering innovation. It has become increasingly evident that the calibre of a company's management team is likely to determine whether this company could become a market leader.

Furthermore, departments are being redesigned and job descriptions revamped to create leaner organizational frameworks. Today, organizations are developing operational excellence and centralized management functions with company-wide oversight, which not only optimize the workforce but also enhance employee visibility and reduce the prevalence of a "siloed culture."

Operational Efficiency and Financial Resilience

Once key performance drivers (e.g., revenue and cost) are established, management should focus on examining the surrounding operational processes to improve efficiencies. Streamlining business operations across key functions such as sales, procurement, and supply chain management, while instituting appropriate governance structures, is crucial for success.

Addressing structural cash flow management issues is another critical focus area. Improving cash cycle efficiency by optimizing working capital will bolster overall liquidity resilience, reduce funding needs, and provide a framework for sustained cash flow improvements.

The integration of modern technology also plays a pivotal role in this process — by embracing automation and implementing digital tools for workflow automation, data analytics, and real-time reporting, businesses can significantly enhance their operational processes.

That said, operational efficiency processes should move away from lengthy, cumbersome manuals. Instead, they should be customized to align with the company's size, culture, and workforce, and the complexity of its products and services. These processes need to be practical and user-friendly, designed with the understanding that they are meant for people to use. Thorough training ensures staff can effectively implement these processes. Additionally, these processes should be tested in practice (e.g., through project pilots), not just documented, to ensure they are functional and effective.

Common Challenges and Pitfalls

Operational restructurings can be fraught with challenges that can impede progress if not addressed effectively.

Strategic Alignment Among Stakeholders

From shareholders to CEOs, management teams, private equity investors, boards of directors, key creditors, and others, the stakeholders driving or wanting operational restructuring can be many.

The complexity arises due to the diverse agendas, interests, and objectives that each stakeholder group brings to the table.

Depending on the stakeholder group and the situation at hand, the objectives might vary:

Given these varied priorities, the restructuring process must establish clear objectives that are adequately communicated to and aligned with all stakeholders. A well-defined restructuring program should incorporate a strategic roadmap that outlines the steps to achieve these objectives, alongside a responsibility matrix that assigns clear roles and responsibilities. This roadmap should be robust enough to withstand potential pulls in different directions by various stakeholders, ensuring that all parties work towards a common goal.

Effective governance structures, such as steering committees or advisory boards, can facilitate this alignment by providing a forum for stakeholders to voice their concerns, agree on differences, and reach a consensus.

Regular updates and transparent communication are crucial in maintaining stakeholder alignment and ensuring that the restructuring stays on track.

Understanding Resistance to Change at Different Organizational Levels

One of the most prevalent obstacles is resistance to change from within the organization — this manifests itself differently among employees, top management, and business owners.

For ***employees,*** resistance often stems from fear of the unknown and potential job insecurity. Restructuring can be perceived as a threat to their current roles. Thus, it is crucial to communicate clearly and consistently the

importance of an operational restructuring. Employees need to understand the bigger picture and how the changes will ultimately benefit the organization as a whole and secure their future roles. Providing reassurances and support, such as retraining or upskilling opportunities, can help alleviate fears and build confidence in the transition.

Top management, on the other hand, may resist restructuring due to concerns about disrupting established processes and potential shifts in power dynamics. They might be comfortable with the status quo and skeptical about the need for change. Overcoming this resistance involves engaging top management early in the process, including them in the planning and decision-making stages to foster ownership and buy-in. Communicating a clear vision and demonstrating how the restructuring aligns with strategic goals can help mitigate their concerns and highlight the benefits of change.

Finally, resistance from ***business owners,*** particularly those of family businesses, can be around attachment to traditional practices and emotional ties to the business, making them wary of change. For instance, owners of rapidly growing family businesses often hesitate to delegate authority, continuing to manage their operations like a small, traditional family-run shop. It is important to emphasize the necessity of evolution for long-term success and sustainability. Engaging owners in discussions about the future vision of the company and how restructuring can help achieve these goals can be persuasive. Additionally, acknowledging their emotional ties and respecting their legacy while explaining how changes can enhance the business for future generations can mitigate this resistance.

Throughout the restructuring process, it is vital to implement changes in a coordinated manner, reassuring yet firm, with a clear vision. While it is essential to strive for alignment and consensus among key stakeholders, it is also important to admit that not everyone will be on board. Recognizing that some resistance is inevitable and can even be a necessary part of the change process helps maintain momentum and keeps focus on achieving the main objectives of the restructuring.

Conclusion

In a world rife with changing market dynamics, geopolitical tensions, supply chain disruptions, and technological advancements, operational restructuring becomes a strategic imperative, especially for businesses showing signs of underperformance.

Short-term restructuring efforts should prioritize quick wins through turnaround initiatives, while long-term success depends on operational transformation. That said, this success hinges on a holistic approach that blends financial acumen with operational expertise to secure long-term business stability.

The first step is to redefine performance drivers and rethink the operating model required to deliver the value proposition. It is, however, equally important to streamline business processes that improve efficiencies, including cash management and modern technology integration.

Yet, this journey is fraught with challenges, from diverse stakeholder agendas to resistance from within the organization. It is crucial to establish strategic alignment among stakeholders, ensuring that all parties work towards common goals despite different priorities. Furthermore, implementing changes in a coordinated manner across the organization can help mitigate resistance and maintain momentum.

Ultimately, the goal is to align operational changes with strategic objectives, ensuring agility, profitability, and value creation in a constantly evolving operating environment.

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EMPLOYEE-RELATED LIABILITIES IN RESTRUCTURING

Mike Harmon

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This article is an excerpt from Chapter 9. The chapter discusses nondebt liabilities including tort claims. This article is limited to a discussion of employee-related claims due to space constraints.

> *"You can't hit what you can't see."*
>
> —Walter Johnson, Professional Baseball Pitcher

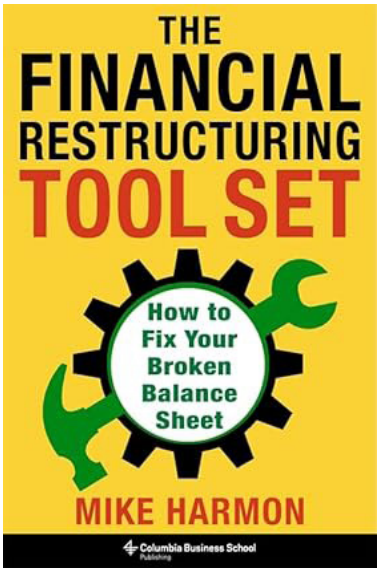
Financial restructuring for a distressed firm involves significantly altering, replacing, or terminating the firm's key financial contracts for the purpose of rehabilitation. Most of these contracts typically relate to debt obligations for which the claim values are known to the firm and each of its counterparties who are involved in the restructuring process. However, a firm may also have significant nondebt claims to contend with, including employee-related liabilities related to defined-benefit pension obligations and retirement benefits. Restructuring these types of claims may be challenging. Unlike debt-related obligations, post-retirement claims are often accrued and contingent, meaning that the values of these claims may not be known at the time of the proposed restructuring plan.

Restructuring transactions involving these types of claims have become highly controversial—for good reason. When a financial institution provides a lot of risky debt to a company, it does so with full knowledge and understanding that there is a reasonable chance of future loss. It has chosen to put itself in that position. In contrast, when a company's employees spend years working with no control or choice over their employer's financial condition, they have every right to expect that their company will honor its pension and post-retirement medical obligations.

That said, the news media does not always get it right when it assesses bankruptcy settlements involving these types of claims. The oft-portrayed perception is that if the claimants have been impaired, and the "evil corporation" is allowed to survive, that this must represent injustice. Some of these assertions are justified, but from a claimant's perspective, the real question is whether their recovery has been maximized by a particular transaction relative to other realistic alternatives. The key is to recognize that a company can only give to its creditors 100 percent of its value, dead or alive. As it pertains to the enterprise itself, financial restructuring on the right side of a company's balance sheet can create more value on the left side. In essence, it can create more enterprise value—a bigger pie—which is available to be distributed to all stakeholders, including employees. If the company is worth more alive than dead, and if it is worth more restructured than not, then claimants may be better off accepting impairment in a restructuring than they would be with other alternatives.

Employee-Related Claims

For many years, most large US companies offered their employees defined benefits as a part of their retirement plans. These included pension and post-retirement medical benefits. In these instances, the amount of the annual benefit to each employee was fixed and known. A challenge for issuing companies was that the size of these liabilities could vary greatly depending on (1) the number of eligible employees and other beneficiaries who could access the programs, (2) how long those employees lived, (3) in the case of pension plans, the investment performance of the assets backing the plans, and (4) in the case of post-retirement health plans, the amount of medical care each of the covered retirees and their eligible dependents would require. In recent years, most companies have abandoned these plans in favor of defined-contribution plans. These involve a company making an investment



on behalf of each of its employees and the employees taking the risk that the benefit may not be sufficient to meet their needs and expectations. While that transition has been taking place with respect to new plans, liabilities associated with legacy defined-benefit plans at many companies still loom large and have created solvency issues in a variety of cases, even in the last twenty years.

Pension Plans

A pension plan is a retirement plan that requires an employer to make contributions to a pool of funds that are set aside for the employees' benefit. In a defined-benefit plan, the employer sponsoring a plan guarantees that the employee receives a fixed amount of benefit upon retirement. This benefit is typically specified through a formula that takes into account the employee's years of service and salary. That employer invests funds over time to support these pension obligations but is still on the hook for any gap between the value of the pension assets and the guaranteed payments. The amount that an employer must pay into the pension plan over time depends on (1) the investment performance of the underlying pension assets and (2) the amount of projected liabilities. These plans have been losing significant share among US employers in the marketplace. From 1980 to 2018, the number of private-sector workers that had access to a defined-benefit plan fell from 83 percent to 17 percent.[1] However, legacy pension liabilities are still quite large at many companies. For example, the aggregate value of pension plan liabilities for S&P 1500 companies was $2.1 trillion as of the end of 2018.[2] As a result, these liabilities continue to figure significantly into certain restructuring situations. According to the service Debtwire, from 2016 to 2019, pension claims were involved in at least 32 bankruptcies.[3]

Linking the Right and Left Sides of the Balance Sheet

The economists Modigliani and Miller famously theorized that the enterprise value of the firm, embodied primarily by the left side of the balance sheet, is unaffected by its capital structure, represented primarily by the right side of the balance sheet.[4] By extension, it would follow that restructuring the right side of the balance sheet would not impact such enterprise value.

However, consider the following: A large determinant of a company's enterprise value comes from its elevator assets or workers. A company's ability to attract and retain these assets is reliant upon its compensation structure, which includes its pension plan and other benefits. Restructuring transactions, particularly in bankruptcy, essentially treat pension obligations in the same manner as they do debt. These obligations can thus be impaired, restructured, or even eliminated, impacting a company's relationship with its elevator assets. In this context, pension plans in restructuring situations may weaken Modigliani and Miller's theory by establishing a link between a company's workforce, who are responsible for generating enterprise value, and its capital structure.

A number of other economists have argued that there is yet another link between the right and left side of the balance sheet related to a firm's labor relationships. They argue that firms tend to respond to aggressively bargaining labor forces by intentionally increasing the amount of financial leverage that the firm carries.[5] The rationale is that more debt service reduces the amount that workers are able to extract from the firm in contract negotiations.

Conflicts Between Beneficiaries

Increasing the complexity of the negotiations in a pension restructuring is the conflict that may exist between current and former employees. Current employees wish to negotiate the best package deal possible with their employers, optimizing (1) the level of wages, (2) the level of employment, and (3) employee benefits, which include their pension-plan benefits. Former employees care only about maximizing post-retirement benefits, including those from pension plans. Unions, which are often leading the negotiations on behalf of both groups, may tend to favor current employees' interests over those of retirees.

Regulation

The Employee Retirement Income Security Act of 1974 (ERISA) requires corporate defined-benefit plans to operate on a fully funded basis so that collateral is available to pay retirement benefits. It granted such plans favorable tax treatment but built in heavy penalties against sponsors who operate with underfunded plans. It also created the Pension Benefit Guaranty Corporation (PBGC), which insures corporate defined-benefit plans.

Treatment in Restructuring

Companies can negotiate with employees to reduce the future benefits associated with a pension plan. Outside of bankruptcy court, pension law includes an anti-cutback

[1] Kate Ashford and John Schmidt, "Understanding Defined Benefit Pension Plans," *Forbes*, October 5, 2021.

[2] Yunhui Han, "Who Monitors Corporate Pension Risks? Board Co-option and Corporate Pension Policies," Working paper, August 30, 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3890943.

[3] Kyle Younker and Reshmi Basu, "McClatchy Lenders Tap Advisor as PBGC Negotiations Proceed," *Debtwire*, January 24, 2020.

[4] Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," *American Economic Review*, June 1958, 268.

[5] S.G. Bronars and D.R. Deere, "The Threat of Unionization, the Use of Debt, and the Preservation of Shareholder Wealth," Quarterly Journal of Economics 106 (1), 231–254, 1991, https://www.jstor.org/stable/2937914.

rule that prohibits changes that would reduce benefits that had been earned to date, even if beneficiaries agreed to the reductions.[6] However, a company can restructure its plan outside of court to reduce future benefits.

Underfunded plans cannot be terminated unless the employer files for bankruptcy or the PBGC determines that the plan is causing financial distress to the employer. Under a distress termination of a pension plan, the debtor must satisfy the reorganization distress test, proving that it would be unable to pay its debts and continue as a business outside of Chapter 11 bankruptcy without terminating the pension plan. Additionally, if the pension plan is subject to the terms of a collective bargaining agreement (CBA) with a company's unions, it may not proceed with the termination unless it has obtained the agreement of the union. Alternatively, it can reject the CBA contract in bankruptcy with court approval if it first negotiates with the union in good faith.[7] Once a pension plan is terminated, the PBGC assumes control of the plan's assets and pays the associated benefits (up to a maximum guaranteed level for each participant based on age) out of these assets and its own funds. Benefits in this scenario are capped to a limit per year, depending on the participant's characteristics. Many retirees and other plan participants suffer a permanent loss of income in a pension termination, despite the partial guarantees provided by the PBGC.

In this scenario, the PBGC typically asserts three claims in bankruptcy against the debtor's estate: (1) unfunded benefit liabilities, which represent the difference between the present value of the plan's liabilities and its assets, (2) unpaid minimum-funding contributions, and (3) unpaid PBGC insurance premiums. While categories 2 and 3 are easily quantifiable, category 1 involves determining an interest rate with which the PBGC can calculate the actuarial present value of the plan benefit liabilities. Because the size of the claim can be highly sensitive to this assumption, debtors and other creditors frequently challenge the asserted rate.

In addition, the PBGC imposes a termination premium of $1,250 per participant per year for three years on plans that undergo distress termination. This premium must be paid upon emergence from bankruptcy and effectively has priority, as it cannot be discharged by the court. For any unpaid minimum-funding contributions prior to a bankruptcy filing in excess of $1 million, the PBGC will have an automatic lien on the assets of the existing plan sponsor,[8] capped at 30 percent of the sponsor's net worth.[9] If the unpaid amounts are asserted after the bankruptcy filing, the automatic stay prevents the PBGC from gaining a lien on the debtor's assets, and the claim remains unsecured. However, the PBGC may assert claims and liens against the assets of any other entity that is deemed to be a plan's sponsor that is not part of the bankruptcy process.

In past bankruptcies, the PBGC has also taken the position that its other claims, as obligations arising from IRS law, should have priority status in bankruptcy equal to those of unpaid taxes (i.e., senior to general unsecured claims). In spite of this position, courts have generally ruled that pre-petition claims should be classified as general unsecured claims. In certain cases, the PBGC has negotiated structural seniority for its claims in exchange for reduced contribution requirements of underfunded plans. The PBGC may also be entitled to a priority claim on any minimum-funding contribution claims or unpaid insurance premiums that are related to the postpetition provision of employee benefits.[10]

Outcomes

PBGC claims have generally not experienced strong recoveries in bankruptcy for three reasons. First, defined-benefit pension plans tend to be highly correlated with businesses that have more left-side-of-the-balance-sheet issues, meaning that they are not growing and do not have a lot of enterprise value to fund recoveries to their stakeholders. Second, given that most of the PBGC's claims are unsecured, they are junior in rank to any secured claims. Finally, lenders to companies with defined-benefit pension plans are more apt to provide credit on a secured basis such that their claims rank senior to those of the pension plans.

In some of these cases, pension beneficiaries are ultimately made whole by the PBGC, and in some cases, they end up worse off. In virtually all of these cases, US taxpayers are made worse off by the amount of the impairment the PBGC is forced to take on its unsecured claims. This raises the question as to whether secured claims should be allowed to have priority over pension claims. In some foreign insolvency regimes, this is not the case, and pension claims must be paid first. The

[6] Brian Furgala, "The Anti-Cutback Rules of IRC 411(d)(6)," 2016 ASPPA Annual Conference, October 23–26, 2016, https://www.asppa.org/sites/asppa.org/files/PDFs/2016AnnualHandouts/WS63%20-%20The%20Anti-Cutback%20Rules%20of%20IRC%20411d6.pdf.

[7] This is a very involved process, which is covered in Section 1113 of the Bankruptcy Code.

[8] The plan's sponsor in this context includes all of the members of its controlled group. This group is generally defined to include a parent company and all of its 80-percent-owned subsidiaries. All of the members of a sponsor's controlled group are jointly and severally liable for the liabilities to the PBGC.

[9] Colleen Hart and Elizabeth Down, "Bankruptcy Impact of Employee Benefit Plans," *Bloomberg Law*, October 2020, https://www.bloomberglaw.com/external/document/XBQM09NC000000/bankruptcy-professional-perspective-bankruptcy-impact-on-employee.

[10] This may also include contributions to benefit plans arising from services rendered within 180 days of filing up to $15,150 per employee ($17,150 for cases commencing after Apr. 1, 2025), minus the amount of wage claims asserted in priority during the same period.

counter argument to this is that if pension claims were provided seniority over secured debt claims, companies with defined pension plans would be challenged to raise secured debt to finance their business at a reasonable cost. Defined pension plans create a high degree of uncertainty to lenders in terms of their ultimate claim amounts and how they might dilute lender recoveries if they were entitled to a priority recovery.

Example–The McClatchy Company[11]

McClatchy is a media company focused on local community newspapers. In 2006, it acquired a rival, Knight-Ridder, financing the transaction with a substantial amount of debt.

Over time, the company suffered from a shift of consumer preferences towards digital and free sources for news content. Even as McClatchy transitioned its own content to digital, it had lost 80 percent of its advertising revenues by 2018. While many other news-media companies were able to consolidate with other competitors and find cost synergies to stay profitable, McClatchy's highly leveraged capital structure prevented it from pursuing similar initiatives.

Complicating matters further, the company shouldered a pension plan that, in 2019, covered 24,500 current and future retirees. The required contributions associated with this plan exceeded the amount of the company's projected EBITDA. The company and its advisors engaged with the PBGC over the idea of pursuing a distress termination of the pension plan outside of bankruptcy. These talks fell apart, and the company filed for bankruptcy in 2020.

After the debtor filed for bankruptcy, it sought a distressed termination of its plan. The PBGC asserted claims as follows: (1) $878 million in unfunded benefit liabilities, (2) $126 million in minimum-funding contributions, and (3) $102 million for unpaid insurance premiums, for a total of $1,106 million in claims.[12]

Table 1 shows the capital structure at the time of the bankruptcy. Note that the company had previously raised three levels of secured debt, which are deemed to be senior in rank to the unsecured claims asserted by the PBGC.

[11] Taylor Harrison, Joshua Friedman, and Rong Ren, "Case Profile: McClatchy enters Chapter 11 with Proposed Plan Amid Ongoing PBGC Negotiations," *Debtwire*, February 13, 2020; and The McClatchy Company, et al., "Disclosure Statement with Respect to the Joint Chapter 11 Plan of Reorganization of the McClatchy Company and its Affiliated Debtors and Debtors in Possession," US Bankruptcy Court Southern District of New York, February 13, 2020. This example has been simplified for explanation purposes.

[12] JCK Legacy Company, et al., "Pension Benefit Guaranty Corporation's Motion for an Order To Compel Mediation Regarding The GUC Recovery Trustee's Objections To PBGC Claims," U.S. Bankruptcy Court Southern District of New York, September 21, 2021.

Table 1[13]

Capital Structure for the McClatchy Company, February 2020
($ millions)

	2/13/2020
First Lien Notes	$ 263
Second Lien Notes	157
Third Lien Notes	268
Total Secured Debt	688
Unsecured Bonds	15
PBGC	1,106
Total Liabilities	**$ 1,809**
2020 Projected Adjusted EBITDA	$ 92
Net Liabilities/Adjusted EBITDA	19.7 x

Ultimately, the debtor decided to sell the assets in a 363 sale to the holders of the First Lien Notes based on a credit bid with the face value of the notes it owned, plus $49 million in cash and the assumption of certain trade claims. The PBGC received a negligible recovery on its claims. The debtor publicly stated that they did not believe the termination of the plan would impact pension beneficiaries given the expected coverage provided by the PBGC. Thus, the company's balance sheet was made healthier, employees and retirees were protected, but US taxpayers ended up footing the bill for the pension plan.

Retiree Medical Claims

Other employee-related liabilities that have played a significant role in restructuring transactions are those related to retiree health and medical benefit plans. Like pension plans, such plans are regulated by ERISA. Also similar to pension plans, these plans have been declining in size and employer share over time. The percentage of workers in the United States that were employed by companies that offered health coverage to retirees fell from 29 percent in 1997 to 18 percent in 2010.[14] This number has declined even further since then with the passage of the Affordable Care Act, which has enabled retirees to access medical coverage under government-sponsored programs.[15]

Unlike pension plans, retiree health insurance benefits are not required to be prefunded under ERISA rules and have thus been largely underfunded. In 2012, companies in the S&P 500 had set aside $67 billion in assets to meet $302 billion in reported other post-retirement benefit obligations.[16]

[13] Source: Harrison, Friedman, and Ren, "Case Profile: McClatchy enters Chapter 11 with proposed plan amid ongoing PBGC negotiations."

[14] Erin S. Leighty, "What's Next for VEBAs? The Impact of Declining Employer-Provided Health Care Coverage and the Affordable Care Act," Pension Research Council White Paper 2014–19, July 1, 2014.

[15] Ibid.

[16] Ibid.

Prior to the early 1990s, companies were allowed to account for their expenses associated with these programs at the time they incurred them. In 1990, accounting standards were revised to require companies with post-retirement benefits to account for the full present value of future expected liability on their balance sheet. This accounting change caused solvency issues for some companies and earnings volatility for many others.[17]

There are several challenges that arise when restructuring these liabilities. First, the valuing of these claims can be extremely difficult, because it is unknown how long beneficiaries will survive and what their medical usage under the benefit plan will be. Also, legal rights and obligations are not always clear under these plans. As described earlier, there may be conflicts of interest between union negotiators' broader goals on behalf of existing employees and those for retirees. Finally, there may be jurisdictional disputes that come into play.

Restructuring Out of Court: VEBAs

In response to the accounting changes in the early 1990s, many companies set up voluntary employees' beneficiary associations (VEBAs). These are typically trusts that are set up with the consent of employees to handle the payment of employee health benefits. Because the consent of employees is required, this structure is uniquely suited to companies with unionized workforces.

In a VEBA trust, the employer prefunds all or a portion of the expected benefits into the trust and then moves the post-retirement medical liabilities off its balance sheet and into the trust. The advantages for the company are (1) these structures are tax exempt, meaning that any income earned by the trust accumulates tax-free, (2) any contributions by the company into the trust are tax deductible, and (3) it removes the risk of changes in the company's post-retirement liability from the company's balance sheet. From the employees' standpoint, it limits their recourse for these benefits, but it also provides them with irrevocable collateral to support the benefits, outside of the reach of other creditors.

Restructuring in Bankruptcy

In 1988, Section 1114 of the Bankruptcy Code was introduced, which sets forth the process for a debtor to terminate or modify retiree health benefits. First, it required the employer to engage in a good faith bargaining process before seeking court approval for the cancellation or modification of these benefits. The purpose was to provide retirees a chance to negotiate a resolution and to prevent management from acting unilaterally without a hearing. It also enabled the bankruptcy court to assess whether the reduction in benefits is lawful, necessary, and equitable under the circumstances. Typically, the court will approve a level of benefit that the debtor will be able to comfortably support after leaving Chapter 11 bankruptcy. The code requires that the portion of that newly determined level of benefit that relates to the postpetition period of time be paid during the bankruptcy case. All remaining unpaid benefits become a general unsecured claim against the estate.

Since bankruptcy courts view their primary objective under Chapter 11 bankruptcy as facilitating the company's survival and emergence from bankruptcy, judges have been inclined to agree to management's request to terminate or reduce the legacy costs of promised health benefits. Unlike certain other creditors, retirees are not seen as important for the value of the business going forward.

Example–Patriot Coal[18]

Patriot Coal was a coal producer in the eastern US that was spun off from Peabody Energy in 2007. At the time of the spinoff, Patriot was saddled with a significant amount of healthcare and pension liabilities. This issue was compounded when Patriot acquired Magnum Coal in 2008, which also held a substantial amount of post-retirement healthcare liabilities.

As a result of weakening coal prices, the company filed for bankruptcy in 2012. In the reorganization plan, the debtor used Section 1114 to reduce its retiree healthcare benefits. As part of its settlement with its unions, the debtor created a VEBA trust and funded this with (1) 35 percent of the post-reorganization equity of the company, (2) a future profit-sharing contribution of up to $300 million, (3) a royalty contribution for every ton of coal produced, (4) annual cash contributions of up to $75 million over four years, and (5) cash contributions from the original parent, Peabody, worth $310 million.

These transactions enabled Patriot to reduce the amount of the retiree medical liability recorded on its balance sheet from $1.4 billion to $90 million. It also reduced its third-party debt and emerged with a significantly improved capital structure. The retirees ended up with reduced benefits but with the secure backing of a trust containing assets with significant value, protected from other creditors. Therefore, retirees likely emerged from this transaction with benefits that had a higher probability of being paid.

[17] Ibid.

[18] Madalina Iacob, "Patriot Coal's Newly Minted Second Lien Bond Bid At 165 As Investors Pin Hopes on Lucrative CoC, Coal Turnaround," *Debtwire*, January 6, 2014. Patriot Coal Corporation, "Annual Report for the Year Ended December 31, 2013." This example has been simplified for explanation purposes.

Table 2 shows the debtor's capital structure at the time of the filing and pro forma for the reorganization.[19]

TABLE 2

Patriot Coal - Pro Forma Analysis
($ millions)

	2012	Pro Forma
First Lien Debt	$ 375	$ 250
Second Lien Debt	-	250
Capital Leases	2	14
Total Secured Debt	377	514
Unsecured Bonds	459	-
Retiree Medical Liability	1,400	90
	$ 2,236	$ 604
2014 Projected Adjusted EBITDA	$ 188	$ 188
Net Liabilities/Adjusted EBITDA	11.9 x	3.2 x

Summary

While companies today are less exposed to defined employee benefits than they were in the past, the lessons from historical restructuring transactions in these areas can and have been applied to other types of nondebt liability claims. These types of claims will surely continue to play a significant role in causing corporate financial distress in the years to come, especially given the rise of mass tort bankruptcies. Such lessons include how to utilize (1) the Chapter 11 bankruptcy process to consolidate and adjudicate large amounts of similar claims and reduce the size of competing debt liabilities, (2) estimates of contingent claims in order to expedite what might otherwise be an expensive and lengthy bankruptcy process, and (3) trusts to separate the claims-adjudication process from the business enterprise, while forcing the debtor to make a meaningful contribution to the solution. Through these mechanisms, a proposed restructuring plan may have a higher probability of maximizing the value of the estate for the benefit of all claimants and stakeholders.

[19] Source: Iacob, "Patriot Coal's Newly Minted Second Lien Bond Bid At 165 As Investors Pin Hopes on Lucrative CoC, Coal Turnaround."

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CASH IS KING - EXCEPT WHEN ANALYZING PERFORMANCE

Steve Cooper

The Footnotes Analyst

We often see investors using cash flow metrics, particularly cash from operations, as a measure of performance. Cash flow may even be preferred to profit because it is supposedly more reliable and less subject to management judgment and potential manipulation … "cash is a fact, but profit is an opinion."

We explain why cash flow may not provide the insights into performance that some investors expect, and how cash flow can often be managed even more freely than profit. Cash flow is nevertheless an important component of equity analysis and "following the cash" is vital to understanding a business.

It is often claimed that cash flow is superior to profit for analyzing the performance of a business, and that investors should pay more attention to cash from operations than to measures of profit. Statements such as "cash is king" or "cash flow is a fact whereas profit is an opinion" often accompany this message. The fact that DCF valuation is based on cash generation rather than forecast profit seems to further confirm the superiority of cash flow. But to what extent are these statements true, and are you really better off "following the cash"?

Consider a situation where a company reports profit growth but declining cash flow. Is this a positive or a negative indicator, and how exactly should you interpret and use cash flow metrics? When is the change in cash flow important and when is it potentially misleading?

Dutch technology company ASML is a good example of diverging profit and cash flow (*See* Table 1).[1] In 2023 the company reported a **27% increase in net profit**, but a **31% fall in cash from operations** (the cash flow equivalent of net profit). What exactly should investors make of these seemingly contradictory signals?

It is not just the difference between the change in profit and change in cash flow that is interesting about ASML, but also the drivers of this difference. For example, notice the negative effect on cash flow of the change in contract liabilities compared with a positive impact in the prior two years. In our experience, many investors are confused by the contract assets and contract liabilities components of working capital and how they should be analyzed, including their impact on the working capital cycle.

TABLE 1 - ASML Reconciliation of Net Profit to Operating Cash Flow[2]

Year ended December 31 (€, in millions)	2021	2022	2023
Cash Flows from Operating Activities			
Net income	€ 6,134.6	€ 6,395.8	€ 8,115.2
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	862.6	875.9	1,047.5
Impairment and loss (gain) on disposal	(15.9)	39.3	37.5
Share-based compensation expense	131.7	66.4	139.8
Gain on sale of subsidiaries	(213.7)	-	-
Inventory reserves	180.7	278.5	485.3
Deferred tax expense (benefit)	(487.9)	(774.7)	233.2
Investments in associates	(49.8)	15.3	4.2
Changes in assets and liabilities:			
Accounts receivable, net	(1,754.9)	(2,338.0)	959.9
Finance receivables, net	542.3	212.2	(88.6)
Inventories	(483.2)	(2,080.9)	(1,646.9)
Other assets	(127.0)	(611.4)	(532.6)
Accrued and other liabilities	410.3	278.7	539.0
Accounts payable	717.4	405.3	(261.1)
Current tax assets and liabilities	215.6	39.8	(931.6)
Contract assets and liabilities	5,529.8	6,632.7	(1,564.6)
Net cash provided by operating activities	€ 11,592.6	€ 9,434.9	€ 6,536.2

	2021 - 2022	2022 - 2023
Change in net income	**4%**	**27%**
Change in net cash provided by operating activities	**-19%**	**-31%**

In addition, even though revenue rose by 30% in 2023, ASML shows a surprising reduction in receivables compared with increases in prior years. This has a positive

[1] We use ASML simply to illustrate how in practice profit and cash flow can diverge. We are not suggesting that the effect we highlight arises from anything other than normal business activities.

[2] The source for the Tables and Figures (with the exception of Figure 1) is the ASML 2023 financial statements, based on International Financial Reporting Standards (IFRS). The financial statements include notes not provided herein. The full 2023 Annual Report including the notes can be found at https://www.asml.com/en/investors/annual-report/2023#downloads.

effect on cash flow; but is this sustainable and is there something other than merely more efficient receivable collection taking place?

Performance measures: Cash flow vs. profit

In our view, you should be very cautious when using cash flow as a measure of performance. The accrual accounting method for determining profit – in other words the recognition of revenue when earned and expenses when incurred – was invented for a very good reason. Only by applying this approach are revenues and expenses recognized in the appropriate period (and matched with each other) to create a meaningful measure of performance. Focusing on cash in and cash out (rather than the economic timing of revenue earned and expenses incurred) is, at best, incomplete and may be highly misleading.

For example, paying cash in one period to acquire goods, and selling those goods and receiving cash in a later period, does not equate to poor performance followed by good performance. A loss has not been incurred in the first period but instead there has been an increase in assets (inventory). These assets turn into an expense in the second period (the inventory asset is "de-recognized" in accounting jargon) when the inventory is sold. In the first period profit is zero, even though cashflow is negative, and in the second period profit is earned but is significantly less than the cash received. Cash flow is not a useful measure of performance in either period.

Our example is simplistic, but we could have chosen from many different examples, both simple and highly complex, to illustrate the point that profit is superior to cash flow as a measure of performance.

Cash flow fails to properly reflect value created and lost in the period

Not only does cash flow fail to capture the fundamentals of performance, it is also a very blunt instrument that fails to reflect the nuances of business activities. Suppose in the above illustration some of the purchases turned out to be a commercial mistake and this inventory could only be sold at a loss. In cash flow accounting this would make no difference to the amounts reported – the impairment is "non-cash." However, when measuring profit, the poor purchasing decision will be reflected in an impairment loss – the inventory asset would be written down to its recoverable amount and an expense reported. If the impairment was apparent in the accounting period prior to the sale taking place, the loss would be recognized at that time and provide investors with valuable and timely information about the overall business performance.

Many investors are tempted to ignore so-called "non-cash" impairments. This is a mistake and will lead to the wrong signals regarding performance. Furthermore, inventory impairments are not actually "non-cash" – the related cash has simply already been paid. What the impairment tells us is that this previous investment will now never be recovered.

Cash flow is a fact while profit is an opinion

Although profit may well provide a more relevant measure of performance, maybe cash flow should still be preferred because, unlike profit, cash flow is supposedly not subject to judgment and potential manipulation by management? The problem is that, although cash flow might seem to be entirely objective, in practice it can be managed more easily than many investors seem to realize.

It is true that once a company has undertaken a series of transactions, and the accounting period has closed, then cash flow is a fact. Cash inflows and cash outflows are as stated in the bank statements. There could be some argument as to exactly what qualifies as cash (is bitcoin cash, what about short-term deposits, etc.?) but essentially cash flow is objective. On the other hand, profit is very much subject to judgment ... Is an asset impaired or not? What is the fair value of an unlisted investment? Does a particular transaction qualify as revenue in that period, or should it be deferred until the next period? Determining profit is invariably subject to many judgments.

Only once transactions have occurred is cash flow more objective than profit

The argument that cash flow can be manipulated, and is therefore just as unreliable as profit, stems from actions management can take within an accounting period. The timing of many cash flows is subject to management discretion and their business and financing choices. For example, trade receivables can be sold to a bank (factored) to bring forward the timing of the receipt. There is nothing wrong with this practice – it is a legitimate method to finance a business. However, the choice of whether to factor receivables (instead of raising the same amount of bank debt) affects operating cash flow.

But cash flow can still be easily managed

Management that wants to meet cash flow targets, or to show a higher cash conversion, can easily do so by using factoring, or many other similar actions that affect the timing of cash payments and receipts. Of course, it needs to be done before the accounting year end date, but that

is generally not difficult given that management systems allow for near continuous monitoring of these metrics.

ASML shows a reduction in receivables even though revenue is up 30%

In 2023, the operating cash flow of ASML was increased by a reduction in trade receivables. In the two prior years, increased receivables had a negative effect on cash flow. For a company which grew 30% in 2023, we would normally expect to see an increase in receivables and other components of working capital, as was the case in 2022. The reduction in 2023 could be due to a change in credit terms offered to customers but it appears that at least some of the effect is due to factoring.

TABLE 2 – ASML Factoring of Trade Receivables Disclosure

Year ended December 31 (€, in millions)	2022	2023
Accounts receivable, gross	€ 5,327.9	€ 4,334.1
Allowance for credit losses	(4.1)	-
Accounts receivable, net	**€ 5,323.8**	**€ 4,334.1**

The decrease in accounts receivable as of December 31, 2023, compared to December 31, 2022, is mainly due to the factoring of receivables during 2023 and the timing of cash receipts from our customers, which is partially offset by an increase in our sales.

In 2023, €993.4 million of receivables were sold through factoring arrangements (2022: €0.0 million). The amounts consist of €245.8 million (2022: €0.0 million) of regular trade receivables and €747.6 million (2022: €0.0 million) of absolute, unconditional, irrevocable accounts receivable for down payments on systems to be shipped in 2024. The amounts have been de-recognized since the asset is isolated from the seller, control is transferred to the buyer and there are no restrictions on the buyer related to the factored items. The fair value of the receivables sold was substantially the same as their carrying value. The cash receipt is treated as an operating cash flow within the Consolidated Statements of Cash Flows.

ASML discloses €993 million of receivable factoring in 2023 compared with zero in 2022. Because the transfer of receivables to a finance company is "absolute, unconditional, and irrevocable," the receivables are de-recognized from the balance sheet, with a positive effect on operating cash flow. Without the factoring arrangement, the reduction in operating cash flow would have been even greater in 2023.

It is not possible to identify whether the use of factoring by ASML is primarily a financing decision or a way to manage operating cash flow. Whatever the reason, the use of factoring, and other forms of working capital financing, such as supply chain finance, results in a financing flow being transformed into cash from operations. This use of financing techniques makes it even more challenging to use operating cash flow as an indicator of performance.

Factoring and other working capital financing changes impact reported operating cash flow

While cash flow may be entirely objective after the event, it can easily be managed prior to the accounting period end. We therefore do not subscribe to the view "cash is a fact; profit is an opinion."

It is not just the use of factoring that produced a positive cash flow impact from the management of receivables by ASML, it also appears that the credit period offered to customers has also been shortened. The debtor days has fallen from 92 days in 2022 to 57 days in 2023, after including the benefit from the factoring program, but we estimate would still have been 71 days even if factoring had not been employed.

Table 3 below shows our analysis of the change in profit and cash flow over the last two years. Notice the positive contribution from receivables is much greater than the factoring arrangement, suggesting that the company is also better at managing its customers' payment behavior.

TABLE 3 – ASML Summary of the Key Changes in the Operating Cash Flow Reconciliation

(€, in millions)	2021 -2022	2022 -2023
Change		
Net Income	€ 261.2	€ 1,719.4
Contract assets and liabilities	1,102.9	(8,197.3)
Accounts receivable	(583.1)	3,297.9
Accounts payable	(312.1)	(666.4)
Inventory and inventory reserves	(1,499.9)	640.8
Other	(1,126.7)	306.9
Change in net cash provided by operating activities	€ (2,157.7)	€ (2,898.7)

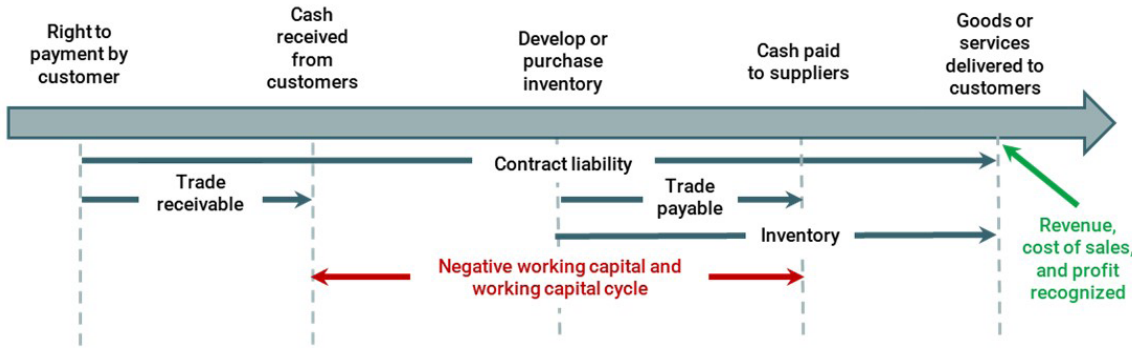
However, by far the biggest contribution in the change in cash flow in 2023 is that identified as "contract assets and liabilities." In our experience, this component of working capital confuses many investors.

Contract assets and liabilities

Contract assets and liabilities arise when there is a difference between when a company supplies goods or services to its customers and when it obtains a right to payment. For many companies these two events coincide – on the same date that goods or services are transferred to a customer an invoice is sent, and payment becomes due. In this case revenue and

Payments due in advance of delivering goods or services result in contract liabilities

FIGURE 1 – Contract Liability and Negative Working Capital Illustration



a trade receivable are recognized on the same date and there are no contract assets or liabilities.

However, if a company demands payment in advance of delivery, a contract liability is recognized instead of revenue. Only when the contract is fulfilled is the contract liability de-recognized and revenue reported. Contract liabilities represent a "performance obligation" and are sometimes described as deferred revenue or payments in advance. The opposite effect produces a contract asset – goods or services are provided in advance of when payment becomes due, such as when multiple deliveries are made with payment only due when the full order is fulfilled.

ASML has significant contract liability balances. For at least some of their products, payment becomes due when customers place orders. Trade credit is still offered such that the amount invoiced is actually settled later, but this still seems to be well in advance of when delivery, and therefore revenue recognition, takes place.

Figure 1 above illustrates how contract liabilities arise and the resulting negative net working capital and working capital cycle. On average, this is the position of ASML, although what we see in the balance sheet and cash flow statement is an aggregation of many different contract timelines.

For ASML, the advance payments received from its customers contribute to a significant negative net working capital balance.

TABLE 4 – ASML Net Working Capital Components[3]

(€, in millions)	2022	2023
Accounts receivable	€ 5,323.8	€ 4,334.1
Contract assets	131.9	240.1
Long-term contract liabilities	(5,269.9)	(4,825.5)
Short-term contract liabilities	(12,481.0)	(11,441.0)
Customer related working capital balance	(12,295.2)	(11,692.3)
Inventories	7,199.7	8,850.7
Accounts Payable	(2,563.5)	(2,346.3)
Net working capital	€ (7,659.0)	€ (5,187.9)

[3] There is no standard definition of net working capital. We have used a relatively narrow definition that excludes some other receivables and payables that would be included for most analytical purposes.

In effect, by providing advance payments ASML customers are not just funding the full inventory balance but also part of long-term investment in fixed assets. This is good for cash flow, especially for a growing business, and it is not surprising that cash from operations has exceeded profit in previous years. The reduction in cash from operations in 2023 may well be an anomaly if the structure of the business and its contracts with customers remain unchanged.

Always include contract assets and liabilities in your cash conversion and working capital cycle analysis

You should always include contract assets and liabilities in any analysis where receivables also feature, such as the analysis of the working capital cycle or net working capital changes applied in deriving free cash flow for DCF valuations.

One of the welcome disclosures that was introduced when new IFRS and US GAAP requirements for revenue recognition were introduced some years ago is the contract assets and liabilities roll-forward.

TABLE 5 – ASML Contract Assets and Contract Liabilities Roll Forward

Year ended December 31 (€, in millions)	2022		2023	
	Contract assets	Contract Liabilities	Contract assets	Contract Liabilities
Balance at beginning of the year	€ 164.6	€ 11,160.9	€ 131.9	€ 17,750.9
Transferred from contract assets to AR	(393.4)	-	(402.0)	-
Revenue recognized during the year ending in contract assets	116.5	-	135.1	-
Revenue recognized that was included in contract liabilities	-	(6,326.6)	-	(11,106.1)
Changes as a result of cumulative catch-up adjustments arising from changes in estimates	-	(118.0)	-	(24.9)
Remaining performance obligations for which considerations have been received, or for we we have an unconditional right to consideration	-	12,790.4	-	9,416.3
Transfer between contract assets and liabilities	244.2	244.2	375.1	375.1
Other	-	-	-	(144.8)
Total	€ 131.9	€ 17,750.9	€ 240.1	€ 16,266.5

An interesting feature of the ASML roll forward is the difference between the revenue recognized in the period that was previously a contract liability (€11.1 billion) and

the new contract liabilities arising in the period (€9.4 billion). This may potentially indicate a reduction in revenue (or at least a slow-down in revenue growth) in the following period, when many of the current contract liabilities will become revenue. Indeed, this interpretation is supported by further disclosure about remaining performance obligations which fell from €45.4 billion to €45.0 billion.

FIGURE 2 – ASML Remaining Performance Obligation Disclosures

Our customers generally commit to purchase systems, service, or field options through separate sales orders and service contracts. Typically the terms and conditions of these sales orders come from volume purchase agreements with our customers which can cover up to 5 years. The revenues for each committed performance obligation are estimated based on the terms and conditions agreed through the volume purchase agreements. When revenues will be recognized is mainly dependent on when systems are delivered or installed, as well as when service projects and field upgrades are performed and completed, all of which is estimated based on contract terms and communication with our customers, including the customer facility readiness to take delivery of our goods or services. The volume purchase agreements may be subject to modifications, impacting the amount and timing of revenue recognition for the anticipated revenues. As of December 31, 2023, the remaining performance obligations amount to €45.0 billion (December 31, 2022: €45.4 billion). The remaining performance obligations mainly include orders related to DUV immersion and NXE lithography systems, and our next-generation EUV platform, High NA. We estimate that 57% (December 31, 2022: 56%) of these anticipated revenues will be recognized during the next 12 months.

The reason the remaining performance obligations are so much higher than the contract liability balance is that, presumably, payments in advance do not apply to all ASML contracts. Where a contract exists to supply goods or services in the future, but no advance payment applies, the contract is called "executory," and nothing appears in the balance sheet. Although ASML has a performance obligation, and the customer will be obliged to pay at some point (most likely on delivery), in financial reporting neither is recognized in the balance sheet. Nevertheless, the unrecognized performance obligations are disclosed and changes in remaining performance obligations provide some evidence of future changes to revenue and therefore profit.

Do not get too carried away with interpreting changes in contract liabilities and changes in the remaining performance obligations. These can only provide a partial view of likely changes in future revenue. There are other explanations for our observations above, notably a change in the structure of contracts and, particularly, a change in product mix (for which there is also evidence in the ASML disclosures).

A better leading indicator of future revenue is changes in new contracts written or orders taken. However, "order book" disclosures are non-GAAP measures and not universally given.

Cash flow may not be a reliable measure of performance

To be clear, we are not saying that you should never link cash generation and cash from operations to business performance. In many cases the changes in cash flow and changes in the difference between cash and profit are meaningful. However, be aware that cash flow is affected by other factors unrelated to business performance. Profit and accruals accounting is the foundation of performance measurement in financial reporting for good reason.

Why cash flow is still important

Although of questionable relevance when analyzing business performance, cash flow metrics are still very important, including when assessing liquidity, as the foundation for DCF valuation, and sometimes even in uncovering profit manipulation.

Cash flow and understanding the dynamics of a business

Although "following the cash" may not necessarily lead you to correctly interpreting the performance of a business, understanding the dynamics of cash flow is important when trying to understand the business itself. Following the cash flows that arise in both purchase and revenue transactions will go a long way to understanding the dynamics of a business and help in forecasting future working capital changes and operating cash flows. Pay particular attention to understanding cash conversion and the cash conversion cycle.

Cash flow and liquidity

Ultimately the key factors that determine a company's survival and ability to develop involve cash flow. Debt is repaid (usually) through cash payments, and cash, not profit, is needed to pay interest, salaries, and other expenses. Of course there are exceptions, such as paying employees through share-based payments, but generally it is cash flow and liquidity that matters.

For most companies with a strong business model and that are profitable, positive cash flow naturally follows. If the company is growing rapidly, which invariably puts strain on cash if the business is capital intensive, there should be ready access to additional financing. But if profitability is suspect, cash flow and liquidity may become all important.

Cash flow and DCF valuation

Profit may be more relevant when assessing performance; however, it is ultimately cash flow that determines the cash payments to investors and therefore the value of the claims on the business. There is no contradiction in this. In DCF valuation, it is not just a single period cash flow that matters - value is the present value of all future cash flows. Any timing effects matter less over multiple periods.

Furthermore, forecast cash flows tend to have a closer relationship to forecast profit than do the equivalent historical flows. This is simply because it is impossible to forecast the more short-term cash flow timing effects that occur in practice, with changes in net working capital invariably linked to changes in revenue. There is nothing wrong with this approach.

Cash flow as a potential indicator of profit manipulation

One of the reasons why investors may be interested in historical single period cash flow metrics is because of the potential for profit to be manipulated. Profit may be artificially enhanced by management through bringing forward revenue recognition using techniques such as channel stuffing or by deferring expenses, such as through judgments about capitalization. A divergence between the trend in profitability versus cash generation may sometimes be an indicator that profit has been managed.

However, as we explain above, there may be other reasons for such a divergence of profit and cash flow. While profit manipulation may be one explanation, in most situations this will not be the case. You should first rule out the effects of working capital and other cash flow timing effects arising from the normal management of a business.

Cash flow and the accruals anomaly

There is a body of academic research (mainly using US data) that gives evidence that investments in the equity of companies with low "accruals" outperform others. "Accruals" refers to the difference between profit and cash flow. "High accruals" means profit is higher relative to cash flow than for "low accruals." Precisely how this is measured and what cash flow metric is being referred to seems to vary by researcher.

Of course, historical out-performance of "low-accrual" stocks does not necessarily mean this will be repeated in the future, but this investment style still seems to attract attention in the world of quant-based investing and is another reason cash flow is important for investors.

Insights for investors

- Be cautious when using cash flow metrics as measures of performance. The timing of cash flows may be very different from the underlying economic gains and losses.
- Cash flow can be volatile due to changes in working capital. Look out for working capital changes arising from a change in the business dynamics, such as a change in product mix, compared with a change in working capital financing, for example, using receivable factoring or supply chain financing.
- Always include contract assets and liabilities in your analysis of cash conversion and the working capital cycle.
- Profit may be subjective, subject to management judgment, and affected by choices of accounting policies; however, it is still preferable as a basis to assess performance.
- Understanding the drivers of cash flow is important for understanding a business and in assessing liquidity. Ultimately value depends on generating cash for distribution to capital providers.

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HERTZ: THIRD CIRCUIT WEIGHS IN ON MAKE-WHOLE PREMIUMS AND THE "SOLVENT-DEBTOR EXCEPTION"

Brad B. Erens
Jones Day

A handful of recent high-profile court rulings have considered whether a chapter 11 debtor is obligated to pay postpetition, pre-effective date interest ("pendency interest") to unsecured creditors to render their claims "unimpaired" under a chapter 11 plan in accordance with the pre-Bankruptcy Code common law "solvent-debtor" exception. Some of these decisions have also addressed: (i) whether a claim for a "make-whole premium" payable under a debt instrument qualifies as "unmatured interest" that must be disallowed in a bankruptcy case; and (ii) the appropriate rate of pendency interest that must be paid to unsecured creditors by a solvent debtor under a chapter 11 plan.

The U.S. Court of Appeals for the Third Circuit weighed in on all of these questions in *In re Hertz Corp.*[1] A divided panel of the court ruled that a bankruptcy court correctly disallowed certain noteholders' claims for a make-whole premium because it was both "definitionally" and the "economic equivalent" of unmatured interest. However, because the debtors were solvent, the Third Circuit panel, concluding that the solvent-debtor exception survived enactment of the Bankruptcy Code as part of the "fair and equitable" requirement for cramdown-confirmation of a chapter 11 plan, held that the bankruptcy court erred by ruling that the debtors' plan need not pay pendency interest on the noteholders' claims at the contract rate of interest, while distributing more than $1 billion to existing shareholders in violation of the "absolute priority rule" and the Bankruptcy Code's priority scheme.

In so ruling, the Third Circuit became the sixth federal circuit court of appeals to conclude that the solvent-debtor exception is alive and well and requires a solvent debtor to pay pendency interest to unsecured creditors to render their claims unimpaired under a chapter 11 plan.

The Bankruptcy Code's Priority Scheme

The Bankruptcy Code sets forth certain priority rules governing distributions to creditors in both chapter 7 and chapter 11 cases. Secured claims enjoy the highest priority under the Bankruptcy Code.[2]

The Bankruptcy Code then recognizes certain priority unsecured claims, including claims for administrative expenses, wages, and certain taxes.[3] General unsecured claims come next in the priority scheme, followed by any subordinated claims and the interests of equity holders.

In a chapter 7 case, the order of priority for distributions on unsecured claims is determined by section 726 of the Bankruptcy Code. The order of distribution ranges from payments on claims in the order of priority specified in section 507(a), which have the highest priority, to payment of any residual assets after satisfaction of all claims to the debtor, which has the sixth or lowest priority. Fifth priority in a chapter 7 liquidation is given to "interest *at the legal rate* from the date of the filing of the petition" on any claim with a higher liquidation priority, including various categories of unsecured claims.[4]

Distributions are to be made pro rata to parties of equal priority within each of the six categories specified in section 726. If claimants in a higher category of distribution do not receive full payment of their claims, no distributions can be made to parties in lower categories.

Thus, if the bankruptcy estate in a chapter 7 case is sufficient to pay claims of higher priority, creditors are entitled to postpetition interest before the debtor can recover any surplus.

In a chapter 11 case, the chapter 11 plan determines the treatment of secured and unsecured claims (as well as equity interests), subject to the requirements of the Bankruptcy Code.

Impairment of Claims Under a Chapter 11 Plan

Creditor claims and equity interests must be placed into classes in a chapter 11 plan and treated in accordance with the Bankruptcy Code's plan confirmation requirements. Such classes of claims or interests may be either "impaired" or "unimpaired" by a chapter 11 plan. The distinction is important because only impaired classes have the ability to vote to accept or reject a plan. Under section 1126(f) of the Bankruptcy Code, unimpaired classes of creditors and interest holders are conclusively presumed to have accepted a plan. Section 1126(g) provides that classes of creditors or interest holders that

[1] *In re Hertz Corp.,* 117 F.4th 109 (3d Cir. 2024), *as amended,* 2024 WL 4730512 (3d Cir. Nov. 6, 2024), *reh'g denied,* Nos. 23-1169 and 23-1170 (3d Cir, Nov. 6, 2024).

[2] *See generally* 11 U.S.C. § 506.

[3] *See id.* § 507(a).

[4] *See id.* § 726(a)(5) (emphasis added).

receive or retain nothing under a plan are deemed not to have accepted the plan.

Section 1124 provides that a class of creditors is impaired under a plan unless the plan: (i) "leaves unaltered the legal, equitable, and contractual rights" to which each creditor in the class is entitled; or (ii) cures any defaults (with limited exceptions), reinstates the maturity and other terms of the obligation, and compensates each creditor in the class for resulting losses.

Section 1124 originally included a third option, then section 1124(3), for rendering a claim unimpaired—by providing the claimant with cash equal to the allowed amotunt of its claim. In *In re New Valley Corp.*,[5] the court ruled that, in light of this third option, and because sections 726(a)(5) and 1129(a)(7) of the Bankruptcy Code (the latter discussed below) are applicable in a chapter 11 case only to impaired creditors, a solvent debtor's chapter 11 plan that paid unsecured claims in full in cash, but without pendency interest, did not impair the claims. The perceived unfairness of *New Valley* led Congress to remove this option from section 1124 of the Bankruptcy Code in 1994. Since then, most courts considering the issue have held that, if an unsecured claim is paid in full in cash with pendency interest at an appropriate rate, the claim is unimpaired under section 1124.[6]

Section 1124(1) "define[s] impairment in the broadest possible terms," so that "any change in legal, equitable or contractual rights creates impairment."[7]

However, the Second, Third, Fifth, and Ninth Circuits have concluded that, because section 1124(1) expressly refers to impairment imposed by a "plan," it does not apply to modifications that occur by operation of the Bankruptcy Code.[8]

Cram-Down Confirmation Requirements

If a creditor class does not agree to impairment of the claims in the class under the plan and votes to reject it, the plan can be confirmed only under certain specified conditions. Among these conditions are requirements that: (i) each creditor in the impaired class receive at least as much under the plan as it would receive in a chapter 7 liquidation;[9] and (ii) the plan be "fair and equitable."[10]

Therefore, in the case of a chapter 11 debtor that can pay its creditors in full with interest, the best interests test in section 1129(a)(7) would arguably require that any impaired unsecured creditors be paid pendency interest on their allowed claims "at the legal rate."[11] However, the meaning of "the legal rate" is unclear—it could mean the contract rate, the post-judgment rate, the federal statutory rate specified in 28 U.S.C. § 1961, or some other rate.[12]

The best interests test, however, applies only to impaired classes of claims or interests. This was not always the case. When the Bankruptcy Code was enacted in 1978, the provision applied to all classes—impaired or not. Congress amended section 1129(a)(7) in 1984 so that it now applies only to impaired classes.[13]

Section 1129(b)(2) of the Bankruptcy Code provides that "the condition that a plan be fair and equitable with respect to [an unsecured] class includes" the requirement that creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, if no creditor or equity holder of lesser priority receives any distribution under the plan. This is commonly referred to as the "absolute priority rule," which was derived in part from common law and practice under the former Bankruptcy Act of 1898 (as amended).

Disallowance of Claims for Unmatured Interest and the Solvent-Debtor Exception

Section 502(b)(2) of the Bankruptcy Code provides that a claim for interest that is "unmatured" as of the petition date shall be disallowed.[14] Charges that have been deemed to fall into this category include not only ordinary interest on a debt but items that have been deemed the equivalent of interest, such as original issue discount.[15] This means that, unless there is an exception stated elsewhere in the Bankruptcy Code (see below), any claim for postpetition interest will be disallowed.

[5] 168 B.R. 73 (Bankr. D.N.J. 1994).

[6] *See, e.g., In re PPI Enterprises (U.S.), Inc.*, 324 F.3d 197, 205–07 (3d Cir. 2003).

[7] *In re Taddeo,* 685 F.2d 24, 28 (2d Cir. 1982); *accord PPI,* 324 F.3d at 202 ("If the debtor's Chapter 11 reorganization plan does not leave the creditor's rights entirely 'unaltered,' the creditor's claim will be labeled as impaired under § 1124(1) of the Bankruptcy Code."); *In re L&J Anaheim Assocs.*, 995 F.2d 940, 942 (9th Cir. 1993) (adopting the *Taddeo* approach).

[8] *See In re LATAM Airlines Grp. S.A.,* 55 F.4th 377, 385 (2d Cir. 2022) (noting that unsecured creditors' contractual right to post-default interest, "'as applied to postpetition debts, was superseded by the Code—specifically, by § 502(b)(2)'s prohibition on the inclusion of "unmatured interest" as part of their claim,'" meaning that the creditors' claims were not impaired by the chapter 11 plan), *cert. denied,* 143 S.Ct. 2609 (2023); *PPI,* 324 F.3d at 204 ("[A] creditor's claim outside of bankruptcy is not the relevant barometer for impairment; [courts] must examine whether the plan itself is a source of limitation on a creditor's legal, equitable, or contractual rights."); *In re Ultra Petroleum Corp.,* 943 F.3d 758, 763 (5th Cir. 2019) ("The plain text of § 1124(1) requires that *'the plan'* do the altering. We therefore hold a creditor is impaired under § 1124(1) only if 'the plan' itself alters a claimant's 'legal, equitable, [or] contractual rights.'"), *cert. denied,* 143 S.Ct. 2495 (2023); *In re PG&E Corp.,* 46 F.4th 1047, 1063 n.11 (9th Cir. 2022) ("[A]n alteration of pre-bankruptcy rights that occurs by operation of the Code does not result in impairment."), *cert. denied,* 143 S.Ct. 2492 (2023).

[9] 11 U.S.C. § 1129(a)(7) (commonly referred to as the "best interests" test).

[10] *Id.* § 1129(b)(1).

[11] *See id.* § 726(a)(5).

[12] *See In re Hicks,* 653 B.R. 562 (Bankr. N.D. Ill. 2023) (discussing the disagreement among courts on the issue).

[13] *See* Bankruptcy Amendments and Federal Judgeship Act of 1984, 98 Stat. 333, Pub. L. 98-353 (1984) § 512(a)(7); *In re Wonder Corp. of Am.,* 70 B.R. 1018, 1024 (Bankr. D. Conn. 1987) ("[T]he 1984 Amendments also modified § 1129(a)(7) so that its provisions now only apply to 'each impaired class of claims or interests' rather than to 'each class of claims or interests.'").

[14] *See* generally COLLIER ON BANKRUPTCY ("COLLIER") ¶ 502.03 (16th ed. 2024) ("fixing the cutoff point for the accrual of interest as of the date of the filing of the petition is a rule of convenience providing for equity in distribution").

[15] *Id.*

The bar on recovery by creditors of interest accruing after a bankruptcy filing pre-dates the enactment of the Bankruptcy Code and is derived from English law.[16] Section 63 of the Bankruptcy Act of 1898, as amended by the Chandler Act of 1938, expressly disallowed unmatured interest as part of a claim.[17]

English law contained notable exceptions to the rule. One of those was the "solvent-debtor" exception, which provided that interest would continue to accrue on a debt after a bankruptcy filing if the creditor's contract expressly provided for it, and would be payable if the bankruptcy estate contained sufficient assets to do so after satisfying other debts.[18] In such cases, the post-bankruptcy interest was treated as part of the underlying debt obligation, as distinguished from interest "on" a creditor's claim.[19]

The fundamental principle barring creditors from recovering postpetition interest on their claims was incorporated into US bankruptcy law—as were some of the exceptions, but only in part.

In pre-Bankruptcy Code cases where the debtor possessed adequate assets to pay all claims in full with interest—meaning that the payment of interest to one creditor did not impact the recovery of other creditors—principles of equity dictated that creditors be paid interest to which they were otherwise entitled, most commonly at the rate determined by their contracts with the debtor.[20]

Even though section 502(b)(2) of the Bankruptcy Code provides that a claim for unmatured interest shall be disallowed, there are specific exceptions to the rule included elsewhere in the Bankruptcy Code. For example, section 506(b) of the Bankruptcy Code provides that an oversecured creditor is entitled to interest on its allowed secured claim.

In addition, as noted above, in a chapter 7 case, the distribution scheme set forth in section 726 of the Bankruptcy Code designates as fifth in priority of payment postpetition interest on an unsecured claim at "the legal rate."

Whether the solvent-debtor exception survived enactment of the Bankruptcy Code in 1978 is disputed. However, prior to *Hertz*, five federal circuit courts—albeit with vigorous dissents in certain cases—had ruled or suggested that the exception survived.[21]

Hertz

Citing disruption to their car rental business caused by the COVID-19 pandemic, the Hertz Corporation and its affiliates (collectively, the "debtors") filed for chapter 11 protection on May 22, 2020, in the District of Delaware. After an auction process, the bankruptcy court confirmed a chapter 11 plan for the debtors on June 10, 2021, under which the debtors' assets were sold to a group of private equity funds. At that time, the debtors' financial fortunes had vastly improved, and they were solvent.

The plan provided for the payment of unsecured creditors in full, including the holders of two series of senior unsecured notes issued by the debtors pre-petition (the "22/24 Notes" and the "26/28 Notes," and collectively, the "Notes"), together with pendency interest at the federal judgment rate, as well as a distribution to shareholders of approximately $1.1 billion in cash and new warrants or subscription rights. The plan accordingly provided that the

[16] *Nicholas v. U.S.,* 384 U.S. 678, 682 (1966) (explaining that "[i]t is a well-settled principle of American bankruptcy law that in cases of ordinary bankruptcy, the accumulation of interest on claims against a bankruptcy estate is suspended as of the date the petition in bankruptcy is filed[, which rule is] grounded in historical considerations of equity and administrative convenience"); *Sexton v. Dreyfus,* 219 U.S. 339, 344 (1911) (recognizing the rule that interest ceases to accrue on unsecured debt upon commencement of bankruptcy cases is a fundamental principle of English bankruptcy law, which is the basis of the U.S. system).

[17] Bankruptcy Act of 1938, ch. 575, § 63, 52 Stat. 840 (repealed 1978).

[18] *See In re Ultra Petroleum Corp.,* 913 F.3d 533, 543-44 (5th Cir.) (citing treatises and cases), *opinion withdrawn and superseded on reh'g,* 943 F.3d 758 (5th Cir. 2019), *cert. denied,* 143 S.Ct. 2495 (2023).

[19] *Id.*

[20] *See Am. Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.,* 233 U.S. 261, 266–67 (1914) (concluding "in the rare instances where the assets ultimately proved sufficient for the purpose, that creditors were entitled to interest accruing after adjudication"); *Debentureholders Protective Comm. of Cont'l Inv. Corp. v. Cont'l Inv. Corp.,* 679 F.2d 264, 269 (1st Cir. 1982) (in refusing to confirm a plan under chapter X of the Bankruptcy Act because it did not pay postpetition interest on unsecured claims, noting that "[w]here the debtor is solvent, the bankruptcy rule is that where there is a contractual provision, valid under state law, providing for interest on unpaid [installments] of interest, the bankruptcy court will enforce the contractual provision with respect to both [installments] due before and [installments] due after the petition was filed"); *Ruskin v. Griffiths,* 269 F.2d 827, 832 (2d Cir. 1959) ("where there is no showing that the creditor entitled to the increased interest caused any unjust delay in the proceedings, it seems to us the opposite of equity to allow the debtor to escape the expressly bargained-for" contractual interest provision); *Sword Line, Inc. v. Indus. Comm'r of N.Y.,* 212 F.2d 865, 870 (2d Cir. 1954) (explaining that "interest ceases upon bankruptcy in the general and usual instances noted … unless the bankruptcy bar proves eventually nonexistent by reason of the actual solvency of the debtor"); *Johnson v. Norris,* 190 F. 459, 466 (5th Cir. 1911) (determining that debtors "should pay their debts in full, principal and interest to the time of payment whenever the assets of their estates are sufficient").

[21] *See, e.g., LATAM,* 55 F.4th at 385–86 (ruling as a matter of first impression that the solvent-debtor exception requiring a solvent debtor to pay pendency interest to unsecured creditors to render their claims unimpaired survived the enactment of the Bankruptcy Code); *Ultra Petroleum*, 51 F.4th at 156 (a divided Fifth Circuit panel concluded that "the solvent-debtor exception is alive and well" and ruled that a solvent chapter 11 debtor was obligated to pay a make-whole premium to unimpaired noteholders amount "even though … it is indeed otherwise disallowed unmatured interest"); *PG&E*, 46 F.4th at 1062 (a divided Ninth Circuit panel ruled that "pursuant to the solvent-debtor exception, unsecured creditors possess an 'equitable right' to postpetition interest [under section 1124(1) of the Bankruptcy Code] when a debtor is solvent"); *Gencarelli v. UPS Capital Bus. Credit*, 501 F.3d 1, 7 (1st Cir. 2007) (stating that "[t]his is a solvent debtor case and, as such, the equities strongly favor holding the debtor to his contractual obligations as long as those obligations are legally enforceable under applicable non-bankruptcy law"); *In re Dow Corning Corp.*, 456 F.3d 668, 678 (6th Cir. 2006) (noting that "[t]he legislative history of the Bankruptcy Code makes clear that equitable considerations operate differently when the debtor is solvent: '[C]ourts have held that where an estate is solvent, in order for a plan to be fair and equitable, unsecured and undersecured creditors' claims must be paid in full, including postpetition interest, before equity holders may participate in any recovery'" (quoting 140 Cong. Rec. H10,752–01, H10,768 (1994)), *cert. denied*, 127 S.Ct. 1874 (2007).

Noteholders' claims were unimpaired, meaning that the Noteholders were deemed to accept the plan.

In accordance with the terms of the relevant indentures, the Notes were accelerated upon the debtors' bankruptcy filing. In addition, redemption of the Notes prior to the stated maturity date under certain specified conditions (including the confirmation of a plan repaying the Notes) triggered the debtors' obligation to pay the Noteholders a "redemption" or make-whole premium designed to compensate the Noteholders for the loss of future interest payments if the debt was paid off before maturity.

The plan confirmation order preserved the rights of the Noteholders to assert entitlement to make-whole premiums and additional interest as necessary to render their claims unimpaired. The plan, which expressly provided that the Noteholders would be paid whatever was necessary to render their claims unimpaired, went effective on June 30, 2021.

On July 1, 2021, the Noteholders (through their indenture trustees) filed a complaint seeking a declaratory judgment that, in addition to the principal and prepetition interest paid to the Noteholders on the effective date of the plan (in excess of $2.7 billion), the debtors were obligated to pay approximately $272 million, consisting of: (i) make-whole premiums due under the Notes totaling approximately $147 million; and (ii) pendency interest at the contract default rate (approximately $125 million), which at that time was 30 times greater than the federal judgment rate. The debtors filed a motion to dismiss the complaint.

The bankruptcy court concluded that the 26/28 Noteholders stated a plausible claim that make-whole premiums were due under the indentures because the redemption of the 26/28 Notes was at the debtor's option, rather than involuntary—i.e., a consequence of acceleration of the 26/28 Notes triggered by a bankruptcy filing that the debtors were forced to make due to the pandemic. However, due to the different language contained in the indentures, the court granted the debtors' motion to dismiss the 22/24 Noteholders' claims for make-whole premiums.

Next, the bankruptcy court considered whether, even if due under the terms of the indenture governing the 26/28 Notes, the make-whole premiums should be disallowed under section 502(b)(2) as the "economic equivalent" of unmatured interest, an issue that has been disputed by the courts.[22]

The bankruptcy court initially declined to decide the issue but did so in a subsequent opinion (discussed below). In this initial ruling, the court noted that, based on relevant case law and other authority, it was "not prepared to conclude, as a legal matter, that make-wholes cannot be disallowed as unmatured interest," but determined that more evidence of the economic substance of the make-whole premiums was necessary.[23]

The bankruptcy court then examined whether, even if the make-whole premiums were the economic equivalent of unmatured interest, the 26/28 Noteholders' claims, in accordance with the solvent-debtor exception, would be impaired under the debtors' plan if the 26/28 Noteholders were not paid the premiums. Initially, citing *Ultra*, *PPI*, and *PG&E*, it explained that "any modification of the Noteholders' claim to unmatured interest or to the [make-whole] premium (if it is the economic equivalent of unmatured interest) is an impairment of the Noteholders' contract claims by operation of section 502(b)(2) of the Bankruptcy Code, not the Debtors' Plan."[24] As a consequence, the court ruled, the 26/28 Noteholders' claims "are not impaired within the meaning of section 1124(1)."[25]

The bankruptcy court noted that, "in essence," the Bankruptcy Code "is silent on what treatment unimpaired creditors must receive in a solvent chapter 11 debtor case."[26] According to their express terms, it explained, "sections 1129(a)(7) and 726(a)(5) provide what treatment impaired creditors are entitled to receive, not what treatment unimpaired claims are entitled to receive in a solvent chapter 11 debtor case."

The court rejected the debtors' argument that, by repealing section 1124(3), lawmakers intended that unimpaired creditors must be paid their contract rate of interest in a solvent-debtor chapter 11 case. Congress, it explained, could have so provided by either: (i) amending section 1124(3) to require that unimpaired creditors receive their contract rate of interest, in addition to payment in full of their allowed claims; or (ii) amending section 502(b)(2) to provide that unmatured interest is disallowed "except in the case of a solvent debtor."[27] Yet it did neither.

The bankruptcy court wrote that "after consideration of the cases cited by the parties, the express language of the Bankruptcy Code, and its Legislative History, the Court is convinced that the solvent debtor exception survived passage of the Bankruptcy Code *only to a limited extent*."[28] It explained that the Bankruptcy Code expressly codified the solvent-debtor exception in section 506(b) as to oversecured creditors and in sections 1129(a)(7) and 726(a)(5) as to unsecured creditors. The court further

[22] *See generally* COLLIER at ¶ 502.03[3](a) (collecting cases).

[23] *Hertz,* 637 B.R. at 791.
[24] *Id.* at 794.
[25] *Id.*
[26] *Id.*
[27] *Id.* at 797.
[28] *Id.* at 800 (emphasis added).

noted that: (i) although sections 1129(a)(7) and 726(a)(5) currently apply only to unsecured creditors impaired by a chapter 11 plan, they applied to all unsecured creditors—impaired and unimpaired—when the Bankruptcy Code was originally enacted; and (ii) when Congress amended the Bankruptcy Code in 1984 to limit the scope of section 1129(a)(7) to impaired classes, "it was motivated by the desire to require voting only by impaired creditors, rather than by a desire to assure that unimpaired creditors get their contract rate of interest."[29]

The bankruptcy court also determined that neither the Bankruptcy Code nor its legislative history expressly states that unimpaired creditors are entitled to their contract rate of interest "or even to more than impaired creditors in the case of a solvent debtor."[30] Instead, it wrote, the legislative history "provides strong evidence Congress intended that unimpaired creditors in a solvent chapter 11 debtor case should receive post-petition interest only in accordance with sections 1129(a)(7) and 726(a)(5)."[31] Moreover, the court reasoned, the legislative history to the repeal of section 1124(3) suggests that lawmakers believed that there was no legitimate reason in a solvent-debtor chapter 11 case to distinguish between impaired and unimpaired unsecured creditors who are receiving full payment of their claims in cash under a plan. As a consequence, it ruled, "both should receive the same treatment: payment of their allowed claim plus post-petition interest at the federal judgment rate in accordance with section 726(a)(5)."[32]

The bankruptcy court accordingly held that the 26/28 Noteholders failed to state a plausible claim that the debtors were obligated to pay pendency interest on the 26/28 Notes at the rate specified in the indenture rather than at the federal judgment rate.

The 26/28 Noteholders and the debtors subsequently filed summary judgment motions on the issue of whether the make-whole premium payable on the 26/28 Notes was unmatured interest, or its economic equivalent, within the meaning of section 502(b)(2). The 26/28 Noteholders, based on the intervening court decisions in *PG&E* and *Ultra Petroleum*, also moved for reconsideration of the court's ruling that the noteholders were entitled only to the federal judgment rate of interest, rather than their contract rate, for any pendency interest due on their claims. In a November 21, 2022, opinion, the bankruptcy court granted the debtors' motion for summary judgment, finding that the make-whole premium was the economic equivalent of unmatured interest and must be disallowed under section 502(b)(2). The court denied the motion for reconsideration but certified a direct appeal of its ruling to the Third Circuit.[33]

The Third Circuit's Ruling

A divided three-judge panel of the Third Circuit affirmed the ruling in part, and denied it in part.

Writing for the majority, U.S. Circuit Judge Thomas L. Ambro agreed with the bankruptcy court that the 26/28 Noteholders' claim for make-whole premiums "must be disallowed under § 502(b)(2), for they fit both the dictionary definition of interest and are its economic equivalent."[34] However, he concluded, based primarily upon the absolute priority rule, the 26/28 Noteholders had a right to receive the make-whole premiums as well as pendency interest at the contract rate because Hertz was solvent.

According to Judge Ambro, Hertz simply could not "use the Bankruptcy Code to force the Noteholders to give up nine figures of contractually valid interest and spend that money on a massive dividend to the Stockholders" in keeping with more than century-old Supreme Court precedent holding that stockholders are not entitled to any distribution until creditors are paid in full.[35] Permitting the debtors to do so, Judge Ambro emphasized, would violate the Supreme Court's ruling in *Czyzewski v. Jevic Holding Corp.*,[36] prohibiting final distributions in a chapter 11 case that "deviate from the basic priority rules … the Code establishes for final distributions of estate value in business bankruptcies."

Based on relevant precedent, the Third Circuit majority concluded that "the Bankruptcy Code entitles every creditor—not just the dissenting impaired creditors who can invoke § 1129(b)—to treatment consistent with the absolute priority rule absent a clear statement to the contrary."[37] Accordingly, Judge Ambro reasoned, "the Noteholders' right to treatment consistent with absolute priority must be honored to leave them unimpaired."[38] He explained that lawmakers' decision to reuse the language "fair and equitable" from pre-Bankruptcy Code law in section 1129(b)(2) and the provision's use of the word "includes" was intended to incorporate the pre-Code common law absolute priority rule into the current statute.[39] That common law and jurisprudence applying it, Judge Ambro wrote, "required solvent debtors to pay

[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *See In re The Hertz Corp.*, Adv. Proc. No. 21-50995 (MFW), 2022 BL 426983, 2022 Bankr. Lexis 3358 (Bankr. D. Del. Nov. 21, 2022), *aff'd in part and rev'd in part*, No. 23-1169 (3d Cir. Sept. 10, 2024).
[34] *Hertz,* 2024 WL 4730512, at *2.
[35] *Id.* at *8 (citing *Chi., Rock Island & Pac, R.R. v. Howard*, 74 U.S. 392, 409-10 (1868)).
[36] 580 U.S. 451, 455 (2017).
[37] *Id.* at *11 (citation and footnote omitted).
[38] *Id.* at *12.
[39] *Id*. at *13.

contract rate interest before making distributions to equity."[40]

Even so, the Third Circuit majority noted that "compelling equitable considerations" might warrant the payment of pendency interest at a rate other than the contract rate, such as where the estate was not sufficiently solvent to pay every unsecured creditor the full amount of its contractual interest.[41]

According to Judge Ambro, if the plan only had to pay 26/28 Noteholders pendency interest at the federal judgment rate, they would recover less than objecting impaired creditors, thereby violating the basic premise that unimpaired "creditors cannot be treated any worse than impaired creditors, who at least get a vote."[42]

U.S. Circuit Judge David J. Porter concurred in part and dissented in part. He agreed with the majority's conclusions, except with respect to the payment of the make-whole premium and pendency contract-rate interest. Largely echoing the dissenting opinions in *Ultra Petroleum* and *PG&E*, Judge Porter wrote that: (i) treatment consistent with the absolute priority rule is not one of the rights "protected" by section 1124(1); and (ii) even if it were a protected right, the 26/28 Noteholders' claims were nevertheless unimpaired because those rights were altered not by the debtors' chapter 11 plan but by section 502(b) of the Bankruptcy Code, which expressly disallows any claim for pendency interest.[43]

Outlook

On September 25, 2024, the Third Circuit vacated its ruling. On November 6, 2024, the court filed an amended opinion that added certain footnotes but did not substantively alter its original opinion. The Third Circuit also denied the debtors' petition for rehearing *en banc*.

With *Hertz*, no fewer than six federal courts of appeals have now determined that the solvent-debtor exception is alive and well and requires a solvent debtor to pay pendency interest to unsecured creditors to render their claims unimpaired under a chapter 11 plan. In the absence of a circuit split on the question, and having repeatedly declined to review circuit court decisions involving the issue, the Supreme Court is unlikely to weigh in on any remaining controversy regarding it among bankruptcy and appellate courts.

The ramifications of *Hertz* and other similar recent rulings may be significant in large chapter 11 cases where the potential obligation to pay millions of dollars in pendency interest on unsecured claims may significantly impact a debtor's ability to confirm a plan. However, despite several recent high-profile bankruptcy cases involving solvent debtors, such cases remain relatively infrequent, so the impact of these rulings may be limited.

Key takeaways from the ruling include:

- If a make-whole premium payable under a debt instrument upon default is either definitionally or the economic equivalent of interest, the claim will be disallowed in the obligor's bankruptcy case as unmatured interest under section 502(b)(2) of the Bankruptcy Code.
- However, to render the claims of unsecured creditors entitled to an otherwise disallowed make-whole premium unimpaired under a chapter 11 plan, the plan must pay the creditors postpetition interest at the contract rate, unless equitable considerations warrant paying a different rate, as well as the make-whole premium amount.

The requirements expressly set forth in section 1129(b)(2) for the "fair and equitable" treatment of an impaired dissenting creditor under a cram-down chapter 11 plan are not exclusive. Other requirements, such as the pre-Bankruptcy Code common law absolute priority rule, may also apply.

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[40] *Id.* (citing cases).
[41] *Id.* at *14.
[42] *Id.* (citation and internal quotation marks omitted).
[43] *Id.* at **16–19.

JUMPING UP: BANKRUPTCY CODE DOLLAR AMOUNTS WILL INCREASE ON APRIL 1, 2025

Per an official notice from the Judicial Conference of the United States, certain dollar amounts in the Bankruptcy Code will be adjusted upward by 13.2004%, perhaps the largest increase to date. Inflation adjustments are made to certain Bankruptcy Code dollar amounts every three years, and these new amounts will apply to cases filed on or after April 1, 2025.

The Federal Register page with a chart listing all of the updated dollar amounts can be found at: https://www.federalregister.gov/documents/2025/02/04/2025-02207/adjustment-of-certain-dollar-amounts-applicable-to-bankruptcy-cases.

Among the most meaningful increases for Chapter 11 and other business bankruptcy cases:

- The employee compensation and employee benefit plan contribution priorities under Sections 507(a)(4) and 507(a)(5) both increase to $17,150 from $15,150;
- The consumer deposit priority under Section 507(a)(7) rises to $3,800 from $3,350;
- The total amount of claims required to file an involuntary petition rises to $21,050 from $18,600;
- The dollar amount in the bankruptcy venue provision, 28 U.S.C. Section 1409(b), which requires that actions to recover for non-consumer, non-insider debt be brought against defendants in the district in which they reside, has increased to $31,425 from $25,700;
- The minimum amount required to bring a preference claim against a defendant in a non-consumer debtor case, specified in Section 547(c)(9), rises to $8,575 from $7,575; and
- The total debt amount in the definition of small business debtor in Section 101(51D) will rise to $3,424,000 from $3,024,725.

Other adjustments will affect consumers more than business debtors. For example, the debt limit for an individual to qualify for a Chapter 13 bankruptcy case will rise to $1,580,125 of secured debt, and certain exemption amounts will also increase.

These new dollar amounts, on top of the 10.973% increase made in 2022, are now approximately 25% higher than the amounts in effect in 2019. Be sure to keep the new, higher amounts in mind when assessing cases filed after April 1, 2025. Official bankruptcy forms will likely be updated as the April 1, 2025 effective date draws near.

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FROM OPIOIDS TO OPT-OUTS: NONCONSENSUAL THIRD-PARTY RELEASES AND THE AFTERMATH OF *PURDUE*

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On June 27, 2024, the Supreme Court released its 5-4 opinion in connection with the bankruptcy case of Purdue Pharma L.P. ("Purdue").[1] Over a vigorous dissent authored by Justice Kavanaugh, a narrow majority of the Supreme Court held that the Bankruptcy Code does not permit chapter 11 plans of reorganization to provide for non-consensual releases of non-debtors outside of the asbestos context. As such, Purdue's bankruptcy plan—which contained extremely controversial third-party releases of the Sackler family for claims arising from the marketing of opioids—was held to be unconfirmable and the case was remanded to the bankruptcy court. The Supreme Court's opinion resolves a circuit split on the hotly disputed issue of third-party releases, but also leaves plenty of space for future litigation as to the legitimacy of consensual ("opt-in" or "opt-out") third-party releases, full-satisfaction releases, and the exculpation of parties and professionals in bankruptcy cases.

The Conflict over Non-Consensual Third-Party Releases

Traditionally, bankruptcy only operates to eliminate claims held by creditors against the debtor. Corporate debtors have increased the number of parties who benefit from the elimination of claims by including non-consensual third-party releases of claims against non-debtors in chapter 11 plans of reorganization, particularly in the mass tort context. These third-party releases, when approved by the bankruptcy court, operate to preclude creditors of the debtor from pursuing claims against non-debtor third parties, including shareholders, officers, and directors. Such releases are often justified by the contributions the third parties have made to the reorganization efforts. Despite increasing prevalence in chapter 11 restructurings, however, third-party releases have remained controversial and the subject of heated debates, both inside and outside the courtroom.

Purdue's Bankruptcy

The debates regarding non-consensual third-party releases led to a split of authority, which culminated in the Supreme Court's decision to address the issue in the chapter 11 bankruptcy case of Purdue. Purdue, a pharmaceutical company with most of its revenue stemming from the sale of the prescription opioid OxyContin, found itself faced with what the bankruptcy court referred to as a "veritable tsunami of litigation" arising from the marketing and sale of OxyContin. As a result, Purdue filed for bankruptcy protection in September 2019. After two years of litigation and extensive negotiation, Purdue obtained confirmation of a reorganization plan which, among other things, contained third-party releases eliminating claims held by creditors of Purdue against Purdue's private owners (the Sackler family) and other non-debtor entities, including claims arising from alleged willful misconduct and fraud. In return, the Sacklers agreed to contribute approximately $4.5 billion to fund charities and certain recoveries under the plan. While the plan was supported by an overwhelming majority of creditors, several states and other creditors objected to, among other things, the plan's release of the Sacklers, and appealed the plan following confirmation.

On appeal, the United States District Court for the Southern District of New York vacated the order confirming Purdue's chapter 11 plan, holding that non-consensual third-party releases were not permitted by the Bankruptcy Code. Following that reversal, the Sacklers entered into further negotiations and agreed to contribute an additional $1.5 billion in exchange for the non-consensual releases. This additional money persuaded certain objectors to drop their objections, but other parties, including the US Trustee, continued to oppose the plan on the basis that more money does not cure the impermissibility of third-party releases. The issue went up to the Second Circuit which reversed the district court and held that non-consensual third-party releases were permitted by the Bankruptcy Code. The case was further appealed to the Supreme Court.

[1] *Harrington v. Purdue Pharma L.P.*, 603 U.S. 204 (2024).

The Supreme Court Decision

In a 5-4 decision, the Supreme Court reversed again, holding the Bankruptcy Code does not permit non-consensual third-party releases. The Supreme Court's analysis was simple and focused tightly on the text of the applicable sections of the Bankruptcy Code. The Supreme Court held that Congress had not drafted the Bankruptcy Code to permit non-consensual releases of non-debtors to be included in a bankruptcy plan except in cases involving claims relating to asbestos. Because it held that there was no statutory authority for the non-consensual releases, the Supreme Court did not need to reach issues concerning the constitutionality of non-consensual third-party releases, which had been raised by several parties.

The Court noted that the only statutory hook the parties had identified to support the inclusion of non-consensual third-party releases in a bankruptcy plan was Bankruptcy Code § 1123(b)(6). Bankruptcy Code § 1123 governs the "contents" of a chapter 11 plan of reorganization. Bankruptcy Code § 1123(a) provides various provisions that a plan "shall" include. Bankruptcy Code § 1123(b) contains various provisions that a plan "may" include, including provisions that "impair or leave unimpaired any class of claims,"[2] provide for the assumption, rejection or assignment of executory contracts,[3] settle or otherwise resolve claims held by the debtor against non-debtors,[4] sell the debtor's property,[5] and modify the rights of holders of secured claims against the debtor.[6] Critically for the *Purdue* case, the list of provisions that "may" be included in a bankruptcy plan includes a "catchall" final subsection: a plan "may" include "any other appropriate provision not inconsistent with the applicable provisions of this title."[7]

The parties defending the plan relied on this catchall provision to justify the Sacklers' releases, arguing the non-consensual release of liability was an "appropriate" provision—in the context of the Purdue bankruptcy—that was not barred by any other "applicable provision" of the Bankruptcy Code. The Supreme Court rejected that argument. It held § 1123(b)(6) was "a catchall phrase tacked on at the end of a long and detailed list of specific directions," and that, under ordinary principles of statutory construction, such a "catchall provision" should not be afforded the "broadest possible construction" but rather should be read only to "embrace only objects similar in nature to the specific examples preceding it."[8]

In connection with § 1123(b), the Supreme Court held that there was an "obvious link" between the preceding five subsections in the list: all "concern the *debtor*—its rights and responsibilities, and its relationship with its creditors."[9] As such, the Supreme Court held that § 1123(b)(6) must be similarly limited—it could not be "fairly read to endow a bankruptcy court with the radically different power to discharge the debts of a nondebtor without the consent of affected nondebtor claimants."[10]

The fact—focused on by the dissent—that § 1123(b)(3) permitted the resolution of claims of the debtor's estate against non-debtors, including the resolution of claims that other parties may be granted "derivative" standing to pursue in place of the debtor, did not change the analysis.[11] Such "derivative" claims "belong to the debtor's estate."[12] That a bankruptcy plan could resolve and release them thus did not justify the position that a bankruptcy court could release *direct* claims of non-debtor creditors against other non-debtors.

To further support its holding, the Supreme Court considered and rejected arguments that broad "policy" considerations should be used to expand the meaning of § 1123(b)(6) beyond the bounds suggested by the statutory wording.[13] It also noted other provisions in the Bankruptcy Code, including § 524(e), that were inconsistent with the view that the Bankruptcy Code granted broad powers to discharge non-debtors[14] and that prior to the Bankruptcy Code's enactment in 1978 no courts granted non-consensual third-party releases. Thus, had Congress intended to radically expand bankruptcy court's power in that respect, one could expect it to have done so clearly, not simply by a reference to "appropriate" provisions.[15] The Supreme Court also expressed concern at the abuse of such releases. The Supreme Court noted the Sacklers were receiving what amounted to a discharge of all Purdue-related claims against them, without the Sacklers delivering all of their assets to a bankruptcy court for equitable distribution, and in derogation of Bankruptcy Code provisions that—in a Sackler bankruptcy—would have prohibited them from being discharged of claims arising from "fraud" or "willful misconduct." In other words, the Supreme Court concluded "the Sacklers seek greater relief than a bankruptcy discharge normally affords, for they hope to extinguish even claims for wrongful death and fraud, and they seek to do so without putting anything close to all their assets on the table."[16] Such expansive relief, the Court held, was not permissible.

[2] 11 U.S.C. § 1123(b)(1).
[3] 11 U.S.C. § 1123(b)(2).
[4] 11 U.S.C. § 1123(b)(3).
[5] 11 U.S.C. § 1123(b)(4).
[6] 11 U.S.C. § 1123(b)(5).
[7] 11 U.S.C. § 1123(b)(6).
[8] *Purdue*, 603 U.S. at 217 (internal quotations and citations omitted).
[9] *Id.* at 218.
[10] *Id.*
[11] *Id.* at 219.
[12] *Id.*
[13] *Id.* at 220.
[14] *Id.* at 221-222.
[15] *Id.* at 223-224.
[16] *Id.* at 223.

The Supreme Court finished its decision by emphasizing what it was *not* deciding. The Supreme Court made clear that it was not seeking to cast doubt on the legitimacy of *consensual* third-party releases or what constituted "consent" for such purposes, the inclusion of "full satisfaction" third-party releases in a bankruptcy plan (releases upon full satisfaction of the subject creditors' claims), or whether equitable mootness could apply to a plan that had been consummated including third-party releases.[17]

Dissent

Justice Kavanaugh authored a dissent, which was joined by Chief Justice Roberts and Justices Sotomayor and Kagan. The dissent, which was phrased in forceful terms, focused largely on policy considerations, arguing the non-consensual third-party releases were the opioid victims' best hope of receiving a recovery on account of their claims and were necessary to deal with "collective action" issues in mass tort cases. The dissent would have taken a much more expansive view of § 1123(b)(6), taking the view that it permits a bankruptcy court to include any provision that it considers "appropriate" to facilitate the Bankruptcy Code's purposes, including non-consensual releases of non-debtors. The dissent further expressed concern that the majority's reasoning would, even if unintentionally, cast doubt on the inclusion in a bankruptcy plan of consensual third-party releases, full-satisfaction releases, or the exculpation of parties and professionals for actions taken during a bankruptcy case, because, on the majority's reading, there was no clear basis to include such provisions in a bankruptcy plan, under Bankruptcy Code § 1123(b)(6) or otherwise.

Immediate Aftermath, Takeaways, and Considerations

The Supreme Court's opinion seeks to resolve one of the most controversial matters facing bankruptcy courts in recent years—the permissibility of non-consensual third-party releases—and firmly rejects them in all circumstances outside asbestos cases. The dissent's and debtors' fears that creditors would get nothing absent the releases has not yet materialized—once the decision was rendered, all parties headed back into mediation to resolve the dispute on the new legal landscape almost immediately. However, it remains to be seen how quickly the parties can come to a consensual resolution, if at all. Moreover, the decision leaves various other issues unresolved, which will likely result in further litigation.

First, and even though the Supreme Court expressly noted it was not deciding this issue, its reasoning casts some doubt on the inclusion of both consensual third-party releases and full-satisfaction releases in bankruptcy plans, as the dissent recognized.

If § 1123(b)(6) must relate solely to the *debtor* and its "rights and responsibilities," as the Supreme Court held, then on what basis can even consensual *non-debtor* releases be included in a bankruptcy plan? It may be possible to justify the inclusion of consensual non-debtor releases in a plan as, essentially, the use of the plan as a mechanism to establish a contract for non-debtors to release claims against other non-debtors. The consensual nature of such relief largely eliminates the concern that the Bankruptcy Code is being abused to benefit private parties who have not satisfied all the criteria for a bankruptcy discharge. As to "full-satisfaction" third-party releases, however, which are non-consensual, it may be challenging to justify including them in a bankruptcy plan following *Purdue*. There is no apparent basis under § 1123(b)(6) to include such releases of non-debtors, and the plan is not being used as a vehicle to offer a contract. It may be possible to argue that they are justified under some other provision of the Bankruptcy Code, or general law providing for the extinguishment of liability upon full satisfaction, but this reasoning may not work if the full-satisfaction release purports to modify the claimant's rights against the third party in any respect not permitted under generally-applicable law. We can expect such arguments to be made in the future, and counter-arguments to be raised by dissatisfied creditors.

Second, and assuming the continued permissibility of consensual third-party releases, the Supreme Court did not decide what constitutes consent. That issue has already been litigated in various cases, with some courts holding that a *failure to object* amounts to consent, and others taking a view of consent as requiring some *express indication of assent*. This issue has already surfaced in the post-*Purdue* confirmation decision in the bankruptcy of Red Lobster Management LLC,[18] in which

[17] *Id.* at 226-227.

[18] *In re Lobster Mgmt. LLC*, No. 6:24-bk-02486-GER (M.D. Fla. Bank. July 26, 2024).

the bankruptcy court granted approval of the debtor's disclosure statement only on the condition that "opt-out" third-party releases (binding parties to such release unless they affirmatively opt out) be removed from the plan, in favor of "opt-in" third-party releases (rendering releases only effective as to parties who affirmatively opt in). On the other hand, Judge Lopez in the Bankruptcy Court of the Southern District of Texas has recently approved a plan containing opt-out third-party releases, holding that such opt-out releases were consensual and not barred by *Purdue*.[19] The issue of consent will now take on an outsized importance. If the more expansive view of consent is widely adopted, then, as a practical matter, the *Purdue* decision may not result in a radical change in results in mass tort cases.

Third, parties will likely raise the *Purdue* case to argue exculpations of parties for their actions during bankruptcy cases are no longer permitted, as suggested by the dissent. That argument is unlikely to prevail. Courts have long been recognized as having an inherent authority to control and limit claims that can be asserted against parties in a case before it, including in the seminal decision of *Barton v. Barbour.*[20] Moreover, exculpations only apply to actions taken in connection with a debtor's bankruptcy case, to advance that bankruptcy case. As such, they arguably contain a more direct nexus to the debtor's reorganization efforts than the releases in *Purdue*. As a result, it is unlikely that *Purdue* should be construed to cast doubt on properly tailored exculpations.

Fourth, issues concerning the constitutionality of non-consensual third-party releases have not been resolved. We can expect such issues to be raised and litigated in the future, including in asbestos cases, where non-consensual third-party releases are explicitly authorized under Bankruptcy Code § 524(g).

Finally, although the availability of non-consensual third-party releases has led to successful debt restructurings with enhanced recoveries for creditors stemming from contributions of such parties to pay for such releases, the *Purdue* decision does not eliminate the benefit of third-party settlements to help fund chapter 11 plans. Although *Purdue* eliminates non-consensual releases of *direct* claims of creditors against settling third parties, plans may still settle the *debtor's* claims, and thus claims derivative of the debtor's claims, and such settlements would in most cases still be highly valuable and worth substantial contributions by third parties. Although such parties have historically insisted on full non-consensual releases because case law allowed them, such parties may accept the releases that survive *Purdue* in exchange for a similar level of currency they would have paid for non-consensual releases pre-*Purdue*. Indeed, all parties in the *Purdue* case have since returned to mediation to reach a new deal, though the results of that mediation remain to be seen.

Moreover, bankruptcy courts acknowledge the availability of litigation stays under Bankruptcy Code § 105 remain appropriate and permissible in certain circumstances to protect third parties while settlements are negotiated.[21] Other creative solutions may exist to work around, or within the parameters of, the *Purdue* decision. For example, the Long Island Roman Catholic diocese, which has been in bankruptcy for approximately four years as a result of alleged sexual abuse claims, recently announced a settlement of all claims against it and its parishes. To provide releases to those parishes, which did not file for bankruptcy with the diocese, the diocese plans to file extremely short chapter 11 cases for the parishes for the sole purpose of effectuating the diocese's settlement with alleged sexual abuse victims and obtaining discharges from tort liability. As a result of these clarifications and work arounds, the long-term impact of the *Purdue* decision may well be significantly less than its perceived significance today.

[19] *See In re Robertshaw US Holding Corp.*, 662 B.R. 300, 322-24 (Bankr. S.D. Tex. 2024).

[20] 104 U.S. 126 (1881).

[21] *In re Parlement Techs., Inc.*, 661 B.R. 722, 728 (Bankr. D. Del. 2024).

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IS YOUR DEBT A 'SECURITY' AND WHY DOES IT MATTER?

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Background

When restructuring a financially distressed corporation, existing creditors can often be issued new debt in the reorganized entity in satisfaction of the existing debt. Whether a creditor recognizes gain or loss in a debt-for-debt exchange often depends on whether the debt qualifies as a 'security' under section[1] 354(a).[2] In many cases the creditor may aim to plan into a loss position, however the loss may be deferred instead and reflected in the basis of the new debt received, provided the exchange qualifies as a reorganization. Each creditor's specific situation will determine whether they prefer a current loss or deferral.

For corporate debtors, the distinction of 'security' versus debt is generally irrelevant. In a debt exchange (deemed or otherwise), the debtor is treated as having satisfied the existing debt with an amount equal to the issue price of the new debt.[3] Generally, "income from discharge of indebtedness," also known as cancellation of debt income ("CODI"), is included in gross income.[4] The rationale behind this inclusion is that the discharge of indebtedness increases the taxpayer's net worth, similar to receiving cash or other forms of income. For example, if a debtor owes $100 and the creditor forgives the entire debt, the debtor economically receives $100, which is treated as income. There are some exclusions to this general rule, such as insolvency or bankruptcy, where the discharged debt may be excluded from gross income.[5]

CODI is recognized to the extent that the adjusted issue price ("AIP") of the old debt exceeds the issue price of the new debt under section 108(e)(10). This applies regardless of whether the underlying debt is a security or not, and regardless of any tax-deferred treatment at the creditor level in the exchange. So, while a debtor corporation might not have preference whether the new debt is a security or not, creditors will, depending on what type of tax treatment they desire. The creditors' tax treatment may therefore drive the debtor's decision.

When is a Debt a Security?

Generally

In the context of debt exchanges, the term 'security' is neither clearly, consistently, nor comprehensively defined in the Code. In some instances a security is defined as "a share of stock in a corporation, a right to subscribe for, or to receive, a share of stock in a corporation, or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation."[6] In another section of the Code the term also includes notional principal contracts, derivative financial instruments, hedge positions, and more.[7] Elsewhere still, the term is restricted to exclude "a short-term purchase money note" in the context of a reorganization.[8]

Factors

Given the varying definitions of what a security *is*, taxpayers and practitioners must analyze the specific facts and circumstances of each situation on a case-by-case basis. *Camp Wolters Enterprises, Inc.*[9] established an insightful and comprehensive test, stating that courts should look at a multitude of factors to determine if a debt is a security. The court considered several factors, some of which are listed below:

- **Nature of the Debt:** The determination of whether an instrument is a security involves an overall evaluation of the nature of the debt, the degree of participation and continuing interest in the business, and the extent of proprietary interest compared with the similarity of the note to a cash payment.
- **Degree of Participation and Continuing Interest:** Whether the note holders had a substantial risk in the taxpayer's enterprise and were tied to the success of the venture, similar to stockholders is considered. This factor helps determine if the notes represent a proprietary interest rather than a mere debt obligation.

[1] All section references are to the Internal Revenue Code of 1986 (the "Code"), as amended, or to underlying regulations.
[2] Section 354(a) is the operative provision which facilitates corporate reorganizations by allowing shareholders to exchange their stock or securities in a corporation involved in a reorganization for stock or securities in another corporation that is also a party to the reorganization, without recognizing gain or loss.
[3] Section 108(e)(10)(A).
[4] Section 61(a)(11).
[5] These exceptions are detailed in other sections of the Code and Treasury Regulations ("Treas. Reg.") that are beyond the scope of this article.
[6] Section 165(g)(2) and section 1236(c).
[7] Section 475(c)(2).
[8] Treas. Reg. Sec. 1.368-1(b).
[9] *Camp Wolters Enterprises, Inc. v. Commissioner,* 22 T.C. 737 (U.S.T.C. 1954).

- **Time Period of the Notes/Maturity:** Although the term length of the notes is an important factor, it is not the sole determinant. The court emphasized that the test is not a mechanical determination, with a brightline number of years, but an overall evaluation of the nature of the debt. Courts have generally upheld that a note with a maturity date less than five years is not a security. Conversely, a note with a maturity date greater than 10 years tends to be long enough to qualify for security treatment.[10]

- **Purpose of the Advances:** Whether the notes were intended to be a permanent contribution to the business or merely temporary advances for current needs is considered. For example, notes which participate in the formation financing of a corporation are indicative of a security, versus short-term lending for general operational expenses.

- **Conditions Precedent to Payment:** The conditions necessary to occur for the notes to be paid are also analyzed. For example, subordinated notes, the payments on which are contingent on the extinguishment of a senior debt, weighs in favor of security treatment.

Debt-for-Debt Exchanges

As mentioned above, in a debt-for-debt exchange, the creditors must generally recognize gain to the extent that the amount realized exceeds the adjusted basis of the exchanged debt,[11] with the amount realized equal to the issue price of the new debt.[12] If, however, the exchange meets the requirements of a recapitalization under section 368(a)(1)(E),[13] then any gain or loss is deferred[14] and the basis of the exchanged debt is reflected in the basis of new instrument.[15] Similar gain/loss deferral may also result from a number of other section 368 reorganizations and tax-deferred transactions (e.g., section 368(a)(1)(D) or section 351 exchanges).

To qualify for this tax-deferred treatment in an exchange, the debtor must exchange a security for stock or securities. Consequently, to the extent the debt exchanged is not a security, the exchange is taxable. Depending on the creditor's circumstances and objectives, a creditor may want tax-deferred treatment as part of a

reorganization. Conversely, other creditors, such as those that bought the old debt at a premium, might want to recognize a loss immediately on the exchange.

Generally, the issuance of equity in exchange for debt is nontaxable to a debtor corporation under section 1032. However, CODI is recognized by the debtor corporation under section 108(e)(8) to the extent the value of the equity issued is less than the debtor's adjusted issue price in the debt. If the exchange is a recapitalization that meets the requirements of section 368(a)(1)(E),[16] gain or loss is deferred for the creditor/holder of the debt, but the debtor may still have CODI.

The IRS has provided guidance[17] that addresses whether a debt instrument issued by an acquiring corporation in a reorganization, in exchange for a security of the target corporation, qualifies as a 'security' under section 354. The ruling involves a scenario where Target Corporation issues debt instruments with a term of 12 years and market interest rates.[18] In a merger qualifying as a reorganization under section 368(a)(1)(A), Target Corporation's security holders exchange their securities for debt instruments of the Acquiring Corporation with identical terms, except for a modified interest rate. The IRS concluded that despite the interest rate modification, the Acquiring Corporation's debt instruments are considered 'securities' for purposes of section 354 because they represent a continuation of the security holder's investment in substantially the same form.

Examples

The purpose of the following examples is to demonstrate how specific provisions provide varying tax implications for both creditors and debtors, including the recognition of gain or loss, the basis of new securities received, and the potential exclusions and reductions of CODI.

[10] *See e.g., Burnham v. Commissioner,* 86 F.2d 776 (7th Cir. 1936); *Commissioner v. Neustadt's Trust*, 131 F.2d 528 (2nd Cir. 1942); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Commissioner v. Sisto Financial Corp.*, 139 F.2d 253 (2nd Cir. 1943); and *Neville Coke & Chemical Co. v. Commissioner*, 148 F.2d 599 (3rd Cir. 1945).
[11] Section 1001(a).
[12] Treas. Reg. Sec. 1.1001-1(g).
[13] Treas. Reg. Sec. 1.368-2(e)(1).
[14] Section 354(a).
[15] Section 358(a).
[16] Treas. Reg. Sec. 1.368-2(e)(1).
[17] Revenue Ruling 2004-78, 2004-2 C.B. 108.
[18] The ruling provides as a matter of fact that the instruments represent 'securities' but does not explain in any real detail as to why.

Example 1

Corporation X has issued $1,000,000 of debentures treated as securities to various creditors. Due to financial difficulties, Corporation X proposes a recapitalization plan whereby it will exchange its debentures for new bonds, which are treated as securities. The fair market value of the new bonds is $800,000 at the time of the exchange.

- This transaction qualifies as a recapitalization under section 368(a)(1)(E), which involves the exchange of debt treated as securities within the same corporation.

Creditors' Tax Consequences

- Under section 358(a), the basis of the new bonds received by the creditors will be the same as the basis of the debentures surrendered in the exchange. If the creditors' basis in the debentures was $1,000,000, this basis carries over to the new bonds received. In other words, any built-in-loss is preserved in the new bonds.
- Under section 354(a)(1), no gain or loss will be recognized by the creditors upon the exchange of debentures for the new bonds, provided the exchange is part of a reorganization plan. Therefore, the creditors will not recognize any gain or loss on this transaction.

Debtor's Tax Consequences

- Under section 108(e)(10), Corporation X is treated as having satisfied the debentures with an amount of money equal to the fair market value of the bonds issued. Therefore, Corporation X will recognize CODI to the extent that the debentures ($1,000,000) exceed the fair market value of the bonds issued ($800,000). Thus, Corporation X will recognize $200,000 as CODI.

Example 2

Corporation X owes Creditor A $100,000. Corporation X is financially distressed; therefore, Creditor A agrees to restructure the Corporation X debt. Corporation X issues a new debt instrument with a principal amount of $70,000 to Creditor A in exchange for the original $100,000 debt. Neither debt is treated as a security.

Creditors' Tax Consequences

- Creditor A must recognize gain or loss on the exchange of the old debt for the new debt instrument. Accordingly, Creditor A realizes a loss of $30,000 ($70,000 amount realized - $100,000 adjusted basis).

Debtor's Tax Consequences

- Corporation X must recognize $30,000 of CODI ($100,000 original debt - $70,000 new debt instrument).

Conclusion

In summary, for distressed corporations undergoing financial restructuring, the classification of debt as a security is critical in determining the tax implications for creditors in a debt-for-debt exchange, affecting whether any gain/loss is recognized on the exchange or is deferred. While a corporate debtor may be subject to CODI regardless of whether the debt is a security or not, creditors' tax objectives, particularly in distressed scenarios, often shape the structure of the exchange. Aligning these considerations is essential to achieving mutually beneficial outcomes during the restructuring process.

Whether the debt is a security will impact the tax treatment of the exchange, and the determination is ultimately a case-by-case facts-based analysis that looks at a number of factors and circumstances. Taxpayers should consult with a tax specialist to understand and address the relevant issues based on their specific circumstances.

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TAX CHALLENGES AND OPPORTUNITIES IN A TIGHTENING ECONOMY

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Navigating a tightening economic cycle—characterized by prolonged high interest rates and uncertainty about future rate cuts and the Trump administration's economic policy—requires care and foresight. In the current financial climate, companies with declining income tend to accrue "tax assets," such as substantial net operating losses (NOLs) and tax credits, while dealing with deteriorating investments in their subsidiaries. In addition, debt modifications and forbearances are common as credit becomes scarce and companies face increased liquidity needs as well as challenges in satisfying their debt covenants and obligations.

In this article, we share our perspectives on the often overlooked and potentially drastic tax consequences that can result from various financial actions. These same actions also provide potential opportunities to optimize cash tax savings and beneficial tax attributes. The challenge for companies and their advisors in the current economic climate lies in avoiding the first while benefiting from the second.

How Can Minor Debt Modifications Trigger Substantial Tax Consequences?

Companies often negotiate changes to debt terms or secure forbearance agreements, which can be a lifeline for companies facing liquidity issues or financial strain. However, if the modifications are "significant," as defined for US federal income tax purposes, the borrower is treated as engaging in a taxable exchange of its original debt for a new, modified instrument.[1] This change could result in the lender recognizing gain or loss on the exchange and the borrower recognizing debt retirement premium or cancellation of indebtedness income (CODI).[2] As a result, it is imperative that companies and their advisors are aware of any contemplated changes to a company's debt instruments, since even seemingly minor changes could lead to substantial tax consequences including, but not limited to, reductions to NOLs and other tax assets.

When considering changes to debt instruments (including changes pursuant to the terms of the debt instrument), companies and their advisors should bear in mind these key points:

- The scope of changes considered "modifications" for tax purposes is broad and encompasses changes made outside a written contract (for example, an oral agreement or conduct of the parties), as well as consent fees and certain prepayment penalties. Additionally, certain changes that occur under the original terms of a debt instrument (for example, a change in obligor or co-obligor) are also within the bounds of modifications subject to these rules.[3]
- Nuanced tax rules determine whether a modification is "significant." There is a general facts-and-circumstances test, along with four specific tests that examine changes in yield, the timing of payments, the obligor or security/collateral, and the nature of the debt instrument (such as a shift from recourse to nonrecourse or from debt to equity).[4]
- A single modification may need to be evaluated under several tests to determine if it is significant. For example, if a fee is paid to extend the maturity date of a debt instrument, the change must be analyzed under both the yield and the timing-of-payments tests.
- If a modification is not initially considered significant, it must still be factored into the analysis of subsequent modifications. Companies must determine if the cumulative effect of all changes constitutes a significant modification, regardless of the time between modifications or whether a

[1] Treasury Regulations Section 1.1001-3.
[2] The amount of the gain or loss is determined by comparing the difference between the issue price of the new debt and the lender's basis in the old debt. See Internal Revenue Code Section 1001. The tax consequences are determined by comparing the difference between the issue price of the new debt and adjusted issue price of the original debt. See IRC Section 108(e)(10) and Treasury Regulations Section 1.61-12(c).
[3] Treasury Regulations Section 1.1001-3(c)(2).
[4] Treasury Regulations Section 1.1001-3(e). For purposes of determining whether the "modified" debt instrument is properly characterized as debt for federal income tax purposes, the financial condition of the obligor is ignored, unless the modification involves a substitution of an obligor or the addition or deletion of a co-obligor. See Treasury Regulations Section 1.1001-3(f)(7).

subsequent modification was anticipated at the time of the first change.[5]

Which Analyses Determine the Tax Consequences of a Significant Modification?

When a company's debt instrument is significantly modified, it triggers two analyses critical for determining the tax consequences: the issue price of the "new" debt instrument and the company's solvency status for tax purposes.

The-Everything-Is-"Publicly Traded" Nightmare

Determining the issue price of a modified debt instrument hinges on whether it is classified as "publicly traded." When either the old or the new debt instrument meets this criterion, the issue price of the new instrument is its *fair market value* at the time of the exchange, which often falls below the issue price of the old debt, potentially triggering CODI.

To be "publicly traded" for this purpose, a debt instrument must satisfy two conditions. First, it must have a stated principal amount *exceeding $100 million*. Second, during the thirty-one-day period ending fifteen days after the new debt issuance, it must have one of the following: 1) an accessible actual transaction price, 2) a buy or sell quote from an identified market maker, such as a broker, a dealer, or a pricing service, where the quote is expected to be actionable, or 3) a nonbinding price estimate from a market maker not covered in the previous price or quote categories (an "Indicative Quote").[6] Especially because of the last category, which can include Bloomberg BVAL and Markit indicative quotes, most debt is treated as publicly traded for this purpose, which comes as a surprise to many debtors and their advisors.

However, not all is lost. A careful analysis of the available quotes could yield a higher, yet reasonable, issue price of the new debt, which would reduce the likelihood that the company would recognize any CODI. Although the hierarchy of quotes is as listed above, if multiple quotes exist within a particular category, a company can use any reasonable method, applied consistently under similar circumstances, to determine the fair market value of a debt instrument. Further, if an Indicative Quote does not accurately reflect the debt's value, a company can use an alternative method to determine its fair market value.

If neither the old debt nor the new debt is publicly traded, the issue price of the new debt is generally the face amount (irrespective of fair market value). This often leads to minimal or no CODI, assuming no reduction in the principal amount of the debt.

Being Insolvent (for Tax Purposes) May Be a Good Thing

One of the most prevalent exceptions to recognition of CODI for tax purposes is the insolvency exception, which allows a company to exclude CODI from taxable income to the extent of its insolvency.[7] Although declaring a company insolvent is akin to dragging nails down a chalkboard for management and their advisors (what with its potential impact on debt covenants, among other risks), for purposes of the CODI exception, insolvency is defined as the excess of the company's liabilities over the fair market value of its assets, both determined immediately before the debt discharge.[8] Therefore, a company can be solvent for financial statement purposes while being insolvent for tax purposes (which generally amounts to a win-win scenario).

To determine if the insolvency exception applies, a detailed analysis of the company's financial position is required, which involves a comprehensive assessment of all the company's liabilities and a valuation of its assets. If the modification is known ahead of time, tax planning strategies, including the following, could be facilitated:

- ***Liability planning*.** Accelerating liability recognition before the debt discharge – especially for liabilities not tied to asset acquisitions – or increasing the amount of liabilities could cause a company to either become insolvent for tax purposes or increase its insolvency position before the significant modification, thereby increasing the amount of excluded CODI.
- ***Insolvency monitoring*.** Monitoring the fair market value of a company's assets, which often yields a range of values rather than a precise figure, can help assess the company's proximity to insolvency and inform decisions on whether it is advantageous to trigger a significant modification.

Special rules apply for testing insolvency when the debtor is a disregarded entity (e.g., a single-member LLC that does not elect to be treated as a corporation for tax purposes) or a partnership, which could affect planning strategies.

Unfortunately, excluding CODI due to the insolvency exception comes at a cost: a company must reduce certain tax assets, including NOLs, tax credit carryforwards, and tax basis in the company's assets, to the extent of its excluded CODI *after* calculating its tax liability for the year

[5] See Treasury Regulations Section 1.001-3(f)(3). The general rule for testing the cumulative effect of a series of debt changes does not apply in all situations. For example, for the change-in-yield test, modifications that occur more than five years before the modification test date are disregarded.
[6] Treasury Regulations Section 1.1273-2(f).
[7] IRC Section 108(a).
[8] IRC Section 108(d)(3). There are special rules governing the determination of insolvency and the corresponding attribution reduction for members of a consolidated group. See Treasury Regulations Section 1.1502-28.

in which the CODI would have been recognized. Special rules govern the reduction of tax attributes where the excluded CODI is of a disregarded entity or a partnership. Because of the timing of the attribute reduction, companies can engage in proactive tax planning strategies, including:

- ***Income and deduction management.*** Deferring deductions or accelerating income to reduce a company's NOLs, tax credits, and other tax assets can help minimize attribute reduction or affect which attributes must be reduced. This can also be accomplished by engaging in extraordinary transactions that use tax assets that would have otherwise been subject to attribute reduction.
- ***Preservation of tax attributes.*** Modeling the prescribed methods for attribute reduction could help companies and their advisors determine the best approach to preserve the more valuable tax assets (which are those that will be used sooner).

Additionally, if liabilities were increased using the strategy above, the extent of attribute reduction required as a result of excluded CODI may be decreased because it is generally capped at the excess of the company's aggregate tax basis of its assets over its liabilities, both determined immediately after the debt discharge.

How Can Companies Benefit from Recognizing CODI?

Although companies may typically avoid triggering taxable income, in certain scenarios it may be advantageous to recognize taxable CODI (CODI that is ineligible for a full exception) through careful planning, including by way of a significant modification. The potential benefits include:

- ***Unlocking deductions.*** Counterintuitively, recognizing CODI can benefit a company because the increase in taxable income can unlock deductions that might otherwise be deferred (for example, the deductions for business interest expenses, charitable contributions, and NOLs) or lost (for example, deductions for foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI)).
- ***Navigating the corporate alternative minimum tax (CAMT).*** For a corporation subject to CAMT – a fifteen percent minimum tax on certain corporations based on their adjusted financial statement income (AFSI) – recognizing CODI might not result in an immediate increase in taxes if its regular taxable income is less than its AFSI. Depending on whether CODI is recognized for financial statement purposes, the recognition of CODI could be "tax-free" in the current year, since the decrease in the corporation's CAMT liability may fully offset the increase in its regular tax liability.
- ***Creating more valuable future deductions.*** As discussed above, as part of a significant modification, a new debt instrument is deemed to be issued. The difference between the debt's stated redemption price at maturity and its issue price is known as original issue discount (OID). This OID, which generally equals the CODI amount, can be amortized and deducted as interest expense over the term of the new debt instrument, which can be beneficial if the CODI is recognized in a year in which an NOL is expected. By recognizing CODI, a company can convert a current-year NOL into tax asset carryforwards in the form of OID tax deductions in future years, which may be subject to the Section 163(j) business interest expense tax deduction limitation but would not be subject to the eighty-percent-of-taxable-income limitation applicable to NOLs.

How Can Companies Recoup Lost Subsidiary Investments as Tax Benefits?

Shifting gears to opportunities for tax savings, companies with debt or equity investments in failed or financially distressed subsidiaries can often recoup some of their lost investment by claiming a bad debt deduction or a worthless stock loss. The following key steps can maximize value:

- Ascertain the maximum amount of the potential deduction or loss, which is generally the adjusted issue price of the debt or the tax basis in the equity investment (applying special rules for consolidated groups).
- Determine the character of the potential deduction or loss. Losses on debt investments are generally an ordinary deduction for the holder.[9] Worthless stock losses, however, are generally capital losses, unless both the shareholder and the worthless subsidiary are corporations and members of the same affiliated group, in which case the loss could be ordinary.[10]
- Forecast the expected use of the potential deduction or loss. Capital loss carryforwards may offset only future capital gains, whereas NOL carryforwards from a bad debt deduction may offset only eighty percent of a company's taxable income.

[9] IRC Section 166.
[10] See IRC Section 165(g)(3) for various requirements for obtaining ordinary treatment.

- Determine how to trigger the loss or deduction. For a debt instrument, a holder may be able to claim a bad debt deduction when it forgives all or some of the debt or modifies the terms such that the change constitutes a significant modification. For equity instruments, liquidations or sales of stock of a subsidiary could trigger a worthless stock loss. Special rules apply for triggering losses within a tax consolidated group.

Companies and their advisors should also assess the full extent of losses that can be recognized, considering other rules that could further limit or reduce NOLs, tax credits, and other tax assets, such as change-of-ownership limitations applicable for corporations under Section 382 discussed below and the attribution reduction required when excluding CODI under the insolvency exception discussed above.

Why Are Ownership Changes Such a Big Deal?

Corporations planning to use their tax attributes must keep abreast of their "Section 382 position" (that is, how close they are to an "ownership change"). If a corporation experiences a Section 382 ownership change, the corporation's ability to use its pre-change NOLs, built-in losses, tax credits, and certain other tax assets to offset post-change taxable income may be limited (generally based on the value of the corporation's equity). In general, a corporation experiences an ownership change whenever its "five-percent shareholders" (which may include indirect shareholders and certain groups of individuals who own less than five percent of the corporation's stock by value) increase their direct and indirect ownership in the corporation by over fifty percent in aggregate over a rolling three-year lookback window.

A corporation that relies heavily on the availability of certain tax attributes and is on the brink of triggering an ownership change, may consider adopting certain share restrictions or a poison pill to reduce the likelihood of an ownership change. Alternatively, if a corporation expects to generate tax assets in the future, it may want to first trigger an ownership change to mitigate the potential effects under Section 382. Importantly, tax assets can be subject to multiple limitations, requiring an ongoing Section 382 exercise, which often involves a historical review of the corporation's ownership, potentially as far back as 1986. In addition, corporations and their advisors should consider how a change in ownership could affect other tax strategies, such as those discussed in this article.

Conclusion

Companies facing significant financial challenges should proactively seize opportunities to generate tax savings while avoiding potentially catastrophic tax effects that could arise from certain debt restructuring decisions or changes in ownership. Complexities abound under each of the challenges and opportunities discussed in this article, which are further compounded by the significant overlap. Applying the underlying tax rules (whether in taking a worthless stock loss or modifying "publicly traded" debt) is rife with traps for the unwary. As a result, companies and their advisors should carefully analyze debt restructuring alternatives and implement tax strategies that maximize savings and minimize adverse tax consequences.

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PRIVATE CREDIT: MORE ROOM TO GROW, BUT INFRASTRUCTURE TO CATCH UP

Jordan Fisher
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Introduction

Private credit continues to raise capital, originate new asset opportunities, and provide attractive financing opportunities for borrowers. While economic activity continues to be robust and credit stress remains limited, there are factors that private credit lenders and advisors should keep in mind, including portfolio management infrastructure and credit recovery strategies when the inevitable credit cycle turns.

Definitions

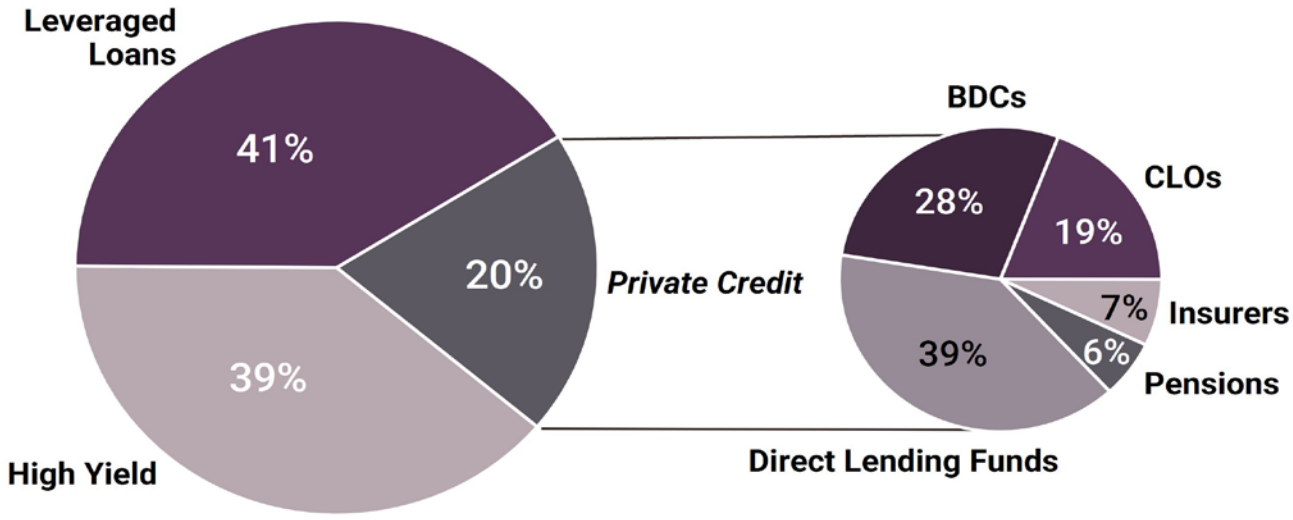
Private credit is defined as corporate lending ***outside*** of regulated bank commercial and industrial (C&I) lending, the investment-grade bond market, and other traditional debt sources, such as bank-sponsored syndicated leverage loans and the high yield bond market. As shown in Figure 1, private credit includes lending by insurance companies, pension funds, Business Development Companies (BDCs), and direct lending funds, and loans that are originated and packaged into Collateralized Loan Obligation (CLO) asset-backed securitization structures.

In general, the private credit market is characterized by floating rate loans with credit documents negotiated directly between the borrower and lender. Enhanced private debt strategies include:

- Litigation finance
- Reinsurance
- Royalty finance
- Infrastructure debt
- Real estate debt
- Asset-backed lending
- Rescue finance
- Venture debt
- Structured CLO debt
- Mezzanine debt

Returns from enhanced strategies are expected to be higher than core lending strategies, by as much as 3% to 5%, depending on the strategy and asset manager.

FIGURE 1: Composition of US Leveraged Credit Market – 2023 Estimates[1]



[1] ICE, Pitchbook LCD, Morgan Stanley Research.

FIGURE 2 – Private Lending by Source 2010-2023[2]

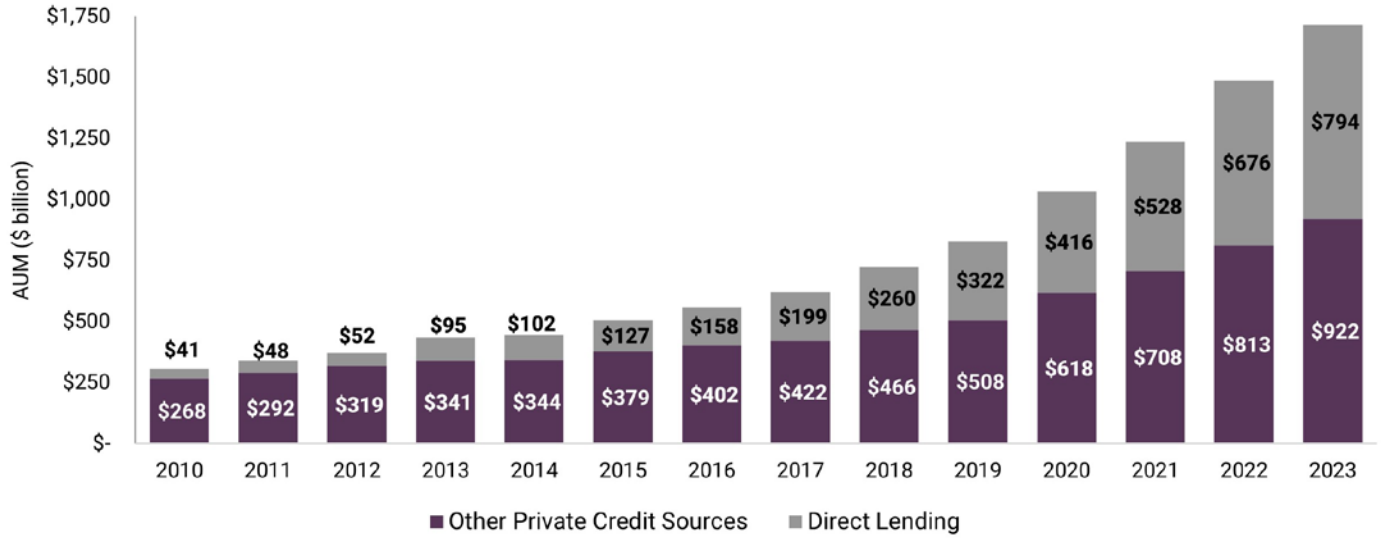
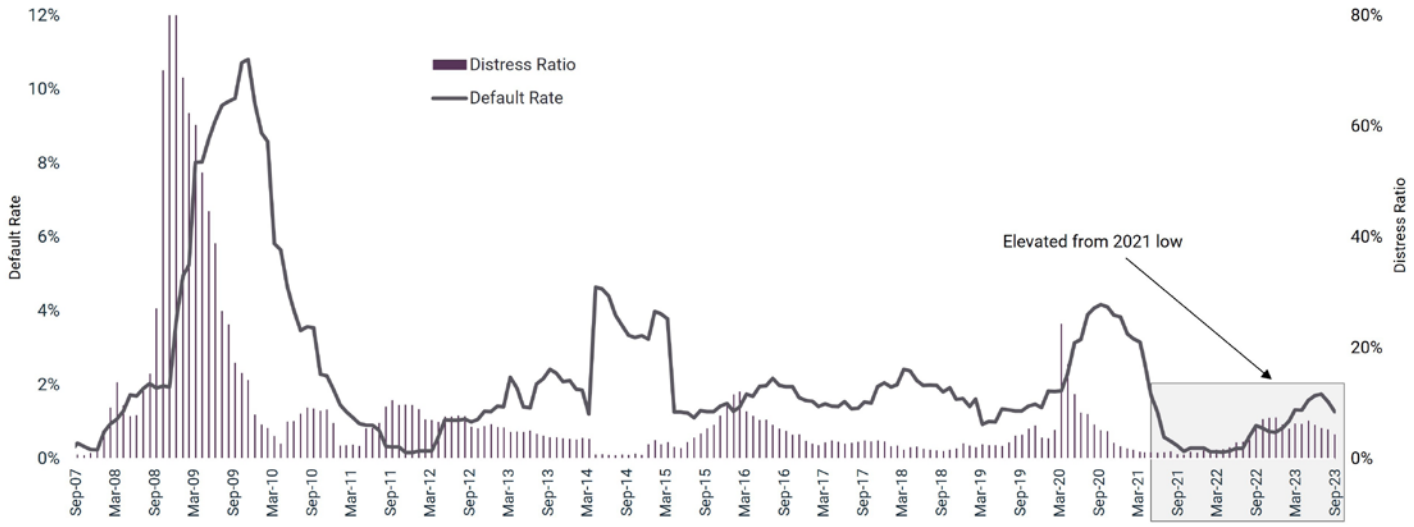


FIGURE 3 – Historical Distress Ratio and Default Rates[3]



Growth Observations

Asset balances within the private credit space have grown significantly since the global financial crisis due to tighter regulations on banks, demand by borrowers for certainty in pricing and transaction execution, long-term, partner-like relationships, customized funding, and smaller transaction sizes. While private credit assets have grown significantly since the global financial crisis (14% annual growth from 2010 through 2023), the largest driver of this growth is direct lending, which has grown at 26% during the same period. Direct lending represented 13% of private credit in 2010 and grew to 46% in 2023.

[2] The Federal Reserve, Preqin.

Economic Cycles

The private credit market is complex and not exempt from the effects of adverse changes in the economic environment. Risks include significant or abrupt interest rate changes, industry sector downturns, labor and wage disruptions, and other geopolitical or technological threats. Since the global financial crisis, the credit cycle has seen short periods of elevated distress and default rates (as illustrated in the leverage loan data in Figure 3), but since 2021, overall credit stress has been relatively low.

[3] Pitchbook LCD Data. Distress ratio represents loans priced below 80 and bonds trading above 1,000 bps yield spread. Default ratio represents trailing 12-month defaults weighted by principal amount.

Private Credit Differences vs. Traditional Lending

Select Benefits

- Private credit lenders are more willing to review, diligence, and underwrite 'storied credit' opportunities
- Borrower terms and acceptable collateral / security may be more flexible and tailored to each situation
- Most private credit organizations are structured with lean and flat organizations, which enables quicker underwriting and amendment decisions
- Higher spreads and the acceptance of higher risks enable a broader set of potential solutions and actions upon credit deterioration, including restructuring and ownership

Select Limitations

- Private credit portfolios are concentrated in middle market-size companies; scale and size have challenges if overall portfolio performance deteriorates
- New capital investment / commitments expect that loan originations will continue at pace, which may pressure lean underwriting teams with sometimes limited credit cycle history and perspectives
- Secondary market for private credit loans is still developing (ETF and CLO volume continues to grow)
- Limited product bundling (e.g., treasury services) limits the visibility and relationship touchpoints with companies

Portfolio Management

Above is a simple comparison of certain benefits and limitations of direct lending versus traditional bank lending.

The same characteristics that have driven the tremendous growth in credit exposure within direct lending funds also present potential risks. Direct lending growth drivers include demand from middle market and upper-middle market borrowers with often asset-light business models. These borrowers pay higher credit spreads due to the non-traditional collateral and, sometimes, because of the less straight-forward credit underwriting proposition that traditional bank lenders avoid.

Within direct lending funds, the credit portfolios are managed by lean, efficient teams of in-house specialists that sometimes tap external advisors to assist with diligence, structuring of operational and financial turnarounds, and documentation of waivers and amendments. These lean direct lending teams facilitate direct discussions between borrowers and lenders, and relatively quick amendment negotiations and decisions, as needed. However, if a significant portion of a direct lender's portfolio were to experience stress, the need for advisors, and expenses associated with these advisors, may have a significant impact to credit recoveries and returns for the asset class.

Opportunity for Advisors

Given the efficient infrastructure at many direct lending platforms, there may be a future opportunity for numerous middle market-size credit disruptions. Advisors may consider positioning efficient teams that can service opportunities of this size and type. Unlike broadly syndicated leverage loans which support significant professionals and professional fees, middle market distress and defaults require hands-on, efficient teams that can identify opportunities and implement solutions quickly and effectively.

The views reflected in this article are the views of the author and do not necessarily reflect the views of Ernst & Young LLP or other members of the global EY organization.

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THE IMPACT OF THE ECONOMIC OUTLOOK ON VALUATION

Jordan Donsky, *Forensic Valuation Associates*
Seth Hersom, *Hilco Enterprise Valuation Services*

The impact of the economic outlook on the valuation of privately held companies can be profound in any number of direct and indirect ways.

A written appraisal or valuation report usually contains a section on the economic outlook. It should include a review of each of the most important leading economic indicators, including any specific to the subject company and its industry. Careful consideration should be applied to indicators which affect customers, suppliers, or other business partners. One typical indicator is economic growth that may be measured on a national, state, and/or local level. Other economic trends may include inflation, housing starts, consumer confidence and spending, business investment, interest rates, or fiscal policy, among others. The source for historical and forecasted economic data should be clearly identified.

Subject Company Cash Flow Forecasts

Forecasts used in a discounted cash flow model are typically five years, unless a shorter or longer period is justified. Growth beyond the discrete projection period is usually projected to be stable and set to match expected long-term inflation levels. The economic outlook in many cases could and should have a direct effect on the subject company's cash flow forecasts. For example, in the post-COVID era, it is common to observe many mature companies forecasting organic revenue growth upwards of 10 to 15 percent per year for several years. While such aggressive growth forecasts from interested parties such as management must always be scrutinized, this level of growth may be more easily justified if the economy is emerging from or recovering from a disruptive event like a pandemic, or if there has been a recent shift in industry trends in which the company operates. A company that had experienced declines in revenue for several years and, like the economy, is in recovery mode, may have an easier time achieving seemingly high sales growth; however, this "growth" may only bring the company back to pre-pandemic levels. In any case, the subject company forecast should make sense relative to economic forces as well as its own recent financial performance.

We recently worked as rebuttal experts on a case where post-pandemic tourism statistics were erroneously used to bolster future sales projections. This example includes the following table:

Year	Visitors	Growth
2014	41,126,512	-
2015	42,312,216	2.9%
2016	42,936,100	1.5%
2017	42,214,200	-1.7%
2018	42,116,800	-0.2%
2019	42,523,700	1.0%
2020	19,031,100	**-55.2%**
2021	32,230,600	**69.4%**
2022	38,829,300	20.5%
2023	40,829,900	5.2%
CAGR (2014 - 2023)		-0.1%
CAGR (2019 - 2023)		-1.0%

The report we reviewed stated, "Management's growth forecasts are supported by tourism data, showing the city continues to recover and grow…" While we agreed that recent post-pandemic recovery trends were favorable, even impressive with 20.5% growth in 2022, we also recognized that measuring the CAGR from 2014 to 2023 and from 2019 to 2023 showed slightly negative longer-term growth trends. In other words, well after the pandemic, for 2023, visitors had yet to exceed pre-pandemic levels going back as far as 2014.

Exceptions always exist. For example, the economic outlook may be dire, while for any number of reasons the subject company is forecasting growth. Perhaps the subject company gains a competitive advantage during hard times? Or maybe the subject company has stockpiled cash and plans to take advantage of the good (or bad) economy through acquisitions. On the other hand, the economic outlook may be grand while the subject company is expected to experience a decline in sales. Such a decline could be an example of a counter-cyclical business, or a company caught in a downward spiral where competition is eroding sales. Taxes or legislation could be to blame. When the company's outlook is different than the overall economic outlook, the valuation expert should be able to explain the discrepancies.

Comparable Company Transaction Multiples

In June 2007, the American Institute of Certified Public Accounts (AICPA) issued the Statement on Standards for Valuation Services No. 1 (SSVS No. 1) that defines the guideline company transactions method as one within the market approach whereby market multiples are derived from the acquisition of majority stakes or entire companies engaged in the same or similar lines of business. This method is also referred to as deal "comps," precedent transaction analysis, merger and acquisition (M&A) method, or comparable M&A transactions. The transactions method uses multiples of the target companies as a guideline for the estimate of reasonable multiples for the subject company. Guideline transaction multiples can include the effect of potential synergies for the acquirer and a control premium. Investment bankers often use precedent transactions in corporate finance as well as mergers and acquisitions, but rarely in equity research. One reason for the lack of popularity is the equity research analysts' perception that this approach tends to be backward looking in nature, instead of a forward-looking method.

Historically, strategic buyers, such as competing companies, have been willing and able to pay higher purchase prices due to the perceived ability to realize synergies from the combined entity. When the public markets supply inexpensive debt with favorable terms, financial buyers like private equity firms can compete with strategic buyers on price. As debt financing becomes scarcer and more expensive, the advantage shifts back to the strongest and most creditworthy strategic buyers that can source acquisition financing.

Seller motivations, such as an urgent need for cash, can influence purchase price. Instead of a value maximization strategy, the seller may accept a lower valuation in exchange for speed of execution and certainty of completion. This may be especially pronounced during periods of grim economic outlook. This, theoretically, would have a downward effect on transaction multiples and the valuation of private companies. In summary:

- Even during periods of uncertain economic outlook, the guideline company transaction method can be useful.
- Just as a larger sample size produces greater statistical significance, the utilization of additional valuation methods may lead to a more accurate business valuation. The various results can then be portrayed in a valuation football field chart.
- It is important to understand the influences on the purchase prices when finalizing the universe of comparable acquisitions, such as the buyer and seller motivations, terms (e.g., all-cash versus financed), whether it was an auction or negotiated process, or a hostile takeover.

The comparable company transaction method has other limitations that should be considered. Some of these limitations include:

- Availability of information such as a limited number of comparable transactions or private transactions with little information.
- Lack of comparability such as different size and scale, difference in maturity, varying profitability and outlook on future performance, or fundamentally different operations.
- Other limitations which may require consideration include transaction timing, market conditions at the time of the observed transactions, financial versus strategic buyer, geographical differences, regulatory environment, and accounting adjustments.

Adjustments can often be made to account for some or all of the limitations discussed.

Comparable Public Company Multiples

SSVS No. 1 also defines the guideline public company method within the market approach whereby market multiples are derived from market prices of stocks of companies that are engaged in the same or similar lines of business and that are actively traded on a free and open market. Guideline public companies are also known as "comps" or comparable companies. This analysis can sometimes include both equity research analyst earnings estimates and the typically more optimistic management projections. For publicly traded companies, multiples based on the 52-week high and low as well as current stock price can be included as a representation the range of how the public markets valued the company. The consensus estimate of equity research analysts is a useful point of reference. Multiples derived from public stock prices and those companies' performance measures or anticipated companies' performance measures are applied to the subject company performance to derive indication of value. As in the comparable company transaction method, adjustments may need to be considered when comparing the subject company to the identified public comps.

The stock market and the economy are intricately and intimately related. This article does not address in detail the implications of the economic outlook on the multiples derived from historical and forward-looking performance measures of public companies. It is meant to serve as

a reminder to look beyond the forward (or historical) multiples to some of the underlying assumptions including the economic outlook and to question why the multiples are as they appear. How does the past and future economy translate in terms of multiples? Are the appropriate companies chosen and why? Is the performance of the companies selected subject to the same or similar economic conditions as the subject company?

Development of Discount Rates

The economic outlook can have a variety of effects on discount rates. Some of the "building blocks" for both equity and debt rates of return commanded by the marketplace will ultimately be affected by government and private sector borrowing rates. For example, US Treasury rates and publicly available market debt rates are commonly used when developing discount rates. Long-term inflationary expectations may also have an effect. Certainly, the alpha, which represents the unsystematic risk for a particular investment in a company, may be swayed by the impact of the economic outlook as it relates such investment in a specific company.

Supporting the Conclusion of Value

A valuation opinion should be self-supporting and stand on its own merit. The overall conclusion should be supported through a series of analyses and a narrative report. The Economic Outlook research and analyses are usually contained within the narrative section of a valuation report. Beware of economic sections with no connection made as to how the outlook affects the subject company. This economic section of a written valuation report often paints a general economic picture but should also address issues specific to the subject company's business and ultimate value. When presented as a whole, the end result should be a congruent work with most if not all indications pointing to the same generally supported conclusion of value for the subject company or interest. The economic outlook is one of many influencing factors to be considered in reaching such a "supported conclusion." This article was meant to add fuel for thought in using, reviewing and preparing opinions about valuation.

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Alvarez & Marsal Announces Gaurav Malhotra as a North American Commercial Restructuring Managing Director

NEW YORK, November 21, 2024—Mr. Malhotra joins Alvarez & Marsal with a quarter century of financial and operational restructuring, strategic transformation, and turnaround management experience, highlighting the firm's strategic talent expansion commitment.

Working across multiple sectors, Mr. Malhotra advises on strategic transformations and liquidity enhancements, multi-party negotiations, cost reduction optimization and commercial pricing plans, along with providing expert testimony.

Jeff Stegenga, Managing Director and A&M's North American Commercial Restructuring Leader, underscored, "Gaurav sees turnaround challenges through the lens of transformation opportunities. His approach aligns with A&M's operational heritage and senior leader-led engagement strategy."

Previously, Mr. Malhotra served as a partner at EY, leading that firm's US Restructuring Practice. During his tenure at EY, he served as financial advisor to the Financial Oversight and Management Board for Puerto Rico, aiding in the restructuring of $70 billion in debt and $55 billion in pension obligations.

Mr. Malhotra commented, "A&M's integrated platform and history of devising bespoke solutions allows for navigating complex restructuring problems across multiple jurisdictions."

Mr. Malhotra is a Chartered Financial Analyst (CFA) and a member of the Turnaround Management Association and the American Bankruptcy Institute.

R3M Law Recognized in the 2025 Best Law Firms Rankings

R3M Law has been recognized for the twelfth year in a row in the highly selective Best Law Firms rankings, now in its 15th edition, including recognition for its work in Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law. This honor highlights R3M's dedication to legal excellence, expertise, and client-focused service.

The Best Law Firms selection process includes rigorous assessments of client feedback, peer recommendations, leadership evaluations, and an in-depth review of practice areas. This distinction reflects the hard work and commitment of R3M's entire team.

In addition to the firm's recognition, Howard P. Magaliff and Jeffrey N. Rich were both recognized for their work in the field of Bankruptcy and Creditor Debtor Rights/Insolvency and Reorganization Law.

Howard P. Magaliff

Jeffrey N. Rich

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2	Jul 08-16, 2025	Online
3	Sep 03-11, 2025	Online
1	Oct 07-15, 2025	Online
2	Nov 18-19, 2025	New York, NY
3	Dec 09-16, 2025	Online

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