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From the Executive Director's Desk



JAMES M. LUKENDA, CIRA

AIRA

Just a short note from me in this issue of *AIRA Journal*. There is plenty of timely content, thought provoking detail, and relevant information to follow in the accompanying articles.

At this point I congratulate Dave Bart on the conclusion of his term as AIRA's president in conjunction with the upcoming virtual annual conference and welcome Mike Lastowski as his successor. Both Dave and Mike have worked tirelessly on behalf of the Association and its membership over the past years. The quality of the articles you see here is a testament to their effort and the efforts of the rest of the editorial team who source the articles and work with the authors to provide this compelling and timely publication.

Hopes are high that the nation has turned the corner on containing the COVID virus. As Mike lays out in his accompanying letter, AIRA is planning for our 10th Annual Energy Conference in September to be an in-person event, our first since VALCON 2020. Member/attendee safety and well-being remain first and foremost in all our planning efforts. AIRA will continue to follow CDC guidance as well as feedback from our membership as planning for this and later events continues. For now, we are remaining hopeful, planning accordingly, and looking forward to seeing our friends, colleagues, and professional acquaintances in person later this year.

Both Dave and Mike's accompanying letters provide additional details on AIRA's upcoming programs and other matters. Please give these letters a careful read.

Once again, my thanks to Dave for all his work this past year as president and welcome to Mike as he undertakes the AIRA presidency.

Stay safe and stay well.

Jim

A Letter from AIRA's President



DAVID BART, CIRA, CDBV

RSM US LLP

As we approach the midpoint of 2021, we look forward to the remainder of a year when live activities are returning. Please see AIRA's calendar for the many activities available to our members.

COMINGS & GOINGS – Congratulations to incoming AIRA President Michael Lastowski of Duane Morris on his upcoming term. Each year, AIRA's leadership changes, and new terms in office begin, in conjunction with AIRA's Annual Bankruptcy and Restructuring Conference. Michael is a good friend and has dedicated many years to AIRA on its Board of Directors. We all wish him the best of luck going forward. I have been honored to serve the AIRA as President and will become the incoming Chairman. Thank you to Brian Ryniker for his leadership as Chairman this past year. Brian is also a personal friend who has dedicated untold hours to leading AIRA. Thank you for all you have done.

EVENTS – AIRA's 37th Annual Bankruptcy & Restructuring Conference (AC21) is scheduled for June 8-30. AC21 converted to a virtual program this year in response to the pandemic. It will be presented in a manner similar to our AC20 virtual program, with our sessions spread out over a four week online experience. Thank you in particular to AC21 Co-Chairs Shirley S. Cho of Pachulski Stang Ziehl & Jones LLP and Thomas P. Jeremiassen, CIRA, of Development Specialists, Inc., and to AC21 Judicial Co-Chairs Hon. Jerrold N. Poslusny, Jr., D. N.J., and Hon. Mark Wallace, C.D. Cal., for their excellent work in pulling together an outstanding program. Also, thank you to the many AC21 sponsors that are featured on the AIRA website. Your support is critical and is very much appreciated. Please register online.

AIRA DISTINGUISHED FELLOWS PROGRAM – I am very excited to promote the new AIRA Distinguished Fellows program. As we go to press, AIRA is reviewing applications for its first class of new Distinguished Fellows that will be announced in conjunction with the AC21 Conference. AIRA conceived this new program as a way to recognize the significant contributions its senior members have made to the art and science of corporate restructuring and to AIRA. Recognition as an AIRA Distinguished Fellow is intended as an academic and professional honor for those members who exemplify the highest quality of professional practices and who have left a legacy in our professional field. Applications

CDBV

Part:

3

Dates:

Aug 24-Sep 02, 2021

Location:

Online

**More information and registration
at www.aira.org/cdbv**

can be made throughout the year, and AIRA plans to announce a new class of Fellows each June. Please see AIRA's website for more information and to apply.

CONGRATULATIONS – Thank you to everyone involved in VALCON in May. The American Bankruptcy Institute and AIRA are presenting another wonderful, joint, virtual event with many participants and sponsors from across the country. Thanks in particular to Jim Lukenda, AIRA's Executive Director, for his efforts and the new programs on valuation.

Stay healthy, and I hope you, your colleagues, and your families all have a terrific summer.

David Bart

A Letter from AIRA's President-Elect



MICHAEL R. LASTOWSKI

Duane Morris LLP

To AIRA's members and supporters:

Many thanks to each of you for your continued support of AIRA during these challenging times. During the past year,

AIRA nimbly navigated COVID-19 lockdown challenges and successfully sponsored, in a webcast format, our usual series of conferences. We are all looking forward to AIRA's 37th Annual Bankruptcy and Restructuring Conference, which will be presented in a webcast environment June 8 - 30.

The annual conference is the event at which the AIRA president passes the baton to his successor. I want to thank outgoing president David Bart, CIRA, CDBV, for his continued good work for AIRA. We have all benefited from David's tireless dedication. He has played a major role in maintaining the continued excellence of the *AIRA Journal* and will continue to serve our organization in his new role of Chairman of the Board. Dave has become a personal friend and I congratulate him for all of his excellent work as president.

Please try to attend these other events, which AIRA intends to present "live" during the remainder of 2021:

- September 9, 2021 - 10th Annual Energy Conference – The Belo Mansion and Conference Center, Dallas TX
- October 8, 2021 – NCBJ Annual AIRA Breakfast Program – Indianapolis, IN

- November 15, 2021 – 20th Annual Advanced Restructuring & Plan of Reorganization Conference – The Union League Club, New York, NY.

AIRA will continue to offer professional certification and educational courses online. AIRA's website, www.aira.org, includes descriptions of our many online CPE offerings and our CIRA and CDBV programs.

Please consider writing an article for the *AIRA Journal*. Although the *Journal* has been published for decades, due to the efforts of David Bart of RSM US LLP and Boris Steffen of Province, Inc., the content of the *AIRA Journal* has reached a new, higher level. Please contact me at mlastowski@duanemorris.com or Boris at bsteffen@provincefirm.com if you want to submit or suggest the topic of an article.

I look forward to working with our incoming Chairman, David Bart, and our Executive Director, Jim Lukenda, to maintain the standard of excellence established by my predecessors. I have always been impressed by the expertise and professional accomplishments of our members. It is a great personal honor to be named president. I look forward to a successful year.

Michael Lastowski

CIRA

2021 COURSE SCHEDULE

Part:	Dates:	Location:
1	Jun 02-14, 2021	<u>Online</u>
2	Jul 13-21, 2021	Online
3	Sep 07-15, 2021	Online
1	Oct 19-27, 2021	Online
2	Nov 16-19, 2021	Online
3	Dec 13-16, 2021	Online

More information and registration
at www.aira.org/cira

RESTRUCTURING CORPORATE DEBT: A DIFFERENT KIND OF CYCLE

MIKE HARMON

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Stanford Graduate School of Business

While economic cycles are as old as time, cycles in the corporate leveraged finance markets are relatively young, having emerged over the forty years that have ensued since the invention of the junk bond in the late 1970s. Some might say they are poised for a mid-life crisis. As Howard Marks, Co-Chairman of Oaktree Capital Management, has described,¹ the credit cycles that have occurred during this period have tended to follow a similar pattern:

- They begin as economic expansion fuels investors' appetite for financial return and diminishes their assessment of (and aversion to) future risk.
- This causes investors to move up the risk curve to find this financial return, translating into comfort with lower credit ratings, higher leverage ratios, and weaker covenants.
- As investors plunge into the credit markets, the increased supply of capital for investment, coupled with the tax advantages of corporate debt, drives down the relative cost for firms to issue risky debt to finance growth initiatives, buyouts, or share buybacks.
- Once debt markets have reached lofty levels and risk profiles, a catalyst, such as an economic downturn, eventually sparks a down cycle in the credit markets.
- In the wake of this down cycle, many firms struggle to service their debt, refinance maturing debt when it comes due, or meet debt covenant requirements.
- This ultimately leads to a wave of restructuring activity.

The most pronounced of these leveraged credit down cycles were the ones that occurred in 1990, 2001 and 2008.²

A similar set of circumstances have characterized the decade-long credit cycle in which we find ourselves today. This time it was a pandemic, and its associated

¹ See Marks, Howard, *Mastering the Market Cycle* (Houghton Mifflin Harcourt, 2018).

² See Altman, Edward, "The Anatomy of Distressed Debt Markets," *The Annual Review of Financial Economics*, 2019. Available at <http://www.annualreviews.org/journal/financial>.

Exhibit 1: US Leveraged Loans at Start of Global Financial Crisis v Current Crisis

US Leveraged Loans	YE 2008	March 2020
Outstanding	\$594 billion	\$1,173 billion
LTM CLO Allocations	52%	71%
Covenant Lite	15%	82%
Rated B and Below	36%	64%
Leverage	5.0x	5.9x

Note: Data is compiled from S&P Global Market Intelligence.

response, which were the catalysts to spark a new wave of corporate restructuring activity. Here are some indicators of the casualties so far: The Bloomberg Corporate Bankruptcy Index, which measures both the occurrence and severity of larger US bankruptcies, is up over 2x since February. The amount of US syndicated leveraged loans that have defaulted has more than doubled for the 12-month period ended August.³ For those companies that have thus far avoided default or bankruptcy, the number of out-of-court amendments (which we view as another restructuring tool) in the US syndicated leveraged loan market are running over five times higher year to date through June than for the same period in 2019.⁴

While this credit cycle is positioned to share some of the most fundamental characteristics of past cycles, it is shaping up to have some very important differences, which we will discuss here.

Companies entered the current crisis with significantly more debt, with that debt bearing a much higher blended risk profile, when compared with past cycles.

A decade long central bank policy of low interest rates has amplified the corporate leveraging that typically takes place during the benign part of the economic cycle. These low rates have both enticed companies to borrow more, and lured investors to move higher up the risk curve in an effort to chase yield. As a result, the global economy found itself with a record \$74 trillion in non-financial corporate debt globally at the end of 2019, according to the IIF. This is up 23% from

where it was just before the global financial crisis in 2008 and represents 92% of global GDP. We estimate that approximately \$6 trillion of this sits on the balance sheets of highly leveraged companies.

As debt levels rose, the market also took on an increasing blended risk profile coming into the pandemic, as evidenced by high leverage ratios, weak covenant quality, and lower average credit ratings. Leverage ratios, a measure of a firm's debt level relative to its operating cash flows, were at or near all-time highs. As shown in Exhibit 1, US leveraged loan issuers were leveraged at an average 5.9x (debt to EBITDA) in March 2020, when the pandemic hit, as compared to 5.0x in 2008 at the start of the global financial crisis, according to S&P. Also, the earnings used to calculate most leverage ratios are of much lower quality during the current cycle with liberal "addbacks" permitted under credit agreements and bond indentures. This means that the change in leverage as measured against real cash flows is much more pronounced. Additionally, over 80% leveraged loans in the US were "covenant lite" prior to the pandemic, compared with 15% in 2008, affording lenders fewer protections when borrowers get into trouble. Finally, a record percentage of loans in the US market were rated single B and below coming into the downturn, and these loans have a much higher probability of default than higher rated debt.

The restructuring "fix" is often more complicated for many companies than it was in past cycles.

In past cycles, it was sufficient for most companies to solve their problems by deleveraging, and restructuring transactions would address this by converting a significant portion of their debt into equity through either a bankruptcy or an out-of-court process. These transactions would simply "right-size" the debt obligations of targeted companies to match their future earnings potential. In the current cycle, many companies have additionally required substantial

³ "US Leveraged Loan Default Rate Tops 4% as Oil & Gas Pumps Out Sector Record," *LCD News and Insights*, S&P Global, August 8, 2020. Available at <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-news/fed-rally-default-fears-bring-bifurcation-back-to-leveraged-loans>.

⁴ "Eyeing Relief, US Leveraged Loan Issuers Continue to Amend Covenants," *LCD News and Insights*, S&P Global, July 16, 2020. Available at <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/eyeing-relief-us-leveraged-loan-issuers-continue-to-amend-covenants-59460304>.

liquidity injections to survive. This is because the current crisis has been more economic in nature, with many companies experiencing significant revenue declines forced by the pandemic response. Firms have addressed this thus far by drawing from their revolving lines of credit, and leveraged companies in the US have already drawn \$310 billion from these facilities through August 1, according to Moodys. When these funds are depleted, companies have resorted, and will continue to resort to, other methods to bring liquidity onto their balance sheets in ways that we have not seen in past cycles (discussed below).

Companies have more contractual leeway to avoid default, and to solve their liquidity problems with more leverage.

Because over 80% of the US leveraged loans are "covenant lite," fewer companies have been triggering a default due to financial covenants, which has prolonged their ability to survive with more debt. Also, in response to the liquidity needs described above, many of them have been able to raise these funds through additional debt on a senior basis by (1) using the more liberal "baskets" that have been built into debt agreements over the past decade, or (2) using forgiving debt agreement language to favorably amend debt documents, or to syphon valuable collateral from existing loans to secure new loans through so-called "liability management" transactions.

For example, Serta Simmons Bedding LLC recently completed a transaction where it was able to raise \$200 million in new financing as a part of a larger restructuring. The new loan, as well as other loans held by participating lenders, gained a priority claim on the company's assets, effectively subordinating other secured lenders lower in the priority waterfall. This was due to permissive credit agreement language which enabled such amendments

to be made with a simple majority of lenders consenting. In past restructuring cycles, these types of "priming" financings would normally be pursued through a formal bankruptcy process where the company would reduce its overall leverage significantly.

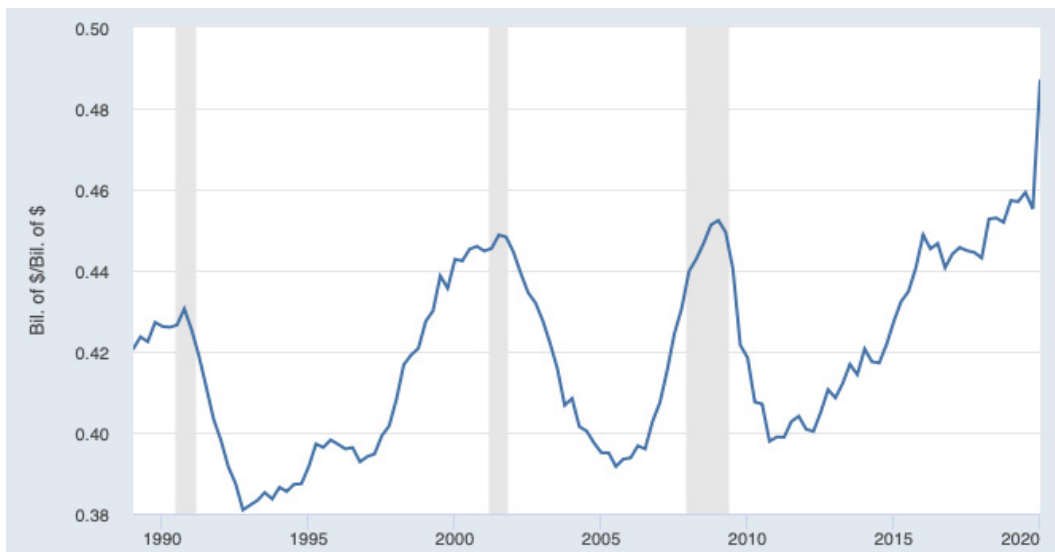
As a result of these factors, bankruptcy filings to date have been lower than they were during the global financial crisis, while amendments and other out-of-court restructuring methods have surged. This also likely means that average recovery rates will be lower for investors in companies that do default than they have been in past cycles. This is because the companies that do actually default will do so as a result of more severe problems such as payment defaults, rather than covenant violations.

Many investors are aligned with borrowers on their desire to keep debt levels high.

Borrowers' objectives of raising liquidity, staying out of bankruptcy, and avoiding dilution to their equity holders are achieved by methods which coincide with higher debt levels from out-of-court restructurings than would typically be achieved in bankruptcy. In many situations, debt investors share this goal, and are complicit in its undertaking. Approximately 60% of the syndicated leveraged loan market in the US is owned by collateralized loan obligations (CLOs), who thus have large "seats at the table" in many restructuring negotiations. These vehicles have structural and contractual disincentives against accepting equity in restructuring transactions.⁵ Other debt investors, such as debt mutual funds and banks, also strongly favor debt instruments over equity. Thus, in many overleveraged capital structures, the majority of debt investors have

⁵ See Harmon, Mike and Victoria Ivashina, "When a Pandemic Collides with a Leveraged Global Economy" in Voxeu.com, April 29, 2020. Available at <https://voxeu.org/article/when-pandemic-collides-leveraged-global-economy>.

Exhibit 2: US Non-financial Business Debt



Source: BEA, Board of Governors

avored, and will continue to favor, restructuring plans that maintain high levels of debt, even if such high amounts would be challenging for the borrower to service in the future. They have often also favored “amend and extend” transactions which “kick the can down the road” on those debt maturities than cannot be refinanced, rather than converting their debt to equity as a part of a more permanent solution.

The Fed’s actions have facilitated and even encouraged the raising of leverage.

In response to the pandemic, the Fed and other central banks have appropriately and aggressively supported debt markets.⁶ The key goal of these policies has been to avoid a systemic crisis where viable companies would en masse be unable to raise liquidity and be forced to liquidate. In the U.S., the U.S. Treasury Department and the Federal Reserve have committed an unprecedented \$4.5 trillion to support the CARES Act and related lending and loan-buying programs. These programs have included purchases of “fallen angels” (investment grade bonds which have been demoted to speculative grade) and direct loans to leveraged companies through the Main Street Lending Program.

While these programs have been significantly underutilized, their announcement has sent a strong signal to the market that the Fed and the U.S. Treasury are prepared to take extreme measures to protect the economy and financial markets. Their willingness to intervene in secondary markets has provided confidence to those markets and has enabled liquidity to flow to those companies that have required it. While it is still early, it would appear that the federal programs have thus far achieved their goal of avoiding a liquidity crisis and have allowed those solvent firms to avoid a wrongful liquidation. However, there is no free lunch. These policies have solved a liquidity problem but not the insolvency problem that persists for many other firms. They can also have unintended consequences affecting both demand and supply of credit.

On the demand side, the policies have enabled many highly-leveraged companies, some which have reached their position recklessly, to raise even more debt, rather than restructure and deleverage. Exhibit 2 shows that in the past three restructuring cycles (shaded areas), the corporate sector reduced leverage as leveraged companies restructured and converted debt into equity, or were liquidated. However, as of the second quarter this year, non-financial business debt grew by over 11% compared to the previous year, according to the Federal Reserve, and the U.S. high yield market is on pace to

break a record for new issuance in 2020. Consistent with the trend towards out-of-court restructurings, in this cycle we have only seen a modest rise of bankruptcies compared to previous cycles. For example, in 2009 there were almost twice as many business bankruptcies as in the average year since 2000. By contrast, through August 2020, filings have only gone up by 12% over their average during the past decade.

Another key aspect of the Fed’s actions and recent guidance regarding rates has been its signaling that these conditions will persist in the near to medium term. This has increased the amount of debt that borrowers feel they can comfortably demand and still meet debt service. However, it is important to keep in mind that many of these companies will still have to service and refinance these high debt levels in future years when interest rates may no longer be low. Therefore, the issue rests (once again) on whether these companies will continue to be economically viable in the future.

One concern is that the conditions that we see today are perpetuating the creation of “zombies,” that is, companies that are technically insolvent but have no real catalyst to restructure. These companies have been shown in past studies to contribute less to the economy in terms of capital investment and employment growth than companies with reasonable amounts of debt. As Torsten Slok, chief economist from Deutsche Bank pointed out, “One consequence of aggressive Fed support to credit markets and long periods of low interest rates is that it interferes with the process of creative destruction and keeps companies alive that would otherwise have gone out of business.” In fact, the Federal Reserve Bank of San Francisco, in a recent article, estimates that the amount of debt issued among firms that are particularly close to insolvency is more than two times the amount for this same risk group during the Global Financial Crisis.⁷

On the supply side, the Fed’s actions have led credit investors to believe that “the Fed has their back,” and will step in to support their investments no matter what, thus lowering the necessity for careful credit analysis. In fact, despite the calamity caused by the pandemic, the S&P/LSTA US leveraged loan price index is down by only 1% for the year (through October 1), after falling 20% through late March. This could potentially create a moral hazard problem if investors do not appropriately price risk when allocating capital to these markets. Moreover, in the global commercial banking market, when nominal interest rates are near zero, lenders have regulatory and other incentives to engage in evergreening (i.e., adding unpaid interest to a loan’s principal). In such environments, it is no longer attractive for lenders to force repayment.

⁶ See Blanchard, Philippon and Pisani-Ferry, “A new policy toolkit is needed as countries exit COVID-19 lockdowns” for a broad description of the types of government responses in the United States and elsewhere. Available at <https://www.piie.com/publications/policy-briefs/new-policy-toolkit-needed-countries-exit-covid-19-lockdowns>

⁷ Friesenhahn, Sophia M. and Simon H. Kwan, “Risk of Business Insolvency during Coronavirus Crisis”, in *FRBSF Economic Letter*, October 5, 2020.

CONCLUSION: *As a result of all of these factors, we believe that this restructuring cycle is more likely to see companies emerge with more debt than we have seen in previous cycles.*



Some have criticized the Fed and other central banks for launching too strong of a response, which has perpetuated or even exacerbated the “zombie” problem. Our view is that the Fed response was appropriate at the time in that it prevented a financial crisis, and protected sound businesses from becoming insolvent. That said, we should recognize

that a consequence of these actions is that they have helped insolvent companies to perpetuate their insolvency problem, which will have a negative impact on their ability to contribute to economic growth. In normally functioning credit markets, these markets do a reasonable job of assessing which businesses should be kept alive under a set of circumstances. They provide liquidity to firms whose net present value of future profits (post-COVID) exceeds the liquidation value of their assets. Conversely, they force liquidation or sale upon those firms whose business model is no longer viable post-COVID. Our view is that so long as central banks maintain a “protect at all costs” approach, these markets will not fulfil this role, and the “zombie” problem will persist. Had more of these companies been allowed to file for bankruptcy, they could have deleveraged and abandoned their “zombie personae.”

Many of these “zombies” will have to restructure eventually. Work by NYU’s Edward Altman estimates that approximately 40% of firms who pursue distressed debt exchanges, a widely-used form of out-of-court restructuring, end up filing for bankruptcy within three years. Similarly, some viable firms will also have added to an unsustainable level of debt to their balance sheets and will probably require some restructuring. Given the recent surge in out-of-court activity and the high levels of remaining leverage, it is quite possible that a larger surge in bankruptcy filings has been delayed, rather than avoided, and we could continue to see a heightened level of bankruptcy filings well past the end of the economic recession. If this occurs all at once, it could strain the bankruptcy courts. Iverson, Ellias

and Roe (2020)⁸ estimate the need for as many as 250 temporary bankruptcy judges in addition to the almost 400 that are active today. “Flattening the curve” of bankruptcies would have the benefits of relieving this court strain, while also matching the timing of bankruptcies with a stronger economy that could better absorb the pain. However, unlike a flattening of a virus curve, a delay of bankruptcies for insolvent companies has real deadweight costs. This is because “zombies” impose real costs on the economy. The misallocation of capital from its high productivity uses at healthy firms to low productivity uses at “zombie” companies leads to a reduction of profits for healthy firms in input and output markets as well as lower employment, growth, and capital investment in the economy.

All in all, a key for the future will be how central banks unwind their actions as the global economy recovers. Ideally, the future central bank actions will “ease off the gas pedal” in a way that facilitates the economic recovery while also seeking to restore accountability and proper pricing of risk into credit markets. This will force those companies who have acted irresponsibly to restructure their debts, and lead to a more efficient allocation of resources in the economy.

⁸ Benjamin Iverson, et al., “Estimating the Need for Additional Bankruptcy Judges in Light of the COVID-19 Pandemic,” UC Hastings Scholarship Repository (2020), https://repository.uchastings.edu/cgi/viewcontent.cgi?article=2811&context=faculty_scholarship.

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Mike Harmon is the managing partner of Gaviota Advisors, LLC, in Manhattan Beach, CA, where he advises and invests in small to medium sized companies. His prior experience includes 21 years as an investment professional in the Special Situations and Global Principal Groups at Oaktree Capital Management in Los Angeles, and positions with CS First Boston, Price Waterhouse, and Society Corporation. Harmon has served as a Lecturer at Stanford Graduate School of Business and a guest lecturer at Harvard Business School; he has also served on 20 boards of directors representing a broad range of industries and causes. He holds an MBA, with distinction, from Harvard Business School and a BA, with distinction, in economics from McGill University.



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WHEN IT REALLY MATTERS.

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WINNING TACTICS FOR REVENUE AND PROFITABILITY WITH A REVENUE WIN ROOM

SUDHAR IYENGAR and PRASAD ADURI
AlixPartners, LLP

In these challenging times, companies have an imperative to regain revenues and achieve profitable growth. While sales organizations could pursue large-scale transformations, these projects usually require large budgets, with long payback periods. The key to winning in the current environment is the ability to quickly pivot among evolving priorities in product sets, geographies, and customer segments. What organizations need now more than ever is a model to identify and address their most pressing needs to regain growth and focus on active opportunities while still driving programmatic commercial initiatives.

THE REVENUE CHALLENGE

Senior sales leaders face several challenges as they try to galvanize all the functions in their company around revenue growth, including the need for:

- An integrated view of their business even as they disaggregate commercial teams' performance, constantly changing market conditions, and internal operating performance.
- A predictive system to enable them to quickly focus on removing the specific roadblocks to meet their targets and maximize performance.



- Alignment among the broader team organizationally and individually, to 'row in the same direction.'

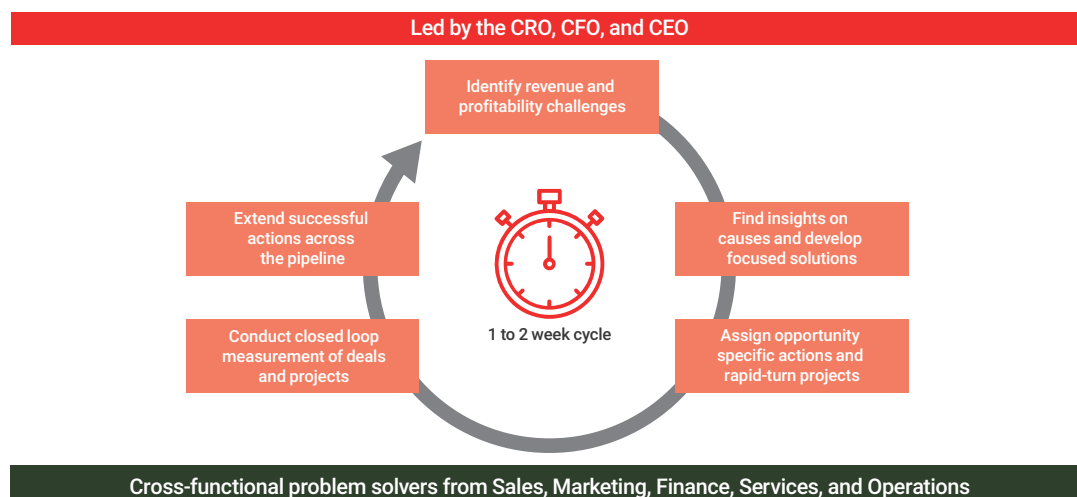
These efforts typically result in well-intentioned groups supporting the sales team working towards different goals and timelines, all frustrated that the other groups do not share their insights. The status quo approach of pipeline management focused on report cards and top ten lists, and deal desk reviews of risk management and pricing thresholds will not be enough to solve this problem.

A practical, fast solution in these constantly changing market conditions is implementing what we call a Revenue Win Room (Exhibit 1). This revenue management program combines traditional pipeline management with deal-by-deal commercial improvement actions and growth initiatives. A Revenue Win Room comprises a highly accountable team, both process and results-oriented metrics and goals, and a rapid action cycle, all working in conjunction to identify and capitalize on the most important revenue-driving opportunities.

ACCOUNTABILITY, METRICS, AND RAPID ACTION

Revenue Win Rooms can deliver a wide range of improvements, including revenue acceleration,

Exhibit 1: Revenue Win Room Design



Source: AlixPartners

sales coverage optimization, pricing, services attach rate, renewals capture, capacity utilization, and lead conversion. These Win Rooms can achieve improved results by integrating five specific views of commercial performance:

1. Current revenue/margin performance
2. Pipeline
3. Improvement initiatives
4. Market conditions
5. Operational performance affecting customers (CSAT, NPS, etc.)

For example, a recent client in the gas distribution industry with short cycle transactional sales wanted to improve its new customer acquisition and sales. The client was operating with only high-level financial goals related to new customer sales and experienced suboptimal sales performance against goals.

The company quickly set up a Revenue Win Room by pulling together a cross-functional team from their Sales, Marketing, and Finance functions. The team then established new goals and metrics to reflect financial performance and underlying operational performance. In this case, those operational metrics included the number of deals in the pipeline, deal size mix, and win rate by sales rep.

The next step was to establish weekly Revenue Win Room sessions to actively solve underperformance. The team identified that one contributing problem was a lack of focus on deal size mix (Exhibit 2). With the marketing

team's help, they then put tools in place to help sales representatives identify and target the right deals.

Within six to eight weeks of launching the Revenue Win Room, the company improved all three metrics established and grew new customer sales by ten percent.

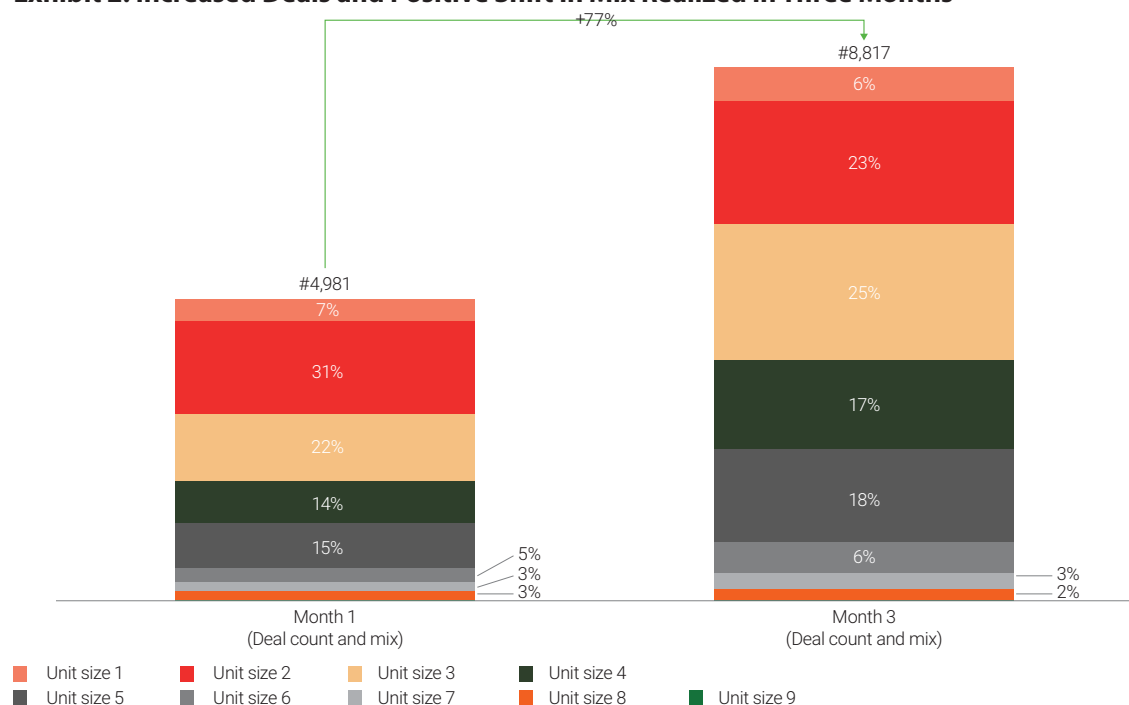
SIMPLIFY COMPLEX INITIATIVES

A critical aspect of creating and running a Revenue Win Room is managing commercial improvement initiatives with a high accountability level.

The Revenue Win Room's pace is far more aggressive than typical transformation initiatives. There are three core operating needs to consider when implementing a Revenue Win Room:

1. **The team must develop recommendations** and responses that align with sales reps' pursuit timelines.
2. **Team members must ask what they need to do differently** for this opportunity right now, then later work on what can be embedded in the process.
3. **The team must agree on specific metrics and analytics** that differentiate leading indicators from post-fact financial results, which often requires using a centralized team to find insights, rather than depending primarily on field managers' pipeline reports.

Exhibit 2: Increased Deals and Positive Shift in Mix Realized in Three Months



Source: AlixPartners

A Revenue Win Room can also help simplify complex initiatives. In one instance, an industrial manufacturing company in the renewable energy space with year-plus sales cycles suffered significant margin decreases and a 15 percent decline in sales as measured against the previous year. A strategic analysis suggested that the decline in financial performance was related to quarter end price drops and poor prioritization of sales opportunities.

A Revenue Win Room was quickly implemented that included sales, finance, and pricing leads. The team then created a new metric called "Project Expected Value" to combine opportunity size and local market competition factors. Next, the team redesigned sales incentives and assigned sales resources to target the higher expected value opportunities. Establishing key metrics and goals positioned the team to track performance weekly.

Within only three months, the company achieved an impressive eight percent increase in revenue and an eight percent increase in average selling price.

CONCLUSION

Driving commercial improvement requires tight execution, having the right metrics and analytics for insights, and maintaining cross-functional accountability and participation. But the rigorous management to goals of a Revenue Win Room is a proven approach for commercial teams to generate valuable, rapid results in these challenging times.

The opinions expressed are those of the authors and do not necessarily reflect the views of AlixPartners, LLP, its affiliates, or any of its or their respective professionals or clients. This article was prepared for general information and distribution on a strictly non-reliance basis.

ABOUT THE AUTHORS



Sudhar Iyengar

AlixPartners, LLP

Sudhar Iyengar is a Managing Director at AlixPartners, who is passionate about revenue growth and complex enterprise turnarounds. He works with industrial, technology, and private equity clients, bringing an operator's perspective to sales growth, and he has transformed many sales forces. Sudhar specializes in sales effectiveness, growth strategy, growth execution, merger integration, and overhead optimization as part of a comprehensive turnaround process or a strategic transaction. Sudhar has an MBA with honors in finance, strategy, and accounting from the University of Chicago's Booth School of Business and a Master of Science in computer systems engineering.



Prasad Aduri

AlixPartners, LLP

Prasad Aduri is a Director at AlixPartners, and advises clients in the technology, industrial manufacturing and distribution, financial services, and automotive supplies industries on top-line and margin improvement topics. He has led many commercial excellence and transformation programs through optimizing Pricing, Marketing and Sales functions. He has deep expertise in leading large-scale product development, integration, and IT transformation programs and has worked with private equity firms on due diligence and post-acquisition performance improvements. Prior to Alix Partners, he led engagements at Houlihan Lokey, other top-tier financial services and technology consulting firms and led product development initiatives at JPMorgan Chase.

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For more information about the 37th Annual Bankruptcy & Restructuring ("AC21") Virtual Series Conference see page 22.

AIRA Announces Distinguished Fellows Program



The new 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.

A TWIST IN STYLE: HOW DISTRESSED AND BANKRUPTCY INVESTING IS DIFFERENT THIS TIME

DOMINIQUE MIELLE

Distressed investing is one of these trends, like shoulder pads, where one must be exacting not only with timing but also interpretation. Both are coming back strong in 2021.

The time is right. Cornerstone Research reported that 138 companies with more than \$100 million in assets filed in the first three quarters of 2020, 84% higher than the same period last year, and only ever eclipsed by 2009. For comparison, the 2005-2019 average annual number is only 76. This type of gargantuan buffet usually foretells fat days for vulture investors. In 2009, a year after the Global Financial Crisis, distressed hedge funds returned +20.95% according to the Callan Periodic Tables. Going back a few seasons, at the risk of showing my age because I lived through it, the 2001 Telecom Crisis (the second largest bankruptcy cycle) caused 263 public companies to file and distressed hedge funds to reap a 20.01% return.

Trends do come back - but with critical nuances. This spring you'd be remiss to wear an old shoulder-padded jacket from the eighties and pray that Grace Jones doesn't call to get it back. So it goes for distressed investing.

The original goals of Chapter 11 were best expressed in a paper by Professor Charles J. Tabb: (1) maximize the value of the debtor firm for all creditors; (2) distribute it fairly and equitably; (3) save jobs; (4) minimize the effect of the firm's failure; and (5) ensure that the restructuring is not worse than the insolvency itself. Alas, they seem outmoded and old-fashioned. A fascinating 2020 study by Kenneth Ayotte (UC Berkeley) and Jared Elias (UC Hastings)¹ concludes that corporate restructurings are increasingly imposed by, and designed to maximize recovery for, pre-petition senior creditors alone.

Why and how? Because these are the financiers who provide bankruptcy - or "DIP" (Debtor-In-Possession) - loans, through which they extract control over the case. Studying decades of DIP financings, they find that between 1995 and 2000, only 10% and 13% of DIP

loans required management to, respectively, implement a specific transaction and hit negotiated milestones. In stark contrast, the percentages for 2015-2018 jumped to 50% of DIP loans funding a specific deal and 86% imposing covenants, locking in a preferred outcome and protecting the claims of the capital providers, i.e. senior creditors. This front-running strategy stands out today. Four of the twenty largest bankruptcies in the first three quarters of 2020 were prepackaged. Neiman Marcus, JC Penney, Guitar Center and J Crew were all prepackaged by the largest pre-filing senior secured creditors.

Does it change the distressed vogue? Radically. It unequivocally favors mega-funds. The winners are the leading handful senior holders who are willing and able to deploy considerably more cash to finance the controlling DIP. Anyone else, vendor, junior creditor, and labor alike will be, as Iggy Pop so elegantly put it, a passenger who rides and who rides. The maneuver hardly prioritizes debtor estate optimization, equitable value distribution and job creation - but this is not my point.

Leaving fairness and social justice aside (seldom winning arguments on Wall Street), here is the rub: accumulating a majority position in the senior secured pre-petition debt - typically a small slice of a capital structure - without moving price beyond a reasonable expected return, in a market prone to lightning fast recovery, are finicky, if not contradictory, aspirations.

First, supply depth appears elusive this time around. The largest bankruptcy of 2020, Hertz Corporation, barely reached \$25 billion in liabilities, a trinket compared to the 2008-2009 cases such as Lehman Brothers (\$613 billion), Washington Mutual (\$328 billion) and 2001-2002's WorldCom (\$104 billion) and Enron (\$61 billion). There were only 52 mega-bankruptcies (defined as over \$1 billion in liabilities) in 2020 versus 75 in 2009 (including Trump Resorts). The top 20 bankruptcies this year only listed \$174 billion in liabilities. Meanwhile, according to a Preqin survey, \$140 billion of potential capital stood to chase these deals by June 2020 - sixty funds targeting \$72bn of capital raise and \$68bn in dry powder. According to Bloomberg, Oaktree Capital



¹ Kenneth Ayotte and Jared A. Elias, "Bankruptcy Process for Sale," [ssrn.com, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3611350](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3611350).

alone announced its intention to raise the largest distressed debt fund in history, at a target size of \$15 billion. Call me a fusspot, but this supply-demand seems tilted.

Second, and complicating the shallow supply, episodes of debt dislocation have dramatically shortened. Distressed bond volumes reached \$1 trillion for only a few weeks around April – only to deflate below \$500 billion by end of May. Junk bonds yielded 6.5% in February, shot up to 11.7% end of March, and promptly rallied to 7% early June. Using the senior loan ETF BKLN as a proxy for the leverage loan market tells the same tale: loans traded at a large discount for barely over a month from March to April. In other words, one hardly had two months to invest, and invest big. By contrast, the peak to trough dislocation persisted for over a year during the Global Financial Crisis and the Telecom Crisis. Simply put, the Fed has learned to act fast, wide, and decisively. It's the Grinch Who Stole Distressed.

Swiftly buying a commanding senior secured position - typically the least discounted debt of the capital structure - and adding significant cash for a DIP, often at a more modest return, or risk being left in the dust as a junior debtholder: this will constrain distressed investing like a corset. The style is still worth trying - but average distressed returns are unlikely to match those of previous cycles.

As always with fashion, it's a matter of style, proportion and scale.

ABOUT THE AUTHOR



Dominique Mielle

Dominique Mielle spent twenty years at Canyon Capital, a \$25 billion multi-strategy hedge fund where she was a partner and senior portfolio manager. She primarily focused on stressed and distressed investments as well as corporate securitizations. She also led Canyon's collateralized loan obligations business.

In 2017, she was named one of the "Top 50 Women in Hedge Funds" by the *Hedge Fund Journal* and E&Y. Her book, *Damsel in Distressed*, the first hedge fund memoir written by a woman, will be released in August 2021.

Ms. Mielle played key roles in complicated bankruptcies, serving as a leading creditors' committee member for Puerto Rico, and as a restructuring committee member for U.S. airlines in the wake of the September 11 attacks. She was a director and the audit committee chair for PG&E during its fifteen-month bankruptcy process and emergence. She currently serves on four corporate boards.

Ms. Mielle graduated from Stanford University Graduate School and HEC Paris.



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- Distressed Asset Investors
- And many others.

AIRA was formed in 1979, at the dawn of modern restructuring work, and we are committed to keeping our members up to date on the latest developments in the profession. AIRA believes in the future of the industry and your membership will help us with the important work of encouraging the next generation of professionals.

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To join visit: <https://www.aira.org/membership>.



THE CALIFORNIA ENERGY INDUSTRY: EXTINCTION, RESTRUCTURING OR REBIRTH?

TIM SKILLMAN

CR3 Partners

A friend of mine, who is a luminary and historian of the California oil industry, recently sent me a link to a controversial documentary, *Planet of the Humans*, produced by Michael Moore. My friend and I have spent hours together debating the future of the industry over lunch and field inspections. His passion for the plight of this industry was the inspiration for this article.

His cover notes to the link said the film “really exposes the realities and hypocrisy of the supposedly ‘green’ renewable-energy industry and NGOs. It has those in the environmental movement quite upset.”

In essence, this film argues why solar, wind, and particularly biomass are not the Holy Grail people think they are. Rather, they may be poor alternatives to petroleum-based fuels. At one point in the film, an automotive-industry executive states that electric cars are actually coal-powered – something I have been saying for years.

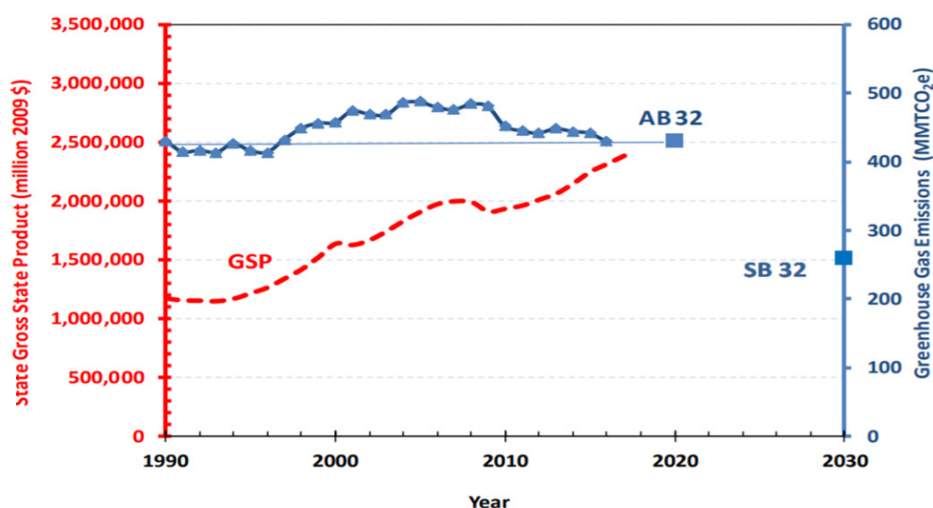
The U.S. Energy Information Administration estimated that in 2019, 62.6% of electricity was produced using fossil fuels and 23.4% was generated using coal.

California has been the tip of the spear in fighting global warming, as well as advocating for and investing heavily in new policies to drive its citizens toward renewable energy. These policies have helped reduce consumption and emissions while the state continues to grow faster than most. According to the California Energy Commission, California has been able to grow its economy while reducing emissions (Exhibit 1).¹

However, these policies are weakening an already fragile industry, and new policies related to enhanced oil recovery, well abandonment, and emissions are making it very difficult to continue operations.

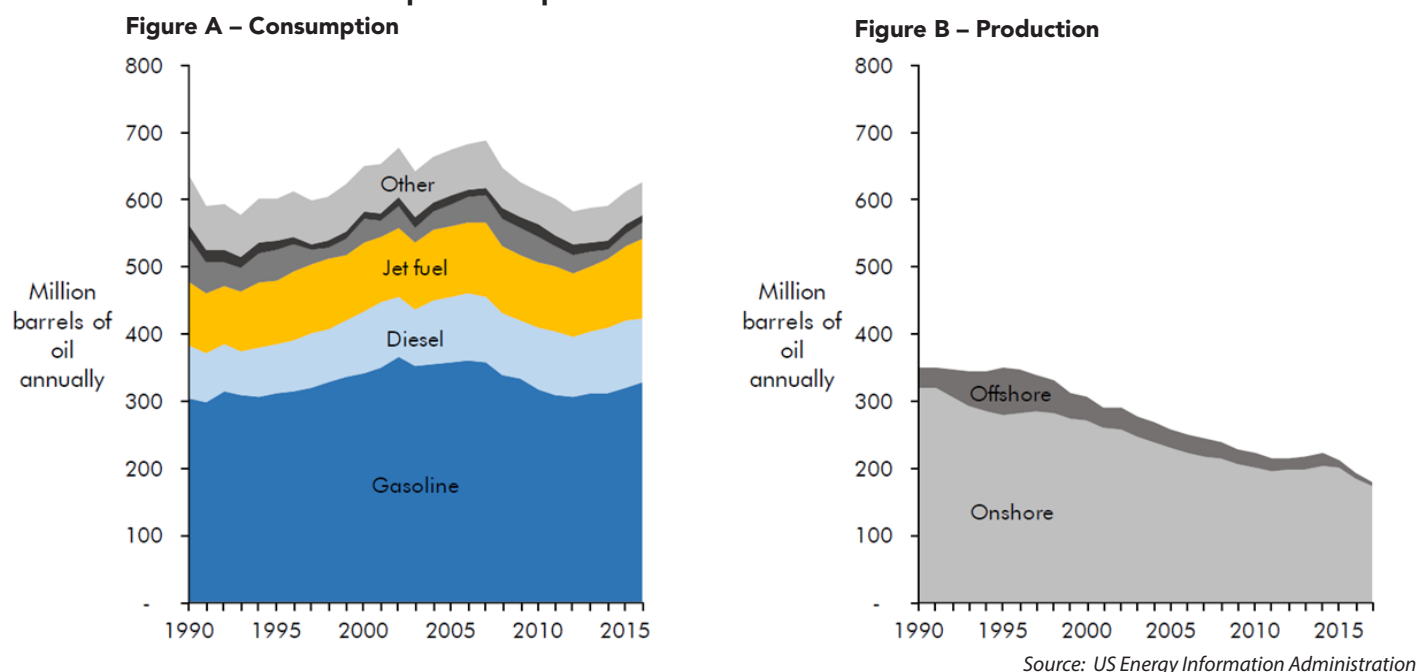
¹ "Greenhouse Gas Emission Reductions", California Energy Commission, https://www.energy.ca.gov/sites/default/files/2019-12/Greenhouse_Gas_Emissions_Reductions_ada.pdf.

Exhibit 1: California gross state product and greenhouse-gas emissions since 1990



Source: California Energy Commission

Exhibit 2: California oil consumption and production since 1990



"Good!" says my imaginary friend the environmentalist, who disagrees with my real friend the California oil-industry expert. But do the environmentalists truly understand the consequences of oil production going away in California? This would drive a significant reduction in employment and tax revenue and increase the state's dependence on foreign oil.

"But we export oil from the U.S.," says the environmentalist. This is true, but California imported 58.4% of the oil it used every day in 2019, compared to only 22.1% of consumption 20 years ago.² While the state makes up just 13% of the U.S. population, it consumes more than 40% of the country's oil imports, and therefore cannot rely on its own production alone to satisfy the state's energy needs.

"But we need to get away from fossil fuels," says the environmentalist. Although this is a laudable goal, California's petroleum-based energy consumption continues to rise (Exhibit 2, figure A).³ In addition, much of the oil that is consumed in California comes in by ship from the Middle East, more so than from the mid-continent or elsewhere in the U.S. because it is cheaper to transport crude by water than by truck, rail or pipe. The lower carbon footprint and transportation cost of producing and shipping within California versus the Middle East, not to mention the human-rights abuses that take place in certain oil-producing countries, should make Sacramento want to support California producers.

In 2015, California's then-Governor Jerry Brown established the goal of cutting the state's current oil consumption up to 50 percent by 2030. And yet, while consumption continues to grow, production continues to slide, particularly in recent years: California's oil production has dropped by 20% in the last 10 years (Exhibit 2, figure B)⁴ while U.S. oil production doubled in the same period (see Exhibit 3 on next page).⁵ If you compare these two production trends, you can see the impact that California's green initiative has had on the industry: disproportionately reduced production in spite of increasing in-state demand.

Why should we care? First, despite the decline in production in recent years, California is the ninth-largest U.S. producer of petroleum reserves.⁶ There are 248 companies that operate in California, producing more than 330,000 barrels of oil equivalent on a daily basis.⁷

Second, over 360,000 people work in California's oil and gas production sector under some of the strictest environmental standards in the world.⁸ The industry generates approximately \$21.5 billion in state and local taxes, including \$11 billion in sales tax, \$7 billion in property taxes, \$1 billion in income taxes and \$96 million in state assessments.⁹

⁴ *Ibid.*

⁵ US Historical Production Historical Chart, <https://www.macrotrends.net/2562/us-crude-oil-production-historical-chart>

⁶ Oil and Gas Activity in California, California oil and gas summary, <https://shalexp.com/california>.

⁷ Oil & Gas Companies in California, <https://www.shalexp.com/california/companies?page=10>.

⁸ Los Angeles County Economic Development Corp, *Oil & Gas in California, 2019 Report*. Available at http://www.kerncitizensforenergy.com/wp-content/uploads/2019/11/LAEDC_WSPA_FINAL_2019-for-2017.pdf.

⁹ *Ibid.*

² Oil Supply Resources to California Refineries, California Energy Commission, <https://www.energy.ca.gov/data-reports/energy-almanac/californias-petroleum-market/oil-supply-sources-california-refineries>

³ U.S. Energy Information Administration, <https://www.eia.gov/state/?sid=CA>.

Exhibit 3: U.S. oil production since 1990 in thousands of barrels per day

Source: Macrotrends LLC.

Third, the National Association of Royalty Owners estimates that between 500,000 and 600,000 ranchers, farmers, retirees and investors receive approximately \$780 million in royalty income on the production of oil.^{10,11} That is a lot of lives and livelihoods that depend on the ability to produce oil and gas at a cost that will enable California-based operators to compete with out-of-state producers.

California producers simply should not count on surviving in the long term under the current social, economic and political state of affairs. It is uneconomical for operators to be prevented from using recovery techniques that would dramatically reduce lifting costs and be burdened with the most onerous plugging and abandonment costs in the world. In addition to higher costs, California producers have great difficulty developing new reserves due to increased regulations that are meant to address environmental risks. If the current political and regulatory trend continues, California producers will not be able to continue operating and may not be able to properly plug and abandon their wells once the fields are played out, presenting an even larger environmental issue.

Can anything be done to mitigate this trend, or is the California oil-production industry doomed to extinction?

While the cost of doing business in California is generally higher than in Texas or North Dakota, Californian producers should otherwise be able to compete with foreign countries and other U.S. states for the California crude oil demand: the reserves are there, the technology to produce it is well developed and the workforce is sufficiently talented. But a long history of spills, disputes and competing development opportunities have starved the California oil industry of the capital it needs to meet in-state energy-consumption needs. Even the potential development of the Monterey Shale, which may be

bigger than Alaska's Prudhoe Bay and could be a key to California's economic future, is unlikely to take place given all the obstacles to developing new formations.

Ultimately, only two things can reverse the decline in California production: Dramatically higher oil prices or changes to policies and attitudes that would encourage investment. The direction of oil prices is of course outside our control and, given the near-term impact on prices of the COVID-19 pandemic and the Russia-OPEC price war in the first quarter of 2020, it is likely that oil prices will not rebound quickly enough to support continued operations or new investment and may cause some of the larger players to fail or restructure.

As to changing policies in order to encourage investment, ironically the impact of COVID-19 may soften the policy toward oil production: Governor Gavin Newsom and state lawmakers are now contending with a forecast \$17 billion deficit in 2024.¹² A renewed

¹² Legislative Analysts Office, 2021-22 Budget – California Fiscal Outlook. Available at <https://lao.ca.gov/Publications/Report/4297#:~:text=The%20operating%20deficit%20is%20relatively,substantially%20from%20our%20main%20forecast.>

ABOUT THE AUTHOR



Tim Skillman
Partner, CR3 Partners

Tim Skillman is a highly experienced and successful senior executive with valuable management, consulting, and finance expertise. He has 20 years of experience advising public and private companies in change management, strategy development, and plan execution. Tim's demonstrated leadership in accountability, capital structure, and financial analysis is highlighted through his commitment to developing and executing profitable growth strategy for his clients. He is active in the restructuring community having served as a past officer and member of the Board of Directors for the Association of Certified Turnaround Professionals.

¹⁰ This assumes 13% on \$30.00 per barrel of oil at 200 million barrels per year.

¹¹ Ed Hazard, "A Voice for State's 600,000 Oil Royalty Owners," available at https://www.bakersfield.com/opinion/a-voice-for-states-600-000-oil-royalty-owners/article_93f4cf90-bc37-526a-85ac-f4c57d5fbc34.html.

interest in oil production could drive the employment and tax revenue that are desperately needed in order to balance the budget and reduce unemployment. The recent departures to other states of several of the largest and most visible California-based companies, including Oracle, Hewlett Packard and SpaceX, could further exacerbate the budget gap that Gov. Newsom will need to close.

Because hoping for higher prices is not a strategy and expecting a change in policies toward California oil producers is a long shot, I anticipate a parade of

restructurings in the California oil industry – something my real friend the oil-industry expert and my imaginary friend the environmentalist should be able to agree on.



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*CLE applications pending approval.

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VIRTUAL SERIES SCHEDULE

Tues, June 08, 2021

2:00PM - 6:00PM ET

Financial Advisors' Toolbox Part 1

Session topics during Part 1 of this program include:

1. Subchapter V
 - a. Overview of Subchapter 5
 - b. Amendment by the CARES Act and Consolidated Appropriations Act
 - c. Key distinctions from typical Chapter 11 practice
 - d. Strategies for Debtors and Creditors in Subchapter V cases
2. The Effect of COVID-19 on Bankruptcy Practice
 - a. Revisions to the Bankruptcy Code: CARES Act and Consolidated Appropriations Act
 - b. Effects on filings across chapters
 - c. Remote Bankruptcy Court practice
 - d. Access to justice issues
3. Retail and Real Estate
 - a. Intersections and symbiosis of retail and real estate companies
 - b. Leases in bankruptcy basics
 - c. Major retail cases from 2020

Panel:



Justin A. Kesselman
(Co-chair)
Arent Fox LLP



Karl Knechtel, CIRA
(Co-chair)
RK | Consultants, LLC



Kathleen Aiello
Klestadt Winters Jureller Southard & Stevens, LLP



Justin R. Alberto
Cole Schotz P.C.



Hon. Andrew B. Altenburg, Jr.
U.S. Bankruptcy Court, D. N.J.



Patrick Diercks, CIRA
Clear Thinking Group LLC



Jennifer B. Kimble
Lowenstein Sandler LLP



Karl Knechtel, CIRA
RK | Consultants, LLC



Howard P. Magaliff
Rich Michaelson Magaliff, LLP



Hon. Jerrold N. Poslusny, Jr.
U.S. Bankruptcy Court, D. N.J.



Vincent J. Roldan
Mandelbaum Salsburg P.C.



Jeffrey N. Rothleder
Squire Patton Boggs (US) LLP



Michael Sutter
Rothschild & Co.



Daniel I. Waxman
KEWA Financial Inc.

Wed, June 09, 2021

2:00PM - 6:00PM ET

Financial Advisors' Toolbox Part 2

Session topics during Part 2 of this program include:

1. Cannabis Business Insolvency
 - a. Overview of state and federal law
 - b. Barriers to bankruptcy
 - c. Alternative restructuring options: ABCs and Receiverships
2. Liquidating Trusts
 - a. Overview of the role of liquidating trusts in Chapter 11 cases
 - b. Tax benefits and compliance requirements
 - c. Traps for the unwary and areas of uncertainty
3. Conflicts and Other Ethical Issues
 - a. Overview of Code section 327, Rule 2014, Conflict Searches and Disclosure Duties
 - b. Ethical issues for Official Committees of Unsecured Creditors

Panel:



Justin A. Kesselman
(Co-chair)
Arent Fox LLP



Karl Knechtel, CIRA
(Co-chair)
RK | Consultants, LLC



Kathleen Aiello
Klestadt Winters Jureller Southard & Stevens, LLP



Hon. Andrew B. Altenburg, Jr.
U.S. Bankruptcy Court, D. N.J.



Patrick Diercks, CIRA
Clear Thinking Group LLC



Sheryl P. Giugliano
Ruskin Moscou Faltischek, P.C.



Ira Herman
Blank Rome



Justin A. Kesselman
Arent Fox LLP



Jennifer B. Kimble
Lowenstein Sandler LLP



Jeffrey N. Rothleder
Squire Patton Boggs (US) LLP



David E. Sklar
Porzio Bromberg & Newman, P.C.



Daniel I. Waxman
KEWA Financial Inc.

Thu, June 10, 2021

2:15PM - 3:30PM ET

Lazarus Rising: The Resurrection of the Hospitality, Gaming, Movie Theater, and Entertainment Industries

In our opening panel, join industry experts for a roundtable discussion on the havoc that the pandemic has wreaked on the gaming, hospitality, and movie theater industries. When will the entertainment sector recover?

Panel:



Brett A. Axelrod
(Moderator)
Fox Rothschild LLP



Amir Agam, CIRA
FTI Consulting, Inc.



David M. Neff
Perkins Coie LLP



Eben Paul Perison
Armory Group, LLC

3:45PM - 4:45PM ET

Emerging Trends in Chapter 11 Plans: New Solutions to Old Problems

A discussion of cutting-edge issues arising in recent chapter 11 cases, including post-petition interest for general unsecured creditors, third party plan injunctions, and a discussion of the rise of DIP-to-Exit financing facilities in recent mega cases.

Panel:



Hon. Martin R. Barash
(Moderator)
U.S. Bankruptcy Court, C.D. Cal.



Ken Enos
Young Conaway Stargatt & Taylor, LLP



Daniel Gwen
Ropes & Gray LLP



Ian T. Peck
Haynes and Boone, LLP



Bradley D. Sharp
Development Specialists, Inc.

5:00PM - 6:00PM ET

Keynote: The Faraday Story - Navigating Challenges, Successes and the Future

The Faraday Story – Navigating Challenges, Successes, and the Future: A Conversation with Carsten Breitsfeld, CEO of Faraday and Jack Butler, CEO of Birch Lake

Speakers:



Jack Butler
(Moderator)
CEO, Birch Lake



Dr. Carsten Breitsfeld
CEO, Faraday Future

Tue, June 15, 2021

2:00PM - 6:00PM ET

Bankruptcy Taxation Part 1

During this two-part bankruptcy tax program the panel of insolvency tax experts will assess challenges still facing big corporations after implementation of the CARES Act and new opportunities from tax laws passed in 2020. Judge Wallace will present on his continuing views from the bench and open up for questions. A discussion on big data and how the IRS continues to improve on using data analytics to do more with less will round out the first session. In Part 2 we will get an annual review and update to Chapter 7 and 11 basics including a discussion on single member LLCs followed by a presentation on the hidden tax dangers in bankruptcy. New speakers to the group will present ideas for tax planning for insolvency and discharge of indebtedness. A discussion on common tax problems experienced when preparing partnership tax returns in bankruptcy will conclude this year's program.

Panel:



Andrew R. Barg, CIRA
(Co-chair)
Barg & Henson CPAs, PLLC



Kimberly J. Lam, CIRA
(Co-chair)
Bachecki, Crom & Co., LLP



Jay D. Crom, CIRA
Bachecki, Crom & Co., LLP



Timothy M. Nichols
KPMG LLP



Robert L. Nistendirk
Woomer, Nistendirk & Associates PLLC



Jeffrey M. Sklarz
Green & Sklarz, LLC



Hon. Mark S. Wallace
U.S. Bankruptcy Court, C.D. Cal.



Christopher W. Woll
KPMG LLP

Wed, June 16, 2021

2:00PM - 6:00PM ET

Bankruptcy Taxation Part 2

In Part 2 we will get an annual review and update to Chapter 7 and 11 basics including a discussion on single member LLCs followed by a presentation on the hidden tax dangers in bankruptcy. New speakers to the group will present ideas for tax planning for insolvency and discharge of indebtedness. A discussion on common tax problems experienced when preparing partnership tax returns in bankruptcy will conclude this year's program.

Panel:



Andrew R. Barg, CIRA
(Co-chair)
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Ron Maroko, CIRA
U.S. Department of Justice



Jack F. Williams, CIRA, CDBV
Baker Tilly US, LLP & Georgia State University College of Law

7:00PM - 8:00PM ET

Networking Happy Hour for Bankruptcy Taxation Speakers and Attendees

Thu, June 17, 2021

2:00 – 3:00 PM ET

From Conference Rooms to Zoom Break-Out Rooms: Mediation in the Time of COVID and Beyond

Bankruptcy-related disputes are particularly well suited for mediation. This panel will discuss the history of mediation and how it has evolved in the bankruptcy arena, different types of mediation and mediators, and the various issues that are raised in mediation including confidentiality. The panel will also discuss how the pandemic has affected mediation and the dynamics of remote mediations through virtual spaces such as Zoom. Join us for a lively discussion by highly accomplished professionals who will draw on their experiences and observations generally and in some recent cases that have benefitted from mediation.

Panel:



Hon. Kevin J. Carey
(Moderator)
Hogan Lovells US LLP



Mark Felger
Cozen O'Connor



Prof. Carrie Menkel-Meadow
University of California, Irvine



Ilan D. Scharf
Pachulski Stang Ziehl & Jones LLP



3:15PM - 4:15PM ET

What's a Financially Distressed U.S. Cannabis Company to Do?

As the rapidly growing \$13.0+ billion cannabis market remains quasi-legal in the U.S., federal bankruptcy options remain off-limits. This interactive panel will discuss recent cases and explore frontier business and legal issues facing struggling cannabis and cannabis-related businesses, and their creditors. Additional topics will cover the status of federal criminalization of cannabis, banking issues, creditors rights, and receivership, along with today's most likely path to restructuring.

Panel:



Claudia Z. Springer
(Moderator)
Reed Smith LLP



Mitch Kahn
Independent Director



Arun Kurichety
Petalfast



Hon. Brian D. Lynch
U.S. Bankruptcy Court, W.D. Wash.

4:30PM - 5:30PM ET

Keynote Presentation - The State of the Economy

During this keynote presentation, Mr. Dan White will speak to the U.S. macroeconomic outlook and how it is expected to impact household credit over the next year or two. That would include a look at how the drawdown of the pandemic is giving way to economic recovery and what role federal stimulus will have as a part of that process.

Speaker:



Dan White
Director, Moody's Analytics

Tue, June 22, 2021

2:00PM - 3:00PM ET

Desperate Times Have Called for Desperate Measures

Unprecedented government stimulus programs have been a lifeline for many businesses and industries. However, vigilance over a wide range of increased fraud during today's financially challenging pandemic times is critical: healthy companies have become stressed, and stressed companies have become distressed. As time and liquidity run short, incidences of financial fraud increase. This panel will focus on the intersection of economic distress and fraud schemes targeting government stimulus funds.

Panel:



Rick Westerman
(Moderator)
CohnReznick LLP



Eric S. Benderson
Small Business Association



Eve H. Karasik
*Levene, Neale, Bender, Yoo & Brill
L.L.P.*

3:15PM - 4:15PM ET

We Are What We Eat - Current Trends in Restaurant Restructurings

The restaurant industry is tough even in the best of times. During the pandemic, restaurant bankruptcies and closures have been an all too common sight. Surviving financial distress from COVID-19 in the restaurant industry requires innovation, capital and high level restructuring skills. This panel will explore key issues in restaurant restructurings, how restaurants can navigate the challenges posed by the pandemic, and the future landscape for successful restaurants.

Panel:



Howard S. Steel
(Moderator)
Goodwin Procter LLP



Vin Batra
Configure Partners



Hon. Daniel P. Collins
U.S. Bankruptcy Court, D. Ariz.



Nishant Machado
Mackinac Partners



Morgan McClure
Fortress Investment Group

4:30PM - 5:30PM ET

I'll Take It From Here: Current Issues Arising in Post-Confirmation Chapter 11 Estate Administration

Efficient and cost-effective post-confirmation winddown of debtors' estates has become critically important in the modern chapter 11 landscape dominated by upfront asset sales and an accelerated plan process. We will highlight the importance of involving the proposed post-confirmation professionals at the earliest stage possible, identify common issues faced by plan administrators and liquidating trustees, including new case studies, common tax issues and strategies, and litigation funding, and discuss practical solutions and pragmatic advice based on our panelists' collective decades of experience. As time and liquidity run short, incidences of financial fraud increase. This panel will focus on the intersection of economic distress and fraud schemes targeting government stimulus funds.

Panel:



Dana P. Kane
(Moderator)
Kelley Drye & Warren LLP



Steve Balasiano
MHR Advisory Group



Scott Cargill
Lowenstein Sandler LLP



Emily Slater
Burford Capital



Susan P. Tomlinson
Crowe LLP



Wed, June 23, 2021

2:00PM - 3:00PM ET

The Complex Web of Healthcare: Regulations, Mission, COVID and Stimulus Funds

Many segments of the healthcare industry were negatively impacted by COVID and propped up by stimulus funds during the pandemic. This panel will discuss the stressors on the industry, including the impact of COVID, the uncertainty of the treatment and repayment of certain stimulus funds and what happens when the money runs out. The panel will also explore the business and legal complexities surrounding restructurings and sales in the healthcare space, including the tension between regulatory oversight of the industry and the goals of bankruptcy generally, sales of non-profits to for profits, leasing arrangements and the bankruptcy court's arguably limited jurisdiction to address certain sale related issues.

Panel:



Felicia Gerber Perlman
(Moderator)
McDermott Will & Emery



Hon. Stacey G.C. Jernigan
U.S. Bankruptcy Court, N.D. Tex.



Randye B. Soref
Polsinelli



Andrew Turnbull
Houlihan Lokey

3:15PM - 4:15PM ET

Can Vendors Be Victorious in Chapter 11? How to Maximize your Chances of Recovering Post-Petition and Reclamation Trade Vendor Receivables in Chapter 11

Our panel of industry experts will review cutting-edge issues affecting vendors in Chapter 11, including best practices pre-petition. They will also provide their insider tips on protecting post-petition and reclamation vendor receivables, drawing on their experience in recent major retailer bankruptcies including Forever 21, Gymboree, Ascena, and others.

Panel:



Hon. Keith L. Phillips
(Moderator)
U.S. Bankruptcy Court, E.D. Va.



Jed Donaldson
LimNexus LLP



Edward Kim
Province



Susan K. Seflin
Brutzkus Gubner LLP

4:30PM - 5:30PM ET

Special Situations: Made Even More Special by COVID?

Special situations and special opportunities have been made even more "special" by the Covid-19 pandemic. Many industries, if not all, have faced the fall-out challenges of managing liquidity, increasing survivability and more, all in a uniquely unprecedented historical time of uncertainty. Join this panel of capital management and financial advisors to get their individual takes on the day-to-day challenges they have seen and navigated in the past year including strategies and lessons learned going forward.

Panel:



Cathy Ta
(Moderator)
Reorg



Jeff Raithel
Ducera Partners LLC



Rick Schreiber
Versa Capital



Matt Underwood
Ares Management LLC

Thu, June 24, 2021

2:00PM - 3:00PM ET

Turbulence in the Air: Recent Developments in the Aviation Industry

During this session, the panel will discuss recent trends in the aviation industry including the recent bankruptcy filings by foreign airlines (AeroMexico, LATAM, Avianca) in the United States. Panelists include current and former airline executives, counsel to an aircraft lessor, a representative of an aviation lender and an industry consultant. The panel will explore the complex issues that arise with respect to aviation lending and restructurings and address the potential for continuing distress in this industry.

Panel:



Neal S. Cohen

(Moderator)
FTI Consulting, Inc.



Captain Lee Moak

The Moak Group



Jonathan G. Ornstein

Mesa Air Group



Kelli Walsh

GE Capital Aviation Services



Claudia Ziemer

Nord/LB

3:15PM - 4:15PM ET

A Cloudy Crystal Ball - Valuation and Feasibility During a Worldwide Pandemic

Whether in pre-filing negotiations, an adequate protection fight, or a contested confirmation proceeding, valuation is a critical piece of the chapter 11 process. Panelists will discuss the implications of COVID-19 and other recent events on various valuation methodologies and provide insight on how stakeholders and courts have addressed valuation and feasibility amidst broader disruption and uncertainty in the marketplace.

Panel:



Hon. Barbara J. Houser

(Moderator)
U.S. Bankruptcy Court, N.D. Tex.



Kevin Haggard

Miller Buckfire



Chad J. Husnick

Kirkland & Ellis LLP



**Michael G. Taylor, CIRA,
CDBV**

Deloitte

4:30PM - 5:30PM ET

Being CRO During a Pandemic

A Chief Restructuring Officer (CRO) can be transformative for a company in financial distress. This session will examine the role of the CRO and how it has evolved through the pandemic. The panel of experienced restructuring advisors will draw on their collective experiences to provide insight into what makes an effective CRO and how to best navigate the competing interests of various stakeholders while successfully leading a company's restructuring efforts.

Panel:



Sabina Jacobs Margot

(Moderator)
Gibson, Dunn & Crutcher LLP



Scott Avila

Paladin Partners



Mohsin Meghji

M3 Partners, LP



John T. Roche

Seadrill Partners



Tue, June 29, 2021

2:00PM - 3:00PM ET

Wildfires and the Future of Winemaking in California

As this conference was going to be in person in California, it was very fitting to discuss the multitude of wildfires in California in the past several years that have devastated many communities and wreaked havoc on the wine industry in particular. From a restructuring perspective, the PG&E bankruptcy case has brought interesting perspectives on liability and tort claims. Wildfires are becoming an annual occurrence in California wine country, and our panel will discuss how it has affected operations, wine-making, and wine vintages.

Panel:



Teri Stratton, CIRA
(Moderator)
Piper Sandler & Co.



John Boken
AlixPartners, LLP



Debra Grassgreen
Pachulski Stang Ziehl & Jones LLP



Jane Kim
Keller Benvenuti Kim LLP

3:15PM - 4:15PM ET

Is Commercial Real Estate in Trouble?

Lenders provided six to eighteen months of relief last spring as the economy shut down due to the pandemic. Our panelists will speak to the retail environment with store closures and deferred rents, as well as how working from home will impact the market into the future beyond the pandemic. In addition, there is roughly \$400 billion of commercial real estate debt coming due this year as compared to \$100 billion of corporate bonds and loans.

Panel:



Thomas Howland
(Moderator)
Piper Sandler & Co.



Dustin P. Branch
Ballard Spahr LLP



Melissa M. Root
Jenner & Block LLP



Hon. Barry Russell
U.S. Bankruptcy Court, C.D. Cal.

4:30PM - 5:30PM ET

Judges Roundtable

A panel of bankruptcy judges informally answer and discuss practitioners' questions of dos and don'ts, best practices, their outlook for bankruptcy cases, and other topics that may be of interest to the group.

Speakers:



Hon. Jerrold N. Poslusny, Jr.

(Moderator)

Judge, U.S. Bankruptcy Court, D. N.J.



Hon. Martin R. Barash

Judge, U.S. Bankruptcy Court, C.D. Cal.



Hon. Daniel P. Collins

Judge, U.S. Bankruptcy Court, D. Ariz.



Hon. Barbara J. Houser

U.S. Bankruptcy Court, N.D. Tex.



Hon. Stacey G.C. Jernigan

Judge, U.S. Bankruptcy Court, N.D. Tex.

Wed, June 30, 2021

2:00PM - 3:15PM ET

Subchapter V Small Business Bankruptcy Cases: A Primer for Insolvency and Restructuring Advisors

Two Subchapter V Trustees, a financial advisor and a US Bankruptcy Judge share their perspectives a year after the enactment of the Small Business Reorganization Act ("SBRA"). The Panel will discuss reasons for the enactment of the SBRA, the main differences between a standard Chapter 11 case and an SBRA case, and the ways in which financial advisors can serve a vital role in these cases.

Panel:



Kailey Wright, CIRA

(Moderator)

Grobstein Teeple LLP



Hon. Scott C. Clarkson

U.S. Bankruptcy Court, C.D. Cal.



Caroline R. Djang

Best Best & Krieger LLP



Doug Flahaut

Arent Fox LLP

3:30PM - 4:45PM ET

How to Successfully Navigate a Board Position (Ethics)

During our final session, the panel will address the issues that should be considered before accepting a board position, as well as what should be top of mind as a board member. Whom/what does the board serve? How can board performance be improved? When should directors resign/not resign? Are many boards doing a less than adequate job? If so, why? What to expect when the company files bankruptcy or is in the planning stages?

Panel:



D. Jan Baker

(Moderator)

Independent Director



Robert J. Keach

Bernstein Shur Sawyer & Nelson



Deborah Hicks Midanek

Independent Corporate Director & Author



Caroline A. Reckler

Latham & Watkins LLP



Harvey L. Tepner

Independent Corporate Director



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Thank you to the Co-Chairs and Planning Committee for their hard work and time in making this year's virtual conference a big success!

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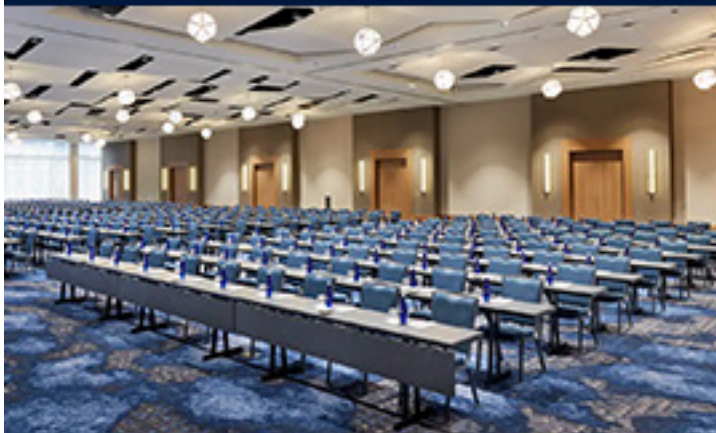
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PPP FORGIVENESS AND EXPENSES: STATE TAX IMPLICATIONS¹

BRIAN KIRKELL and MO BELL-JACOBS

RSM US LLP

One of the largest relief measures in the federal Coronavirus Aid, Relief, and Economic Security Act (CARES Act) is the Payroll Protection Program (PPP). The intent of the PPP is to assist both for-profit and nonprofit employers in maintaining their payroll during the COVID-19 crisis. Under the program, the Small Business Administration provided 100% federally insured loans for certain covered expenses. Generally, these loans are forgivable in full if employers retain employees at salary levels comparable to those before the crisis. Under normal circumstances, forgiven loan amounts are generally taxable for federal income tax purposes, but the CARES Act, under section 1106(i) of the act, expressly excludes the forgiveness of PPP loans from federal gross income, and thus federal income tax.

Will forgiven loan amounts be subject to state income taxation?

At first glance, determining whether debt forgiveness under the CARES Act is taxable in a state seems straightforward. In the 20-odd states and the District of Columbia that have rolling conformity to the Internal Revenue Code (IRC), the forgiven loans will likely not be subject to tax. These states conform to the latest version of the IRC including any amendments or revisions as they occur. Static or fixed-date conformity states conform to the IRC on a given date or conform to specifically enumerated provisions. Accordingly, in the states with static or fixed-date conformity, taxpayers receiving loan forgiveness could face substantial state income tax liabilities as a result.

Whether a borrower's loan forgiveness is taxable at the state level largely rests on the particular state's conformity rules. That being said, taxpayers should be aware that it is difficult to generalize about conformity during a dynamic period of frequent state and federal changes. Some rolling conformity states may opt to decouple from the CARES Act and thus the loan forgiveness exclusion; however, many static conformity



states are likely to conform to the federal exclusion. It is imperative for borrowers to know the status of their states' conformity rules and to plan accordingly.

An additional twist

Section 1106(i) of the CARES Act provides that forgiven loans are excluded from gross income for purposes of the IRC. That forgiveness provision does not amend the IRC. Most states calculate state income using some connection or conformity to the IRC. When reviewing state conformity for purposes of the PPP loan forgiveness exclusion, a state could take a position that section 1106(i) has no impact on whether the loans are forgiven for state tax purposes because, while the state may conform to the IRC, it may not conform to section 1106(i) and the other federal provisions in Title 15 (where the PPP provisions are codified) of the federal code. Accordingly, even in states that conform to the IRC, the federal loan forgiveness provisions may not apply to the state calculation of taxable income, resulting in the forgiveness being included in state taxable income. While some states do conform to the IRC and other federal code provisions, others may only conform to the IRC, or Title 26. While highly nuanced, taxpayers should be aware that states may need to provide additional guidance clarifying that PPP loans are also forgiven for state tax purposes.

What about expenses?

An additional complexity at the state level is the treatment of expenses incurred when using funds from the PPP. Originally, the IRS released Notice 2020-32 providing that taxpayers who receive forgiveness for a loan under provisions of the PPP may not 'double-dip' by also deducting the amount paid out to employees as expenses if the payment of the expense results in the forgiveness of the loan. However, this was recently reversed when congress approved the deductibility of covered expenses paid with PPP funds through the Consolidated Appropriations Act of 2021 (CAA), and

¹ Originally published on [rsmus.com](https://rsmus.com/what-we-do/services/tax/state-and-local-tax/income-and-franchise/ppp-forgiveness-and-expenses-state-tax-implications.html), Jan. 15, 2021, available at <https://rsmus.com/what-we-do/services/tax/state-and-local-tax/income-and-franchise/ppp-forgiveness-and-expenses-state-tax-implications.html>.

signed into law by the president on Dec. 27, 2020.² The Notice was subsequently made obsolete by the IRS.

Like the nuance as to whether states will conform to the income exclusion, some states may deny the deduction or require income inclusion and allow the deduction. Ultimately, it is anticipated that the states will provide guidance on whether they will allow taxpayers a 'double benefit' with respect to PPP income and expenses.

Some states are taking affirmative steps to address these issues in legislation and guidance. For example, on June 30, 2020, North Carolina Governor Roy Cooper signed House Bill 1080,³ updating the state's fixed conformity date to the Internal Revenue Code to May 1, 2020 and specifically incorporated the loan forgiveness provisions under section 1106 of the CARES Act. However, the bill also requires an addition modification for any expenses deducted under the IRC to the extent that payment of the expense results in forgiveness of a covered loan pursuant to section 1106(b) of the CARES Act. Subsequently, the North Carolina Department of Revenue released a notice⁴ on PPP forgiveness. That notice provides clear guidance on its treatment of both of these issues for both individuals and corporations. In both cases, the state provides that the amount of forgiven PPP loan is not included in the calculation of North Carolina taxable income. However, any expenses paid using the proceeds of the PPP loan that are deducted for federal tax purposes are not deductible when calculating North Carolina taxable income. As a note of caution, this position may change through subsequent legislation.

Through early March of 2021, a majority of states have either issued guidance or legislative amendments that exclude forgiven loans from state taxable income and allow expenses to be deducted. However, a number of states have yet to address or confirm to that treatment.

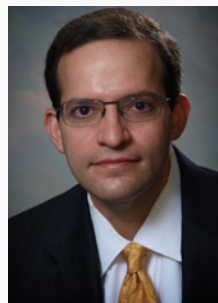
Takeaways

Taxpayers should carefully assess the state tax effects of applying for PPP loans and the consequences of successfully having those loans forgiven. It is critical to closely review the general conformity rules concerning

forgiveness of debt, the state's response and conformity to the CARES Act, and the response and conformity to the CAA for expenses before taking a position on a return. It is also important to understand the more subtle opportunities and risks associated with state taxation of loan forgiveness.

From a more practical perspective, many states will exclude the PPP loan forgiveness from income and allow a deduction for related expenses, essentially following the federal treatment. However, some states may treat the forgiveness and expense deduction differently among corporate and individual taxpayers. Taxpayers should be aware that pending quarterly estimates may need to be adjusted based on how states respond to forgiveness and expenses. Accordingly, taxpayers may consider filing extensions to allow the states additional time to issue guidance or adopt legislative amendments to existing tax code. Taxpayers with questions about the state response to PPP conformity and expense deduction are highly encouraged to reach out to their tax advisors as state guidance on these issues is evolving.

ABOUT THE AUTHORS



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Brian is the Washington D.C. National Tax National Tax State & Local Tax leader at RSM US LLP. He provides tax services to clients across the US on sales and use, credits and incentives, income and franchise, and property tax issues. He is also a Professor at George Washington University Law School, an editor for Tax Analysts, and serves on the Tax Analysts State Tax Advisory Board, BNA State Tax Advisory Board, and Hartman SALT Forum Advisory Board. He is admitted to the State Bar of Tennessee and US Tax Court, and he is a member of the American Bar Association.



Moshe "Mo" Bell-Jacobs
RSM US LLP

Mo is a senior manager in RSM's Washington National Tax SALT group. He routinely examines state and local tax issues and the impact of legislation on middle-market businesses. He is responsible for tracking legislation, reviewing significant court developments, providing client service, and acting as a technical resource. Mo's experience has included state tax law research and planning, state audit defense representation through appeals and settlement negotiations, voluntary disclosures, and a full spectrum of Wayfair planning and response.

² "Congress Passes Law Containing PPP Tax Fix; Second-Draw Program," Tax Alert, rsmus.com, Dec. 22, 2020, <https://rsmus.com/what-we-do/services/tax/federal-tax/tax-accounting-services/congress-passes-law-containing-ppp-tax-fix-second-draw-program.html>.

³ "North Carolina Decouples from CARES Act Provisions," Tax Alert, rsmus.com, July 1, 2020, <https://rsmus.com/what-we-do/services/tax/state-and-local-tax/income-and-franchise/north-carolina-decouples-from-cares-act-provisions.html>.

⁴ "Important Notice: North Carolina's Reference to the Internal Revenue Code Updated - Impact on North Carolina Corporate and Individual Income Tax Returns," North Carolina Dept. of Revenue, July 20, 2020, https://files.nc.gov/ncdor/documents/files/2020-7-20-Important-Notice-Code-Update-Decoupling_0.pdf.

VENEZUELA: PROSPECTS FOR RESTRUCTURING SOVEREIGN DEBT AND REBUILDING A NATIONAL ECONOMY AGAINST THE BACKDROP OF A FAILING STATE¹

STEVEN T. KARGMAN

Kargman Associates/International Restructuring Advisors



OVERVIEW OF THE CRISIS

For the last several years, Venezuela has been facing an unprecedented crisis on a truly tragic scale. It has been first and foremost a grave humanitarian crisis, with untold suffering on the part of the Venezuelan people resulting from widespread malnutrition, growing poverty, the spread of otherwise preventable diseases such as malaria, and a breakdown of Venezuela's health care system.² In response to the breakdown in

Venezuelan society in recent years, approximately five million or more Venezuelans have voted with their feet, fleeing Venezuela and seeking refuge in neighboring countries in Latin America and the Caribbean, such as in Colombia, Peru, Chile, Ecuador, Argentina, and Brazil. This outward migration of Venezuelans has, in turn, caused refugee crises in some of these neighboring countries and has led to tensions, for instance, between Colombia and Venezuela along their common border.

This humanitarian crisis in its different dimensions has been compounded by the arrival of the COVID-19 pandemic in Venezuela and its subsequent adverse impact on the Venezuelan people and Venezuelan society generally. Venezuela entered the COVID crisis from a very weak position, given that its healthcare system pre-COVID was already under substantial strain, if not in a state of complete dysfunction. Nonetheless, even as the human suffering of the Venezuelan people appears to have continued unabated over the last year, the COVID crisis has seemingly allowed the Venezuelan regime led by Nicolas Maduro to further consolidate its hold on power, given the strictures of a lockdown that was imposed by the government in response to the pandemic.

Beyond this humanitarian crisis, Venezuela is also facing a major financial and economic crisis. By many different indicators, the Venezuelan economy is currently in a state of virtual collapse, with the economy estimated to have contracted by approximately 65 percent between 2013-2019, according to the International Monetary Fund.³ As many observers have noted, the contraction of the Venezuelan economy is even greater than the

¹ This article is adapted (and updated) from the author's article that was published in a Venezuelan law review, *La Revista Venezolana de Legislación y Jurisprudencia* (Venezuelan Journal of Legislation and Jurisprudence) (RVLJ), as part of a special tribute issue to prominent Venezuelan lawyer James O. Rodner. The RVLJ article contains a complete set of footnotes and, accordingly, should be referred to for sources of authority in this article. The RVLJ article was posted on the Harvard Law School Bankruptcy Roundtable blog (July 7, 2020) as well as on the Oxford Business Law Blog (July 20, 2020). The full RVLJ article can be found at [http://www.kargmanassociates.com/RVLJ_S.Kargman_Venezuela_Debt_Restructuring\(FINAL2020\).pdf](http://www.kargmanassociates.com/RVLJ_S.Kargman_Venezuela_Debt_Restructuring(FINAL2020).pdf) and/or on the HLS or Oxford blogs.

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² An IMF blog described the situation as follows: "Since the beginning of the crisis, living conditions have severely deteriorated for Venezuela's 31 million inhabitants. Extreme poverty rose from 10 percent of the population in 2014 to 85 percent in 2018. And severe shortages of food and medicines continue to plague the population." See IMF Blog, November 21, 2019, "For Venezuela's Neighbors, Mass Migration Brings Economic Costs and Benefits," available at <https://blogs.imf.org/2019/11/21/for-venezuelas-neighbors-mass-migration-brings-economic-costs-and-benefits/> (last visited on March 28, 2021).

³ *Id.*

severe contraction experienced by the US during the Great Depression.

The Venezuelan economy was believed to have suffered a major contraction in 2019 and 2020 and is projected to suffer a further contraction in 2021. According to the IMF, the Venezuelan economy experienced a 35% decline in GDP in 2019, and, as of last October, the IMF was projecting that GDP would decline by 25% for 2020. In its latest set of forecasts for the global economy released in early April, the IMF has projected that the Venezuelan economy would shrink by a further 10% in 2021, although a recent forecast from Credit Suisse was more optimistic and projects growth of 4% for 2021.

Among the many major economic and financial woes that Venezuela is facing, it is suffering from serious hyperinflation, a deeply devalued currency, high unemployment, and dwindling foreign exchange reserves. Venezuela is also facing an unsustainable debt burden with outstanding debt that is believed to exceed one hundred fifty billion dollars.

PROSPECTS FOR VENEZUELAN DEBT RESTRUCTURING

In light of Venezuela's precarious societal and financial/economic situation and Nicolás Maduro's regime appearing to remain firmly in control politically, it may seem premature to contemplate the possibility of a national restructuring of Venezuelan debt in the near term. In fact, several observers have characterized Venezuela as a "failing," if not "failed," state, and thus the prospects for a debt restructuring in that context may seem chimerical at best.

Yet, it was just under two years ago that there seemed to be some optimism regarding the prospects for a debt restructuring or at least there seemed to be some momentum in that direction. At that time, both the

Juan Guaidó-led "interim" government and the largest grouping of Venezuelan bondholders sketched out their respective visions of the key principles that could guide any eventual Venezuelan debt restructuring.

Since then, however, the Maduro regime has tightened its grip on power. This was reflected in the December 2020 elections for the National Assembly (the "NA") which gave the Maduro-aligned forces control of that legislative body. However, the elections were boycotted and widely criticized and condemned by the opposition, the US government, and other observers who considered the elections to be flawed and not meeting basic standards of electoral fairness. For their part, the opposition forces seemed to have lost some momentum and political cohesiveness, and the leadership of Guaidó has come under some challenge or criticism from certain quarters within the opposition.

US government policy toward Venezuela under the Trump administration — namely, a tough sanctions regime vis-à-vis the Venezuelan government and its leaders as part of a policy of "maximum pressure" against the Venezuelan government — clearly did not achieve its goal of regime change, with the Maduro regime still remaining in power. Nonetheless, US sanctions have placed substantial economic pressure on the Venezuelan government, and, yet, the Maduro regime has developed ways to continue to hold on to power. For instance, the Maduro regime has sought to mitigate the impact of US sanctions through trading with countries such as Turkey and Iran and by pursuing other strategies. The Maduro regime has also undertaken other steps to keep certain parts of the economy functioning by loosening its control of the economy, such as by allowing greater use of the US dollar as a medium of exchange in the economy given that the Venezuelan currency, the bolivar, has become essentially worthless.



SOME KEY EVENTS UNDER CHAVEZ AND MADURO*



1998 – Hugo Chavez is elected president; launches 'Bolivarian Revolution' with new constitution; socialist and populist policies funded by high oil prices.

2001 – Chavez passes laws aimed at redistributing land and wealth; concern grows re concentration of economic and political power.

2002 – Armed forces rebel over stand-off between government and state oil monopoly. Chavez is taken into military custody, but interim government collapses and he returns to office.

2004 – Opposition parties boycott election; parties loyal to Chavez dominate.

2006 – Chavez signs \$3bn arms deal with Russia; wins third term with 63% of the vote.

2007 – Nationalization of key energy and telecommunications companies approved by parliament. US companies Exxon Mobil and ConocoPhillips refuse to hand over majority control; Venezuelan government expropriates them.

2008 – Venezuela and Russia sign oil & gas accord.

2009 – Voter referendum ends term limits for elected officials, allowing Chavez to run again in 2012.

2010 – Chavez devalues currency to boost revenue from oil exports after economy shrank 5.8% in Q4 2009; in Sept parliamentary elections, opposition makes significant gains.

2012 – Gov't extends price controls on basic goods to battle inflation; Chavez wins 4th term; withdraws from ICSID.



2013 – After a long battle with cancer, Chavez dies in March and his hand-picked successor, Nicolás Maduro, is elected president by a contested margin.

2014 – Public spending cut as oil prices reach 4-yr low; at least 28 die in suppression of anti-government protests.

2015 – Opposition coalition wins two-thirds majority in parliament; 16-year control by Socialist Party ends.

2016 – Hundreds of thousands protest in Caracas, blaming Maduro for economic crisis and calling for his removal; recall referendum leads to impasse with the National Electoral Council.

2017 – Major protests and violent confrontations continue; a controversial election is convened by Maduro to replace the National Assembly.

2018 – National elections are held amid confusion, date changes, accusations of irregularities, and low voter turnout. The opposition contests official victory of Maduro.

2019 – Maduro is inaugurated in January for a second 6-year term in the face of strident objections from the opposition and the US, UK, EU and others. National Assembly opposition leader Juan Guaidó declares interim presidency recognized by 50+ countries. On 30 April, a group of several dozen military personnel and civilians join Guaidó in an uprising against Maduro, however, an "uneasy peace" is established the same day. Norway facilitates mediation efforts; the US imposes sanctions.

2020 – Opposition parties boycott legislative elections, losing seats in the National Assembly; the Guaido movement wanes. Failed coup attempt is labeled "Bay of Piglets."

2021 – Economic and humanitarian crisis worsens with widespread shortages, hyperinflation, hunger, COVID-19. A national "Loyalty ID" is implemented and connected to vaccination. New clashes occur along the Colombian border; Maduro blames Colombian oligarchy.

**Note: This timeline was compiled by the editors as a supplement to the article.*

With US sanctions effectively limiting imports into Venezuela and otherwise putting constraints on the Venezuelan economy by limiting which parties Venezuela may trade with and how it conducts international financial transactions, it is widely believed that US sanctions may have contributed to further suffering among the Venezuelan people. To be sure, though, there was widespread misery and suffering in Venezuela even before the imposition of US sanctions due, in no small part, to the mismanagement by the Chavez-Maduro governments of the economy and the pervasive corruption in Venezuela's government and its agencies.

It remains to be seen what new policies, if any, the new Biden administration will pursue in dealing with the situation in Venezuela. For example, will the new Administration simply continue the existing US sanctions regime vis-à-vis Venezuela or will it modify that sanctions regime? Will the Biden administration encourage or support a diplomatic approach to the resolution of Venezuela's political stalemate which might have as its ultimate goal the establishment of a post-Maduro transition government in Venezuela? The formation of such a transition government was the ostensible aim of a since-terminated Norway-led mediation process in the last few years that involved the Venezuelan opposition and the Maduro regime.

As I first wrote over two years ago in a four-part article in *The International Economy* (TIE) in which I discussed what I called Venezuela's "debt restructuring conundrum,"⁴ Venezuela urgently needed a debt restructuring at that time, and yet such a debt restructuring was unlikely to occur then or in the foreseeable future as long as the Maduro regime remained in power. That was true particularly in light of US sanctions and their impact on the ability of US creditors to interact with the Maduro regime and to obtain new debt securities from the Maduro regime as part of any bond exchange that would be an integral feature of any eventual Venezuelan debt restructuring.

When I wrote the article in TIE mentioned above, I argued that the more time which passed before Venezuela began a debt restructuring process, the more difficult it would be to reach a satisfactory debt restructuring outcome for the country and its creditors, especially since at the time of that article the Venezuelan economy in general, and the oil industry in particular, were already

in a state of fairly serious decline. I also noted that the risk of litigation against the Republic and/or PDVSA (with the possibility of judgments eating into the assets of the Republic and/or PDVSA) would only increase with the passage of time. The bottom line, I argued, was that the continued decline of the economy and the increased risk of litigation would mean that there would ultimately be fewer resources available to a Venezuelan government to work out a satisfactory restructuring with its creditors,

Since the first installment of the article in TIE was published in December 2018 – and even since the fourth installment of the article was published in December 2019 – the deterioration of the Venezuelan economy and the Venezuelan oil industry has continued apace. Moreover, the litigation against the Republic and PDVSA has taken on a life of its own, with many lawsuits having already been filed and many still pending in the US. Thus, in light of these developments and in keeping with the thesis in my earlier article, the prospects for a debt restructuring would appear to have become even more problematic than they were just a few short years ago.

Nonetheless, the prospects for a debt restructuring could improve if the political situation were somehow to change in the not-too-distant future, but particularly if that were to happen before the Venezuelan economy and the structures of Venezuelan society completely collapse. For example, if the Maduro regime were dislodged from power by a new government with more democratic leanings, or if a transition regime were able to successfully combine elements from both the opposition and the Maduro regime, then it might be possible to contemplate a Venezuelan debt restructuring. Of course, at this point, those are not immediately foreseeable scenarios, although the possibility that the landscape could shift unexpectedly cannot be ruled out.

With the state of Venezuelan affairs as they now are, time may be fairly short for the political and economic situation in Venezuela to turn around significantly in a reasonable period of time. It should be noted that the longer it takes to reach the point where Venezuela and its creditors could even contemplate negotiating a potential debt restructuring, the steeper the "haircut" creditors would likely need to accept in any such eventual debt restructuring. The prevailing pessimism among investors and creditors about the prospects for a Venezuelan debt restructuring and a satisfactory creditor recovery has been reflected in the deeply distressed trading prices of Republic and PDVSA debt on the secondary market.

As of the end of March 2021, Republic bonds were reported to be trading generally in the range of 10-11 cents on the dollar and PDVSA bonds are reported to

⁴ See author's four-part article in *The International Economy* (TIE) from Fall 2018-Fall 2019: S. Kargman, "Venezuela Needs Debt Restructuring," TIE, Fall 2018, pp. 58-61; S. Kargman, "Venezuelan Debt Conundrum," TIE, Spring 2019, pp. 38-41; S. Kargman, "Oh! What a Tangled Web," TIE, Summer 2019, pp. 50-55; and S. Kargman, "Shrinking Pie," TIE, Fall 2019, pp. 52-56. For other articles by the author on the Venezuelan debt situation (apart from the RVLJ article cited in footnote 1), see S. Kargman, "Venezuela's Debt Restructuring: Predictable Uncertainties" (Parts 1 & 2), *Global Restructuring Review* (June 10-11, 2020), and S. Kargman, "Thoughts on the Possible Restructuring of Venezuelan Debt," Interview for Newsletter of LEC Abogados (Caracas, Venezuela) (January 2020).

be trading in the range of 4-5 cents on the dollar.⁵ Even so, Venezuelan debt is apparently very thinly traded on the secondary market for various reasons, including the role of US sanctions (which, among other things, have prohibited US persons from trading Venezuelan debt with other US persons, thereby severely crimping liquidity in Venezuelan debt).

In short, it is truly a race against time for Venezuela to successfully undertake a debt restructuring and economic recovery program. Crucially, if too much more time elapses before this happens, Venezuela's economy and finances, not to mention Venezuelan society, may reach a point where they are effectively beyond repair and remediation. In other words, if Venezuela does not reverse its downward trajectory in a reasonable period of time, it sadly risks eventually becoming the ultimate nightmare scenario of economists, development experts, financiers, and humanitarians worldwide: namely, another failed state with a truly dysfunctional economy of the type that has been seen in some developing countries in recent decades (e.g., Zimbabwe under Mugabe, as some have suggested).

So far, the Maduro regime has been able to slog through and hold onto power despite the grave situation now facing the Venezuelan people. However, even if the regime can maintain control in the near term (and thus, at least for the time being, prevent the emergence of a new government), it remains to be seen whether it will be able to continue to do so in the longer term, particularly if Venezuela continues on what in the last few years has seemed like an inexorable downward spiral.

MAJOR LEGAL AND POLICY ISSUES IN DEBT RESTRUCTURING SCENARIOS

Yet, if and when Venezuela eventually does reach the stage where it is in a position to restructure its debt, it will face a myriad of challenges associated with a comprehensive debt restructuring and any associated economic recovery/reconstruction program. At that point, all relevant stakeholders will need to hit the ground running in the race against the clock discussed above. This is why it is so important that such stakeholders think through clearly and in detail the types of issues they may encounter in such an undertaking.

The following discussion highlights some of the key legal and policy challenges that Venezuela and its stakeholders

may face when undertaking a comprehensive debt restructuring and economic recovery/reconstruction program.

Venezuela has a staggering debt load estimated to be \$150 billion or more. This consists of debt from both the Republic of Venezuela and its state-owned oil company, PDVSA. Unlike a typical sovereign debt restructuring, a Venezuelan debt restructuring would involve not simply one obligor but rather two separate (albeit closely related) obligors. Venezuela, through the Republic and PDVSA, owes debt to an extremely broad range of creditors, including bondholders, bilateral creditors, suppliers/trade creditors, arbitration award holders, holders of claims for blocked funds (e.g., airlines, etc.), and promissory noteholders, among others. (While there is actually a third Venezuelan government-connected obligor, Venezuela's state-owned electricity utility, Electricidad de Caracas (ELECAR), the amount of ELECAR's outstanding debt pales in comparison to the amount of outstanding debt of the Republic and PDVSA.)

For Venezuela to eventually recover economically, it will need to undertake a comprehensive debt restructuring so that post-restructuring it will not have the unsustainable debt burden that it is now carrying—a debt burden that is so unsustainable that Venezuela is currently in default on most of its outstanding debt. Any eventual Venezuelan debt restructuring, which is not likely to take place until a new government is in place, promises to be unlike any recent sovereign debt restructurings.

There are many factors that could potentially complicate a Venezuelan debt restructuring. In the first place, there is the large number and wide range of creditors which may pose significant challenges for creditor coordination, a crucial element in any complex debt restructuring. In addition, there is the broad diversity of creditor interests which could well lead to major intercreditor tensions and/or conflicts among and between the various creditor constituencies. Furthermore, the collapsed state of the Venezuelan economy could, among things, limit the resources available to support a Venezuelan debt restructuring, and thus in turn likely increase the sacrifice that stakeholders would have to make as part of any eventual restructuring deal.

Moreover, Venezuela's largest bilateral creditors, China and Russia, could play wild card roles in any eventual debt restructuring. China and Russia became such significant creditors to Venezuela when they entered into so-called loan-for-oil (or oil-for-loan) transactions with Venezuela. Under these transactions, China and Russia extended loans to Venezuela, and, in return, Venezuela agreed to repay those loans in shipments of oil to China and Russia.

⁵ It should be noted that there are two PDVSA bonds that are outliers: the PDVSA 8 ½% 2020 bonds are reported to be trading in the range of 23-26 cents on the dollar (due to the special pledge of Citgo Holding stock), and the PDVSA 6% 2022 bonds are reported to be trading in the range of 2.75-3.75 cents on the dollar (due to the controversy surrounding these bonds which are sometimes referred to pejoratively as the "hunger bonds" since they were said to prioritize the payment of debt service over meeting the dire social needs of the Venezuelan people). (This pricing information was kindly furnished by Russ Dallen of Caracas Capital.)

Thus, for a broad range of reasons including those discussed above, any eventual Venezuelan debt restructuring promises to be extraordinarily messy and complicated — probably much more so than any of the sovereign debt restructurings of recent years.

Applying Standard Restructuring Tools and Techniques

Nevertheless, classic restructuring tools and techniques that have been used in other sovereign debt restructurings could potentially be applied to resolve Venezuela's debt crisis. For example, there may well need to be debt forgiveness by Venezuela's creditors with the aim of leaving Venezuela with a sustainable debt burden post-restructuring. Alternatively, at least at the outset of any restructuring exercise, there might be short-term reschedulings of debt service payments on Venezuela's outstanding debt (which are known as debt reprofiling in the sovereign context) in order to relieve payment pressures on Venezuela in the near term.

For those creditors and other stakeholders who believe that Venezuela is fundamentally facing more of a liquidity crisis as opposed to a solvency crisis in light of Venezuela's vast oil reserves (reputed to be the largest in the world), such debt reprofiling, where debt service payments are pushed out a few years, may well be a more palatable option than outright reductions in principal through debt forgiveness. Moreover, as with many sovereign debt restructurings, any eventual Venezuelan debt restructuring may involve adjustments in the interest rates or coupons on Venezuela's outstanding debt so that Venezuela's debt service payments become more manageable or sustainable.

As has been suggested by various observers, in view of the significance of oil to the overall Venezuelan economy, Venezuela may end up including so-called oil warrants as part of any debt restructuring package. Other oil-producing countries have used oil or other commodity-based warrants in past sovereign debt restructurings. Basically, with oil warrants, creditors would be entitled to an additional payout on their restructured debt above and beyond the required debt service payments if and when the price of oil exceeds a certain baseline projection for the price of oil.

Oil warrants are one type of so-called "value recovery instruments" that have been used in previous sovereign debt restructurings.⁶ GDP warrants, which were used in the Greek debt restructuring in 2012 and the Argentine debt restructurings in 2005 and 2010, represent another

type of value recovery instrument where creditors would make an additional recovery if a country's GDP exceeded certain baseline projections for the country's GDP performance.

Applying Less Commonly Used Sovereign Debt Restructuring Tools and Techniques

In addition to the foregoing debt restructuring techniques, there may be other techniques employed in any Venezuelan debt restructuring that have not been employed in other recent sovereign debt restructurings in the last decade or longer.

1980s-Style Debt-for-Equity Swaps Updated for the Current Environment

A future Venezuelan debt restructuring might, for instance, involve debt-for-equity swaps or conversions. Debt-for-equity swaps in corporate debt restructurings are not uncommon and represent a fairly straightforward way for a corporate debtor to deleverage its balance sheet, but debt-for-equity swaps work much differently in the sovereign context than in the corporate context. Obviously, a national government, in contrast to private corporations, does not issue shares in itself, and thus the sovereign itself does not have any equity in itself that it can offer as part of a debt-for-equity swap.

Rather, the sovereign government in question needs to identify companies in the debtor country where a creditor/foreign investor could effectively swap debt for shares in those companies identified by the government. Not infrequently in prior sovereign debt restructurings, the companies which sovereigns identified for purposes of a debt-for-equity swap were companies that were formerly state-owned enterprises but that were subsequently privatized (and thus may have had equity or stock available for purchase/exchange by the creditor/foreign investor).

At its most basic level, in a debt-for-equity swap in the sovereign context, the "commercial debt owed by a sovereign debtor to private creditors is purchased by an investor in the secondary market and is then converted into an equity investment in the debtor country."⁷ However, in previous sovereign debt-for-equity swaps, there was often an intermediate step in this process: the foreign investor exchanged the debt it had purchased on the secondary market into the local currency of the sovereign debtor, and it was that local currency that was then used by the foreign investor to purchase the equity in the local company.

⁶ For a discussion of value recovery instruments (including so-called GDP warrants and oil warrants), see generally Lee Buchheit, Guillaume Chabert, Chanda DeLong, and Jeromin Zettelmeyer, "How to Restructure Sovereign Debt: Lessons from Four Decades," p. 14-15 (Peterson Institute for International Economics, Working Paper 19-8, May 2019).

⁷ See, e.g., S. S. Radha, "Debt-Equity Swaps: Structure, Impacts and Perspectives," p. 3 (available at <http://borealisga.com/wp-content/uploads/2015/10/International-Debt-Restructuring.pdf>) (last visited on March 28, 2021). For a slightly more elaborate explanation of a sovereign debt-for-equity swap, see id. at pp. 3-4 ("In a debt-equity swap, external debt of a developing country is converted into local currency funding for equity investment in that developing country..." (internal citation omitted)).

These types of debt-for-equity exchanges were not uncommon in Latin American debt restructurings of the mid-1980s through the mid-1990s, when a number of Latin American countries were undergoing major sovereign debt restructurings in connection with the debt crisis of that era.⁸ In roughly the same time frame, a number of Latin American countries experienced a wave of privatizations of their state-owned enterprises, and these privatizations provided a source of equity that national governments could then effectively exchange for debt instruments as part of the debt-for-equity swaps in their respective sovereign debt restructurings.

Indeed, Venezuela adopted a debt-equity swap program in the mid-1980s and applied it through the early 1990s. Under that program, the foreign investor first purchased Venezuelan sovereign debt at a discount from a creditor (such as a commercial bank) in the secondary market. Next, the foreign investor converted that debt into bolivars, which was the legal tender of Venezuela, at a predetermined rate set by the Venezuelan government. Finally, the foreign investor used those bolivars to purchase equity in a company that was operating in Venezuela, but the foreign investor could do so only in certain types of companies as was specified in guidelines published at the time by the Venezuelan government.

In the context of an eventual Venezuelan restructuring in the coming years, it is possible that a new Venezuelan government might consider whether there are any state-owned enterprises that would be suitable candidates for privatization. For example, there are a number of major Venezuelan companies in various industries—e.g., cement, aluminum, steel, auto parts, etc.—that are now Venezuelan state-owned companies, but these same companies were previously privately owned companies until they were expropriated by the Chavez regime in the period from roughly 2007 onward.

Many of these companies have now fallen on hard times as state-owned enterprises, and thus, as a policy matter, a new Venezuelan government might wish to consider whether privatization would provide a reliable pathway for improving the performance and profitability of these companies. If some of these now state-owned enterprises were to be privatized by a new Venezuelan government, that might create the conditions for establishing a new program of debt-for-equity swaps as

one avenue for Venezuela to restructure its outstanding debt. Under such a program, Venezuela's creditors could exchange their debt for shares in what would be the then-newly privatized enterprises.

Nonetheless, if a new Venezuelan government initiated a new debt-for-equity swap program, the Venezuelan debt held by the creditor/investor would need to be exchanged directly for shares in the private companies such as newly privatized enterprises. Such a debt-for-equity swap would take place without what was previously an important intermediate step in this process: namely, exchanging the debt in question for the local currency (e.g., Venezuelan bolivars) and then using the local currency to purchase equity in the privatized enterprise.

The bolivar-based approach for Venezuelan debt-for-equity swaps in the 1980s-1990s would not work under present circumstances due to the serious hyperinflation that currently exists in Venezuela. With a deeply devalued bolivar as a result of the existing hyperinflation in Venezuela, a company participating in the debt-for-equity swap would basically have no use for bolivars, except perhaps to make an immediate payment of an invoice denominated in bolivars.

(The Venezuelan government has replaced and/or devalued its currency several times since the 1980s, while continuing to call its currency some form of a Venezuelan bolivar. The hyperinflation that has existed in Venezuela in the recent past has had the effect of rendering the form of bolivar that was then in use fairly worthless as a currency. For example, the Venezuelan government replaced its currency most recently in 2018 when it replaced the *bolívar fuerte* (Bs.F.) with the *bolívar soberano* (Bs.S); the exchange ratio for the replacement was 1 Bs.S to 100,000 Bs.F. Nonetheless, the introduction of the new currency in 2018 has not halted the continued decline of the Venezuelan economy, nor has it eliminated the hyperinflation that has afflicted the Venezuelan economy for the last several years.)

Finally, it should be noted that, when implementing a debt-for-equity swap along the lines discussed above, a new government in Venezuela would certainly want to ensure that it had conducted a proper financial

8 For a discussion of debt-for-equity swaps as used in the Latin American debt crisis, see, e.g., "Debt-Equity Swaps Draw Latin Criticisms," *The New York Times*, January 2, 1989 (noting various objections by Latin American government to debt-for-equity swap programs); Daniel H. Cole, "Debt-Equity Conversions, Debt-for-Nature Swaps, and the Continuing World Debt Crisis," (1992) (articles by Maurer Faculty, Paper 690; John K. Shubin and Daniel J. Gibby, "The Promotion of Debt-Equity Swaps in Latin America: A Survey of the Regulatory Regimes and the International Policy Framework," *Inter-American Law Review*, Vol. 20:1 (1988); Stephen M. Wallenstein and James R. Silkenat, "Investment Funds and Debt-Equity Swaps: Broadening the Base of New Financial Tool," *Fordham International Law Journal*, Vol. 12:8 (1988).



valuation of the enterprise in which the foreign investor/creditor would receive equity in exchange for its debt. That would be the only way the new government could ensure that it is receiving fair value for the equity that it is giving to the foreign investor/creditor in exchange for the debt that is being tendered, and thus the only way that the government could ensure that it would not be shortchanging itself or the Venezuelan people.

New Venezuela-Specific Debt-for-Equity Swaps Based on Oil (and Other Mineral) Development Rights

Another type of debt-for-equity swap, where the equity component of the swap is broadly construed, may also be relevant for those parties developing any eventual Venezuelan restructuring plan. Yet, unlike the 1980s-style debt-for-equity swaps discussed above, the equity component of the swap would not relate to shares in a corporation but rather would relate to development rights in Venezuela's oil reserves which notably are widely reputed to be the largest oil reserves in the world.

It is conceivable that in a future Venezuelan debt restructuring some of the creditors, such as perhaps creditors who are players in the oil industry (e.g., oil field service operators, etc.), may be willing to forgive a portion of their debt in exchange for, say, a certain quantity of development rights in previously undeveloped Venezuelan oil fields. There are, in fact, many trade creditors/suppliers such as oil field service operators which are owed large amounts of money by Venezuela, and these trade creditors/suppliers represent an important constituency in the overall Venezuelan creditor body.

For those creditors undertaking such an exchange, they would need to be knowledgeable about the oil business, particularly with respect to matters concerning oil exploration and development, including the crucially important technical and commercial aspects thereof. The value that the creditors will be receiving as part of this exchange would be dependent on their ability to produce oil from the development rights that they have been given and would also be dependent on the price of oil at that point in time when these creditors would be trying to sell the oil that they have developed.

These creditors will need to reach a view as to how difficult it will be to develop the oil reserves in question as well as how long it will take to develop such reserves. These creditors will also need to develop a view regarding the future price of oil, although that in and of itself is a matter that is inherently subject to a considerable amount of uncertainty given the significant fluctuations in the price of oil over time (especially in view of oil's boom and bust cycles).



A new Venezuelan government would also need to understand the value of oil development rights that it would grant the creditor/investor participating in the debt-for-equity swap. This question is inherently complex and will require experts to undertake a financial valuation of the development rights in question. Otherwise, a new Venezuelan government might be opening itself up to criticism that it was giving away the Venezuelan national patrimony at "bargain basement" prices.

For the present discussion, structuring such debt-for-equity swaps, including defining the precise mechanics for such swaps, will require Venezuelan law expertise to ensure that such swap transactions would work properly under Venezuelan law. Venezuelan lawyers will also need to work through various Venezuelan legal questions that might arise. For instance, what type of entity under Venezuelan law could be granted development rights by the Venezuelan government as part of a debt-for-equity swap of the type described above?

Venezuelan lawyers will also need to consider whether such development rights could be granted by the Venezuelan government to a single creditor/corporation (particularly if it is a foreign creditor/corporation), as opposed to those development rights that may be granted to a joint venture between a foreign investor and a Venezuelan government-owned entity such as PDVSA. In the past, the joint venture path has been the usual, and indeed the only legally permissible, way by which a foreign entity could invest in Venezuela's oil sector under Venezuelan law, and in fact the foreign investor's interest was even capped by law so that the Venezuelan state-owned entities such as PDVSA held greater than a 50% interest in the hydrocarbon joint venture. It was often the case that as a matter of practice the foreign investor in the joint venture would hold a 40% interest in such joint ventures with PDVSA and/or another state-owned entity holding the remaining 60% interest.

The same idea of debt-for-equity swaps where the equity component consists of development rights in oil could also be applied to development rights for other minerals found in Venezuela which, like oil, also exist in some abundance in Venezuela. For example, Venezuela is richly endowed with other minerals such as iron, gold, coal, bauxite, nickel, titanium, zinc, copper, and diamonds. Thus, the development rights for these other minerals might represent an attractive option for creditors to Venezuela who are willing to exchange debt for equity in the form of development rights in the types of minerals mentioned above but who may not be specifically interested in receiving development rights in oil reserves.

Potential Challenges to Prior Debt Issuances and/or Other Debt Obligations

If and when a new government comes to power in Venezuela, it will need to decide which of its outstanding debt obligations it plans to honor. There may be certain debt issuances which the new government considers to be invalid or possibly even illegitimate.

A new government may wish to consider whether any debt claims against the Venezuelan government or PDVSA were incurred as a result of corruption and/or fraud and therefore would not need to be recognized as part of any debt restructuring. Indeed, the so-called interim government led by Juan Guaidó, in a statement in July 2019 setting forth guidelines for any eventual restructuring negotiations, referred specifically to “claims *procured or tainted by demands of corruption* allegedly committed by officials in the Chavez/Maduro regimes....” (emphasis added).⁹

In that vein, Venezuelan lawyers will need to work with accountants and others in considering which debt claims are appropriate, and which should be recognized for purposes of repayment versus those debt claims that are fraudulent and/or otherwise considered to be invalid or illegitimate. As outlined in the guidelines from Venezuela’s so-called interim government discussed above, that will be an important element of the claims reconciliation process (which is itself an integral part of the overall debt restructuring process) since the claims reconciliation process essentially separates out those claims that will be included as part of the restructuring process and those claims that will basically be thrown out and not included in the restructuring process.

Separately, there may be very few available targets of opportunity for a new Venezuelan government in the future (or even for the Guaidó-led opposition at the present) as to which potential challenges can be

mounted to the validity of Venezuelan debt that has been publicly issued by the Republic or PDVSA in the last few years, particularly since 2016 when the Maduro regime seemingly began to encroach upon the powers of the opposition-controlled National Assembly. Specifically, the Republic has apparently not issued any foreign law-governed public debt in the period from 2016 to the present.

But this was not the case with PDVSA. In 2016, as part of a so-called distressed exchange offer to replace PDVSA bonds due to mature in 2017 but that were then on the verge of default, PDVSA issued new bonds commonly known as the PDVSA 2020 bonds since they had a final maturity date of 2020. (The new bonds also bore a coupon of 8 ½ percent.)

In one challenge already brought by the alternate PDVSA Board of Directors (controlled by the Guaidó-led “interim” government), the PDVSA board filed a lawsuit in the US District Court for the Southern District of New York seeking to invalidate what are known as the PDVSA 2020 bonds and the related governing documentation, including an all-important pledge of Citgo Holding stock (discussed below). The lawsuit was ultimately unsuccessful in the District Court, but that ruling has since been appealed to the US Court of Appeals for the Second Circuit. Thus, with the appeal in that case still pending as of late March, the eventual outcome of this case—and thus whether or not the challenge to the validity of the PDVSA 2020 bonds and the governing documentation (including the pledge of Citgo Holding stock) will ultimately be successful—remains uncertain for the time being.

The PDVSA 2020 bonds had an unusual feature in that they were secured by a pledge of a 50.1 percent interest in the shares of Citgo Holding, the holding company for Citgo Petroleum Corporation (Citgo), which is almost universally considered to be one of PDVSA’s crown jewels in light of Citgo’s valuable refinery and pipeline assets in the US. Thus, since late October 2019 when PDVSA defaulted on payment of the PDVSA 2020 bonds, PDVSA has been at risk of losing control of Citgo to the PDVSA 2020 bondholders.

If that were to occur, that would be a major blow to PDVSA and to the so-called interim government led by Juan Guaidó since Citgo represents one of the few assets that the interim government putatively controls. This flows from the US government’s decision to recognize both the Guaidó-led interim government and the decision by US courts to recognize the validity of the alternate PDVSA Board of Directors which is aligned with the interim government and the opposition.

Nonetheless, apart from any court proceedings related to the PDVSA 2020 bonds, the holders of the PDVSA 2020 bonds have been prevented from executing on

⁹ See Office of the Special Attorney General of the Bolivarian Republic of Venezuela, “Guidelines for the Renegotiation of the Chavez/Maduro Era Legacy Public External Debt,” July 1, 2019, p. 2. See also Colby Smith and Robin Wigglesworth, “Venezuela’s Opposition Sets Out Debt Restructuring Plans,” *Financial Times*, July 3, 2019.

their pledge of Citgo Holdings shares due to actions taken by the Office of Foreign Assets Control (OFAC) of the US Treasury Department. Essentially, dating to 2019 and now extending to July 2021, the holders of the PDVSA 2020 bonds have been prevented from exercising on their collateral and selling the shares of Citgo Holding unless and until they obtain a special "license" from OFAC to do so, but OFAC has not yet granted such a license to those bondholders.

In the lawsuit it brought in the US District Court for the Southern District of New York, PDVSA and certain affiliates challenged the validity of the PDVSA 2020 bonds since the security arrangement underlying the bond issuance—namely, the pledge of CITGO Holding stock to the PDVSA 2020 bondholders—was not approved by Venezuela's National Assembly. Essentially, the argument by the alternate PDVSA board was that since the granting of the security interest to the PDVSA 2020 bondholders was, to use the term of art under the Venezuelan constitution, a "national public interest contract," it should have been approved by the National Assembly as required by Article 150 of the Venezuelan constitution. Furthermore, the PDVSA-related parties in the case also called attention to the fact that the Venezuelan National Assembly had passed a resolution disapproving the transaction that PDVSA was proposing to enter into involving the PDVSA 2020 bonds and the related pledge of shares of Citgo Holding stock.

In an October 2020 decision, Judge Katherine Polk Failla of the US District Court for the Southern District of New York rejected the challenge of the alternate PDVSA Board to the validity of the PDVSA 2020 bonds and the governing bond transaction documentation. The District Court's decision was based on the grounds that ultimately, among other factors that the District Court considered relevant in establishing sufficient contacts between the PDVSA 2020 bonds and the governing documentation and New York (and thus establishing the applicability of New York law), the bonds and the related transaction documentation were by their terms governed by New York law. Thus, in the District Court's view, the considerations of Venezuelan law raised by the PDVSA-related parties as a basis for challenging the validity of the PDVSA 2020 bonds and the governing bond documentation were not relevant to the Court's disposition of the case.

However, as noted above, shortly after the District Court decision was handed down last fall, the PDVSA-related parties in the case appealed the District Court's ruling to the US Court of Appeals for the Second Circuit, and, as of late March, the appeal was still pending in the Second Circuit. Among other matters, the appeal raises issues concerning conflict of laws; i.e., what jurisdiction's law is the relevant applicable law for



resolving the dispute, New York law or Venezuelan law. The case has also raised issues as to what deference should be accorded to the acts of a foreign state (e.g., resolutions of the National Assembly) under the "act of state" doctrine and what deference should be accorded to a foreign government's interpretation of its own laws under principles of international comity.

On a different front, there is a possibility that a new Venezuelan government might also raise issues of "odious debt" as a basis for challenging the validity or legitimacy of certain debt issuances by Venezuela.¹⁰ While commentators often refer to the "odious debt doctrine," it is not, strictly speaking, a legal doctrine in the traditional sense since it has not been formally recognized by courts of law or other tribunals. Thus, the "odious debt" concept, if it were raised by a successor Venezuelan government in the course of a judicial proceeding, might not gain much, if any, traction in such a formal proceeding. However, as more fully discussed below, if a successor Venezuela government were to raise the odious debt issue (whether or not it did so in court or simply in its public pronouncements), and assuming that the new government had a sound basis for raising or invoking a claim of odious debt, it might put itself in a more advantageous position in any debt restructuring negotiations that the government was engaged in with the creditors putatively responsible for the odious debt.

In the Venezuelan context, odious debt might come into play if a new Venezuelan government could satisfy a three-part test in the standard formulation of the "odious debt doctrine" as set forth by Alexander Sack in his classic 1927 treatise on this subject. Pursuant to that test as applied to the situation in Venezuela, a successor government in Venezuela would have to prove three elements. The first element is that the loan transaction in question was not approved by the Venezuelan populace, and the second element is that the debt that Venezuela incurred was not for the benefit of the Venezuelan people. The third element is that the creditors extending such loans knew that loans would not be used for the benefit of the Venezuelan people and also knew that the loans were not approved by the Venezuelan people.

¹⁰ See, e.g., Robin Wigglesworth, "Venezuela Crisis Raises Talk of 'Odious Debt' Doctrine," *Financial Times*, September 11, 2017.

For example, a new Venezuelan government might raise odious debt claims regarding the validity or enforceability of debt incurred by the Chavez regime in connection with its arms purchases from Russia in the early 2000s. Specifically, such a claim might arise if such debt was incurred by the Venezuelan government to purchase arms for the Venezuelan military forces and those arms were not used for proper military purposes for the benefit of the Venezuelan people such as for defending against external foes but instead were used, for example, to repress the Venezuelan people. As part of the three-part test for odious debt discussed above, it would also need to be shown that the loans were not approved by the Venezuelan people and that the party extending the credit to Venezuela knew that was how the loan proceeds would be used and also knew that the loan was not approved by the Venezuelan people.

In the early 2000s, the Chavez regime incurred debt from the Russian government so that the Venezuelan government could purchase several billion dollars' worth of arms from Russia. Indeed, those arms purchases from Russia were considered a cornerstone of the then budding relationship in the early 2000s between the Chavez regime and the Putin-led Russian government, a relationship that allowed Russia to establish influence with a country in the geopolitical "backyard" of the United States.

Nonetheless, whether those arms transactions would actually give rise to valid odious debt claims would obviously involve a highly fact-specific inquiry. Among other areas of possible investigation, such an inquiry might well center on whether the military purchases were used for proper military purposes or, rather, for illegitimate purposes such as for repressing the Venezuelan people if and when, say, they opposed or demonstrated against the Chavez-Maduro regimes.

Such an inquiry would also have to examine whether the Russian government, as the putative lender in question, knew that was how its loans would be used and also knew that the loans were not approved by the Venezuelan people. To be sure, any such inquiry would also depend on the quality and probative value of any odious debt-related evidence adduced by the successor Venezuelan government.

Separately, a new Venezuelan government might raise odious debt claims if the previous governments under Chavez and Maduro issued debt only to divert the proceeds of such debt issuances from the national treasury into the pockets of government officials or other individuals for their private benefit (and the creditors knew that this represented a potential use of the loans they were providing and knew that such loans were not approved by the Venezuelan people). This might present a classic odious debt fact pattern or scenario in which the proceeds of a loan entered into

by a government are not used for the betterment of its citizens but are instead used for the self-enrichment or self-aggrandizement of those ruling the country in question.

Since there have reportedly been massive diversions of funds from public coffers in Venezuela for the personal benefit of certain individuals who are or were part of the Chavez-Maduro regimes or were otherwise connected to these regimes, this leg of an odious debt inquiry might also be of considerable potential interest to any new successor Venezuelan government. Again, such a successor Venezuelan government would also have to adduce the relevant evidence showing that the loan proceeds were used for the personal benefit of those ruling the country and that the lenders knew that is how the loan proceeds would be used and knew that the loans were not approved by the Venezuelan people.

Whether or not Venezuela would ultimately prevail in a court of law if it raised an odious debt claim is very much open to question, particularly in view of the fact that the notion of odious debt, in the nearly 100 years since Alexander N. Sack first published his treatise on the "odious debt doctrine," has apparently never received the formal imprimatur of a court ruling. Further, in the view of some legal scholars, the "odious debt doctrine" has not risen to the level of custom in international law. Therefore, if a successor Venezuelan government decided to pursue an odious debt claim in court, its chances of success could hardly be guaranteed by any stretch of the imagination.

Importantly, though, the mere act by a new Venezuelan government of raising the odious debt issue (assuming, again, that a new Venezuelan government had some type of a valid basis for raising or invoking "odious debt") might improve Venezuela's negotiating position vis-à-vis the affected creditors since it might allow Venezuela to claim the moral high ground in its negotiations with the creditors in question and thereby potentially increase its leverage in such negotiations. Moreover, simply raising odious debt as a public issue might also carry some weight in the court of international public opinion among a range of stakeholders in the international system. Since sovereign debt restructurings (especially high-profile sovereign debt restructurings) often play out on an international stage, an odious debt claim by Venezuela might help Venezuela gain moral or political support from various international stakeholders. In turn, this might affect the dynamics of any actual negotiations between Venezuela and the creditors putatively connected to the "odious debt" in question.

Nonetheless, whenever a sovereign contemplates a challenge to the validity of debt it has issued or otherwise incurred (whether it does so on the basis of odious debt or on other grounds), it needs to take into account the potential costs and benefits of pursuing such a course

of action. Assuming that the sovereign is successful in its quest to invalidate the debt in question, at what cost will it have achieved that benefit? For example, will the sovereign in any way be tarnishing its reputation in the credit or capital markets as a borrower that honors its contractual obligations, or will the sovereign's basis for challenging the validity of the debt in question be so compelling and persuasive that it will not suffer such a hit to its reputation?

Or, for instance, might the sovereign be able to achieve the objective it is seeking through other means, such as through attempting to negotiate a deep haircut on the outstanding debt in question? Of course, as noted above, the fact that a sovereign raises the odious debt issue, even if it does not seriously pursue the issue in court, may assist the sovereign in its effort to achieve such a deep haircut; i.e., merely raising the issue may potentially give a sovereign some leverage in debt restructuring negotiations.

MAJOR LEGAL AND POLICY ISSUES IN AN ECONOMIC RECOVERY SCENARIO

If and when a new Venezuelan government comes to power, it will need to implement a multidimensional program to rebuild the Venezuelan economy. It will need to take several key programmatic initiatives, including reviving Venezuelan's oil industry, diversifying Venezuela's economy, and recovering billions of dollars of government assets that may have been diverted from government coffers.

Economic Recovery—Reviving the Venezuelan Oil Industry

It is no secret that the Venezuelan oil industry has deteriorated in a major way in recent years, and its oil-producing infrastructure is currently viewed as being in a state of major disrepair and dysfunction due to many years of neglect and lack of capital investment.¹¹ Oil production has plummeted in recent years, going from a level of 2.5 million barrels per day as recently as 2016 to a level of approximately 750,000 barrels per day in the first half of 2019 or so, a depressed level of production that had not been seen in over fifteen years.¹²

¹¹ For a discussion of the state of Venezuela's oil industry and the industry's centrality to Venezuela's economy, see, e.g., Steven T. Kargman, "Venezuelan Debt Conundrum," *The International Economy* (Spring 2019). See also Ruth Krivoy, "Venezuela: In a Hole, and Still Digging," *Emerging Markets Restructuring Journal* (Summer 2018), pp. 1-6.

¹² Energy Information Administration (US Department of Energy), "Venezuelan Oil Production Falls to Lowest Level Since January 2003," May 20, 2019 (pointing out that "[t]he number of active oil rigs—an indicator of future oil production—also fell from nearly 70 rigs in the first quarter of 2016 to 24 rigs in the first quarter of 2019") (available at <https://www.eia.gov/todayinenergy/detail.php?id=39532>) (last visited on March 28, 2021).

More recently, oil production has declined to half a million barrels by mid-2020¹³ and less than a half-million barrels as of year-end 2020/January 2021. A projection in early January 2021 by S&P Global Platts energy reporting service stated that Venezuelan oil production might decline to approximately 300,000 barrels per day in 2021.¹⁴ However, oil production in Venezuela has reportedly increased to over 500,000 barrels per day in the last two months. Venezuela was reported to have produced 538,000 barrels per day in February and 578,000 barrels per day in March (compared to 484,000 barrels per day in January), according to data from OPEC.

Whether or not this recent reported increase in production is sustainable over time and is indicative of a longer-term trend remains to be seen. It should be noted that Venezuela has also recently benefited from the strong rebound in global oil prices over the past few months.

Separately, the number of active operational oil rigs in Venezuela has declined sharply in recent years,¹⁵ and there have been reports that as of August 2020 Venezuela had not a single rig that was operational.¹⁶

In light of the marked deterioration of the production capabilities of the Venezuelan oil industry over many years, it is widely acknowledged that Venezuela will need billions of dollars—perhaps even tens of billions of dollars, by some estimates—to restore its oil industry. Some of the necessary funding for this economic redevelopment generally may come from the international financial institutions, such as the World Bank (including its private sector arm, the International Finance Corporation (IFC)), the Inter-American Development Bank, and CAF (Development Bank of Latin America), as well as from national export credit agencies (ECAs) and national development finance institutions. Nonetheless, funding solely from those institutions may not be sufficient by itself.¹⁷

¹³ See US Energy Information Administration, "Country Analysis Executive Summary: Venezuela," updated November 30, 2020, available at https://www.eia.gov/international/content/analysis/countries_long/Venezuela/venezuela_exe.pdf (last visited on March 28, 2021).

¹⁴ See, S&P Global Platts, "Commodities 2021: Venezuela's Oil Industry Expected to Deteriorate Further," Jan. 4, 2021 (available at <https://www.spglobal.com/platts/en/market-insights/latest-news/oil/010421-commodities-2021-venezuelas-oil-industry-expected-to-deteriorate-further>) (last visited on March 28, 2021).

¹⁵ See *supra* note 11.

¹⁶ See, e.g., "Venezuela's Rig Count Officially Falls To Zero," available at <https://oilprice.com/Energy/Energy-General/Venezuelas-Rig-Count-Officially-Falls-To-Zero.html> (last visited on March 28, 2021).

¹⁷ For a broader discussion of how the Venezuelan economy can recover in a post-Maduro regime scenario, see, e.g., "The Day After: How Venezuela's Economy Can Recover from The Maduro Regime," *The Economist*, January 31, 2019 (a brief discussion of the so-called "morning-after plan" developed by Harvard professor Ricardo Hausmann, including the need for an infusion of approximately \$60 billion from the international financial institutions including the IMF). See also Earl Anthony Wayne and Moises Rendon, "Planning for the Day After in Venezuela," Center for Strategic & International Studies (CSIS), March 28, 2019 (available at <https://www.csis.org/analysis/planning-day-after-venezuela>) (last visited on March 28, 2021).

Rather, Venezuela may also be very dependent on investment from the private sector as well, including from foreign investors and foreign companies that would have an interest in reviving Venezuela's oil-producing capabilities on a profit-making basis. Of course, as a threshold matter, a new Venezuelan government would need to make certain that it would be comfortable with foreign investment playing such a major role in the redevelopment of Venezuela's oil industry. Further, in light of any potential political sensitivities surrounding this issue (i.e., questions that might be raised by Venezuelan politicians or citizens as to whether, as discussed above, the Venezuelan government would be "giving away" its national patrimony), a new government would undoubtedly want to ensure that the Venezuelan public supports such an approach.

To be sure, regardless of whether the necessary funding comes from the international financial institutions or the private sector or other financing sources, any new Venezuelan government would presumably want to ensure that any future oil exploration and development activities in Venezuela are undertaken a manner that is as environmentally sensitive and responsible as possible. A new Venezuelan government would also most likely need to be responsive in one way or another to global concerns about the role of fossil fuels in climate change and investor interest in ESG (environmental, social, and governance) matters.

In order to attract this type of investment, it is likely, though, that the current Venezuelan legal framework for foreign investment in general and foreign investment in the oil industry in particular will need to be reviewed to see whether that framework is adequate or robust enough to facilitate this new investment. Specifically, Venezuelan lawyers and policymakers will need to consider whether, in order to facilitate greater foreign investment in the Venezuelan oil industry, there will need to be changes to Venezuela's existing hydrocarbons law and/or its foreign investment law generally.

For example, in a joint venture context, Venezuelan policymakers will need to consider questions such as the following: Will the hydrocarbons law need to be revised in order to permit majority foreign ownership in joint ventures with PDVSA, something that is now prohibited by current law? And, as some commentators have argued, will Venezuela's current royalty rates need to be lowered in order to make Venezuela more competitive with other oil-producing countries in the region?¹⁸

As with any type of foreign investment that a new Venezuelan government will hope to attract, future

foreign investors in the oil industry will want greater certainty in the contractual arrangements that they will enter into with Venezuelan government counterparties. This is particularly true in light of the spate of expropriations that took place under the Chavez regime, including expropriations that took place specifically in the oil industry.

A key element in providing such certainty would be to afford parties to the relevant contractual arrangements the possibility of resorting to international arbitration in a venue outside the host country jurisdiction when there is a dispute between the parties. The availability of international arbitration as a contractually agreed upon means of dispute resolution is often a *sine qua non* for foreign parties investing in an emerging market or developing country jurisdiction since foreign parties do not want to end up settling contractual disputes in the local courts in the host country jurisdiction.

Venezuela had previously been a party to the ICSID Convention under which international investment disputes between investors and States are handled by an arbitration tribunal under the auspices of the World Bank affiliate, ICSID (the International Centre for the Settlement of Investment Disputes). However, in 2012, Venezuela under the Chavez regime withdrew from (or, in the technical parlance, "denounced") the ICSID Convention. Significantly, this withdrawal or denunciation by the Venezuelan government did not affect cases against Venezuela that were then pending at ICSID.¹⁹ There were a number of such cases that were then pending at ICSID, and several of them ultimately resulted in very sizeable judgments against Venezuela, such as an ICSID judgment against Venezuela that was awarded to ConocoPhillips in the original amount of \$8.7 billion.²⁰

Thus, if a new Venezuelan government aims to regain the trust and confidence of foreign investors (whether in the oil industry or in other sectors of the Venezuelan economy), it will certainly have to seriously consider rejoining the ICSID Convention.

Economic Recovery—Diversifying Venezuela's Economy

As is well known, the Venezuelan economy is overwhelmingly dependent on a single commodity, namely oil. In years past, oil revenues have constituted a not insignificant part (approximately 25 percent) of Venezuela's GDP, funded a substantial part (approximately 50 percent) of Venezuela's national

¹⁸ Andres Guevara de la Vega and Carlos Bellorin, « ¿Por qué sí hace falta una Nueva Ley Orgánica de Hidrocarburos? (Why Do We Need a New Hydrocarbons Law) », *Prodavinci*, February 27, 2019 (available at <https://prodavinci.com/por-que-si-hace-falta-una-nueva-ley-organica-de-hidrocarburos-1/>) (last visited on March 28, 2021).

¹⁹ Sergey Ripinsky, "Venezuela's Withdrawal From ICSID: What it Does and Does Not Achieve," *Investment Treaty News*, April 13, 2012 (International Institute for Sustainable Development) (available at <https://www.iisd.org/itn/2012/04/13/venezuelas-withdrawal-from-icsid-what-it-does-and-does-not-achieve/>) (last visited on March 28, 2021).

²⁰ That judgment was then apparently reduced to \$8.5 billion. "World Bank Tribunal Lowers ConocoPhillips Award for Venezuela Expropriation: Document," *Reuters*, September 2, 2019.

budget, and generated a huge part (approximately 90-95 percent) of Venezuela's hard currency export earnings.

Yet, the Venezuelan economy was not always a "one-trick pony." Venezuela used to have a fairly productive manufacturing sector in industries such as auto parts, cement, steel, aluminum, and so forth, but notably that was when companies in those industries were privately owned. As noted above, it was essentially not until the expropriations of the Chavez regime in 2007 and thereafter that Venezuela's manufacturing sector seemed to fall into decline.²¹

While at least in the near to medium term oil will almost certainly play an important role in the future of the Venezuelan economy, any new government in Venezuela will need to consider whether it wishes to remain so heavily dependent on a single commodity such as oil (especially a commodity whose price is subject to such wild swings) or whether it wishes to diversify its economy so that there is greater balance in the economy between the oil and non-oil sectors as was previously the case in Venezuela.

Moreover, there could be an additional impetus—and indeed a global imperative—for Venezuela to pursue a strategy of economic diversification: specifically, the concern worldwide about climate change and in particular the major role of fossil fuels in contributing to carbon emissions. Obviously, global concern about these issues could lead to lower worldwide demand for fossil fuels going forward, and as a result, just as oil companies will face a vastly different business landscape in the coming years, oil-producing countries such as Venezuela will have to reckon with this new global reality as well.

A strategy of economic diversification is not guaranteed to succeed, or at least not to achieve success overnight or without encountering obstacles along the way, judging by the prior experience of other developing countries. Nonetheless, unlike a number of other developing and emerging market countries that have pursued strategies of economic diversification in the past, Venezuela at least has a model for what a more diversified economy would like, and that is basically the economy that existed prior to the Chavez-era expropriations.

In other words, for Venezuela, an economic diversification strategy might possess an element of "back to the future"—i.e., reviving some of the Venezuelan manufacturing industries that existed through the mid-2000s prior to the expropriations that took place in the ensuing years. Yet, a new Venezuelan

government might want to carefully consider which of its prior manufacturing industries have the potential to be competitive in the coming years, so that it can then encourage investment in those particular industries rather than in industries that will not be competitive in the future.

However, policymakers in a new government will also need to consider whether there are any other new industries in which Venezuela in the future could enjoy a comparative advantage in the global economy. A new government should consider encouraging investment in any such new, promising industries.

A new Venezuelan government and its advisers will need to consider whether any changes in its legal and/or regulatory framework are necessary in order to encourage investment by foreign investors (but also by any potential Venezuelan investors) in non-oil sectors of the Venezuelan economy. For example, a new government might wish to consider whether the processes for granting permits for investments or granting work visas for foreign employees are too burdensome and/or time-consuming. Further, as mentioned above in connection with the discussion of attracting new investments in the Venezuelan oil industry, Venezuela's rejoining the ICSID Convention could provide foreign investors with additional comfort when investing in non-oil sectors in Venezuela.

Asset Recovery

It is widely believed that billions of dollars—possibly tens of billions of dollars, if not more—have been improperly diverted from Venezuela's public coffers into the hands of individuals, including reportedly former or current government officials as well as individuals who are associates or relatives of government officials. According to various reports, PDVSA assets in particular have been a major target of opportunity for those Venezuelans seeking to misappropriate assets from Venezuela.

In the summer of 2018, the US Attorney's Office in Miami unveiled a major indictment of a number of Venezuelans who were allegedly engaged in money laundering involving more than a \$1 billion, and at the same time the US Attorney's Office also froze real estate and other assets that were alleged to have been purchased with funds stolen from PDVSA. More recently, in March 2020, the US government issued indictments against Maduro and several high-ranking Venezuelan government officials, past and present, for their alleged involvement in drug trafficking, money laundering and so-called "narco-terrorism."

If the funds that have reportedly been misappropriated from Venezuela could ultimately be recovered, they could play an important role in providing funding to help with the rebuilding of the Venezuelan economy

²¹ Jim Wyss, "Venezuelan Government Controls More Than 500 Businesses—and Most Are Losing Money," *Miami Herald*, March 14, 2017 (citing a report indicating that 70 percent of the 511 companies that are either wholly owned or partially owned by the Venezuelan government are losing money).

and Venezuelan society more broadly. Thus, when any new government comes into power, it might be well advised to consider how it could undertake a broad-reaching asset recovery effort so that it can recapture these billions of dollars for the benefit of the Venezuelan people.²²

A note of caution is certainly in order, since any asset recovery program could involve painstaking efforts over an extended period of time—possibly even over a period of a number of years—before the asset recovery efforts might bear significant (or perhaps even modest) results. Accordingly, as a matter of prudence and sound planning, any debt restructuring and/or economic recovery plan pursued by a new government should probably not be predicated on achieving a specific dollar amount of asset recoveries and obviously not on achieving such recoveries in a short period of time. Instead, whatever funds are recovered through such efforts might better be viewed essentially as an unexpected (but certainly most welcome) windfall.

CONCLUSION

If and when a new government comes into power in Venezuela, it will have to address a broad array of monumental challenges with respect to both humanitarian/social issues and financial/economic issues. In terms of the financial/economic issues discussed in this article, a new government will have to make some fundamental decisions early on concerning what position it wants to take on major policy matters.

A new government will need to decide a range of issues such as whether it wants to support a program that

privatizes state-owned enterprises, and whether it will want to diversify the Venezuelan economy so that it is not so heavily dependent on the oil industry. It will also have to decide whether it will welcome foreign investors who can play an important role in the revival of the Venezuelan economy, and whether it will support debt-for-equity exchanges that could transfer ownership stakes in newly privatized enterprises and/or its natural resources to foreign investors/creditors. Furthermore, depending on these policy choices, a new government will have to develop detailed plans and programs for implementing its overall policy objectives, and such plans and programs will have to be carefully analyzed for their conformity with relevant Venezuelan law. Finally, a new government will want to ensure that it has broad public support for the initiatives it is undertaking.

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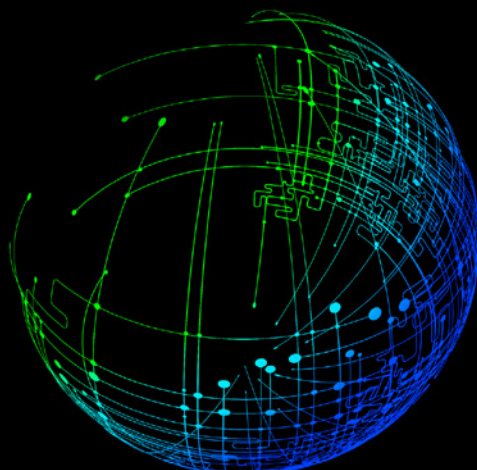
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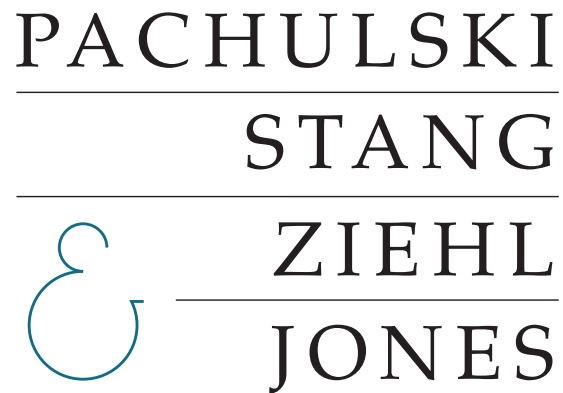
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Bribery is a social evil and necessarily warrants criminal sanction. One of the most prevalent and not so discernible forms of bribery transpires in dealings with government Revenue departments regarding tax assessment and litigation cases. These pose a “double whammy” that does not get due recognition and can be prone to corruption. In this article, we explore how tax evasion and facilitation payments made to the Revenue department can be a significant drain on the Treasury. We also examine how bribery can be contained if adequate policy steps are framed and due process implemented. An example of the impact that bribery has on the economy is also presented.

Tax evasion in this context may take either or both of the following forms:

- **Understatement of revenue:** Some corporations reduce their exposure to taxation by under reporting revenue through various means.
- **Overstatement of expense:** Expenses are overstated with inflated bills from vendors, salaries of ghost employees, payment to consultants, utility and service bills.

Time-bound Nature of Tax Assessments

Tax assessment is time-bound by statute. It is also a complex process that can involve face-to-face interactions with tax authorities and their counterparts if it is negotiated. It entails the production and analysis of books of accounts, financial statements, financial documents, possibly legal and other documents, etc. Corporations and other business entities often seek early closure of such assessments to free resources and time for other activities and to ensure that they do not carry unusually large amounts of tax liability in their books or as a contingent liability for reporting purposes. Therefore, timely and amicable closure of tax assessments is paramount.

Modus Operandi: Engagement of Consultants

With the emergence of more stringent anti-bribery laws (i.e., the Foreign Corrupt Practices Act in the

TAX EVASION, FACILITATION PAYMENTS, AND ANTI-BRIBERY COSTS AND COMPLIANCE

VENKAT PILLAI

US, and the Bribery Act 2010 in UK), it has become customary to engage consultants, and even legal counsel, to complete and to debate the amount of tax assessments. Consultants can work their way through Revenue department offices and negotiate in person to enable quick closure of the assessments, at a cost. Their professional fees may incorporate additional costs and are invoiced to the companies. These costs are accounted for as professional fees, and tax deductions are claimed on such expenses, treating them as presumably genuine business expenditures. This practice and its associated expenses can present a gross disservice to society at large by penalizing the honest taxpayer. Furthermore, the true cost to the Treasury may be doubled, as the consultant can invoice with taxes such as Goods and Service tax on the inflated amount of the consultant's bills, while the resulting tax is analyzed for possible input tax credits that are offset against genuine output tax liabilities by the corporation.

Government thus stands to lose on both counts: 1) facilitation payments being treated as genuine business expenditure and hence tax deductible, and 2) input tax on such payments being taken as a credit against genuine output tax liability.

Illustrative Example (Exhibit 1)

Clark Inc. was in the business of manufacturing and selling handkerchiefs in the United States. Companies in the handkerchief market, a small niche market, often achieve higher profitability margins; Clark Inc. was paying higher Income tax. The company was also facing other litigation from the department of Revenue for not filing monthly returns on time and for wrongly availing input credit. Tim, the CEO of Clark, was worried. He consulted his CFO, Rob, who referred him to Stuart, the Tax consultant. Stuart advised both Tim and Rob to suppress Clark Inc.'s income to avoid Income tax liability and promised favorable orders on all pending indirect taxation matters for a consideration. Stuart charged Clark Inc. for his professional fees which included facilitation payments made to the Revenue department. The spreadsheet in Exhibit 1 shows a sample calculation of actual and economic costs for this example of tax evasion, facilitation payment and bribery, including understatement of revenue and overstatement of expense.

Exhibit 1: Example Calculation of Costs of Tax Evasion, Facilitation and Bribery

FY - 2018-19		Amount	Federal tax rate	Federal tax
Particulars		USD Millions	%	USD Millions
Actual income subject to taxation	A	50	25%	12.50
Adjusted income offered for taxation	B	35	25%	8.75
Differential income and corresponding tax revenue lost	C = (A-B)	15	25%	3.75
Facilitation payment to Revenue department officials (10% of Federal tax saved)	D	3.75	10%	0.38
Tax deduction claimed on the facilitation payment	E	0.38	25%	0.09
Input credit for taxes such as in this case, GST (Goods and Service Tax) or VAT (Value Added tax) –applicable to the facilitation payment invoiced by the consultant	F	0.38	28%	0.11
Assuming out of actual income subject to taxation, the understated revenue subject to GST or VAT is	G	10		
Output GST or VAT liability not discharged	G	10	28%	2.80
Total cost of bribery	H=(C+D+E+F+G)			7.12
Assuming tax assessment is closed in FY 2021-22 (3 years from the end of the financial year)				
Discount rate (Tax free Government bond rate)	I		5%	
Time value of total cost of bribery	J=(H/(1+I) ^3			6.15
Cost of bribery on Actual taxable income	K = (J/A) %			12.31

Mitigation of Costs and Risks

Bribery risks can be mitigated by implementing effective internal controls and policies around the following:

1. Financial reporting integrity.
2. Tax policy.
3. Critical mapping of differences between statutory books and income tax books.
4. Comprehensive check list for tax assessments.
5. Risk appetite and tolerance with respect to discharging tax liability.
6. Behavioral change from tax manipulation to tax compliance and a culture emphasizing ethical standards.

1. Financial reporting integrity.

Best practices for financial reporting of income should involve a robust closing process accompanied by a rigorous review of the income statement, account

changes, and analysis of variance between actuals and forecast. Checklists, questionnaires, Sarbanes-Oxley process flow charts, Internal control over financial reporting (ICOFR), risk control matrices, and control documents can assist in better organizing the finance function to enable it to deliver on its objectives. Integrity of the finance function is of paramount importance.

2. Tax policies and practices.

Adherence to internal tax practices and procedures can go a long way in ensuring that the tax managers behave ethically. Internal tax policies should require exemplary behavior and practices in approaching tax assessments and litigations. Policies should enumerate the broad steps to be followed when facing assessments, and they should articulate the method(s) that may be followed. Tax policies can range from time bound mandates from the Board, exploring voluntary assessments, and a proactive approach in responding to department notice. A Tax policy can also provide the modus operandi to avoid ex parte orders and penalties levied by a Revenue department.

3. Critical mapping of differences between financial reporting versus income tax reporting.

The various tax adjustments that are made to book profits to arrive at the income tax profit must be explained and evidenced by adequate, appropriate, and relevant supporting documentation. The bridge between book profits and income tax profits must be analyzed item-by-item and the explanations documented. The reconciliation should be approved and signed-off by the CFO.

Typical causes for difference between book and tax items may include, but are not limited to, the following:

1. Difference in method and rates of depreciation. Income tax laws follow accelerated depreciation to a written-down asset value. Company financial statements often report assets that reflect straight-line depreciation. Rates of depreciation are also different for different categories of fixed assets.
2. Few expenditures are tax deductible based on actual payments, whereas many companies follow the accrual system of accounting.
3. Taxes, excise charges, duties and other levies may be disallowed for income tax purposes if not remitted within the statutory timelines.
4. Deductions for various penalties may not be allowed under tax laws.
5. Expenditures of a personal nature are typically not allowed under tax laws.
6. Expenditures on research and development may have different treatments.
7. Acquired goodwill and internally generated goodwill typically require different treatment between tax reporting and financial reporting.

4. Comprehensive checklist for tax assessments.

A sample tax assessment checklist could include the following:

1. Whether all revenue streams have been considered – Technically there should not be any difference between the financial and tax books unless the period closing falls on a different date. This would require separate cut-off procedure to be carried out for both books and a bridge drawn.
2. Whether all tax-deductible expenses are considered.
3. Whether expenditures subject to disallowance under income tax law should be considered separately.
4. Whether a notice has been received from a Revenue department.

5. If the answer is yes to point 4, consider developing and tracking a chronology of events that have unfolded up to the conclusion of assessment and passing of final order.
6. Whether advance tax, if any remitted, should be tracked.
7. Whether advance tax paid and corresponding income tax liability can be mapped on a yearly basis.

5. Risk appetite and tolerance with respect to discharging tax liability.

Risk appetite is defined as the overall threshold of risk that the organization is willing to absorb in its day-to-day activities to achieve its objectives. There should be no tolerance for the risk of bribery.

6. Behavioral change from tax manipulation to tax compliance and culture emphasizing ethical standards.

Culturally, we need to shift away from tolerating tax manipulation and even tax evasion toward a mindset that seeks honest tax adherence and compliance. The primary aim of any tax management leader should be to close out the regular assessment in a manner that it does not reach litigation, which can involve enormous amounts of time, effort and money. If the source of tax related litigation arises from conflicts in principle, it is incumbent on the tax leader to refer the matter to legal experts. The most important business issue is to avoid influencing any tax assessment or litigation decisions. Reiterating a model code of conduct, ethics policy, and corporate value systems of the organization can go a long way toward instilling the discipline and right conduct in the behavior of tax management personnel.

ABOUT THE AUTHOR



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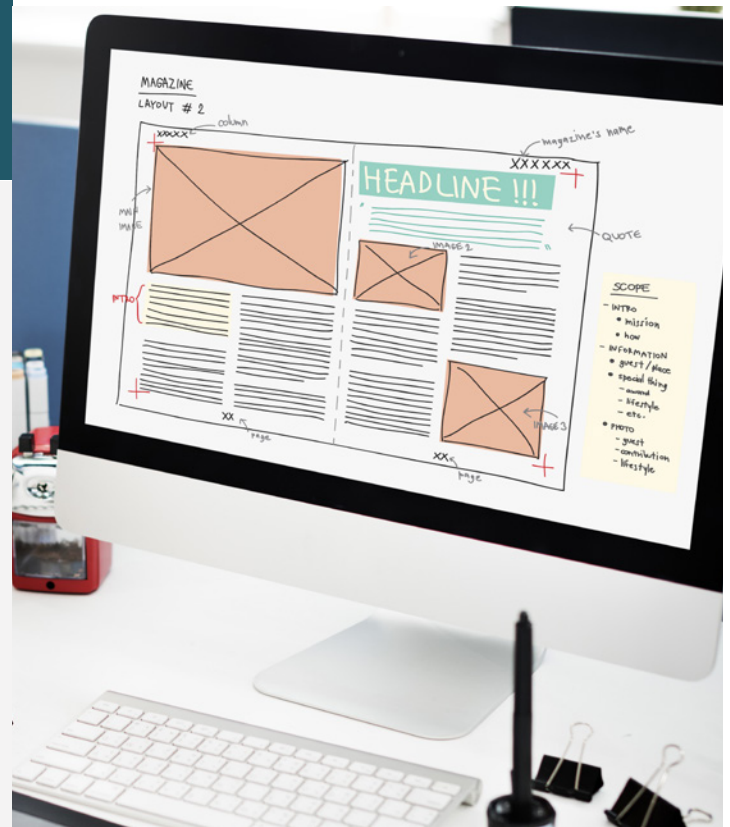
Venkat is a double Chartered Accountant from the Institute of Chartered Accountants of England and Wales and The Institute of Chartered Accountants of India. He is also an ACFE Certified Fraud Examiner in the USA. Venkat currently works in the controller function of a supply chain organization where he has diverse expertise in areas of internal controls, internal audit, and fraud prevention and detection. His interests include profiling, assessing and modelling functional areas for risk mitigation, and fraud prevention.

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Exhibit 2: Hurdle Rate as Opportunity Cost

Accounting Test
Return on invested capital
(ROIC) > Cost of Capital

Time Weighted CF Test
NPV of the Project > 0

Time Weighted % Return
IRR > Cost of Capital

Hurdle Rate = Return you can make on investment of equivalent risk

Should reflect the risk of the investment, not the entity taking the investment.
Should use a debt ratio that is reflective of the investment's cash flows.

No risk subsidies
If you use the cost of capital of the company as your hurdle rate for all investments, risky investments (and businesses) will be subsidized by safe investments (and businesses).

No debt subsidies
If you fund an investment disproportionately with debt, you are using the company's debt capacity to subsidize the investment.

simple and effective fix is to shift the focus away from how much it costs a company to raise money to the risk of the project or investment under consideration. The notion of opportunity cost makes sense only if it is conditioned on risk, and the opportunity cost of investing in a project should be the rate of return you could earn on an alternative investment of equivalent risk (Exhibit 2).

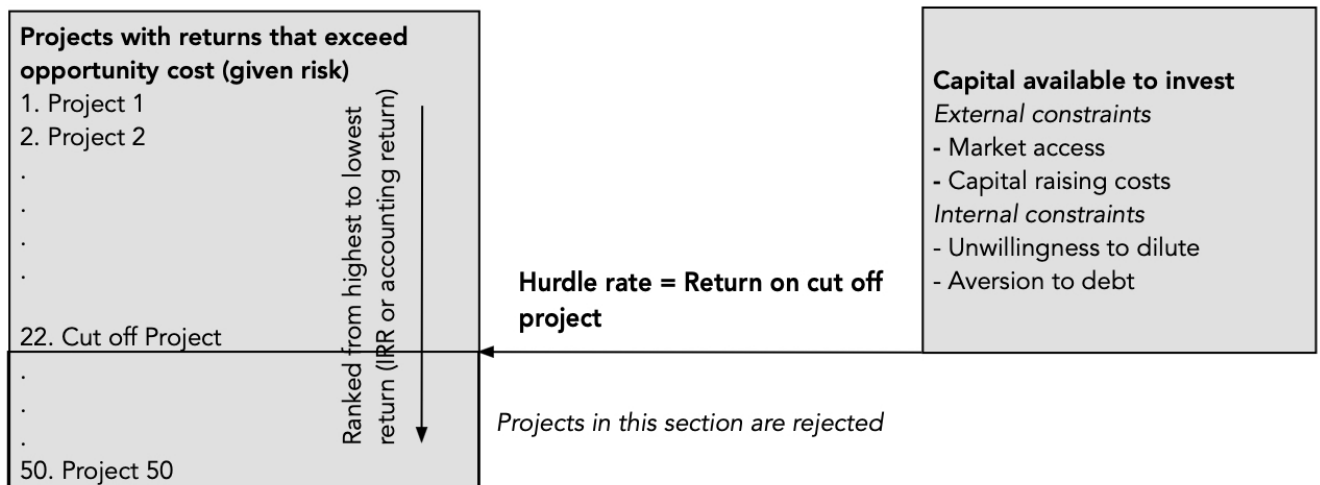
If you follow this practice, you are replacing a corporate cost of capital with a project-specific hurdle rate, that reflects the risk of that project. It is more work than having one corporate hurdle rate, but you are replacing a bludgeon with a scalpel, and the more varied your projects, in terms of business and geography, the greater the payoff.

3. Capital Constrained Clearing Rate: The notion that any investment that earns more than what other investments of equivalent risk are delivering is a good one, but it is built on the presumption that businesses have the capital to take all good investments. Many companies face capital constraints, some external

(lack of access to capital markets) and some internal (a refusal to issue new equity because of dilution concerns), and consequently cannot follow this rule. Instead, they find a hurdle rate that incorporates their capital constraints, yielding a hurdle rate much higher than the true opportunity cost. To illustrate, assume that you are a company with fifty projects, all of similar risk, and all earning more than the 10% that investments of equivalent risk are making in the market. If you faced no capital constraints, you would take all fifty, but assume that you have limited capital, and that you rank these projects from highest to lowest returns (IRR or accounting return). The logical thing to do is to work down the list, accepting projects with the highest returns first until you run out of capital. If the last project that you end up accepting has a 20% rate of return, you set your hurdle rate as 20%, a number that clears your capital (Exhibit 3).

By itself, this practice make sense, but inertia is one of the strongest forces in business, and that 20% hurdle rate often becomes embedded in practice, even as the company grows and capital constraints disappear.

Exhibit 3: Hurdle Rate as Capital Constrained Clearing Rate



The consequences are both predictable and damaging, since projects making less than 20% are being turned away, even as cash builds up in these companies.

While the three approaches look divergent and you may expect them to yield different answers, they are tied together more than you might realize, at least in steady state. Specifically, if market prices reflect fair value, the cost of raising funds for a company will reflect the weighted average of the opportunity costs of the investments they make as a company, and a combination of scaling up (reducing capital constraints) and increased competition (reducing returns on investments) will push the capital constrained clearing rate towards the other two measures. If you are willing to be bored, I do have a paper on cost of capital that explains how the different definitions play out, as well as the details of estimating each one.²

HURDLE RATE - THE DRIVERS

For the rest of this discussion, I will adopt the opportunity cost version of hurdle rates, where you are trying to measure how much you should demand on a project or investment, given its risks. In this section, I will point to the three key determinants of whether the hurdle rate on your next project should be 5% or 15%. The first is the business that the investment is in, and the risk profile of that business. The second is geography, with hurdle rates being higher for projects in some parts of the world, than others. The third is currency, with hurdle rates, for any given project, varying across currencies.

Business

If you are a company with two business lines, one with predictable revenues and stable profit margins, and the other with cyclical revenues and volatile margins, you

would expect to, other things remaining equal, use a lower hurdle rate for the first than the second. That said, there are two tricky components of business risk that you need to navigate:

1. *Firm Specific Versus Macro Risk*: When you invest in a company, be it GameStop or Apple, there are two types of risks that you are exposed to, risks that are specific to the company (that GameStop's online sales will be undercut by competition or that Apple's next iPhone launch may not go well) and risks that are macroeconomic and market-wide (that the economy may not come back strongly from the shut down or that inflation will flare up). If you put all your money in one or the other of these companies, you are exposed to all these risks, but if you spread your bets across a dozen or more companies, you will find that company-specific risk gets averaged out. From a hurdle rate perspective, this implies that companies, where the marginal investors (who own a lot of stock and trade that stock) are diversified, should incorporate only macroeconomic or market risk into hurdle rates. For small private firms, where the sole owner is not diversified, the hurdle rate will have to incorporate this and be higher.

2. *Financial Leverage*: There are two ways you can raise funding for a company, and since lenders have contractual claims on the cash flows, the cost of debt should be lower than the cost of equity for almost every company, and that difference is increased by the tax laws tilt towards debt (with interest expenses being tax deductible). Unfortunately, there are many who take this reality and jump to the conclusion that adding debt will lower your hurdle rate, an argument that is built on false premises and lazy calculations. In truth, debt can lower the hurdle rate for some companies, but almost entirely because of the tax subsidy feature, not because it is cheaper, but it can just as easily increase the hurdle rate for others, as distress risk outweighs the tax benefits. (More on that issue in a future data update post...)

² Aswath Damodaran, "The Cost of Capital: The Swiss Army Knife of Finance," April 2016, available at <http://people.stern.nyu.edu/adamodar/pdfiles/papers/costofcapital.pdf>.

Exhibit 4: How Costs of Capital Can Vary Across Businesses

Sub Group	# firms	Cost of Capital in US\$: Percentiles				
		10th	25th	Median	75th	90th
Communication Services	2,252	4.17%	5.46%	6.25%	6.57%	7.48%
Consumer Discretionary	6,228	5.13%	5.53%	6.36%	7.46%	8.78%
Consumer Staples	2,990	4.10%	4.60%	5.06%	6.03%	7.84%
Energy	1,753	5.13%	5.28%	5.39%	6.37%	8.24%
Financials	5,154	2.15%	3.39%	3.73%	4.59%	6.30%
Health Care	4,326	5.07%	5.31%	5.51%	5.97%	6.54%
Industrials	8,047	4.67%	5.19%	5.92%	6.66%	7.81%
Information Technology	5,963	5.93%	6.30%	6.81%	7.66%	8.66%
Materials	6,184	4.84%	5.02%	5.75%	6.48%	7.78%
Real Estate	2,725	3.61%	3.92%	4.31%	4.93%	5.85%
Utilities	936	3.44%	3.78%	4.42%	5.30%	6.55%

I know that many of you are not fans of modern portfolio theory or betas, but ultimately, there is no way around the requirement that you need to measure how risky a business is, relative to other businesses. I am a pragmatist when it comes to betas, viewing them as relative risk measures that work reasonably well for diversified investors, but I have also been open about the fact that I will take an alternate measure of risk that accomplishes the same objective.³

To illustrate how costs of capital can vary across businesses, I used a very broad classification of global companies into sectors, and computed the cost of capital at the start of 2021, in US \$ terms, for each one (Exhibit 4 on previous page).

If you prefer a more granular breakdown, I have estimated costs of capital by industry (with 95 industry groupings) in US \$ to which I have posted links (for US, Europe, Emerging Markets, Japan, Australia/NZ & Canada, Global) in my blogpost of this article.⁴

Geography

As a business, should you demand a higher US \$ hurdle rate for investing in a project in Nigeria than the US \$ hurdle

rate you would require for an otherwise similar project in Germany? The answer, to me, seems to be obviously yes, though there are still some who argue otherwise, usually with the argument that country risk can be diversified away. The vehicle that I use to convey country risk into hurdle rates is the equity risk premium, the price of risk in equity markets, that I talked about in my earlier post on the topic.⁵ In that post, I computed the equity risk premium for the S&P 500 at the start of 2021 to be 4.72%, using a forward-looking, dynamic measure. If you accept that estimate, a company looking at a project in the US or a geographical market similar to the US in terms of country risk, would accept projects that delivered this risk premium to equity investors.

But what if the company is looking at a project in Nigeria or Bangladesh? To answer that question, I estimate equity risk premiums for almost every country in the world, using a very simple (or simplistic) approach. I start with the 4.72%, my estimate of the US ERP, as my base premium for mature equity markets, treating all Aaa rated countries (Germany, Australia, Singapore etc.) as mature markets. For countries not rated Aaa, I use the sovereign rating for the country to estimate a default spread for that country, and scale up that default spread for the higher risk that equities bring in, relative to government bonds (Exhibit 5).

³ Aswath Damodaran, "Alternatives to the CAPM: Part 1: Relative Risk Measures," <http://aswathdamodaran.blogspot.com/2011/04/alternatives-to-capm-part-1-relative.html>

⁴ See links embedded in the original posting of this article at <https://aswathdamodaran.blogspot.com/2021/02/data-update-4-for-2021-hurdle-rate.html>.

⁵ Aswath Damodaran, "Musings on Markets: Data Update 2 for 2021: The Price of Risk!" <http://aswathdamodaran.blogspot.com/2021/01/data-update-2-for-2021-price-of-risk.html>.

Exhibit 5: ERP Estimation

ERP Estimation Procedure - January 1, 2021

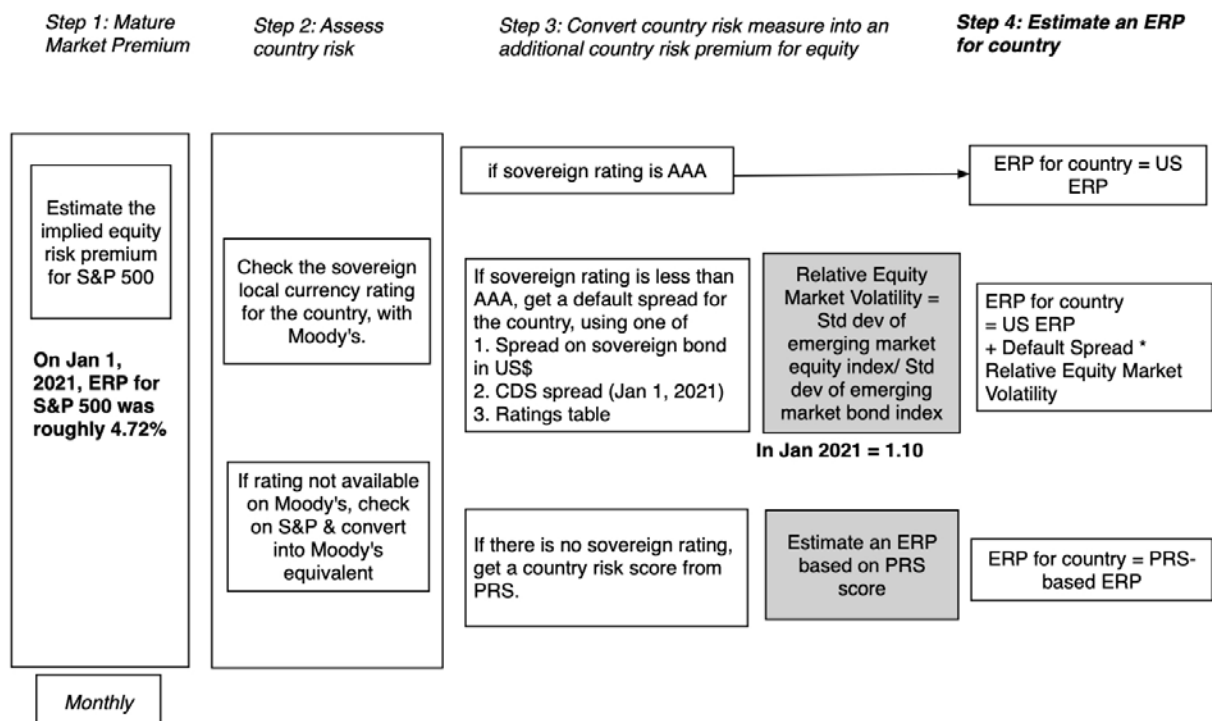


Exhibit 6: ERP by Country

ERP : Jan 2021

Andorra	Caa1	7.26%	11.98%	Italy	Baa3	2.13%	6.85%
Austria	Aa1	0.38%	5.10%	Jersey	Aaa	0.00%	4.72%
Belgium	Ba3	0.59%	5.31%	Liechtenstein	Aaa	0.00%	4.72%
Cyprus	Ba2	2.91%	7.63%	Luxembourg	Aaa	0.00%	4.72%
Denmark	Aaa	0.00%	4.72%	Malta	A2	0.82%	5.54%
Finland	Aa1	0.38%	5.10%	Netherlands	Aaa	0.00%	4.72%
France	Aa2	0.48%	5.20%	Norway	Aaa	0.00%	4.72%
Germany	Aaa	0.00%	4.72%	Portugal	Baa3	2.13%	6.85%
Greece	Ba3	3.49%	8.21%	Spain	Baa1	1.55%	6.27%
Guernsey	Aaa	0.00%	4.72%	Sweden	Aaa	0.00%	4.72%
Iceland	A2	0.82%	5.54%	Switzerland	Aaa	0.00%	4.72%
Ireland	A2	0.82%	5.54%	Turkey	B2	5.33%	10.05%
Isle of Man	Aa3	0.59%	5.31%	UK	Aa3	0.59%	5.31%
				Western Europe		0.84%	5.56%

Canada	Aaa	0.00%	4.72%
United States	Aaa	0.00%	4.72%
North America		0.00%	4.72%

Caribbean		5.31%	10.03%
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Argentina	Ca	11.62%	16.34%
Belize	Caa3	9.68%	14.40%
Bolivia	B2	5.33%	10.05%
Brazil	Ba2	2.91%	7.63%
Chile	A1	0.68%	5.40%
Colombia	Baa2	1.84%	6.56%
Costa Rica	B2	5.33%	10.05%
Ecuador	Caa3	9.68%	14.40%
El Salvador	B3	6.30%	11.02%
Guatemala	Ba1	2.42%	7.14%
Honduras	B1	4.36%	9.08%
Mexico	Baa1	1.55%	6.27%
Nicaragua	B3	6.30%	11.02%
Panama	Baa1	1.55%	6.27%
Paraguay	Ba1	2.42%	7.14%
Peru	A3	1.16%	5.88%
Suriname	Caa3	9.68%	14.40%
Uruguay	B1	4.36%	9.08%
Venezuela	C	19.18%	23.90%
Latin America		3.99%	8.71%

Country	Rating	CRP	ERP
Angola	Caa1	7.26%	11.98%
Benin	B2	5.33%	10.05%
Botswana	A2	0.82%	5.54%
Burkina Faso	B2	5.33%	10.05%
Cameroon	B2	5.33%	10.05%
Cape Verde	B2	5.33%	10.05%
Congo (DR)	Caa1	7.26%	11.98%
Congo (Rep of)	Caa2	8.72%	13.44%
Côte d'Ivoire	Ba3	3.49%	8.21%
Egypt	B2	5.33%	10.05%
Ethiopia	B2	5.33%	10.05%
Gabon	Caa1	7.26%	11.98%
Ghana	B3	6.30%	11.02%
Kenya	B2	5.33%	10.05%
Mali	Caa1	7.26%	11.98%
Morocco	Ba1	2.42%	7.14%
Mozambique	Caa2	8.72%	13.44%
Namibia	Ba3	3.49%	8.21%
Niger	B3	6.30%	11.02%
Nigeria	B2	5.33%	10.05%
Rwanda	B2	5.33%	10.05%
Senegal	Ba3	3.49%	8.21%
South Africa	Ba2	2.91%	7.63%
Swaziland	B3	6.30%	11.02%
Tanzania	B2	5.33%	10.05%
Togo	B3	6.30%	11.02%
Tunisia	B2	5.33%	10.05%
Uganda	B2	5.33%	10.05%
Zambia	Ca	11.62%	16.34%
Africa		4.94%	9.66%

Albania	B1	4.36%	9.08%
Armenia	Ba3	3.49%	8.21%
Azerbaijan	Ba2	2.91%	7.63%
Belarus	B3	6.30%	11.02%
Bosnia & Herzegovina	B3	6.30%	11.02%
Bulgaria	Baa1	1.55%	6.27%
Croatia	Ba1	2.42%	7.14%
Czech Republic	Aa3	0.59%	5.31%
Estonia	A1	0.68%	5.40%
Georgia	Ba2	2.91%	7.63%
Hungary	Baa3	2.13%	6.85%
Kazakhstan	Baa3	2.13%	6.85%
Kyrgyzstan	B2	5.33%	10.05%
Latvia	A3	1.16%	5.88%
Lithuania	A3	1.16%	5.88%
Macedonia	Ba3	3.49%	8.21%
Moldova	B3	6.30%	11.02%
Montenegro	B1	4.36%	9.08%
Poland	A2	0.82%	5.54%
Romania	Baa3	2.13%	6.85%
Russia	Baa3	2.13%	6.85%
Serbia	Ba3	3.49%	8.21%
Slovakia	A2	0.82%	5.54%
Slovenia	A3	1.16%	5.88%
Tajikistan	B3	6.30%	11.02%
Ukraine	B3	6.30%	11.02%
Uzbekistan	Baa2	1.84%	6.56%
E. Europe & Russia		2.08%	6.80%

Abu Dhabi	Aa2	0.48%	5.20%
Bahrain	B2	5.33%	10.05%
Iraq	Caa1	7.26%	11.98%
Israel	A1	0.68%	5.40%
Jordan	B1	4.36%	9.08%
Kuwait	A1	0.68%	5.40%
Lebanon	C	19.18%	23.90%
Oman	Ba3	3.49%	8.21%
Qatar	Aa3	0.59%	5.31%
Ras Al Khaima	Aaa	0.00%	4.72%
Saudi Arabia	A1	0.68%	5.40%
Sharjah	Baa2	1.84%	6.56%
United Arab Emirates	Aa2	0.48%	5.20%
Middle East		1.53%	6.25%

Country	PRS	CRP	ERP
Algeria	57.25	8.72%	13.44%
Brunei	80	0.82%	5.54%
Gambia	63.75	6.30%	11.02%
Guinea	53.5	11.62%	16.34%
Guinea-Bissau	62	7.26%	11.98%
Guyana	65.75	5.33%	10.05%
Haiti	52.75	11.62%	16.34%
Iran	59.25	8.72%	13.44%
Korea, D.P.R.	50.75	11.62%	16.34%
Liberia	53.5	11.62%	16.34%
Libya	58.25	8.72%	13.44%
Madagascar	63.25	6.30%	11.02%
Malawi	58.75	8.72%	13.44%
Myanmar	63.75	6.30%	11.02%
Sierra Leone	58.75	8.72%	13.44%
Somalia	50.5	11.62%	16.34%
Sudan	38.25	19.18%	23.90%
Syria	47	19.18%	23.90%
Yemen, Republic	50	19.18%	23.90%
Zimbabwe	52.25	11.62%	16.34%

Bangladesh	Ba3	3.49%	8.21%
Cambodia	B2	5.33%	10.05%
China	A1	0.68%	5.40%
Fiji	Ba3	3.49%	8.21%
Hong Kong	Aa3	0.59%	5.31%
India	Baa3	2.13%	6.85%
Indonesia	Baa2	1.84%	6.56%
Japan	A1	0.68%	5.40%
Korea	Aa2	0.48%	5.20%
Laos	Caa2	8.72%	13.44%
Macao	Aa3	0.59%	5.31%
Malaysia	A3	1.16%	5.88%
Maldives	B3	6.30%	11.02%
Mauritius	Baa1	1.55%	6.27%
Mongolia	B3	6.30%	11.02%
Pakistan	B3	6.30%	11.02%
Papua New Guinea	B2	5.33%	10.05%
Philippines	Baa2	1.84%	6.56%
Singapore	Aaa	0.00%	4.72%
Solomon Islands	B3	6.30%	11.02%
Sri Lanka	Caa1	7.26%	11.98%
Taiwan	Aa3	0.59%	5.31%
Thailand	Baa1	1.55%	6.27%
Vietnam	Ba3	3.49%	8.21%

Australia	Aaa	0.00%	4.72%
Cook Islands	B1	4.36%	9.08%
New Zealand	Aaa	0.00%	4.72%
Australia & NZ		0.00%	4.72%

Blue: Moody's Rating
Red: Added Country Risk
Green: Total ERP

That additional premium, which I call a country risk premium, when added to the US ERP, gives me an equity risk premium for the country in question (Exhibit 6).

What does this mean? Going back to the start of this section, a company (say Ford) would require a higher cost of equity for a Nigerian project than for an equivalent German project (using a US \$ risk free rate of 1% and a beta of 1.1 for Ford).

- Cost of equity in US \$ for German project = 1% + 1.1 (4.72%) = 6.19%
- Cost of equity in US \$ for a Nigerian project = 1% + 1.1 (10.05%) = 12.06%

The additional 5.87% that Ford is demanding on its Nigerian investment reflects the additional risk that the country brings to the mix.

Currency

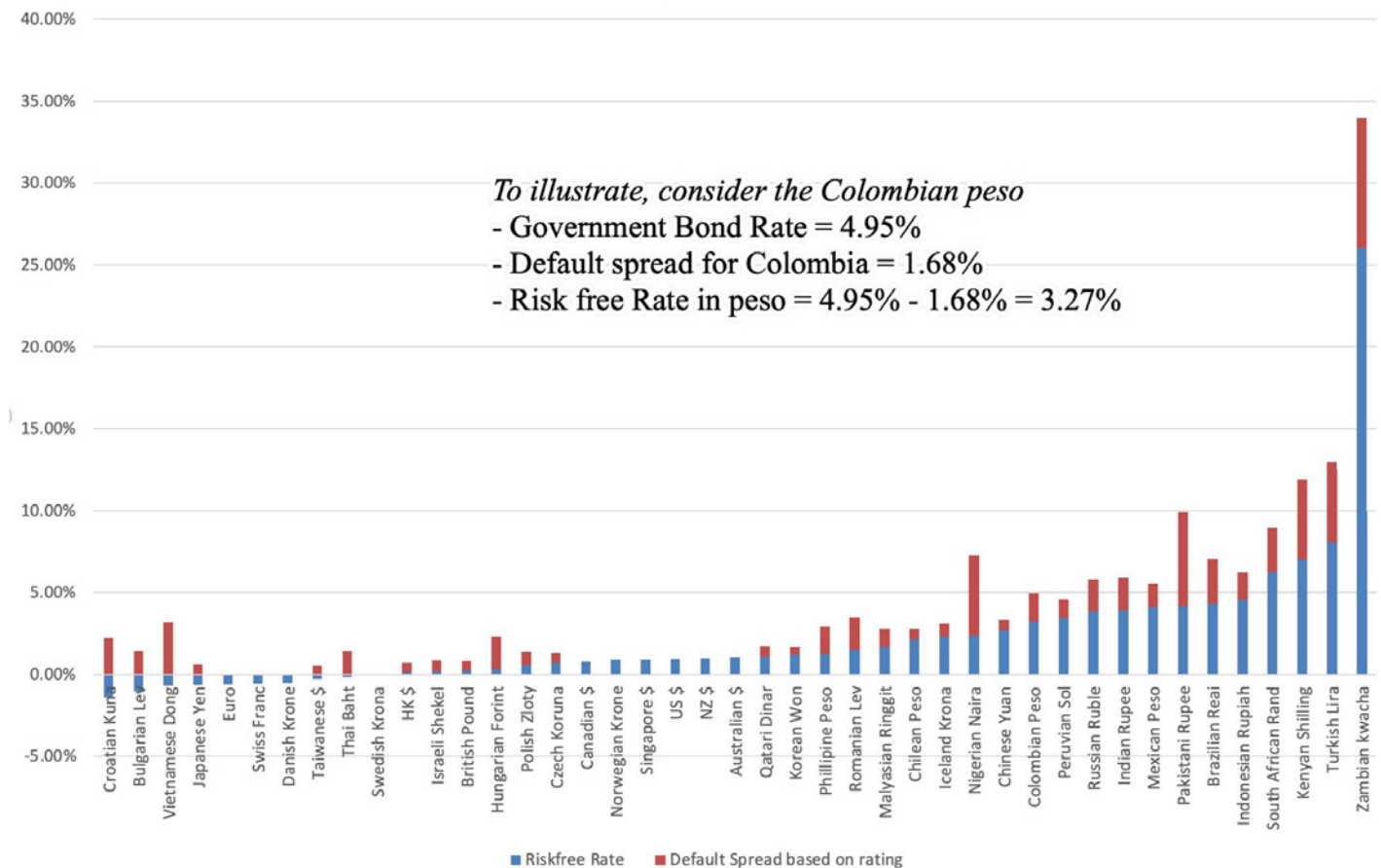
I have studiously avoided dealing with currencies so far, by denominating all of my illustrations in US dollars, but that may strike some of you as avoidance. After all, the currency in Nigeria is the Naira and in Germany

is the Euro, and you may wonder how currencies play out in hurdle rates. My answer is that currencies are a scaling variable, and dealing with them is simple if you remember that the primary reason why hurdle rates vary across currencies is because they bring different inflation expectations into the process, with higher-inflation currencies commanding higher hurdle rates. To illustrate, if you assume that inflation in the US \$ is 1% and that inflation in the Nigerian Naira is 8%, the hurdle rate that we computed for the Nigerian project in the last section can be calculated as follows:

- Cost of equity in Naira for Nigerian project (approximate) = 12.06% + (8% - 1%) = 19.06%
- Cost of equity in Naira for Nigerian project (precise) = $1.1206 * (1.08/1.01) - 1 = 19.83\%$

In effect, the Nigerian Naira hurdle rate will be higher by 7% (7.77%) roughly (precisely) than a US \$ hurdle rate, and that difference is entirely attributable to inflation differentials. The instrument that best delivers measures of the expected inflation is the riskfree rate in a currency, which I compute by starting with a government bond

Exhibit 7: Government-Bond Based Risk Free Rates (January 2021)



rate in that currency and then cleaning up for default risk. At the start of 2021, the riskfree rates in different currencies are shown (Exhibit 7).

These risk free rates are derived from government bond rates, and to the extent that some of the government bonds that I looked at are not liquid or widely traded, you may decide to replace those rates with synthetic versions, where you add the differential inflation to the US dollar risk free rate. Also, note that there are quite a few currencies with negative risk free rates, a phenomenon that can be unsettling, but one you can work with, as long as you stay consistent.

IMPLICATIONS

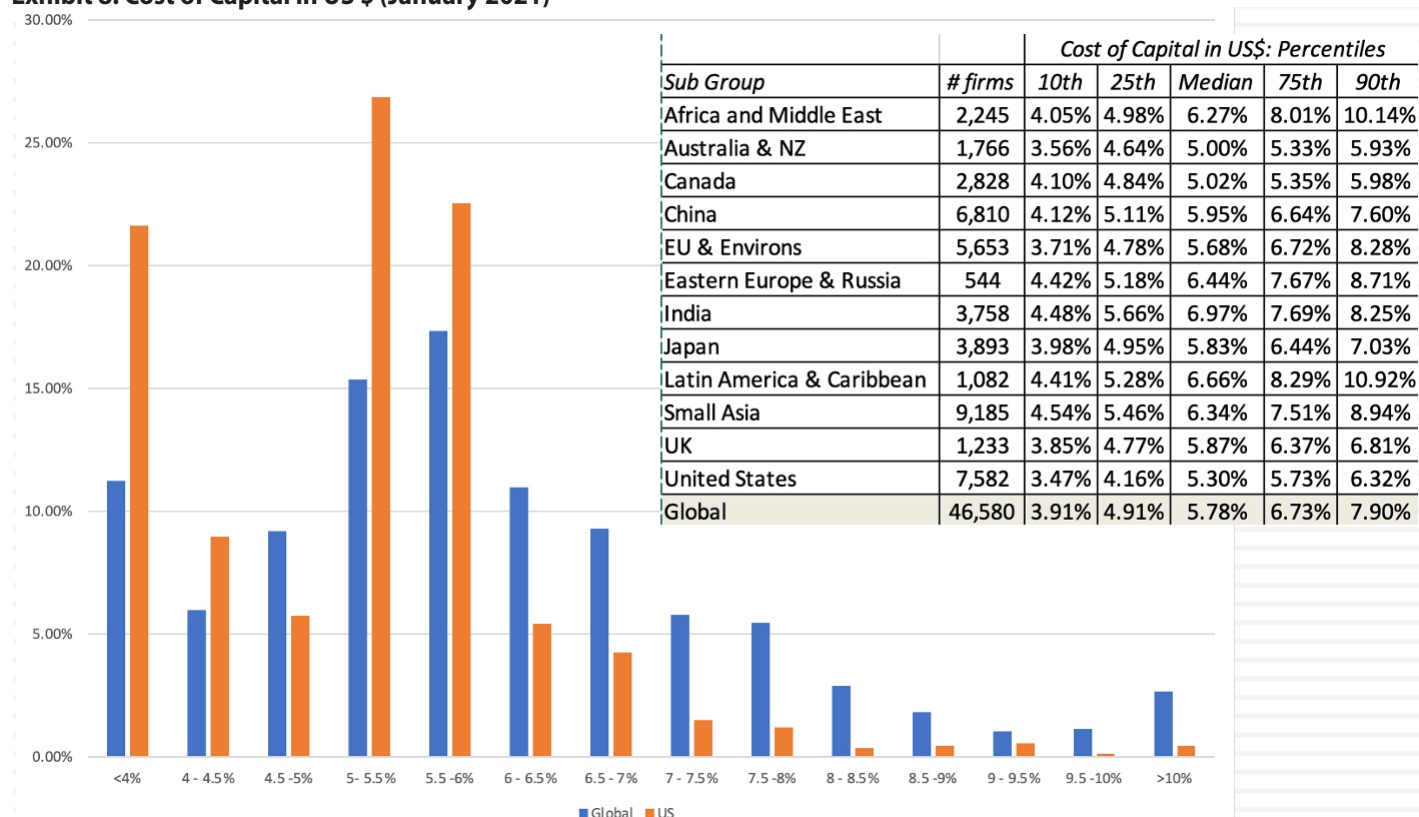
As we reach the end of this discussion, thankfully for all our sakes, let's look at the implications of what the numbers at the end of 2020 are for investors and companies.

Get Currency Nailed Down: We all have our frames of reference, based often upon where we work, and not surprisingly, when we talk with others, we expect them to share the same frames of reference. When it comes to hurdle rates, that can be dangerous, since hurdle rates will vary across currencies, and cross-currency comparisons are useless. Thus, a 6% hurdle rate in Euros may look lower than a 12% hurdle rate in Turkish lira, but after inflation is considered, the latter may be the lower

value. Any talk of a global risk free rate is nonsensical, since risk free rates go with currencies, and currencies matter only because they convey inflation. That is why you always have the option of completely removing inflation from your analysis, and do it in real terms.

A Low Hurdle Rate World: At the start of 2021, you are looking at hurdle rates that are lower than they have ever been in history, for most currencies. In the US dollar, for instance, a combination of historically low risk free rates and compressed equity risk premiums have brought down costs of capital across the board, and you can see that in the histogram of costs of capital in US \$ of US and global companies at the start of 2021 (Exhibit 8 on next page).

The median cost of capital in US \$ for a US company is 5.30%, and for a global company is 5.78%, and those numbers will become even lower if you compute them in Euros, Yen or Francs. I know that if you are an analyst, those numbers look low to you, and the older you are, the lower they will look, telling you something about how your framing of what you define to be normal is a function of what you used to see in practice, when you were learning your craft. That said, unless you want to convert every company valuation into a judgment call on markets, you have to get used to working with these lower discount rates, while adjusting your inputs for growth and cash flows to reflect the conditions that

Exhibit 8: Cost of Capital in US \$ (January 2021)

are causing those low discount rates. For companies and investors who live in the past, this is bad news. A company that uses a 15% cost of capital, because that is what it has always used, will have a hard time finding any investments that make the cut, and investors who posit that they will never invest in stocks unless they get double digit returns will find themselves holding almost mostly-cash portfolios. While both may still want to build a buffer to allow for rising interest rates or risk premiums, that buffer is still on top of a really low hurdle rate and getting to 10% or 15% is close to impossible.

Don't Sweat the Small Stuff: I spend a lot of my time talking about and doing intrinsic valuations, and for those of you who use discounted cash flow valuations to arrive at intrinsic value, it is true that discount rates are an integral part of a DCF. That said, I believe that we spend way too much time on discount rates, finessing risk measures and risk premiums, and too little time on cash flows. In fact, if you are in a hurry to value a company in US dollars, my suggestion is that you just use a cost of capital based upon the distribution in the graph above (4.16% for a safe company, 5.30% for an average risk company or 5.73% for a risky company) as your discount rate, spend your time estimating revenue growth, margins and reinvestment, and if you do have the time, come back and tweak the discount rate.

I know that some of you have been convinced about the centrality of discount rates by sensitivity analyses that show value changing dramatically as discount rates

change. These results are almost the consequence of changing discount rates, while leaving all else unchanged, an impossible trick to pull off in the real world. Put simply, if you woke up tomorrow in a world where the risk free rate was 4% and the cost of capital was 8% for the median company, do you really believe that the earnings and cash flows you projected in a COVID world will remain magically unchanged? I don't!

ABOUT THE AUTHOR



Aswath Damodaran

Aswath Damodaran is the Kerschner Family Chair Professor of Finance at the Stern School of Business at New York University, where he teaches corporate finance and valuation courses in the MBA program. His research interests lie in valuation, portfolio management and applied corporate finance. Among many publications, Aswath has written four

books on valuation (Damodaran on Valuation, Investment Valuation, The Dark Side of Valuation, The Little Book of Valuation), and two on corporate finance (Corporate Finance: Theory and Practice, Applied Corporate Finance: A User's Manual). In addition to his blog, Aswath has an active presence online, on Twitter (@AswathDamodaran) and with his website (<http://www.damodaran.com>). His corporate finance and valuation classes are carried online and on iTunes U (with more than 100,000 students on iTunes U) and his online classes were chosen as one of the top ten MOOCs in the world in 2012. He is a keynote speaker at VALCON 2021, presenting the topic "A Jedi Guide to Valuation: Disrupting the Status Quo."

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Jonathan P. Friedland served as the principal author and Editor-in-Chief for the 2021 editions of ***Commercial Bankruptcy Litigation*** and ***Strategic Alternatives For and Against Distressed Businesses***. He is also among the dozens of insolvency and restructuring professionals from top national firms who

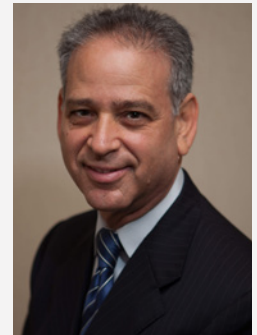
contributed to building these treatises which are published each year by Thomson Reuters.

Strategic Alternatives For and Against Distressed Businesses is widely considered a foundational text for non-bankruptcy alternatives. This treatise is a comprehensive practice manual that offers state-by-state comparisons of assignments for the benefit of creditors (ABCs) and state court receiverships, as well as other legal tools available to deal with a financially distressed business. *Commercial Bankruptcy Litigation* contains key guidance and insight covering general chapter 11 bankruptcy and procedure, including the new Subchapter V.

Jonathan is a partner with Sugar Felsenthal Grais & Helsinger LLP in Chicago. He is also chairman of DailyDAC, LLC, d/b/a Financial Poise.™ Jonathan has extensive experience advising financially distressed companies, their owners and D&Os, and their other constituents in both bankruptcy and non-bankruptcy alternatives throughout the United States. You can reach Jonathan at jfriedland@sfigh.com.

SIX TOP CPAS AND LITIGATION SUPPORT PROFESSIONALS AT KAPILAMUKAMAL HONORED IN 2021 SOUTH FLORIDA LEGAL GUIDE

The 2021 *South Florida Legal Guide*, an annual publication listing the Top Law firms, Top Lawyers and Top CPAs and Litigation Support Professionals in South Florida, has honored six CPAs and Litigation Support Professionals at the fiduciary and insolvency services firm of KapilaMukamal, LLP.



The six honorees are: Founding Partners **Soneet R. Kapila, CIRA**, and **Barry Mukamal, CIRA** (pictured above, left to right); Partners **Melissa Davis, CIRA**, **Sharmila Khanorkar, CIRA**, and **Kevin McCoy, CIRA**; and Consultant **Mark Parisi, CIRA**.

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CASE STUDY

AN OUT-OF-COURT PROCESS MAY PROVE BETTER THAN BANKRUPTCY

CohnReznick was recently hired as CRO for a Pennsylvania-headquartered, for-profit health network. At its peak, the network was servicing 12,000 patients a week and operating 25 facilities. It eventually began to struggle, amassing nearly \$170 million in debt. When CohnReznick was retained, the company was down to just eight weeks of cash on hand.

In weighing the in-court versus out-of-court options, we concluded that the significant assets that existed in the health network would be destroyed by a bankruptcy filing. So, we opted for an out-of-court process. Our work involved an initial cash triage, an operational turnaround to drive value, interim bridge funding to extend the cash runway, and identifying the right buyer for the network and its stakeholders.

After a lengthy process, the health network was returned to positive EBITDA and then acquired by a larger, financially stable not-for-profit health network with a history of operational excellence. Creditors were paid and, except for the owner and family members, all physicians and employees were retained.



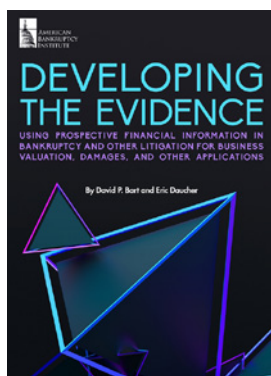
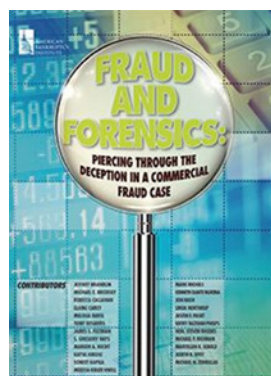
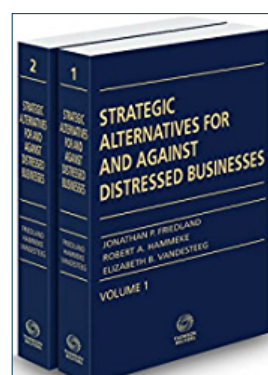
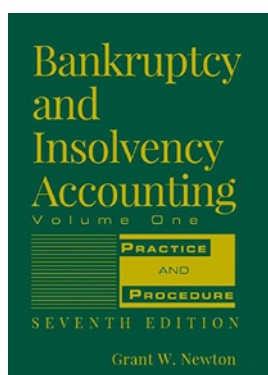
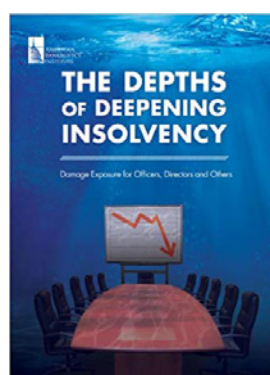
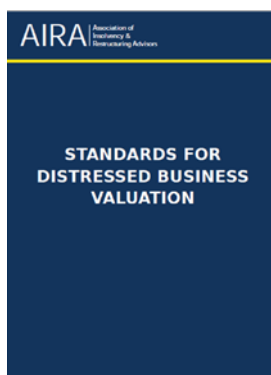
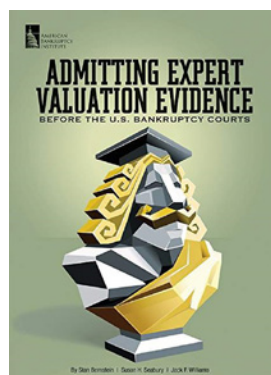
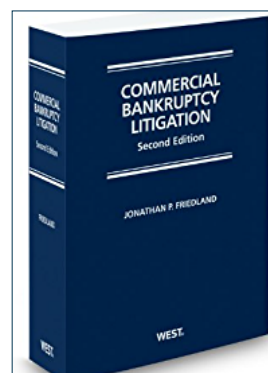
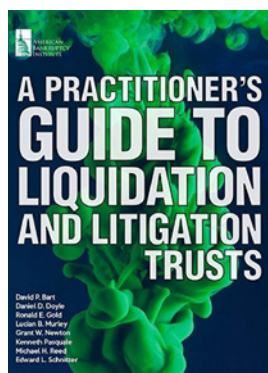
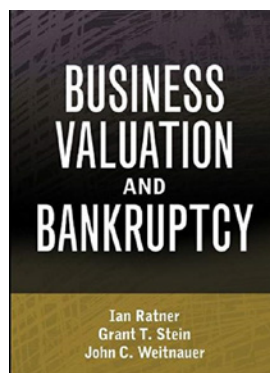
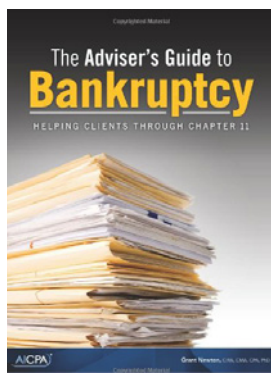
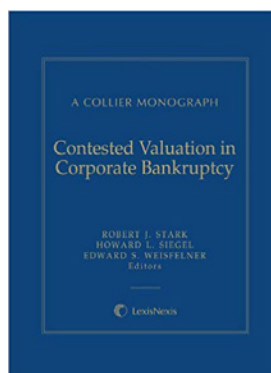
Read the full case study by **Cynthia Romano**, Global Director, Restructuring and Dispute Resolution Practice, New York, NY, and **Eric Danner, CIRA**, Partner, Restructuring & Dispute Resolution Practice, New York, NY, at: <https://www.cohnreznick.com/insights/how-out-of-court-process-may-prove-better-than-bankruptcy>

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