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Valuation in Chapter 11: Overview and Tools for Consensual Resolution

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Introduction

One of the cornerstones of the U.S. Chapter 11 process is the absolute priority rule, which requires that, unless they consent otherwise, junior creditors may not receive any value on account of their claims unless senior creditors are paid in full. The problem is that it can be difficult to determine whether a given class of creditors is paid in full. In cases where the currency of payment is debt or equity in a going-concern, valuation of the business underlies this important determination. But the valuation of a going-concern is based in part on future performance, and determining that value is not an exact science. The bigger and more complicated the business, the more inexact the science.

When the parties-in-interest in a U.S. Chapter 11 case cannot agree on a valuation, it is up to the bankruptcy court, relying on the testimony of dueling and contradictory experts hired by the various parties, to determine the debtor's value. The valuation of a large company in bankruptcy is a process fraught with uncertainty. Judge D. Michael Lynn of the U.S. Bankruptcy Court for the Northern District of Texas captured the uncertain nature of bankruptcy valuation in his oft-cited opinion in the 2005 Chapter 11 case of Mirant Corporation ("Mirant"), where he wrote that valuing a company is "an exercise in educated guesswork [with] too many variables, [and] too many moving pieces in the calculation of value…for the court to have great confidence that the result of the process will prove accurate in the future". *In re Mirant Corp. ("Mirant")*, 334 B.R. 800, 848 (Bankr. N.D. Tex. 2005).

In the current economic climate, valuation in Chapter 11 is even more complicated, and often more critical, than ever before. During the past decade, in part as a result of extraordinarily strong credit markets, many companies became highly leveraged, often through the use of multilayered capital structures. Now, as a result of the global economic downturn, a great number of these companies are, or soon will be, seeking refuge in Chapter 11. There will be an unprecedented number of parties competing for pools of assets that are rapidly shrinking in value.

The increasing difficulty and importance of the valuation question, combined with its subjective and imprecise nature, means that extremely protracted and expensive valuation litigation will dominate some - or many - cases in the coming wave of restructurings. Having the tools to understand and hopefully resolve these issues outside of litigation can result in significant efficiency gains. This article discusses some of these tools. Beginning by charting the jurisprudential and legislative basis for valuation and then examining how valuation disputes are commonly resolved by bankruptcy courts, we discuss why consensual resolution of valuation disputes is usually preferable to litigated resolution, and explore how consensual resolution can be facilitated through an understanding of the differing goals of the various parties-in-interest and a willingness to explore creative solutions to valuation disputes.

I. Why the Valuation Question is Posed: The Absolute Priority Rule

The need to value a debtor in a Chapter 11 proceeding stems from the absolute priority rule, which requires that claims senior in priority be paid in full before those junior receive any value, and that junior claims be paid in full before equity holders receive any value. The rule arose as the result of a series of U.S. Supreme Court decisions in the early 20th century. The most important of these decisions were *Northern Pacific Ry. Co. v. Boyd ("Boyd")*, 228 U.S. 482 (1913) and *Case v. Los Angeles Lumber Products Co. ("Case")*, 308 U.S. 106 (1939). In *Boyd*, the U.S. Supreme Court held that a plan of reorganisation could not impair junior creditors unless they had approved the plan or had their day in court. Over time this became known as the "fair and equitable principle". However, *Boyd* left unanswered the question of the circumstances in which a court-approved plan of reorganisation that lacked junior creditor approval was acceptable. This question was taken up and answered by the U.S. Supreme Court in *Case*. In *Case*, Justice Douglas, writing for a majority of the Court, held that the fair and equitable principle required that each creditor have its "full right of priority against the corporate assets". *Case* at 122. The principles articulated in *Boyd* and *Case* were codified in §1129 of the modern U.S. Bankruptcy Code and serve as the foundation for the absolute priority rule.

Once a bankruptcy proceeding is commenced, the absolute priority rule requires that creditors be paid according to their "relative priority" (meaning their right to payment from the assets of the debtor when there is a conflict with another creditor). Relative priority is governed by the U.S. Bankruptcy Code, which divides creditors into different classes and mandates their treatment. As a basic framework, the U.S. Bankruptcy Code provides that secured creditors are paid first to the extent of their collateral, followed by administrative (post-petition) creditors, certain priority creditors (e.g., certain claims by employees), general unsecured creditors and, finally, equity holders. The absolute priority rule operates like a series of stacked champagne glasses, requiring that the glasses of the senior creditors that are first in line get filled completely before allowing any value to cascade down to the glasses of lower-ranking creditors.

Prior to 1978, Chapter X of the old U.S. Bankruptcy Act required the absolute priority rule to be met in every reorganisation. In 1978, the Bankruptcy Act was replaced with the modern Bankruptcy

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Code, and in connection therewith, the U.S. Congress effected a number of important changes to the U.S. bankruptcy system. One of these changes included the absolute priority rule. Congress having determined that the old scheme was too rigid, under the modern Bankruptcy Code, senior classes can accept a plan that provides a return to junior classes even when senior classes are not paid strictly according to the absolute priority rule.

Senior classes may have a number of strategic reasons for allowing junior classes to be paid in this manner. For example, junior classes may be comprised of trade creditors or business owners with institutional knowledge necessary to facilitate the debtor's post-bankruptcy operations. Receiving value in a plan of reorganisation may induce these groups to continue their relationship with the debtor. Alternatively, providing some payout to junior classes can also be an effective means of reaching consensual resolution of a plan of reorganisation, thereby avoiding the need for litigation over enterprise value or over the amount or validity of the senior lenders' liens or claims.

The absolute priority rule applies today under the Bankruptcy Code in all reorganisations where the different classes of creditors are unable to agree on a plan structure. For instance, the rule comes into play when a class of creditors votes against, or is deemed to have rejected, a proposed plan of reorganisation. A class of creditors is deemed to reject a plan of reorganisation if it receives no value under the plan. It rejects the plan if either 1/2 of the claimants in number or 1/3 in amount of those voting vote against the plan. See 11 U.S.C. §1126(c),(g). In the face of objecting classes of creditors, the debtor can still gain court approval for its proposed plan of reorganisation, so long as at least one class of impaired creditors who are not insiders accepts the plan and certain other tests, including the absolute priority rule, are met with respect to the dissenting classes of creditors. See 11 U.S.C. §1129(b)(2)(B)(ii). The expected return in a plan that complies with the absolute priority rule provides a starting point for creditors in negotiations, because creditors know that if the negotiations go awry, a plan complying with the rule can always be approved and implemented over their objections.

II. Valuation Methods

Valuation disputes stem in large part from uncertainty associated with the valuation process. As Judge Lynn put it in *Mirant*, valuation is at times "not much more than crystal ball gazing". *Mirant* at 848. The bankruptcy court in the 1989 Chapter 11 case of Pullman Construction Industries similarly opined that "all valuations of going business value are only educated estimates". *In re Pullman Const. Indus.*, 107 B.R. 909, 932 (Bankr. N.D. Ill. 1989).

As one author has described it, there are two primary causes for this uncertainty: "actual uncertainty" about the value of the debtor's business and "judicial valuation uncertainty", meaning uncertainty about how the judge will decide to value the business. Kerry O' Rourke, *Survey: Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 Colum. Bus. L. Rev. 403, 414-415 (2005). Actual uncertainty stems from the fact that valuation requires an estimate of a business' future prospects and the future is inherently uncertain. "Sources of actual uncertainty include imperfect information about the market for a debtor's goods or services, the abilities of a debtor's management team, and other factors relevant to the debtor's business". *Id.* at 415. Judicial valuation uncertainty stems from the fact that it is the subjective opinion of the bankruptcy judge that will ultimately determine the debtor's value. A bankruptcy judge is not making a mathematical calculation of the debtor's worth, but rather relies on his or her personal and subjective views of the circumstances and the testimony to make a determination based on less than perfect information. Although judges may be predisposed to approach these issues in a certain way, their past behaviour gives no guarantee as to how they will decide valuation questions in the future. The role of a bankruptcy judge in a Chapter 11 case will be discussed further in Section IV.A.

Further contributing to the uncertainty of the valuation process is the fact that the experts brought in to opine on value are not neutral and impartial arbiters; rather, they are hired by the goal-oriented parties-in-interest. Some variance in the valuations of different experts would be expected in any event, as different experts may be considering different factors even if using the same valuation method. *See e.g., In re American Homepatient, Inc.* 298 B.R. 152, 187 (Bankr. M.D. Tenn. 2003), aff'd, 420 F.3d 559 (6th Cir. 2005) ("valuation of property is an inexact science . . . and variance of opinion by two individuals does not establish a mistake in either"). However, given that experts are likely to be inclined to arrive at valuations suiting their clients, some of the variance that occurs in certain cases may result from subtle or unsubtle bias. *See, e.g., Mirant* at 815 ("[the expert] has served as an advisor to the debtors since before commencement of these Chapter 11 cases…it is reasonable to infer that [the expert] would have some commitment to a strategy (and its factual underpinnings) that he helped devise"). To minimise the effect of potential bias, courts will often discredit experts who receive success fees, as this is seen as creating a conflict of interest and giving the expert too much incentive to align their valuation with their client's interests. *See, e.g., In re Oneida Ltd.,* 351 B.R. 79, 92 (Bankr. S.D.N.Y. 2006) ("[the] contingent fee, and the circumstances surrounding it, seriously undermine [the expert's] credibility").

It is thus before a backdrop of uncertainty that creditors and bankruptcy courts must decide how to value debtors. This uncertainty is exacerbated by the fact that there are several approaches to valuation, none of which is universally accepted, and each of which has strengths and weaknesses. Understanding the different approaches to valuation, and why each is imperfect, is an important step in understanding why consensual resolution is often preferable.

A. Discounted Cash Flow Method

A popular method for valuing a going-concern is the discounted cash flow method ("DCF"), which involves arriving at a present value estimate of the company's future earnings. *See, e.g., Consolidated Rock Products Co. v. Du Bois,* 312 U.S. 510, 526 (1941) ("The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable."). Under this method, one estimates the relevant company's future free cash flow and discounts it using a discounting factor such as the weighted average cost of capital, or a modification of that number that takes into account risk, to arrive at a present value. The obvious problem with this method is that predictions as to future earnings are always questionable, as a company could perform substantially better or worse than its projections would indicate. This is particularly true in the case of a reorganised entity that has not yet been tested in its new form or with its new management. Additionally, the discount factor could be inaccurate by failing to take into account certain risk factors or future events, such as inflation. Therefore, two parties, both using DCF to value a company, could produce vastly different results depending on their subjective views of future events.

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B. Comparable Transactions Method

A second method used by courts to value a company is the "comparable transactions" method, which, as the name suggests, uses prices from analogous third-party sale transactions to value the enterprise. This method avoids the problems presented by DCF, because it does not involve predicting the future. However, it is often of limited utility because it can be used only in cases where comparable transactions exist and information about them is available. The comparable transactions approach can also be problematic because no two companies or transactions are ever exactly alike. Even very similar companies may be valued differently because of factors such as goodwill or the value of their trademarks. This is exacerbated in a Chapter 11 situation, as the debtor company will be looked at differently from similar companies sold in non-distressed situations.

In some cases, the debtor company itself may have been marketed, and bids for the company could be used to derive its value. In such a case, the court will have to scrutinise the reasons why the proposed transaction did not materialise and whether new factors need to be taken into account, such as additional capital (e.g., exit financing), new management or changes in the market that would make it inappropriate to use the previous valuation. Historically, U.S. courts have not been unanimously enthusiastic about using the market approach to value a bankrupt company. *See e.g., In re Penn Central Transp. Co.,* 596 F.2d 1102, 1115-6 (3d Cir. 1979) (holding that market prices are not an adequate measure of enterprise value in bankruptcy). However, in *Bank of America National Trust and Savings Ass'n v. 203 North LaSalle Street P'ship,* 526 U.S. 434, 456-7 (1999), the U.S. Supreme Court strongly validated the use of market-based approaches to valuation, at least where there is a competitive bidding process with multiple bidders.

C. Securities Valuation Method

The value of a debtor's securities could provide information about the debtor's intrinsic value if such securities have continued to trade in a public market during the debtor's bankruptcy. Using this method assumes that the market is liquid and reliable, and is not subject to the risk of market manipulation or irrational behaviour. Even assuming that there is a liquid market for one type of security, such as the debtor's stock, does not mean that there will be a market for others, such as the debtor's bonds. In a bankruptcy situation it is likely that the relevant securities will be the debtor's bonds, debts and other claims on its assets, as they often convert into an ownership stake in the debtor post-reorganisation, while preexisting equity will be rendered worthless. However, the market for claims in a bankruptcy situation is limited because their value is uncertain, which frightens away many potential buyers. In the absence of a public market for all relevant securities, the utility of this valuation method is questionable.

III. Why Consensual Resolution of the Valuation Question is Better Than Litigation

Litigation over enterprise valuation is costly and often destructive of value. While an individual claimant may benefit from advancing and prevailing on a claim for a valuation favourable to his or her interests, claimants as a whole always lose out because the litigation creates both direct and indirect waste.

Direct waste is created because of court costs, attorneys' fees and the costs of discovery and expert testimony. If the valuation involves a large public company, the process can be incredibly complicated, and accordingly the costs will be high. There is no shortage of examples of protracted valuation litigation in U.S. Chapter 11 cases. *See, e.g., In re Nellson Nutraceutical, Inc.,* No. 06-10072 (CSS), 2007 Bankr. LEXIS 99, *3 (Bankr. D. Del. Jan. 18, 2007) ("[t]he court devoted 23 trial days to determine the enterprise value of the [debtor]"); *Mirant* at 809 ("[t]he Valuation Hearing . . . continued for 27 days over . . . 11 weeks").

Even if a party can get a verdict in its favour, there is always the likelihood that competing parties-in-interest will appeal. This is especially likely when the debtor company is large, and both junior and senior claimants have substantial claims against it. The prospect of a significant recovery that outweighs the direct costs of litigation provides an incentive to keep the parties fighting.

Indirect waste results from the fact that while the purported value of the debtor company is being litigated, its actual value is gradually declining as a result of externalities implicit in the bankruptcy process. While the litigation is ongoing, critical suppliers may not want to do business with the debtor because of heightened fears that they will not get paid, customers may be reluctant to purchase its products because of fears that warranties will not be honoured, and essential employees may decide to seek other opportunities because of uncertainty surrounding their jobs. Further, the debtor is also incurring significant costs in the form of professional fees for its lawyers and other advisors as well as having to pay the litigation costs of certain other parties, such as the unsecured creditors' committee, as required by § 503(b)(3) of the Bankruptcy Code. These factors will contribute to a decline in the real value of the debtor, which is detrimental to all parties-in-interest. While the various claimants are squabbling over the size of the piece of the pie each will get, the debtor often has to remain in Chapter 11, with the entire pie shrinking, thereby leaving less for all involved. This is exactly the scenario that was feared in the 2003 Chapter 11 case of Conseco Corporation ("Conseco"), where the debtor, a large insurance holding company, faced the prospect of regulatory action if its reorganisation was not completed quickly. *In re Conseco Corp.,* ("*Conseco*") No. 02-49672 (Bankr. N.D. Ill., 2003). This fear prompted the bankruptcy court overseeing the case to mandate a process designed to arrive at a consensual resolution of the valuation dispute that was holding up the debtor's reorganisation. Senior creditors ultimately had to share with junior creditors some of the value that might have otherwise been owing to them in order to arrive at a consensual resolution.

IV. Tools for Reaching Consensual Resolutions to Disputed Valuations

In order to reach a consensual resolution to a disputed valuation, it is important to have an understanding of the different goals and motivations of the various parties-in-interest and to be aware of creative solutions that can facilitate a resolution. It is primarily the tension between the parties-in-interest that makes valuation a difficult process. For example, senior creditors will invariably prefer a lower valuation so that they can claim more of the debtor's ownership or assets, and junior creditors will want the opposite. Arriving at a consensual resolution in the face of this tension requires consideration of the goals of the various parties-in-interest as well as the motivations that may drive them toward litigation or consensual resolution. The use of creative solutions, typically involving some method of reducing or eliminating valuation uncertainty, can facilitate a consensual resolution by helping to avoid the valuation question altogether.

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A. Understanding the Key Parties-In-Interest

While there are a great many parties-in-interest in a U.S. Chapter 11 case, this section focuses on five of the most important in many valuation disputes: senior creditors, junior creditors, the debtor (as represented by its management), the bankruptcy court judge and the attorneys.

i. Senior Creditors

Senior creditors are in an advantageous position due to the absolute priority rule, which allows them to insist on being paid in full before any payments are made to junior claimants. The fact that senior creditors are entitled be paid in full before other classes of claimants receive any value provides a strong incentive for them to advocate for a low valuation, which will enable them to obtain a greater percentage of the reorganised debtor's equity.

A senior creditor's position may also provide it with an incentive to seek quick and expedient resolutions to the bankruptcy process that may not fully maximise the debtor's value. For example, senior creditors are highly motivated to accept a purchase offer for the debtor's business immediately and obtain a full recovery for themselves and little or nothing for junior claimants, as opposed to waiting months or even years to permit a more fulsome sale or reorganisation process that might ultimately result in a higher recovery for junior classes but with substantially increased risk and delay to the senior creditors.

One must also bear in mind that a class of senior creditors is usually not monolithic but instead is likely to be made up of members with differing incentives. For instance, an original lender in a senior credit facility or an investor that bought its position at or near par is likely to view a given restructuring very differently from a distressed investor that bought the same debt at 20 cents on the dollar after the borrower began to experience financial problems. A valuation leading to a 30 cents on the dollar recovery may be a disaster for one and a home run for the other. Also, since distressed investors tend to focus heavily on the time value of the money they have invested and are less likely to have institutional relationships with the debtor, they may well be much more focused on a quick process and payout than an original lender that may be looking at their claim as long-term equity in the reorganised borrower.

ii. Junior Creditors

The incentives of junior creditors are often opposite those of senior creditors. Since junior creditors know that the absolute priority rule will keep them from receiving any value if the senior creditors are not paid in full, junior creditors will insist on a high valuation for the debtor so that they can share in the recovery with senior creditors. Further, because junior creditors often would not be "in the money" should the company be sold today, they may well seek to postpone the timing of a potential sale or insist on a reorganisation.

Just as with senior creditors, junior creditors may have an incentive to insist on their preferred valuation even if such valuations do not ultimately prove accurate. An example of this is seen in the 2003 Chapter 11 case of Exide Technologies, where the unsecured creditors' committee proposed a value of $1.4 to $1.6 billion for the debtor, while the debtor itself projected a value of only $950 million. *In re Exide Techs.,* 303 B.R. 48 (Bankr. D. Del. 2003). The court, persuaded by the unsecured creditors' committee, authorised a plan that set the debtor's enterprise value at $1.5 billion, and allocated a significant amount of shares to the unsecured creditors. Within a year, the value of the reorganised debtor's stock had fallen more than 50% from the value implied by the plan, meaning that had the debtor been properly valued, the unsecured creditors would have received nothing.

Junior creditors that realise they will receive little or nothing in a proposed plan may also be incentivised to threaten litigation. Threatening litigation, or actually litigating, allows junior creditors to exercise leverage against senior creditors as a result of both the direct and indirect waste caused by litigation. Douglas Baird and Donald Bernstein refer to this incentive as an "option that has value", because by requesting a valuation hearing the junior creditors can either prompt a settlement from the senior creditors or possibly obtain a judicial valuation that puts them "in the money". Douglas G. Baird and Donald S. Bernstein, *Enterprise Valuation and the Puzzling Persistence of Relative Priority Outcomes in Corporate Reorganization,* Univ. Cal., Berkeley Law and Econ. Spring Workshop 35 (2005).

iii. The Debtor-As Represented by Its Management

The debtor is the central figure in a U.S. Chapter 11 case. In addition to being the focus of the reorganisation to be effected therein, the debtor uniquely has a fiduciary duty to all parties-in-interest in the case. *See Smart World Comm. v. Juno Online Servs. ("In re Smart World Tech."),* 423 F.3d 166 (2d Cir. 2005). However, the debtor is an entity and as such is represented by its management. A debtor's management has an important role in any valuation of the debtor, because it is management's projections as to the company's value and future performance that are the starting points for valuation by the other parties-in-interest. Although the debtor has a fiduciary duty to all parties-in-interest, and should always act fairly and impartially in that regard, in practice this is not always the case. Management may, in certain circumstances, act in a self-interested manner. The current management of a debtor may want to retain their positions and/or secure their legacy and reputation *vis-à-vis* the enterprise and as such may be more likely to favour a reorganisation for the debtor rather than a liquidation. Further, management may tend to align with certain parties-in-interest to the detriment of others. For example, in the 1990 Chapter 11 case of National Gypsum Company, which eventually made its way to the Texas Supreme Court, junior creditors alleged that management had intentionally undervalued the debtor by hiding cost savings of $30 to $40 million, so as to benefit senior note holders in exchange for retaining their jobs after the reorganisation. *Browning v. Prostok*, 165 S.W.3d 336 (Tex. 2005).

Putting aside any self-interested inclinations to the contrary, a debtor's fiduciary duty to all parties-in-interest should in many cases provide management a strong incentive to reach consensual resolution of valuation disputes whenever possible. Through consensual resolution, management can keep the value of the debtor from declining during a drawn-out litigation.

iv. The Judge

In a valuation dispute, the judge is the neutral arbiter who reviews the competing proposed valuations put before him or her and makes the ultimate value determination. Judges are assumed by some to be experts in enterprise valuation. However, even if a bankruptcy judge has been through numerous valuation proceedings, he or she will not in most instances be an expert on the debtor's industry, nor will he or she be an expert in economic forecasting. The judge will typically rely on the testimony of experts, which as discussed above can be biased in favour of their client.

Resolving a valuation dispute, which a judge has a reputational stake in doing correctly, can be an unpleasant experience for a judge who is torn by two seemingly equally persuasive value projections. Further, bankruptcy judges generally favour expedient resolutions that don't result in the costs and time loss of litigation and, frankly, don't continue to encumber their often crushing dockets. Because of these concerns, a judge may well favour - and encourage - a consensual resolution of a valuation dispute, as this will avoid the laborious process of evaluating the arguments of competing

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experts, the possibility of being wrong in ascertaining the debtor's value, and the time and burden of litigation.

v. The Attorneys

As repeat players in valuation disputes, attorneys are uniquely positioned to know when consensual valuation will be better for their clients than litigation. For example, an attorney representing senior creditors may view the junior creditors' chances of prevailing in a valuation dispute (or an attack on fraudulent conveyance or preference grounds) as significant, and therefore push for consensual resolution to avoid the risk to his client. However, the incentives of attorneys in advocating for consensual resolution may be mixed because of the fees to be gained from litigating the dispute. This incentive may be countered by the fact that attorneys also value their professional reputation, and an attorney who is known as an honest broker that doesn't pointlessly litigate will be better perceived among the bar and other restructuring professionals and may therefore garner more clients.

B. Creative Solutions

Given the diverse and conflicting goals of the various parties-in-interest, it is often easier and more efficient to bypass the valuation question altogether. Doing so, however, often requires a willingness on the part of the key parties-in-interest to explore creative solutions. This section will briefly discuss a few such mechanics from recent cases.

i. Volume Weighted Average Price ("VWAP")

VWAP is a post-confirmation pricing mechanism that avoids the need for valuation litigation by estimating the value of the debtor and assigning equity based on this estimate. In order to utilize the VWAP method, a number of shares of equity in the reorganised debtor are kept in reserve at emergence and not distributed pending the resolution of the VWAP process. To arrive at a valuation, the court then aggregates the value of all shares traded during a specific period and divides by the number of shares traded. The VWAP share price is then multiplied by the total number of shares to arrive at a value for the company. At the conclusion of the VWAP process, certain classes of claimants are "trued-up," or given more shares, based on the actual post-confirmation market value of the debtor and whether the debtor's initial valuation was an underestimate or overestimate. Under this approach, senior creditors would initially receive the shares not held in reserve. The shares held in reserve are distributed after the VWAP process to senior creditors if the debtor's value had been overestimated or to junior creditors if the value had been underestimated. This approach was used successfully in the 2007 Chapter 11 case of Dana Corporation to determine the value of new shares in the reorganised debtor. *In re Dana Corp., Inc.,* No. 06-10354 (Bankr. S.D.N.Y. 2007).

ii. Purchase Approach

The purchase approach should be advocated by junior creditors who feel that a senior creditor is intentionally undervaluing the debtor. Under this approach, junior claimants are allowed to purchase claims from the senior claimants at the price the senior claimants assert is the true value. If the junior claimants are correct that the debtor is really worth more than asserted by the senior claimants, they end up with the surplus. It also gives the senior claimants an incentive to be more realistic and not undervalue the debtor, because if they do so they will be bought out by the junior creditors at an artificially low price. This approach was attempted in the 1993 Chapter 11 case of E-II Holdings where a group of junior creditors led by financier Carl Icahn asserted that the proposed plan undervalued the company and gave too much value to senior creditors. The junior creditors made a series of bids for the company, each time valuing it slightly more than the amount proposed by the senior creditors, and each time the senior creditors raised their plan estimate of the total value of the company to exceed the bid. *In re E-II Holdings Inc.,* No. 92 B 43614 (CB) (Bankr. S.D.N.Y. 1992) (unpublished memorandum decision).

iii. Auction Approach

In certain circumstances where the relevant parties-in-interest cannot agree on a value for the debtor's business, it may make sense to simply auction off the business. In this approach, the bankruptcy court would approve a set of procedures for conducting the auction and then the business (or significant parts thereof) are simply put up for sale to the highest bidder. Whether or not a sale is ultimately approved and effectuated, the auction process can help to set a value for the estate. An auction was successfully used in the Chapter 11 case of Adelphia Communications Corporation ("Adelphia") where junior creditors believed that a plan proposed by management undervalued the debtor for the benefit of senior creditors. The junior creditors obtained court approval for an auction of Adelphia's businesses, which ultimately led to Adelphia being sold to a group led by Time Warner Cable and Comcast Corporation for $17.6 billion. *In re Adelphia Communications Corp.,* No. 02-41729 (Bankr. S.D.N.Y. 2002).

iv. Convertible Securities

Valuation disputes can sometimes be avoided through the use of strategically-designed convertible securities. Such securities, when issued as part of a plan of reorganisation, can be used to allocate value among competing groups of creditors based on the post-emergence market value of the reorganised debtor. For instance, senior creditors, believing that the value of a post-emergence entity will be less than their claims, might receive the common stock of the reorganised debtor in their plan of reorganisation. However, junior creditors, believing that the reorganised debtor's business will be worth more than the value of the senior creditors' claims, might be granted warrants to purchase shares of common stock in the reorganised debtor at a strike price indicating payment in full for the senior creditors. In this way, if the senior creditors are correct, they will receive the full value of the entity; but if the junior creditors are correct, they will realise value over that required to pay in full the senior creditors. See Douglas G. Baird and Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1964-1965 (2005).

A similar approach was successfully utilised in the Conseco case. Senior creditors in that case believed that the reorganised debtor would be worth significantly less than the value of their claims, so they supported a plan of reorganisation that would have provided little value to junior creditors. However, the junior creditors believed that the entity would be worth enough to pay the senior creditors in full and leave them with the equity in the company. Accordingly, a plan was structured such that the junior creditors received the common stock of the reorganised debtor, while the senior creditors received convertible shares. If the company were not able to redeem the convertible stock by paying the senior creditors an amount sufficient to make them whole by a certain date after reorganization, the convertible stock would convert into common shares and effectively displace the junior creditors. Ultimately, the enterprise value of the reorganised Conseco proved to be substantially higher than the value of the senior debt and, as a result, the junior creditors were able to realise significant value even after the senior creditors were paid in full. *Conseco*, No. 02-49672 (Bankr. N.D. Ill. 2003). Different securities, but to similar effect, were designed to resolve valuation disputes in the 2001 Chapter 11 case of La Roche Industries, *In re Laroche Indus., Inc.*, No. 00-1859 (Bankr. D. Del. 2001), and in the 2008 out-of-court restructuring of Tekni-Plex, Inc.

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Conclusion

The uncertainty created by the valuation process (or other litigation threats) gives junior creditors a "valuable option." However, valuation litigation often has negative consequences for all parties-in-interest as a result of its direct and indirect costs. It is often value-maximising for the parties-in-interest to reach a consensual agreement on plan distribution. By doing so, the debtor's value is preserved or enhanced, and there is more value left to be shared. In order to help achieve this efficient result, it is essential to consider the differing goals and perspectives of the various parties-in-interest, and for the key parties-in-interest to be willing to think creatively in fashioning a plan of reorganisation.

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