VALUATION UNCERTAINTY IN CHAPTER 11 REORGANIZATIONS

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I. INTRODUCTION

The value of even a healthy business enterprise is inherently uncertain, and a company's pursuit of the bankruptcy reorganization process further amplifies this uncertainty. As a result, when the valuation of a distressed entity becomes necessary, opportunities for error and unintended financial consequences arise. The history of Exide Technologies' Chapter 11 litigation and reorganization process, coupled with its subsequent performance, illustrates the problematic nature of valuing a bankrupt enterprise.[1]

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In October 2003, Exide ("the Debtor" or "the Company")[2] proposed a plan of reorganization that fixed the enterprise value[3] of the reorganized company ("New Exide") at $950 million and gave the Debtor's prepetition secured lenders 99.2% of the equity value in New Exide.[4] The Debtor's unsecured creditors voted overwhelmingly against the plan.[5] At the "cramdown" hearing,[6] the Official Committee of

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[1] Exide Technologies filed for bankruptcy protection on April 15, 2002. Press Release, Exide Technologies, Exide Technologies Files for Reorganization (Apr. 15, 2002), *available at* http://www.exide.com/News/pressrelease/general/20020415_exide_technologies_files_for_reorganization.html. The court declined to cram down Exide's proposed plan of reorganization on December 30, 2003. *In re* Exide Techs., 303 B.R. 48 (Bankr. D. Del. 2003). Based on the court's ruling, Exide proposed a revised plan of reorganization which was confirmed by the court on April 21, 2004. Press Release, Exide Technologies, Court Confirms Exide Technologies' Plan of Reorganization (Apr. 21, 2004), *available at* http://www.exide.com/News/pressrelease/financial/20040421_court_confirms_reorganization_plan.html. The reorganized entity ("New Exide") emerged from bankruptcy on May 5, 2004. Press Release, Exide Technologies, Exide Technologies Emerges from Chapter 11 (May 5, 2004), *available at* http://www.exide.com/News/pressrelease/financial/20040505_emerges_from_chapter_11.html.

[2] The debtors in this proceeding included Exide Technologies, f/k/a Exide Corporation; Exide Delaware, L.L.C.; Exide Illinois, Inc.; RBD Liquidation, L.L.C.; Dixie Metals Company; and Refined Metals Corporation. *Exide Techs.*, 303 B.R. at 48. For ease of communication, the singular "Debtor" is used herein.

[3] Enterprise value is the sum of a company's equity value and its net debt (debt, preferred stock, and minority interests, less cash).

[4] The Bankruptcy DataSource, Exide Technologies, Summary of Debtors' Fourth Amended Joint Plan of Reorganization—Oct. 24, 2003, (New Generation Research, Inc. Dec. 2003). Assuming that the Company issued twenty-five million new equity shares, the Company's implied stock price would have been $20.64 and the secured creditors would have received total equity value in the amount of $516 million.

[5] *Exide Techs.*, 303 B.R. at 57-58.

[6] When the parties to a restructuring process cannot agree on a consensual plan of reorganization, a judicial valuation determination must occur before a judge can "cram down" the proposed plan over the dissenters' objections. *See* 11 U.S.C. § 1129(b) (2000); Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New*

Unsecured Creditors' valuation expert argued for a higher enterprise valuation range of $1.5 to $1.7 billion.[7] The court sided with the unsecured creditors in rejecting the Debtor's plan on the grounds that it undervalued New Exide and thus overcompensated the secured creditors at the expense of the unsecured creditors. In particular, the court rejected the expert for the Debtor's reliance on market-based indications of value, including a single $950 million outside bid for the Company.[8] Instead, the court concluded that New Exide's enterprise value was in the range of $1.4 to $1.6 billion.[9] In April 2004, the court confirmed a revised plan negotiated by the parties. The plan assumed a midpoint enterprise value of $1.5 billion and allocated 22.5 million common shares, or ninety percent of New Exide's equity value, to the secured creditors and 2.5 million shares, or ten percent of the equity, to the unsecured creditors, who received warrants to purchase an additional 6.25 million shares, or twenty percent of the fully-diluted equity.[10] The secured creditors thus surrendered at least (more if warrants are exercised) ten percent of the equity value in New Exide as a result of the court's "cramup."[11]

Bankruptcy Code, 53 AM. BANKR. L.J. 133 (1979); GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW § 9.04(f) (4th ed. 1996).

[7] *Exide Techs.*, 303 B.R. at 59.

[8] *Id.* at 59 & n.24, 66. After marketing the Company to approximately seventy-five private equity firms, the Debtor's adviser received only three second round bids for the Company; in addition to the $950 million bid, two other firms bid less than $900 million for the Company. *Id.* at 59 n.24.

[9] *Id.* at 66.

[10] Press Release, Exide Technologies, Court Confirms Exide Technologies' Plan of Reorganization (Apr. 21, 2004), *available at* http://www.exide.com/News/pressrelease/financial/20040421_court_confirms_reorganization_plan.html. Under the revised plan, New Exide's implied stock price was $24.50 per share. At this stock price, the equity component of the secured creditors' recovery was valued at $551 million. The warrants were exercisable at a price of $32.11 per share.

[11] *See* Barry E. Adler, *The Emergence of Markets in Chapter 11: A Small Step on North LaSalle Street*, 8 SUP. CT. ECON. REV. 1, 17 n.34 (2000) ("Where [a junior claimant] asserts solvency and retains an interest on that basis, one might refer to the coerced acceptance by a [senior class] as "cramup.").

In retrospect, it appears that the court overvalued New Exide, providing too much recovery for the unsecured creditors at the expense of the senior secured creditors. By the end of 2004, New Exide's stock price had declined from the $24.50 price per share implied in the Company's confirmed plan of reorganization to $13.78 per share.[12] At this price, New Exide's total equity value was approximately $345 million,[13] and its total enterprise value was less than $950 million,[14] the value initially proposed by the Debtor but rejected as too low by the court. The warrants, of course, remained far out of the money. Given this outcome, it appears that the Debtor's plan should have been confirmed.[15]

While the *Exide* account invokes valuation only in the context of plan confirmation and cramdown,[16] the Bankruptcy Code and related jurisprudence may require valuation assessments at multiple points in a bankruptcy proceeding. For example, the determination of a claimant's secured status requires valuation of the underlying collateral,[17] and the merit of an avoidance action depends upon whether a debtor was solvent at the time of the

[12] Stock price as of December 31, 2004. The stock began trading at $24.50 on April 21, 2004. By May 12, the Company's stock price had already slipped below $20.00. Current and historical NASDAQ stock quotes for Exide (ticker symbol: XIDE) are available at http://www.nasdaq.com.

[13] The equity value calculation is based on twenty-five million New Exide shares outstanding, the number issued pursuant to the confirmed reorganization plan.

[14] Enterprise value is based on New Exide's net debt as reported in the company's form 10-Q dated September 30, 2004.

[15] Although New Exide's stock price was at least partially impacted by events occurring after the Company's emergence from bankruptcy, the relatively rapid and substantial decline suggests that New Exide stock may have been overvalued from the outset.

[16] Hereinafter, discussion of cramdown also includes reference to potential cramup.

[17] *See* Harold S. Novikoff & Beth M. Polebaum, *Valuation Issues in Chapter 11 Cases*, SJ082 ALI-ABA 239, 241 (2004); David F. Heroy & Adam R. Schaeffer, *Valuation in Bankruptcy*, 862 PLI/COMM. 153, 157-58 (2004).

contested transaction.[18] The resolution of such issues will clearly impact the ultimate recovery that any claimant receives. However, the focus of this Note is on valuation issues arising in the context of plan confirmation and cramdown, where neither the debtor nor the bulk of its assets are sold without contest to a third party for an ascertainable sum pursuant to the plan.

In particular, this Note explores the factors that may have contributed to the observed outcome in *Exide* and the possibility of avoiding similar outcomes in future bankruptcy cases involving debtors of comparable size with comparable investor profiles. Part II provides an overview of the plan confirmation process. Part III explains how and why valuation disputes arise. Part IV examines the parties' incentives to negotiate versus litigate their valuation disputes, as well as the observed outcomes of these disputes. Finally, Part V presents potential methods for resolving the problems posed by valuation uncertainty.

II. VALUATION AND THE PLAN CONFIRMATION PROCESS IN CHAPTER 11 REORGANIZATIONS[19]

Any company seeking to reorganize under Chapter 11[20] of the Bankruptcy Code will likely require an enterprise value determination. As Judge Fullam explained in *In re Owens Corning*, "[t]o achieve an acceptable [plan], it will be necessary . . . to determine the value of the Debtors . . . and to determine the correct allocation of values to be distributed to the various creditors."[21] In other words, the size of the

[18] *See* Novikoff & Polebaum, *supra* note 17, at 241; Heroy & Schaeffer, *supra* note 17, at 158.

[19] For the purposes of this Note, "reorganizations" exclude uncontested sales, mergers, or other dispositions involving third parties in which valuation uncertainty is not present.

[20] 11 U.S.C. §§ 1101-1174 (2000).

[21] 316 B.R. 168, 170 (Bankr. D. Del. 2004) (ruling on a substantive consolidation dispute). *See also* Peter V. Pantaleo & Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419, 419 (1996) ("The outcome of every Chapter 11 case, whether litigated or negotiated turns on reorganization value."); Heroy & Schaeffer, *supra* note 17, at 155 ("Valuation plays a critical role in every bankruptcy."); 7 COLLIER ON BANKRUPTCY ¶ 1129.06[2]

remaining pie must be established before it can be apportioned among competing claimants. Moreover, the size of the pie relative to the claims outstanding is critical in determining whether a given class of claimants is entitled to any distribution at all.

Assuming that a debtor company will be reorganized rather than liquidated,[22] a court must confirm a plan of reorganization before the company can emerge from Chapter 11.[23] The debtor typically enjoys a 120-day exclusivity period in which to file a plan;[24] however, creditors are permitted to file competing plans upon termination of the exclusivity period.[25] If the parties develop a plan that is accepted by all

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(Alan N. Resnick & Henry J. Sommer eds., Matthew Bender & Co., Inc. 15th ed. rev. 2004) ("Entity valuation is ever present in non-consensual confirmation."); H.R. REP. NO. 95-595, at 414 (1977) ("[A] valuation of the debtor's business . . . will almost always be required under Section 1129(b) in order to determine the consideration to be distributed under the plan.").

[22] "The Code nominally requires a liquidation valuation of the debtor to ensure that a plan meets the 'best interests' test of section 1129(a)(7). Generally, however, liquidation value is so low that distributions under the plan clearly exceed the section 1129(a)(7) minimum, and no formal valuation is necessary." Chaim J. Fortgang & Thomas Moers Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1106 (1985). For a discussion of liquidation analysis, see Heroy & Schaeffer, *supra* note 17, at 166-68.

[23] 11 U.S.C. §§ 1129, 1141 (2000).

[24] 11 U.S.C. § 1121(b) (2000). Under § 1121(d), a court may increase or reduce this period.

[25] 11 U.S.C. § 1121(c) (2000). As noted by one commentator,

> U.S. bankruptcy law resolves valuation through negotiation. The reorganization plan is premised on an estimate of value for the restructured firm. The debtor's management has substantial control over the process, with an exclusive right to initially propose a reorganization plan. Creditors who disagree can vote against the plan or acquire more claims to influence the vote. Creditors can also lobby for an alternative value, join an official committee, or align themselves with management to develop a plan that best serves their interests. Creditors can petition the court to remove exclusivity and file a competing reorganization plan, or can request a formal valuation hearing.

classes of claimants,[26] they have presumably reached an agreement on the valuation of the reorganized entity. It is important to keep in mind, however, that the parties to such a consensual plan may waive the absolute priority rule, which requires in its simplest terms that all members of a given class are paid in full before members of a more junior class receive any recovery.[27] As a result, senior claimants are permitted to offer part of their recovery to junior claimants—who are not technically entitled to this recovery under the absolute priority rule—in order to avoid costly litigation. A corollary to the absolute priority rule states that "a senior class cannot receive more than full compensation for its claims."[28]

If a plan is rejected by one or more classes of impaired claimants, a judge may still "cram down" the plan over their objections.[29] A cramdown plan must meet all requirements of Section 1129(a) applicable to consensual plans except for Section 1129(a)(8), which requires the approval of all impaired classes. Nevertheless, Section 1129(a)(10) dictates that at least one impaired class must accept the plan before it can be approved. In addition, the plan must be "fair and equitable" and must not "discriminate unfairly."[30] The "fair and equitable" test essentially requires that a cramdown

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Stuart C. Gilson et al., *Valuation of Bankrupt Firms*, 13 REV. OF FIN. STUD. 43, 44 (2000).

[26] 11 U.S.C. § 1126 provides guidelines for determining whether a particular class has accepted a plan.

[27] The absolute priority rule is laid out in the Bankruptcy Code at 11 U.S.C. § 1129(b)(2)(B)(ii). *See also* 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.04[4][a].

[28] *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 612 (Bankr. D. Del. 2001) (citing *In re* MCorp. Financial Inc., 137 B.R. 219, 235 (Bankr. S.D. Tex. 1992)).

[29] "The Bankruptcy Code does more than provide an opportunity for negotiation . . . . Within specified limits, the Code also allows the bankruptcy judge to settle matters when the parties cannot agree." Adler, supra note 11, at 2-3. *See* 11 U.S.C. § 1129(b) (2000); Treister et al., supra note 6, § 9.04(f).

[30] 11 U.S.C. § 1129(b)(1) (2000).

plan not violate the absolute priority rule.[31] Determining whether a plan violates this rule in turn requires a valuation hearing and assessment. "Unfair discrimination" is not defined in the Code, but courts generally attempt to determine "whether there is a reasonable basis for [any] discrimination, and whether the debtor can confirm and consummate a plan without the proposed discrimination."[32] A "cramup" is also possible when a judge rejects a plan on the basis of undervaluation. By assigning to the debtor a higher valuation, a judge mandates a greater recovery for junior claimants under the absolute priority rule.[33] *Exide* is an example of a case involving cramup. If the parties are unable to agree on a consensual plan and the judge cannot cram down a nonconsensual plan, the judge has the option to convert a reorganization case under Chapter 11 to a liquidation case under Chapter 7,[34] although this measure is typically used only as a last resort.

Cramdown situations in which prepetition equity holders attempt to take advantage of the so-called "new value corollary" to the absolute priority rule[35] present an additional complication. Such situations typically arise in cases involving single asset real estate debtors.[36] The new value

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[31] Bank of America Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 441-42 (1999).

[32] *Genesis Health Ventures*, 266 B.R. at 611 (discussing the various tests courts utilize).

[33] *See supra* note 27 and accompanying text.

[34] 11 U.S.C. § 1112(b)(5) (2000).

[35] The "new value corollary" does not appear in the Bankruptcy Code, but "the main thrust of the decision in *LaSalle* was that the Supreme Court affirmed the doctrine of new value." David R. Kuney, *The Supreme Court and New Value: The Elusive Search for "True Value" and Neutral Bargaining Devices: Market Value vs. Judicial Value*, 8 J. BANKR. L. & PRAC. 505, 507 (1999). *See generally LaSalle*, 526 U.S. 434; Harvey R. Miller et al., *Leaving Old Questions Unanswered and Raising New Ones: The Supreme Court Furthers the New Value Controversy in* Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership, 30 U. MEM. L. REV. 553 (2000).

[36] *See, e.g.*, David Gray Carlson & Jack F. Williams, *The Truth About the New Value Exception to Bankruptcy's Absolute Priority Rule*, 21 CARDOZO L. REV. 1303, 1332 (2000) (finding that eighty-seven percent of

corollary essentially authorizes prepetition equity owners to purchase new equity interests in the reorganized entity at market value, even though existing creditors with senior claims will not be paid in full.[37] In *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*, the Supreme Court ruled that a debtor's plan granting prepetition equity holders an exclusive right to purchase new equity value "without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan"[38] ran afoul of the absolute priority rule, and added that "the best way to determine value is exposure to a market."[39] Nevertheless, the Court did not decide "[w]hether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity."[40] What constitutes satisfaction of the market test requirement thus remains unclear,[41] although the courts have begun to hammer out this strain of jurisprudence.[42]

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202 randomly selected "new value" cases were single asset real estate cases).

[37] Kuney, *supra* note 35, at 510.

[38] 526 U.S. at 454. The Court reasoned that "'the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals' . . . rendered the old equity's right to purchase the equity a property interest extended 'on account of' the old equity position and thus [ran afoul of the absolute priority rule]." Robert J. Keach, LaSalle, *the 'Market Test' and Competing Plans: Still in the Fog*, 21 AM. BANKR. INST. J. 18, 18 (2003).

[39] *LaSalle*, 526 U.S. at 457.

[40] *Id.* at 458.

[41] Keach, *supra* note 38, at 52.

[42] "[T]here are sharp divergences in the way the courts interpret LaSalle . . . . Some courts reviewing new value plans have mandated the termination of the debtor's exclusive period to file a plan in order to open the door to competing plans . . . . Other courts have held that provision in the plan for an opportunity for competitive bidding satisfies LaSalle . . . . [Still others have held that] the appropriateness of the 'market test' for the new value exception must be considered on a case by case basis." Novikoff & Polebaum, *supra* note 17, at 251-52 (reviewing and collecting cases). Another author notes that "[p]aradoxically, the experience after *LaSalle* does not include any report of an auction or other method of a choice by the

More important for purposes of this Note, and discussed in Part III below, is the potential applicability of *LaSalle*'s market test to non-"new value" enterprise valuation disputes.

Other non-valuation issues are also intricately related to the determination of enterprise value and may be contested during a reorganization. For example, the doctrine of substantive consolidation concerns whether "the assets of, and claims against" a debtor and all of its subsidiaries and affiliates should be "consolidated and treated as a single unit" for purposes of a bankruptcy reorganization.[43] Whether substantive consolidation occurs determines whether one aggregate pool or multiple separate pools of value are available for distribution, and therefore impacts the potential recovery for claimants to subsidiary entities under the debtor's corporate umbrella. Not surprisingly, this issue is frequently contested.[44]

The standards for resolving substantive consolidation disputes, unlike pure valuation disputes, are relatively clear, however. A prima facie case for substantive consolidation is established if there is "substantial identity between the entities to be consolidated" and "consolidation is necessary to avoid some harm or to realize some benefits."[45] The proponent having made such a showing, the burden then

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market." Nicholas L. Georgakopoulos, *New Value, After* LaSalle, 20 BANKR. DEV. J. 1, 12 (2003). Professors Carlson and Williams assert that the new value exception is "absolutely unimportant" and that *LaSalle* was "uncertworthy" since the utility of the new value exception is "all but limited to real estate bankruptcies," and new value plans were confirmed in only twelve of 202 randomly selected new value cases between 1981 and 1999. Carlson & Williams, *supra* note 36, at 1305-07, 1332.

[43] *In re* Owens Corning, 316 B.R. 168, 169 (Bankr. D. Del. 2004). *See also* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 153-54 (1992) (explaining the doctrine of substantive consolidation).

[44] *See, e.g.*, Thomas Moers Mayer & Philip Bentley, *WorldCom, MCI and the Second Circuit's Substantive Consolidation Doctrine: Asserting Creditors' Rights in the Largest Bankruptcy Case in History—Part I*, METRO. CORP. COUNSEL, Dec. 2003, at 5.

[45] *Owens Corning*, 316 B.R. at 171 (citing Drabkin v. Midland-Ross Corp. (*In re* Autotrain Corp., Inc.), 810 F.2d 270 (D.C. Cir. 1987) and Eastgroup Props. v. S. Motel Assocs., Ltd., 935 F.2d 245 (11th Cir. 1991)).

shifts to the creditor opposing substantive consolidation to show "that it relied on the separate credit of one of the entities to be consolidated" and "that it [would] be prejudiced by substantive consolidation."[46] After ruling that substantive consolidation was appropriate in *Owens Corning*,[47] Judge Fullam admonished the parties that "[it seems] to me rather obvious that the interests of *all* parties would be best served by the prompt achievement of a reasonably acceptable plan of reorganization; that litigating every conceivable issue to finality would be unduly expensive; and that the parties would be well-advised to settle their differences."[48]

This substantive consolidation discussion yields two observations that are relevant to the valuation problem that is the focus of this Note. First, Judge Fullam's remark emphasizes the parties' incentives to settle, rather than litigate, their disputes in a bankruptcy proceeding. Yet his words would surely be lost on the former owners of $750 million of pre-WorldCom MCI's subordinated Qualified Income Preferred Securities (QUIPS), who fared well by pursuing litigation of their substantive consolidation dispute in WorldCom's bankruptcy.[49] WorldCom proposed a plan that would have substantively consolidated the MCI entities, which held the bulk of the combined company's assets, into WorldCom, thereby reducing or precluding any recovery for the QUIPS holders. But since the QUIPS holders would have been entitled to a substantial recovery if the entities were not consolidated, they chose to litigate the issue. While the QUIPS securities traded at about eight percent of face value prior to the trial in anticipation of a loss, the holders of QUIPS securities ultimately recovered forty-five percent of their face value in a settlement reached on the first day of

[46] *Id.*

[47] *Id.* at 172.

[48] *Id.*

[49] For a complete discussion of the substantive consolidation dispute in WorldCom's bankruptcy, see Mayer & Bentley, *supra* note 44, and Thomas Moers Mayer & Philip Bentley, *WorldCom, MCI and the Second Circuit's Substantive Consolidation Doctrine: Asserting Creditors' Rights in the Largest Bankruptcy Case in History—Part II*, METRO. CORP. COUNSEL, Jan. 2004, at 5.

trial. For the QUIPS owners, the decision to pursue litigation clearly paid off. The potential implications are broad. As with a substantive consolidation dispute, any impaired claimant receiving little or no recovery under a proposed plan might similarly choose to litigate a valuation dispute, rather than settle early on, in expectation of a greater potential recovery. *Exide* demonstrates that such a strategy might be successful in at least some valuation cases.

Second, as with a substantive consolidation dispute, the parties in a reorganization proceeding may need to decide whether to litigate a valuation dispute. But their decisions on these two issues will not necessarily be the same. A court might be perceived as fully capable of applying the substantive consolidation doctrine and burden-shifting analysis to reach an equitable result on that issue, yet endowed with little relevant business expertise and no special ability to navigate the technicalities and uncertainties involved in valuing an enterprise.[50] Thus, parties facing a valuation dispute might prefer to reach a compromise on their own rather than to leave the resolution to a judge.

III. BANKRUPTCY VALUATION: HOW AND WHY DISPUTES ARISE

A. Valuation Uncertainty

Valuation disputes are largely attributable to valuation uncertainty, although strategic behavior made possible by the existence of valuation uncertainty[51] can also play a role. Two basic types of valuation uncertainty confront the stakeholders in bankruptcy: uncertainty regarding the true value of an enterprise ("actual uncertainty") and uncertainty

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[50] *See* Robert K. Rasmussen & David A. Skeel, Jr., *The Economic Analysis of Corporate Bankruptcy Law*, 3 AM. BANKR. INST. L. REV. 85, 91-96 (1995) (arguing that judges are well equipped to police misbehavior by the parties but not as prepared to make business decisions, including valuation determinations).

[51] "Strategic behavior" refers to self-interested attempts to maximize one's own position, often at the expense of another's legitimate rights.

regarding the value that a judge would assign to the enterprise ("judicial valuation uncertainty").[52] Since the "going concern" value[53] of an enterprise represents its perceived future prospects, actual uncertainty is intuitive in that it is a result of human inability to predict (and prove) future events with certainty. Sources of actual uncertainty include imperfect information regarding the future market for a debtor's goods or services, the abilities of a debtor's management team, and other factors relevant to a debtor's business.[54] The combined reorganization of Genesis Health Ventures and Multicare AMC, both providers of long-term healthcare, offers a pertinent example of how these factors contribute to actual uncertainty. In that case, competing claimants disagreed regarding the impact that an improving government reimbursement environment, a skilled nursing staff shortage, and a potential acquisition would have on the debtors' business,[55] and thus, disagreed over the debtors' actual valuation as well. The sources of uncertainty in judicial valuation determinations are somewhat more complicated and are discussed in Section III.D below. Neither type of uncertainty can be fully mitigated solely by deferring to current market indicators of value, discussed in Section III.B below, or by strictly applying standard valuation methodologies, discussed in Section III.C below. And as long as this uncertainty persists, both legitimate

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[52] *See* Douglas G. Baird & Donald S. Bernstein, *Enterprise Valuation and the Puzzling Persistence of Relative Priority Out-comes in Corporate Reorganization*, Univ. of Cal., Berkeley Law and Econ. Spring Workshop (2005) (pp. 38-39), (discussing reasons why bankruptcy claimants might agree to waive the absolute priority rule), *available at* http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1109&context=berkeley_law_econ.

[53] "Going concern" value may differ from "liquidation" value if any entity-specific value is generated by the existing use of a firm's assets. For a discussion of "liquidation" versus "going concern" value, see Heroy & Schaeffer, *supra* note 17, at 165-85.

[54] Baird & Bernstein, *supra* note 52, at 30 (discussing actual uncertainty in the context of a hypothetical bankruptcy case).

[55] For a complete discussion of the valuation dispute, see *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 611-16 (Bankr. D. Del. 2001).

valuation disputes and illegitimate exploitation of this uncertainty are possible.

B. Potential Market Failures

Efficient markets offer an ideal indication of value. Yet markets—especially those for distressed businesses—are often imperfect, whether due to illiquidity, incomplete or asymmetric information among investors, strategic behavior, or other factors. Often, stakeholders in a reorganization proceeding will agree to become "restricted" in their ability to trade their existing claims in exchange for access to material, non-public information regarding a debtor's business.[56] For this and other reasons, the parties involved in a reorganization may have greater information about the debtor's future business prospects than the general public, or the public may simply believe that this is the case. As a result, any outside bids for a debtor or its underlying securities might undervalue or overvalue a bankrupt entity.[57] This is an example of an asymmetric information problem.

A similar problem might arise in a thin market situation where few or no bids for the debtor are placed. A thin market could be the result of general market forces that have weakened competitors' and other strategic buyers' ability to bid for the debtor,[58] a collective action or illiquidity problem

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[56] *See, e.g.*, Stuart C. Gilson, *Investing in Distressed Situations: A Market Survey*, FIN. ANALYSTS J., Nov.-Dec. 1995, at 21-22, *available at* http://www.cfapubs.org/faj/issues/v51n6/pdf/f0510008a.pdf (discussing restrictions faced by members of official committees or other parties signing confidentiality agreements).

[57] *See, e.g.*, Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 763 (1988) (noting that informational asymmetries may prevent third parties from accurately assessing the value of a company).

[58] *See* Rasmussen & Skeel, *supra* note 50, at 105 (discussing potential problems with auctions and other market valuation tests). For example, the depressed state of the manufactured housing industry arguably contributed to the thin market for non-distressed Clayton Homes Inc., which was ultimately acquired by sole bidder Berkshire Hathaway as a financial investment. *See Berkshire Bid for Clayton Homes is Backed*, N.Y. TIMES, Jul. 8, 2003, at C4.

among dispersed junior creditors who would otherwise seek to "purchase" the debtor from senior claimants that allegedly undervalue its business,[59] or simply the debtor's small size and inability to attract significant interest from bidders, as in certain "new value" cases.[60] Strategic behavior poses a special threat in thin markets so courts must also beware of bids by parties with incentives to underbid.[61]

Adelphia Communications' ongoing Chapter 11 auction process demonstrates how a thin market can arise. Adelphia considered selling its assets in seven separate regional clusters, but indicated that it would entertain bids for the entire company as well.[62] At one point, Adelphia's board considered blocking a joint bid for the entire company by Time Warner and Comcast Corporation on the grounds that it would reduce competition in the company's auction process and allow the bidders to pay a lower price.[63] Although Adelphia ultimately allowed the joint bid,[64] the company also encouraged a consortium of private equity investors to submit a competing bid for the entire company in order to

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[59] Technically, junior creditors arguing for a higher valuation are always free to "purchase" the debtor from senior creditors at the lower valuation they propose and thus retain for themselves any excess value. Practical collective action and illiquidity problems may prevent such a transaction, however. *See* Baird & Jackson, *supra* note 57, at 763-64. This possibility will be explored in greater detail later in this Note.

[60] *See, e.g.*, Adler, *supra* note 11, at 16 (arguing that debtors in some new value cases may be too small to attract the attention of bidders other than the debtor's prepetition investors). The logic applies to both small debtors and extremely large debtors in non-new value cases as well.

[61] 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.06[2][b] (discussing *In re* Prince, 85 F.3d 314 (7th Cir. 1996), in which an individual debtor sought to repurchase the stock in his professional orthodontics practice and did not face any competition). This possibility clearly concerned the *LaSalle* court. *See supra* notes 38-42 and accompanying text.

[62] *See Adelphia Wins Court Approval for Auction Plan*, N.Y. TIMES, Oct. 23, 2004, at C4.

[63] *See* Peter Grant, *Adelphia May Not Accept Joint Bid for the Company*, WALL ST. J., Oct. 6, 2004, at B2.

[64] *See* Dennis K. Berman, *Adelphia Clears Way to Joint Bid for Assets*, WALL ST. J., Oct. 26, 2004, at C5.

create a more competitive auction.[65] In this case, the debtor's large size contributed to the thin market.

In *In re Pullman Construction Industries*, the court lamented that "all valuations of going business value are only educated estimates in the absence of one or more buyers ready, willing and able to purchase the business."[66] In that case, the privately-held debtor had been in bankruptcy for two years, but no potential buyer had come forward. The court concluded that the debtor's closely-held status and the "inherent uncertainties of future business in the construction industry" had precluded any bids for the debtor.[67]

Implied valuations based on the debtor's publicly traded debt and equity securities[68] can also be problematic. The trading value of these securities may fail to reflect the company's actual market value either because the securities are traded infrequently,[69] or because investors have made unwise investment decisions. For example, in *In re Kasper A.S.L.*, the company's prepetition equity holders sought approval to form an official equity committee on the grounds that the debtor's valuation was arguably sufficient to provide

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[65] *See* Andrew Ross Sorkin, *Equity Firms Said to Explore a Giant Offer for Adelphia*, N.Y. TIMES, Nov. 12, 2004, at C1 (noting Adelphia's encouragement of a competing bid); James Politi, *KKR and Providence Plan to Mount Joint Bid for Adelphia*, FIN. TIMES (London), Jan. 31, 2005, at 17 (announcing a probable competing bid).

[66] 107 B.R. 909, 932 (Bankr. N.D. Ill. 1989).

[67] *Id.*

[68] *See* Rasmussen & Skeel, *supra* note 50, at 101 (arguing that "[a]ctive claims trading also provides a market assessment of the value of a debtor"). For a general discussion of claims trading in distressed entities, see Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1 (1990).

[69] *See, e.g., In re* N.Y., New Haven & Hartford R.R., 4 B.R. 758, 791 (D. Conn. 1980) ("If the investing public is well informed, and the securities are seasoned and trading actively in a stable market, it seems apparent that market price should approximate the intrinsic value of the securities.").

them with a recovery.[70] Their assertion was based on the fact that the debtor's stock was trading at approximately two dollars per share and that the debtor's bonds were trading near par. The court denied the equity holders' request after opponents suggested that "the value of the stock was not reflective of market value, but of foolhardy investment decisions by an uninformed public."[71]

Yet the courts' greatest concern appears to be that markets tend systematically to undervalue distressed companies simply because they are distressed.[72] The validity of this concern is called into question, at least in part, by the relatively high rate—twenty percent or so—at which reorganized companies re-file for bankruptcy protection.[73]

Finally, all market valuation indicators suffer from the inherent limitation that rational investors will generally only purchase an asset for less than they believe it to be worth. As a result, market price data might properly be viewed as a valuation floor in many instances.

C. Valuation Methodologies

Valuation is typically performed by valuation professionals, although bankruptcy judges are also called upon to make or review valuation determinations. The three

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[70] *See* David M. Feldman & Matthew J. Williams, *Appointing Equity Committees*, N.Y.L.J., Aug. 9, 2004, at 9 (referencing *In re* Kasper A.S.L. Ltd., Case No. 02-10497 (Bankr. S.D.N.Y. 2002)).

[71] *Id.* (referencing *Kasper*, Transcript of Hearing, July 15, 2003, at 40).

[72] *See, e.g.*, *In re* Penn Cent. Transp. Co., 596 F.2d 1102, 1115-16 (3d Cir. 1979) ("[The market's] perception may well be unduly distorted by the recently concluded reorganization and the prospect of lean years for the enterprise in the immediate future.").

[73] *See* John Yozzo & Randall S. Eisenberg, *Rethinking WACC in Estimating Reorganization Value*, 22 AM. BANKR. INST. J. 38, 38 (2003) (asserting that at least nineteen percent of the 295 public companies that emerged from bankruptcy between 1992 and 1998 re-filed between 1995 and 2001). Data provided on Lynn M. LoPucki's Bankruptcy Research Database, available at http://lopucki.law.ucla.edu, indicate that approximately twenty percent of the companies that filed for bankruptcy between 1980 and 1999 re-filed within five years of their emergence from bankruptcy.

standard valuation methodologies include the "market comparison" (or "comparable company") approach, the "comparable transaction" (or "precedent transaction") approach, and the "discounted cash flow" ("DCF") approach.[74]

The market comparison approach attempts to derive a debtor's enterprise value from the enterprise value relative to earnings potential that the market has assigned to each of its peers.[75] This valuation proceeds in two steps. First, a financial performance metric for the debtor, e.g., normalized earnings before interest, taxes, depreciation, and amortization ("EBITDA"), must be calculated. Next, the multiple, or average multiple if more than one company is used, of a "healthy" comparable company's market-assigned enterprise value to its corresponding EBITDA must be determined. These two inputs are then multiplied to generate an enterprise valuation estimate for the debtor. Potential problems with this approach include deciding which debtor performance metric should be chosen, which financial performance period the valuation should be based on given the debtor's current financial condition, and which companies, if any, are truly "comparable" to the debtor.

The comparable transaction approach is similar, but seeks to derive the debtor's enterprise valuation from the prices (enterprise valuations) paid by purchasers in recent acquisitions of comparable companies,[76] rather than from market-assigned enterprise values. Complications associated with this approach include determining which transactions involved "comparable" companies and adjusting

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[74] *See, e.g., In re* American HomePatient, Inc., 298 B.R. 152, 174 (Bankr. M.D. Tenn. 2003); HOULIHAN LOKEY HOWARD & ZUKIN, BUYING AND SELLING THE TROUBLED COMPANY 25-30 (2002), *available at* http://www.hlhz.com/library/bsttcacs.pdf [hereinafter HLHZ]. HLHZ offers financial advisory services to distressed companies.

[75] *See generally* 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.06[2][a][i] (explaining the market comparison valuation methodology); Pantaleo & Ridings, *supra* note 21, at 421-27.

[76] *See generally* Heroy & Schaeffer, *supra* note 17, at 183-85 (explaining the comparable transaction valuation methodology).

for any control premium[77] which a purchaser may have paid. A control premium might not be appropriate if equity interests in the reorganized entity will be dispersed.[78] Generally speaking, this method is "best utilized to corroborate valuations obtained by other methods," given the uniqueness of each transaction.[79]

Finally, the DCF approach aims to calculate enterprise value based on the present value of a debtor's projected cash flows.[80] The DCF analysis includes several steps. The first step requires projection of the debtor's cash flows for the near-term, typically five years. These cash flows are then discounted back to present value using a weighted average cost of capital ("WACC"). The WACC represents the return that a hypothetical investor would demand from an investment in the company, based in part on the company's relative debt to equity ratio.[81] Next, a terminal value, representing the value of the debtor's cash flows beyond the projection period into perpetuity, is calculated by applying an enterprise value multiple or perpetual growth rate to the final year of projected cash flows. Lastly, the terminal value is discounted back to present value using the WACC and this amount is then added to the present value of the projected near-term cash flows to obtain the debtor's enterprise value. Choosing appropriate inputs for the DCF analysis, like the other valuation methods, can be difficult.

An example helps to demonstrate the complexities involved in applying these methodologies. In *In re American HomePatient*, a group of secured lenders (the "Lenders")

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[77] "The Control Premium is a measure of the difference in value between a controlling interest in a company and a minority interest and can be found in successful public tender offers where the investor acquired a control position." *American HomePatient*, 298 B.R. at 174 n.19.

[78] *See* Novikoff & Polebaum, *supra* note 17, at 256.

[79] Heroy & Schaeffer, *supra* note 17, at 184 (quoting MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F. Supp. 913, 942 (S.D.N.Y. 1995) (non-bankruptcy case)).

[80] For explanations of the DCF valuation methodology, see 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.06[2][a][ii]; Pantaleo & Ridings, *supra* note 21, at 427-36.

[81] *See* 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.06[2][a][ii][B].

argued that the $250 million valuation adopted in the plan of reorganization proposed by American HomePatient (the "Debtor") was too low and that the Debtor's actual value was in excess of $300 million.[82] Both parties' experts assessed the Debtor's valuation using the market comparison, comparable transaction, and DCF approaches, yet the experts reached substantially different conclusions based on the inputs they selected:

Table 1. Selected American HomePatient Valuation Inputs

($ millions)

	Debtor's Expert	Lenders' Expert
Market Comparison Approach		
EBITDA	$46.6	$47.5
Multiple	5.0 – 5.5x	6.0 – 6.5x
Implied Valuation	*$230.0 – 260.0*	*$285.0 – 309.0*
Comparable Transaction Approach		
EBITDA	$46.6	$47.5 – 49.3
Multiple	5.0 – 5.5x	6.25 – 6.75x
Implied Valuation	*$230.0 – 260.0*	*$297.0 – 333.0*
DCF Approach		
WACC (%)	12.5%	12.16%
Financial Projections	similar to Lender's	similar to Debtor's
Implied Valuation	*$250.0 – 290.0*	*$315.0 – 357.0*

In the market comparison approach, both experts selected the same three comparable companies for purposes of determining an appropriate multiple, yet they selected

[82] For a complete discussion of the parties' valuation dispute and the court's resolution, see *American HomePatient*, 298 B.R. at 172-79. For additional examples of the difficulties involved in applying these methodologies, see *In re Coram Healthcare Corp.*, 315 B.R. 321, 337-43 (Bankr. D. Del. 2004) and *In re Cellular Info. Sys., Inc.*, 171 B.R. 926, 930-36 (Bankr. S.D.N.Y. 1994).

different multiples based on their divergent views of American HomePatient's strength and its growth prospects relative to those of the comparable companies. The experts' selection of differing multiples resulted in a midpoint valuation difference of approximately $50 million. For the comparable transaction approach, the experts chose their multiples based on somewhat different pools of comparable transactions. Both experts also considered bids received in American HomePatient's previously abandoned sale process, but they assumed different underlying EBITDA figures and thus derived different implied multiples. Under the comparable transaction approach, the difference in the experts' selected multiples resulted in a midpoint valuation difference of $70 million. In the DCF valuation, the Debtor's expert based his WACC assumption on the debt to equity ratios of comparable companies while the Lenders' expert calculated WACC based on the Debtor's current debt to equity ratio; the experts also utilized different values for the cost of equity financing. In addition, the Lenders' expert calculated DCF value both with and without the value of the Debtor's net operating losses ("NOLs"), while the Debtor's expert did not consider NOLs based on his belief that they could not legally be utilized by the Debtor. The experts' midpoint valuation difference was approximately $65 million under this approach. The court ultimately adopted the Debtor's proposed valuation range as a result of its expert's greater perceived credibility.

In summary, valuation is an inexact science.[83] This is true in part because "[a]t least as important as the methodology employed [in] arriving at market value is the 'quality and reasonableness of the assumptions which are

[83] *See, e.g., In re* Gustave Schaefer Co., 103 F.2d 237, 242 (6th Cir. 1939) ("The valuation of property is an inexact science and whatever method is used will only be an approximation and variance of opinion by two individuals does not establish a mistake in either."); *In re* Jones, 5 B.R. 736, 738 (Bankr. E.D. Va. 1980) ("True value is an elusive Pimpernel.").

plugged into [the methodologies].'"[84] The underlying assumptions will inevitably vary from one valuation attempt to another based on the judgment, experience, situation-specific knowledge, and expectations of the individual performing the valuation. Thus, "[t]o avoid gross error, and in cases in which entity valuation is critical to a fair and equitable outcome of the case, courts . . . should use multiple methods to check value."[85] Unfortunately, even the performance of a meticulous valuation analysis cannot guarantee that the parties (or a court) will get the valuation right.[86]

D. Judicial Valuation Determinations

As discussed in Section III.A, disputes over the value of a reorganizing entity may stem in whole or in part from attempts to exploit the uncertainty surrounding judicial valuation determinations. A judge will be called upon to make a valuation determination when the parties cannot reach an agreement themselves because, in order to cram down a reorganization plan over the objections of impaired claimants, a judge must ensure that the plan adheres to the absolute priority rule.[87] But "[a] determination of absolute priority . . . does not, in fact, assure adherence to such

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[84] *In re* Vanderveer Estates Holding, LLC, 293 B.R. 560, 564 (Bankr. E.D.N.Y. 2003) (quoting *In re* Carmania Corp., 156 B.R. 119, 121 (Bankr. S.D.N.Y. 1993)).

[85] 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.06[2][a][iv].

[86] *See* Gilson et al., *supra* note 25, at 53-54 (finding in a proprietary study of sixty-three firms emerging from Chapter 11 between 1984 and 1993 that the results produced by traditional valuation methods tend to underestimate value as compared to post-emergence market value, although the range of error in both directions is substantial, and that DCF valuation proved to be more accurate than comparable company valuation). The authors attribute the imprecision of traditional valuation methods to the administrative, rather than market-based, nature of the bankruptcy process, which reduces the quality and availability of information, and permits the strategic manipulation of estimates by the parties involved. *Id.* at 45.

[87] 11 U.S.C. § 1129(b)(2)(B)(ii) (2000).

priority,"[88] since a judge may get the valuation wrong. The sources of this judicial valuation "risk" or "uncertainty" are detailed below.

1. Bankruptcy Valuation Jurisprudence

Congress expressly declined to include a statutory valuation formula in the Bankruptcy Code.[89] Instead, the courts were directed to "determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case."[90]

The Supreme Court has historically discouraged lower courts from making bankruptcy valuation decisions based on what third parties are willing to pay for a bankrupt enterprise.[91] Rather, the Court has indicated that "[t]he 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."[92] This decision reflects the previously cited belief that markets tend to undervalue companies tainted by bankruptcy.[93]

In contrast to that principle, however, the Court noted in its review of the "new value" proposal in *LaSalle* that "the best way to determine value is exposure to a market."[94]

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[88] Barry E. Adler & Ian Ayres, *A Dilution Mechanism for Valuing Corporations in Bankruptcy*, 111 YALE L.J. 83, 90 (2001) (observing that markets are superior to judges in making valuation determinations).

[89] H.R. Rep. No. 95-595, at 216 (Sept. 8, 1977) ("A statutory valuation formula would have been helpful. The Committee has considered a number of suggested formulas but has been unable to come up with a satisfactory one. The valuation problem is, therefore, left to the referees and judges.").

[90] *Id.* at 356.

[91] *See* 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.06[2][a].

[92] Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 526 (1941).

[93] *See, e.g.*, *In re* Penn Cent. Transp. Co., 596 F.2d 1102, 1116 (1979) ("[The market's] perception may well be unduly distorted by the recently concluded reorganization and the prospect of lean years for the enterprise in the immediate future.").

[94] Bank of America Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 457 (1999).

Accordingly, *LaSalle* requires that the price (valuation) at which new value infusions are permissible be determined by reference to an actual market, rather than the traditional bankruptcy valuation methodologies discussed above. While the Court made this observation in the context of a new value contribution by prepetition equity holders, in which the threat of strategic behavior is particularly strong, commentators have speculated that it might be appropriate to extend the Court's reasoning to bankruptcy valuation more generally.[95] Other bankruptcy scholars have observed that modern judges already make sufficient use of market valuation indicators.[96] For instance, in *In re Adelphia Communications*, the court acknowledged the benefit of using markets by endorsing Adelphia's decision to pursue both a standalone reorganization and a sale of the company simultaneously in order to test valuation. The thin market concerns cited above notwithstanding,[97] the court noted that Adelphia had

> appropriately responded to concerns by parties in interest and the Court that market opportunities be fully explored to confirm that the value of [the] estate is maximized, and that the measure of the estate's value be tested by exposing the estate to bids by third parties, whose bids might be a better indicator of value than the testimony of experts.[98]

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[95] *See, e.g.*, Adler, *supra* note 11, at 18 ("it seems reasonable to [extend] the Court's language in *North LaSalle Street* and conclude that 'disfavor for decision untested by competitive choice ought to' reach all cases of cramdown and not only those with 'an old equity holder's proposed contribution'" (citing *LaSalle*, 526 U.S. at 457-58)).

[96] *See* Baird & Bernstein, *supra* note 52, at 8 ("One can press for greater use of markets, but there is little evidence to support the idea that Chapter 11 as currently practiced in large cases fails to make sufficient use of markets.").

[97] *See supra* notes 62-65 and accompanying text.

[98] *In re* Adelphia Communs. Corp., 2004 Bankr. LEXIS 971, at *2-3 (Bankr. S.D.N.Y. 2004).

2. Sources of Judicial Valuation Uncertainty

Uncertainty regarding the value that a judge would assign to a reorganizing entity stems from several potential sources, including utilization of the imprecise methodologies discussed in Section III.C, judicial technical error in applying these methodologies, inconsistent treatment of precedent, judicial perception of the parties' and their experts' credibility, and a judge's own opinions and beliefs.

In determining the value of a reorganizing entity, judges face the same valuation uncertainty as the parties themselves.[99] This problem is compounded by the fact that the "[a]ccuracy of [valuation] results . . . depends on the quality of the data used and the fidelity to proper application of the method," and "courts have not universally applied the methods correctly."[100]

And, since judges face substantial time constraints and are generally not valuation professionals, they must often rely heavily on valuations performed by the parties' experts.[101] For example, the court in *In re Vanderveer Estates Holding* included in its valuation opinion an appendix detailing the modifications that it had made to one expert's analysis in order to arrive at its own valuation conclusion.[102] Moreover, the valuations submitted by the parties may not be unbiased.[103] As a result, "[i]t is not unusual" for a battle of experts

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[99] Adler, *supra* note 11, at 10 ("[N]o judge is omniscient. Even an honest, unbiased estimate is subject to error.").

[100] 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.06[2][a][iv]. *See also* Pantaleo & Ridings, *supra* note 21, at 440 ("courts have not had an easy time properly applying the discounted cash flow analysis in reorganization cases . . . . [t]hey have misunderstood the purpose of beta . . . erred in determining the cost of equity . . . and have made debatable assumptions about rates of future growth").

[101] *See* Novikoff & Polebaum, *supra* note 17, at 265; Keith Sharfman, *Valuation Averaging: A New Procedure for Resolving Valuation Disputes*, 88 MINN. L. REV. 357, 358-59 (2003).

[102] *See In re* Vanderveer Estates Holding, LLC, 293 B.R. 560, 577-80 (Bankr. E.D.N.Y. 2003).

[103] *See* Gilson et al., *supra* note 25, at 59 ("the administrative process allows the strategic use of valuation because different estimated values

> to be resolved on the basis of which expert the court deems to be the most credible. It should also be borne in mind that not all bankruptcy judges have extensive financial backgrounds. An expert's personal skills, in addition to impeccable credentials, may prove to be key factors in persuading a court of the reasonableness of the expert's analysis.[104]

Courts may also take into account an expert's familiarity with the debtor and its situation, "expectation of future business with the parties," "objectivity," "demeanor, research, and methodology," "conduct of thorough due diligence," experience, "straightforward application of valuation principles," "use of common sense," and "disclosure of assumptions" in deciding whether to rely on a given valuation.[105] The court's perception of the parties' experts was a decisive factor in the *American HomePatient* case discussed above.[106]

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imply different payoffs"); *Vanderveer Estates*, 293 B.R. at 562 ("Not surprisingly, the appraisal each offers serves its own purposes, and the two diverge significantly in their conclusions as to value.").

[104] Novikoff & Polebaum, *supra* note 17, at 266.

[105] *Id.* at 266-67 (collecting authorities). *See also* Heroy & Schaeffer, *supra* note 17, at 187-89 (discussing how courts evaluate expert valuation testimony).

[106] *In re* American HomePatient, Inc., 298 B.R. 152, 177-79 (Bankr. M.D. Tenn. 2003). Specifically, the court laid out a tabular comparison of the competing experts based on their education, training, experience, manner of appraisal, testimony on direct and cross-examination, and overall ability to substantiate their basis for valuation. In finding the debtor's expert and his valuation more credible, the court noted, inter alia, that

> [the debtor's expert] has performed or been involved in over 1000 valuations during his career. He has been hired by debtors, unsecured creditors, and lenders and has represented varied and often competing interests. [The creditors' expert], on the other hand, has represented both debtors and creditors in private placements, but has never testified as an expert for any party other than secured lenders. In fact, his continuous referral during his testimony to 'we' to include himself in the Lenders' camp gave the appearance that he was in fact of similar interest.

Id. at 178-79.

Differing treatments of precedent and valuation philosophies may also have an impact on the value that a judge would assign to a reorganizing entity. For example, the pre-*LaSalle* jurisprudence described above expresses general disfavor for the use of market-based valuations in the bankruptcy context, yet bankruptcy judges have not entirely eschewed market indicators of value.[107] In an apparent rejection of the market imperfection concerns discussed in Section III.B and the Supreme Court directive cited in Subsection III.D.1 above, one court observed that

> [d]ue to these difficulties in approximation, where market information is available, looking to the stock's "fair market value"–what an arm's length buyer would be willing to pay for the stock on the open market–is generally the best means of gauging the stock's present value . . . . The collective appraisal of market participants is considered to be a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.[108]

Had the *Exide* court adopted a similar philosophy, the debtor's original plan might have been confirmed.

But perhaps the most problematic aspect of judicial valuation uncertainty is the possibility that a judge will consider his personal bankruptcy policy opinions when assigning value to a debtor. As Professor Nimmer has observed, valuations are

> extensively influenced by policy and equitable factors in addition to economics. In choosing a higher (or lower) value, a court allocates the risk that will either injure or benefit the parties.
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> In another context, Congress has written that the decision about who should receive the benefits or bear the risks of valuations should be determined by

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[107] *See supra* notes 96-98 and accompanying text. *Cf. In re* Exide Techs., 303 B.R. 48, 59 & n.24, 66 (Bankr. D. Del. 2003) (rejecting the indications of value provided by a failed sale process).

[108] *In re* Prince, 85 F.3d 314, 320 (7th Cir. 1996) (pre-*LaSalle* new value case). This case is discussed in greater depth at 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶ 1129.06[2][b].

> the courts in light of the equities of the case. This is true also in reorganization practice. Absent an agreement, a court's decision about the value of the enterprise . . . represents a basic loss allocation. Even though the language of valuation is economic, the consequences must be equitable, reflecting a conscious understanding of how they apportion risk.[109]

The following account of *In re Evans Products*[110] provided by Professors LoPucki and Whitford demonstrates the scope of a bankruptcy judge's discretion regarding valuation issues:

> Even though the company bordered on solvency and cram down would ultimately turn on the testimony of investment bankers about the value of the securities being issued, the judge denied the motion of the official Non-Insider Equity Committee to retain an investment banker or an accountant. The controlling shareholder, a highly unpopular corporate raider, blocked acceptance of a plan that would have distributed $18 million to equity. The Non-Insider Equity Committee sued to compel acceptance, but the judge refused to intervene. The bank creditors then filed a different plan providing nothing for equity. In the face of conventional wisdom that litigation over valuation was so complex and unwieldy as to be impractical, the judge scheduled a confirmation hearing with only a single day for the presentation of evidence and argument, and he informed counsel that no additional time would be allocated. At the hearing, the same judge crammed down the plan.[111]

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[109] Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions*, 36 EMORY L.J. 1009, 1046-47 (1987) (internal citations omitted). Choosing a higher valuation allocates the risk of error to senior claimants, while choosing a lower valuation allocates this risk to more junior claimants.

[110] *See In re* Evans Prods. Co., 65 B.R. 31 (Bankr. S.D. Fla. 1986).

[111] *See* Lynn M. LoPucki and William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 718-19 (1993).

Finally, the often substantial range of disagreement between the parties in a valuation dispute highlights the significance of judicial valuation uncertainty, whatever its source:

Table 2. Range and Judicial Resolution of Selected Bankruptcy Valuation Disputes[112]

($ millions)

Debtor	Debtor's Proposed Valuation	Competing Valuation Proposal	Judicially Determined Value	Disputed Valuation Range
Allegheny International	$518	"substantially higher"	$518	N/A
American HomePatient	$250	>$300	$250	>$50
Cellular Information Systems	$134-59	$101	$110	$33-58
Coram Healthcare	$220	$279	$220	$59
E-II Holdings	$824	$1,345	$824	$521
Exide Techs.	$950-1,050	$1,500-1,700	$1,400-1,600	$450-750
National Convenience Stores	$210	>$300	$210	>$90
National Gypsum	<$200	>$1,000	<$200	>$800
Storage Technology	$500-600	$250	$874	$250-350

[112] Data for Allegheny International, E-II Holdings, National Convenience Stores, National Gypsum, and Storage Technology are based on case studies provided in Gilson et al., *supra* note 25, at 70-73. "Judicially Determined Value" means the court's finding or the valuation implied by the confirmed plan of reorganization, and "Disputed Valuation Range" means the difference between the competing valuation estimates. Data for the remaining debtors are based on *In re American HomePatient, Inc.*, 298 B.R. 152, 172-79 (Bankr. M.D. Tenn. 2003); *In re Cellular Info. Sys., Inc.*, 171 B.R. 926, 930-36 (Bankr. S.D.N.Y. 1994); *In re Coram Healthcare Corp.*, 315 B.R. 321, 337-41 (Bankr. D. Del. 2004); and *In re Exide Techs.*, 303 B.R. 48, 58-66 (Bankr. D. Del. 2003).

The manner in which a court chooses to resolve this uncertainty will determine whether, and to what extent, absolute priority will be observed and the various parties will recover their investments.[113]

IV. VALUATION DISPUTES AND THE PARTIES' INCENTIVES

This Part explores valuation uncertainty and other factors which may impact the parties' incentives to settle versus litigate a bankruptcy valuation dispute. As explained in Part II, a judicial valuation determination is not required for plan confirmation unless a class of claimants has voted against the plan.[114] Therefore,

> the parties usually try to negotiate acceptance by all classes, and valuation becomes a negotiating weapon. Senior creditors advance conservative valuations of the debtor because the more conservative the valuation the safer the payout to senior debt. By contrast, subordinated debt and shareholders advance optimistic valuations because the greater the value the more a plan can distribute to junior classes.[115]

And, while courts are required to enforce the absolute priority rule in cramdown situations,[116] which they do with varying degrees of success,[117] consensual plans of reorganization may deviate from this rule. Thus, in

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[113] *See* Arturo Bris et al., The Costs of Bankruptcy 27 (rev. Nov. 29, 2004) (working paper, *available at* http://ssrn.com/abstract=523562) (finding that "the identity of the judge mattered" after analyzing absolute priority violations in a sample of bankruptcy cases in New York and Arizona between 1995 and 2001).

[114] This assumes that reorganization value clearly exceeds liquidation value. A consensual plan of reorganization need only satisfy the provisions of 11 U.S.C. § 1129(a). Section 1129(b) is only applicable in cramdown situations. *See* Fortgang & Mayer, *supra* note 22, at 1106; 7 COLLIER ON BANKRUPTCY, *supra* note 21, ¶¶ 1129.03, 1129.04.

[115] Fortgang & Mayer, *supra* note 22, at 1106.

[116] 11 U.S.C. § 1129(b)(2)(B)(ii) (2000).

[117] *See supra* Part III.D.2 (discussing factors that impact judicial valuation determinations).

consensual plans, which are effectively settlement agreements,[118] junior classes will often receive a greater recovery than they are entitled to under the absolute priority rule, coming at the expense of senior classes.[119]

Multiple incentives to settle a valuation dispute exist for all parties. As Judge Fullam observed in *Owens Corning*, plan litigation is expensive both in terms of direct costs and delay.[120] Litigation entails substantial advance preparation[121] and delay has the potential to exacerbate the debtor's business problems so that enterprise value declines as the process continues.[122] Litigation can thus reduce the recovery available to all parties. In addition, senior creditors may fare better by giving away a portion of their own recovery than by risking judicial overvaluation, or cramup, made possible by the valuation uncertainty discussed in Part III.[123] This certainly may have been true in *Exide*. In such a case, the adoption of a consensual plan that departs from absolute priority can be viewed at least in part as the purchase by senior creditors of an option on judicial overvaluation from junior creditors.[124] Junior creditors, of course, face a corresponding risk of judicial undervaluation. Juniors will also be hit hardest by any reduction in the value of the estate

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[118] *See* Baird & Bernstein, *supra* note 52, at 49 ("Negotiations over the plan of reorganization are merely settlement negotiations.").

[119] *Id.* at 1. *See also* Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 286 (1990) (finding that absolute priority was violated in twenty-nine of thirty-seven bankruptcy cases filed between 1979 and 1986); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 754 (1989) (finding that absolute priority was violated in twenty-one of twenty-seven bankruptcy cases filed between 1970 and 1983). *But cf.* Bris et al., *supra* note 113, at 25 (finding that absolute priority was strictly observed in eighty-eight percent of Chapter 11 cases in New York and Arizona between 1995 and 2001).

[120] *In re* Owens Corning, 316 B.R. 168, 173 (Bankr. D. Del. 2004)

[121] Howard Seife, *Bankruptcy for Bankers*, 121 BANKING L.J. 541, 547-48 (2004).

[122] Fortgang & Mayer, *supra* note 22, at 1107.

[123] *See* Baird & Bernstein, *supra* note 52, at 33-36 (discussing the uncertainty inherent in even unbiased judicial valuation determinations).

[124] *See id.* at 35, 38.

precipitated by litigation since senior claims are paid first under the absolute priority rule applied in cramdown litigation. Finally, managerial preferences, a policy preference for loss spreading, public relations concerns, a desire to maintain a market for the debtor's securities, and social norms within the legal culture that favor settlement may provide additional incentives to compromise.[125]

On the other hand, the parties also possess competing incentives to litigate their disputes. Senior claimants benefit from strict enforcement of the absolute priority rule as long as judges do not overvalue debtors. In addition, senior claimants may benefit from a debtor's initially exclusive right to propose a plan of reorganization, since junior claimants advocating higher valuations cannot submit competing plans during the exclusivity period.[126] If a judge finds the valuation implied in a debtor's plan credible, junior claimants may be effectively excluded from the process (although they may still receive some recovery under the debtor's plan). Lastly, settlement might be inadvisable from the perspective of a senior creditor either when negotiating is likely to "invite others to engage in the same kind of behavior in the future,"[127] or when the determinate costs of acceding to the demands of junior claimants (i.e., partial forfeiture of recovery in a settlement) are likely to be more than the indeterminate costs of litigation (i.e., attorney fees, delay and judicial valuation risk).

But junior claimants, typically unsecured creditors, bondholders and equity holders, also possess a powerful ability to hold up a plan confirmation process because they can demand litigation of a debtor's value in a cramdown hearing if a proposed plan does not provide them with the level of recovery that they believe a court might award

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[125] Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 154-58 (1990).

[126] *See* 11 U.S.C. § 1121 (2000). While this is often the case, not all debtor plans are favorable to senior creditors.

[127] Baird & Jackson, *supra* note 57, at 749 ("A strategy of never negotiating with terrorists may be [best].").

them.[128] Moreover, when, as is often the case, junior claimants are not required to pay for the costs incurred in contesting a plan (or in proposing an alternate plan once the exclusivity period has expired), they possess a compelling incentive to litigate even if they do not believe that the debtor's plan truly undervalues the company.[129] This is true because the expenses of an official committee of creditors or equity holders incurred in challenging or developing a plan of reorganization will typically be paid from the bankruptcy estate.[130] Nevertheless, a court can disallow attorney fees for litigation not undertaken in good faith. For example, in *In re Heck's, Inc.*, the court largely denied reimbursement to an equity committee that had undertaken litigation to extort a settlement.[131] A committee of creditors holding unsecured claims is generally appointed as of right[132] and an equity committee may be appointed if the court believes that a committee is necessary to "adequately represent" the shareholders.[133] In *In re Northwestern Corp.*, the court denied a request to appoint an official equity committee after finding that "it was 'not in the best interests of the estate . . .

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[128] 11 U.S.C. § 1129(a)(8) requires that all impaired classes accept a consensual plan of reorganization, otherwise § 1129(b) will require a valuation hearing prior to cramdown.

[129] Junior creditors spend on professionals "to capture a larger part of the estate than the absolute priority rule would otherwise grant to them." Arturo Bris et al., Who Should Pay for Bankruptcy Costs? 1 (Feb. 17, 2004) (working paper, *available at* http://ssrn.com/abstract=401300).

[130] *See* 11 U.S.C. §§ 330(a), 503, 1102, 1103 (2000); Bris et al., *supra* note 113, at 28 (finding that courts almost always granted fees in a sample of bankruptcy cases in New York and Arizona between 1995 and 2001).

[131] 112 B.R. 775, 802-04 (Bankr. S.D. W. Va. 1990).

[132] *See* 11 U.S.C. § 1102(a)(1) (2000).

[133] *See* 11 U.S.C. § 1102(a)(2) (2000). In making its determination, a court will consider factors including: the number of shareholders; the complexity of the case; the solvency of the debtor; the timing of the motion relative to the case; whether the interests of shareholders are already represented by other parties in interest; whether the costs of the committee outweigh the potential benefits; and the integrity of the bankruptcy process. *See* Feldman & Williams, *supra* note 70 (collecting cases). The U.S. trustee is also authorized to appoint an equity committee up front. 11 U.S.C. § 1102(a)(1) (2000).

to shift the cost of the valuation dispute' from the equity committee proponents to the estate where it was unlikely that equity would receive a recovery."[134] Importantly, even though litigation expenses will reduce the size of the bankruptcy estate, and thus the value available to junior claimants, litigation will benefit junior claimants when a court determines that a proposed cramdown plan has undervalued a debtor by more than the total amount of litigation expenses.

If left unchecked, juniors' holdup power, enhanced by the Bankruptcy Code's fee reimbursement provisions, could lead either to settlements that arguably overcompensate junior classes or to potentially inefficient cramdown litigation.[135] However, mitigating factors, such as the threat of a sale which would "[crystallize] the rights of creditors and [determine] whether junior creditors are entitled to receive anything," and judges' "diminishing patience with stalling tactics of out-of-the-money junior classes when a sale is in prospect" exist.[136]

The focus turns next to how these ubiquitous valuation disputes are actually resolved and whether the currently observed outcomes are efficient. In practice, cramdowns are infrequent[137] and parties regularly adopt consensual plans of reorganization that compromise on valuation and depart from the absolute priority rule by providing a recovery to junior classes that are not technically entitled to such recovery.[138] The prevalence of consensual plans is generally celebrated,[139] although some decry the deviations from

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[134] Feldman & Williams, *supra* note 70 (citing *In re* Northwestern Corp., 2004 Bankr. LEXIS 635, at *7-8 (Bankr. D. Del. May 13, 2004)).

[135] *See* Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 777-81 (1988) (discussing imperfections in the bargaining system).

[136] Baird & Bernstein, *supra* note 52, at 12-13.

[137] *See* Gilson, *supra* note 56; Franks & Torous, *supra* note 119, at 752.

[138] *See* Baird & Bernstein, *supra* note 52, at 1.

[139] *See, e.g.*, G. Eric Brunstad, Jr. et al., *Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One*, 53 BUS. LAW. 1381, 1406 n.136 (1998) (describing Congress' observed preference for negotiated valuation determinations);

absolute priority.[140] For one thing, settlements that violate the absolute priority rule may be inefficient to the extent that they increase the upfront costs of debt financing by depriving senior creditors of the priority for which they contracted ex ante.[141] In addition, it may be that "the larger the deviations from strict priority the system tolerates, the harder the junior creditors will push to expropriate value from the senior claimants. This [would mean] more intractable, longer, and more costly conflicts among claimholders."[142] By this account, traditional settlement is not a panacea for Chapter 11 valuation disputes, and valuation uncertainty continues to pose a problem.

Alternative solutions may exist, however. Methods of reducing or eliminating valuation uncertainty could yield two important benefits. First, the cost of making a valuation determination or resolving a valuation dispute should be lower when uncertainty is removed. And second, since "[o]ne has to worry about whether bankruptcy can distinguish with sufficient accuracy cases where bargaining involves only brinkmanship from cases where there is a genuine dispute over the value of the Firm as a going concern,"[143] the reduction or elimination of valuation uncertainty could act as a check on strategic behavior in both settlement negotiations

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LoPucki & Whitford, *supra* note 125, at 126, 141, 178 (arguing that deviations from absolute priority are relatively small and settlements common based on their proprietary study); Baird & Bernstein, *supra* note 52, at 2 (arguing that valuation "settlements" in consensual plans may be a rational response to valuation uncertainty).

[140] *See, e.g.*, Bebchuk, *supra* note 135, at 780 ("Sometimes the deviation is unintentional, the result of inaccurate evaluation. Sometimes the deviation is deliberate: participants might use their power to delay in order to extract a reorganization plan that gives them more than the value to which they are entitled.").

[141] When senior creditors recover less than they contracted to recover ex ante, they may anticipate similarly reduced recoveries in other cases and thus raise their interest rates accordingly. *See, e.g.*, Adler & Ayres, *supra* note 88, at 88-89; Michael C. Jensen, *Corporate Control and the Politics of Finance*, 4-2 J. APPL. CORP. FIN. 13, 30-31 (1991).

[142] Jensen, *supra* note 141, at 30.

[143] Baird & Jackson, *supra* note 57, at 759.

and litigation. The next Part explores whether any feasible methods of reducing valuation uncertainty exist.

V. RESOLVING VALUATION UNCERTAINTY

A. Actual Uncertainty

The parties to a reorganization process could potentially resolve their disputes over a debtor's value—without resorting to litigation or questionable settlements—through either of two general approaches. One approach (the "Purchase Approach") would require the party or parties arguing for a higher valuation (i.e., the junior claimants) to buy out the claims of the parties arguing for a lower valuation (i.e., the senior claimants) at that lower valuation.[144] Alternatively, under the "Options Approach," the parties could agree to postpone, through the use of securities with option features, a final value allocation decision until the uncertainty regarding the debtor's actual value had diminished.[145]

1. The "Purchase Approach"

The rationale for asking junior claimants to "purchase" the debtor (or claims to the debtor) from senior claimants[146] is that

> the danger of erring on the side of over-valuation is much more significant than that of erring on the side of under-valuation. It is always open to the stockholders if they believe that the debtor is under-valued, to come forward with persons whom they can persuade of such under-valuation to produce the money with which to pay off all the senior security holders who otherwise would be given the under-valued enterprise. On the other hand, if the enterprise is over-valued, nobody will make the

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[144] *See generally* Bebchuk, *supra* note 135; Adler & Ayres, *supra* note 88.

[145] *See generally* Baird & Bernstein, *supra* note 52, at 43-49.

[146] *See supra* note 59 and accompanying text.

> senior security holders whole when the over-valuation is "discovered"—which is inevitably *after* consummation of the reorganization. They have no alternative source of compensating for erroneous approximation in the valuation process.[147]

The *Exide* case elegantly illustrates this point. Once a plan was confirmed, Exide's senior creditors lost the ability to demand additional compensation.

Although this approach would not technically solve the problem of actual valuation uncertainty, it would arguably distribute the risks posed by actual uncertainty more fairly when the parties have a legitimate valuation dispute. This approach would also alleviate the strategic behavior problem. Senior claimants will have little incentive to undervalue the company relative to their own beliefs since junior claimants can call their proverbial bluff. Similarly, junior creditors and equity holders will not claim that senior claimants have undervalued the debtor unless they truly believe that additional value exists. Thus, if a given class of claimants declines to buy out the claims of more senior classes, we can infer that this class does not truly believe that the value of the debtor is sufficiently high to provide it with a recovery under the absolute priority rule.

This general approach was tried in E-II Holdings' 1993 bankruptcy.[148] Financier Carl Icahn, who owned 31.4% of E-II's junior debt securities, alleged that the debtor's proposed plan undervalued the company and thus violated the absolute priority rule by awarding too much value to

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[147] Victor Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305, 320 n.32 (1974) (citing Walter J. Blum, *Some Marginal Notes on TMT Trailer Ferry Reorganization: The New Math*, 1968 SUP. CT. ECON. REV. 77, 84-87 (1968))(emphasis in original).

[148] *See generally* Nikki Tait, *Court Gives Approval to E-II Reorganisation Plan*, FIN. TIMES (London), May 26, 1993, at 25; Stephanie Strom, *E-II Holdings Wins Fight for Reorganization Plan*, N.Y. TIMES, May 26, 1993, at D3; *Icahn, Ametek Bid for Culligan*, CHI. TRIB., May 25, 1993, at B3; Stephanie Strom, *Ametek and Icahn Join in Bid to Control E-II*, N.Y. TIMES, May 25, 1993, at D5; Press Release, Icahn Holding Corp., Icahn Confirms Bid for Operating Assets of E-II Holdings (May 24, 1993).

senior claimants. In support of his allegations, Icahn made a series of bids for the company. E-II rebuffed each bid, yet repeatedly revised its own valuation estimate upward to match Icahn's bids. Icahn offered a final bid at the cramdown hearing, but, after questioning Icahn's ability to effect a purchase of the company and noting that a cramdown hearing was not an appropriate venue in which to conduct an auction, the judge confirmed the debtor's plan over Icahn's objections.

Unlike in the *E-II* case, the junior claimants in a Chapter 11 proceeding may instead be a large and dispersed group in which individual claimants lack Carl Icahn's extensive financial resources. The collective action problem posed by requiring such dispersed junior claimants to purchase the debtor from senior claimants in order to prove their undervaluation claims credible was alluded to earlier.[149] Fortunately, bankruptcy scholars have suggested several modified methods of resolving valuation disputes in this manner. Professor Bebchuk's proposal[150] would require a junior claimant who asserts that the debtor has been undervalued to purchase (or pay) his pro rata share of all senior claims at face value in order to obtain a pro rata claim to the total value of the reorganized entity. Claimants would have the opportunity to purchase senior claims in order of increasing priority, and such purchases would occur as soon as practicable following reorganization. Thus, if all members of the most junior class elected to purchase their pro rata portion of the senior claims, then the junior class would own the debtor, and all senior claimants would be paid the full value of their claims. If a junior claimant was correct that the debtor had been undervalued, the value of his pro rata claim would exceed the amount that he paid and he would enjoy at least a partial recovery of his initial investment in

[149] *See supra* note 59 and accompanying text. This problem does not exist when claims are held by a relatively small number of parties.

[150] *See generally* Bebchuk, *supra* note 135. Professors Adler and Ayres have also suggested a mechanism which, although differing in several important specifics, is similar in theory to the Bebchuk proposal. *See generally* Adler & Ayres, *supra* note 88.

the debtor. While this mechanism would mitigate the collective action problem, in an attempt to make the Purchase Approach more practical, it would also deviate from the ideal purchase described above in that senior claimants would receive the face value of their claims even if they believed that their claims were worth less than face value.

The appeal of forcing junior claimants to "put their money where their mouth is" is clear. But even under the modified approach described above, problems remain. Professors Adler and Ayres point out that "[a]ny suggestion for reform of the bankruptcy reorganization process must sail carefully past the economic versions of Scylla and Charybdis: thin markets and high transaction costs."[151] Under the Bebchuk proposal, a thin market problem could arise if junior claimants faced liquidity constraints or were unwilling to invest additional resources in the distressed entity.[152] And, even assuming a willingness to do so, junior claimants' ability to overcome their liquidity constraints by borrowing funds might be limited by lenders' concerns about the debtor's financial risk.[153] As a result, any undervaluation might remain undiscovered.[154]

Research has failed to uncover any attempt in practice to implement a mechanism of the type proposed by Bebchuk.[155] However, plans adopting analogous "rights offering" features have been confirmed. A rights offering can take varying forms, but generally such mechanisms grant stakeholders who are not entitled to a full recovery under a confirmed

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[151] Adler & Ayres, *supra* note 88, at 148.

[152] *See* Bebchuk, *supra* note 135, at 797; Baird & Bernstein, *supra* note 52, at 33.

[153] *See* Adler & Ayres, *supra* note 88, at 121; Baird & Bernstein, *supra* note 52, at 33.

[154] *See* Bebchuk, *supra* note 135, at 797; Adler & Ayres, *supra* note 88, at 119-20.

[155] One article suggests that "although Bebchuk's scheme is ingenious, it may be regarded as too complicated in some circumstances." Philippe Aghion et al., *The Economics of Bankruptcy Reform*, 8 J.L. ECON. & ORG. 523, 535 (1991) (propounding an alleged improvement on Bebchuk's scheme).

plan subscription rights to purchase common or preferred stock in the newly reorganized debtor.[156] These subscription rights generally do not entitle an impaired claimant to buy out the reorganized debtor's existing shareholders,[157] but rather offer the impaired claimant an opportunity to maintain a stake in the debtor. In theory, any claimant who believes that a confirmed plan has undervalued a debtor should seize an opportunity to invest in the reorganized debtor's correspondingly undervalued securities. Rights offerings have been utilized in several recently concluded Chapter 11 cases, including Atlas Air Worldwide Holdings, XO Communications, PennCorp Financial Group, Forcenergy, and Paragon Trade Brands.[158]

More importantly, under current law, use of the Purchase Approach would be voluntary rather than mandatory. This is true because the Code does not oblige junior claimants to provide the additional capital and bear the additional risk required by the Purchase Approach. As a result, the current utility of this approach may be limited.

2. The "Options Approach"

The Options Approach, while avoiding the illiquidity problem associated with the Purchase Approach, raises other potential complications. The absolute priority rule which governs the cramdown process treats a reorganization as "a recognition event that collapses all future possibilities [for

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[156] *See* Baird & Bernstein, *supra* note 52, at 44 & n.57.

[157] Such a transaction is generally termed a "tender offer."

[158] *See generally* The Bankruptcy DataSource, Atlas Air Worldwide Holdings, Inc., News Notes (New Generation Research, Inc. July 2004); The Bankruptcy DataSource, XO Communications, Inc., News Notes (New Generation Research, Inc. Nov. 1, 2002); The Bankruptcy DataSource, XO Communications, Inc., Summary of Debtor's Third Amended Plan of Reorganization—July 22, 2002 (New Generation Research, Inc. Oct. 1, 2002); The Bankruptcy DataSource, PennCorp Financial Group, Inc., News Notes (New Generation Research, Inc. Jul. 1, 2000); The Bankruptcy DataSource, Forcenergy, Inc., News Notes (New Generation Research, Inc. Feb. 1, 2000); The Bankruptcy DataSource, Paragon Trade Brands, Inc., Debtor's Second Amended Plan of Reorganization—Nov. 15, 1999 (New Generation Research, Inc. Dec. 1, 1999).

the debtor] to present values."[159] This value is then allocated to claimants in order of priority. Accordingly, those who are not entitled to a recovery based on the debtor's present value suffer a permanent loss. The absolute priority rule can thus promote fierce contention regarding the debtor's valuation among the parties.

An alternative priority regime is conceivable, however, and it provides the basis for the Options Approach. As one court has observed:

> It [should be] possible for experienced reorganization professionals to devise—for those variables or uncertainties that cannot be adequately quantified within a reasonable time—appropriate "after-shock mechanisms" in the plan itself, together with "expandable" financial devices, such as warrants or participation certificates, income bonds, zero-coupon bonds or preferred stock, that can appropriately take into account such variables.[160]

Under such a "relative priority" regime, the parties can avoid valuation uncertainty and strategic behavior problems by "[allowing] the market to determine the actual value of the enterprise before the ultimate ownership allocation is finally determined."[161] In the meantime, stakeholders' relative priority status is preserved. Underlying this theory are the assumptions that markets will eventually value reorganized companies appropriately since "the stigma of bankruptcy surely lessens as time goes by," and that a

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[159] Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921, 936 (2001).

[160] *In re* Pub. Serv. Co., 88 B.R. 521, 538 (Bankr. D.N.H. 1988) (allowing extension of a debtor's exclusivity period given alleged feasibility of developing a confirmable plan).

[161] Baird & Bernstein, *supra* note 52, at 44. For a discussion of absolute versus relative priority, see generally James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127 (1928), and see generally Baird & Bernstein, *supra* note 52.

"sophisticated investor is capable of analyzing with some success the future prospects of [a reorganizing debtor]."[162]

The parties' risks are not reciprocal under a relative priority regime. In the event that the debtor's value proves sufficient to provide a recovery for a given class of junior claimants, this class will receive a recovery. But junior claimants are not required either to compensate senior claimants ex post if the debtor's value proves insufficient to provide a recovery for senior claims, or to compensate senior claimants ex ante for assuming this risk.[163] Nevertheless, senior claimants are at least partially compensated by avoiding both the risk of judicial overvaluation and litigation costs.[164] Moreover, logic and fairness dictate that "desirable" deviations from absolute priority suffered in an attempt to achieve the goals of decreased valuation costs and reduced strategic behavior (e.g., deviations under the Options Approach) should be considered separately from "undesirable" deviations extracted through strategic behavior or at great expense (e.g., bad faith settlements and cramdown litigation).

There are many ways to implement a reorganization plan based on relative priority.[165] One option is to give claimants who are impaired under the plan warrants to purchase common stock for a specified exercise price at some point in the future.[166] The exercise price should in theory be set based on the implied valuation at which the owners of these warrants would be entitled to a recovery under the absolute

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[162] *In re* N.Y., New Haven & Hartford R.R., 632 F.2d 955, 963 (2d Cir. 1980) (finding a market-based valuation approach to be plausible).

[163] *See* Baird & Bernstein, *supra* note 52, at 48 n.60 (explaining that junior creditors would be required to compensate senior claimants for this right under the absolute priority rule). *See also* Brudney, *supra* note 147, at 331-35 (arguing in response to a relative priority proposal made by the Commission on the Bankruptcy Laws of the United States that "those who are given an opportunity to participate if excess value materializes in the future, should only be given that opportunity if they (or some third persons) are willing to pay the seniors the cost of a failure in the future").

[164] *See* Baird & Bernstein, *supra* note 52, at 48.

[165] *See generally* Baird & Bernstein, *supra* note 52, at 43-49.

[166] *See id.* at 44.

priority rule. Plans of reorganization incorporating warrants are relatively common:

Table 3. Utilization of Warrants in Selected Chapter 11 Reorganization Plans[167]

Filing Year	Confirmed Plans	Confirmed Plans Utilizing Warrants	Percentage of Confirmed Plans Utilizing Warrants
1995	9	3	33%
1996	7	4	57%
1997	8	3	38%
1998	7	4	57%
1999	15	3	20%
2000	23	7	30%
2001	18	8	44%
2002	52	19	37%
2003	44	17	39%
2004	25	5	20%

Another option is to give junior claimants common stock and senior claimants debt or preferred stock securities that would be convertible into common stock if and when it became apparent that the debtor was not actually worth enough to provide a recovery to the junior claimants under the absolute priority rule.[168] The use of transferable put rights ("TPRs") and contingent value rights ("CVRs") that

[167] Sample includes companies with at least $500 million in assets whose cases were disposed of between 1995 and 2004 via confirmed plans of reorganization (including Chapter 11 sale and liquidating plans). List compiled from information on Lynn M. LoPucki's Bankruptcy Research Database, *available at* http://lopucki.law.ucla.edu (updated through Nov. 20, 2004). Warrant utilization statistics based on: information compiled by The Bankruptcy DataSource (New Generation Research, Inc.); news articles available on The InterNet Bankruptcy Library, *available at* http://www.bankrupt.com, and LexisNexis; SEC filings; and company news releases. Includes warrants conditional on acceptance of a plan.

[168] *See* Baird & Bernstein, *supra* note 52, at 45-46 (noting that debtors in at least two recent reorganizations, LaRoche Industries in 2001 and Conseco, Inc. in 2003, have utilized convertible preferred securities).

guarantee the owners of these securities a certain value afford yet another alternative.[169]

The outcome of bargaining under this approach should mirror the outcome under the Purchase Approach described above. When options are utilized, it is futile for the parties to advocate a valuation which is higher or lower than they actually believe. Instead, the market will determine both the value of the debtor and the ultimate allocation of this value among the claimants.

The relative advantages of the Options Approach are that (1) it avoids the illiquidity problem associated with the Purchase Approach and (2) it is likely to be more workable (and less expensive) in practice than the Purchase Approach. The existence of a market for options and the use of securities with conversion features largely eliminate the need for additional cash outlays[170] and no voting mechanism is required. However, the use of these securities raises a separate question regarding the appropriate time period in which to allow their exercise or conversion. The closer the exercise period is to the debtor's emergence from Chapter 11, the less likely it is that the market will have "forgotten" about the debtor's bankruptcy taint. But the further away the exercise period, the more likely it is that post-reorganization factors (hopefully positive) will have begun to impact the debtor's valuation. As a result, the parties will have to compromise on an exercise period that distributes the risks in a manner acceptable to all.

Ultimately, the Options Approach suffers from the same fatal flaw as the Purchase Approach: its use must be voluntary. Current law prohibits a judge from cramming down relative priority plans because "[u]nder the absolute priority rule, senior creditors being asked to absorb equity

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[169] *See generally* Donald B. Hausch & James K. Seward, Mitigating the Corporate Valuation Problem in the Reorganization of Financially Distressed Firms: Transferable Put Rights and Contingent Valuation Rights (rev. Feb. 1999) (working paper, *available at* http://instruction.bus.wisc.edu/dhausch/powerpoint/cvr2001.pdf) (detailing the use of TPRs in the 1993 Petrolane reorganization and CVRs in the 1993 LTV reorganization).

[170] Baird & Bernstein, *supra* note 52, at 44-45.

risk would need to be given sufficient compensation when things go well to offset the risk that there will not be enough to pay them in full if things go badly."[171] The adoption of a consensual plan utilizing the Options Approach can thus be viewed as a more structured form of settlement. However, the Options Approach has the additional advantages of limiting the deviations from absolute priority, mitigating strategic behavior, and reducing the costs involved in reaching a settlement through the use of mechanical option securities. Nevertheless, the parties' incentives to forego traditional settlement may still apply. Senior creditors may hesitate to offer juniors even a potential recovery when they believe the debtor's value is truly insufficient to provide a full recovery to seniors and when the plan of reorganization entails substantial execution risk. On the other hand, senior creditors may also avoid the Options Approach when they believe that junior creditors very likely would be entitled to a recovery in the future. Similarly, juniors may prefer to force cramdown litigation in the hopes of obtaining a certain recovery than to accept the merely potential recovery available to them via options.

So despite their potential to cheaply and objectively resolve valuation disputes and deter strategic behavior, the Purchase Approach and Options Approach are limited to use in consensual reorganization plans under the existing legal regime. As an alternative, methods of reducing judicial valuation uncertainty could be useful in mitigating strategic behavior and encouraging voluntary use of the Purchase Approach and Options Approach.

B. Judicial Valuation Uncertainty

Faced with a reduction in judicial valuation uncertainty, the parties to a valuation dispute would find it more difficult to exploit this uncertainty to their own advantage and might

[171] *Id.* at 48 n.60. *See also In re* PWS Holding Corp., 228 F.3d 224, 244 (2000) (denying a creditor's claim that he should be awarded warrants to purchase common stock if and when the debtor's value became sufficient to pay him off on the grounds that "the bankruptcy estate is evaluated and distributions made at the time of the effective date of reorganization").

be more inclined to pursue the Purchase Approach or Options Approach voluntarily. But while judicial valuation uncertainty can in theory be alleviated, each of the general proposals outlined below suffers from shortcomings and none is sanctioned under current law.

One category of proposals generally seeks to limit judicial discretion. The "valuation averaging" approach, which is "[b]ased on the preferences revealed by valuation clauses in joint venture and other sophisticated commercial agreements," proposes a discretion-limiting default valuation procedure that would treat the average of competing valuation estimates as the presumptive valuation.[172] However, the proponent of this approach would limit its use to valuation disputes that fall within a twelve-percent range; beyond that, a more complicated formula based on the parties' own estimates and that of a neutral expert would be utilized.[173] Aware that the "valuation averaging" approach would be employed, any potential litigants finding themselves within the twelve-percent range would likely settle. Beyond this range, the parties would continue to face a more constrained version of existing judicial valuation uncertainty.

An alternative approach advocated by many suggests giving presumptive deference to available market value indicators.[174] This proposal is controversial because, as discussed earlier, markets—particularly distressed markets—are often imperfect.[175] Yet this objection loses force

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[172] *See* Sharfman, *supra* note 101, at 370-82. Sharfman's approach is designed to address a wide range of corporate valuation disputes.

[173] *Id.* at 371.

[174] The theory can be summed up as follows:

> valuation is a core problem in bankruptcy law; the courts are poor determinators of value; an external market test is the preferred price determinator; and the removal of the court from the valuation process is part of an overall effort to remove perceived leverage in bargaining position by those who gain from uncertainty in the judicial process.

Kuney, *supra* note 35, at 508.

[175] *See supra* Part III.B.

if judicial valuations are similarly imperfect.[176] A potentially more serious concern is that even if a useful market baseline were established, the parties would remain able to game the system by manipulating market prices and then pointing to the presumptive deference rule, or by exploiting existing market imperfections. Thus, any rule of market deference would have to be truly presumptive rather than mandatory in order to preserve judges' ability to police strategic behavior by the parties.

A second category of proposals reflects an attempt to circumvent judicial valuation determinations altogether. Under one such proposal, the court would appoint a neutral expert to perform a valuation analysis and then use this analysis to resolve any valuation dispute.[177] An expert should be more skilled in the "inexact science" of valuation, but would arguably face many of the same sources of uncertainty as the judge himself. A theoretically more promising proposal suggests that bankruptcy valuation disputes should be governed by contractual valuation procedures bargained for ex ante.[178] Despite the successful use of such contracts in joint venture and similar contexts, it is not clear to what extent bankruptcy judges would feel bound by such agreements or that the procedures outlined in a contract could ever suffice to resolve a complex bankruptcy valuation dispute.

A final alternative would be, in a direct attempt to encourage voluntary use of the Purchase Approach or Options Approach, to give presumptive deference to the valuation proposed by any party that had previously made a good faith, yet unsuccessful, attempt to implement a plan utilizing either of these approaches. Determining what

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[176] Rasmussen & Skeel, *supra* note 50, at 95 ("Many of the problems which may impair markets have the same or greater tendency to impair bankruptcy courts.").

[177] *See* Sharfman, *supra* note 101, at 362-63 (introducing and ultimately rejecting this approach).

[178] *See id.* at 363-64 (discussing the use of such contracts in joint venture contexts); Deborah Minehart & Zvika Neeman, *Termination and Coordination in Partnerships*, 8 J. ECON. & MGMT. STRATEGY 191, 207-13 (1999) (describing commonly used anticipatory valuation approaches).

constitutes good faith behavior could be problematic for judges, but is unlikely to be more problematic than determining the debtor's valuation.[179] Again, the deference would have to be presumptive rather than mandatory so that judges could continue to monitor the parties' conduct.

VI. CONCLUSION

Valuation uncertainty and strategic behavior present serious problems in bankruptcy valuation, and existing law poses few obstacles to a repeat of the *Exide* scenario. Whether that outcome was the result of a legitimate valuation dispute that was—in retrospect—wrongly resolved or a successful attempt by Exide's unsecured creditors to extract undeserved value from the company's secured creditors, it should disturb all creditors. Equally troubling cases in which junior claimants were denied their rightful recovery exist as well.

The proposals discussed herein, particularly the Options Approach, offer the opportunity to reduce valuation uncertainty and curb strategic behavior, making the resolution of bankruptcy valuation disputes both less costly and more equitable. The identified shortcomings of current approaches suggest that any potential improvements in the resolution of bankruptcy valuation disputes are worth exploring.

[179] *See supra* note 50.