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Valuation Issues in the UK Restructuring Plan

Alfino Eu[*]

The newly enacted restructuring plan under Part 26A of the Companies Act 2006 represents one of the key pieces of reform introduced by the Corporate Insolvency and Governance Act 2020. Central to the restructuring plan, which is modelled after the English scheme of arrangement, is the introduction of a new cross-class cramdown mechanism and a new 'genuine economic interest' principle, both of which are intended to facilitate restructurings by preventing out-of-the-money creditors from holding up a restructuring plan. Their introduction will invariably raise disputes over the enterprise value of the debtor company, a subject area which remains relatively underexplored in English restructuring law.

Where a going concern valuation of the debtor company is found to be appropriate, how should such a valuation be conducted? This article explores two potential options: first, an expert valuation approach as adopted in the US which is reliant on expert evidence and, second, a market testing approach which entails the conduct of an auction or a similar sales process to value the debtor company. It considers recent empirical evidence in the US which casts doubt on criticisms of the expert valuation approach raised by English academics and notes certain potential disadvantages of a market testing approach.

Keywords: Restructuring plan, Chapter 11, Valuation, Debt restructuring, Schemes of arrangement

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I. Introduction

The newly enacted restructuring plan under Part 26A of the Companies Act 2006 ('Part 26A') represents one of the key pieces of reform introduced by the Corporate Insolvency and Governance Act 2020 ('CIGA').[1] Central to the restructuring plan, which is modelled after the English scheme of arrangement ('scheme'), is the introduction of a new cross-class cramdown mechanism which allows dissenting creditor classes to be bound by a restructuring plan if it is shown, *inter alia*, that the restructuring plan is in the 'best interests' of the dissenting creditor classes.[2] The introduction of a cross-class cramdown mechanism, alongside a new 'genuine economic interest' principle, is intended to facilitate restructurings by preventing out-of-the-money creditors from holding up a restructuring plan.

Crucially, determining whether a restructuring plan is in the best interests of dissenting creditor classes and/or whether certain creditor classes have a genuine economic interest in the debtor requires the court to conduct a valuation of the debtor based on the scenario that is most likely to occur if the restructuring plan were not sanctioned (i.e. the 'relevant alternative scenario'). In most cases, such a valuation is likely to be straightforward: a failure to enter into an effective restructuring plan is likely to result in the debtor being wound up or placed into administration. This would entail a valuation based on either a piecemeal sale or, in certain circumstances, a going concern sale of the debtor's assets.[3]

However, there is likely to be a category of cases where the relevant alternative scenario is not one involving liquidation or administration. The debtor may, for instance, be in a sufficiently healthy financial state where a failure to enter into a restructuring plan is not necessarily fatal to its rehabilitative prospects or its ability to continue as a going concern in the short- to medium-term. In such cases, the adoption of a going concern valuation would be appropriate.

How then should such a going concern valuation be conducted? Part 26A does not prescribe how such valuation issues should be addressed by the courts. These issues have also not been definitively addressed by the English courts whether in the context of the scheme or the

[1] c. 12.
[2] Companies Act 2006 ('CA 2006'), s 901G(3).
[3] See, for example, Lorenzo Stanghellini, 'Best Practices in European Restructuring – Contractualised Distress Resolution in the Shadow of the Law' (20 September 2018) ('Best Practices') at 35 <https://ssrn.com/abstract=3271790> (accessed 15 January 2021).

restructuring plan. Broadly speaking, there are two potential options. The first is an expert valuation approach akin to that adopted by the US bankruptcy courts in Chapter 11, which requires a judge to determine a debtor's enterprise value based on valuation evidence tendered by the parties' experts. The second is what may be termed as a market testing approach, which entails the conducting of an auction or a similar sales process where the debtor's enterprise value is determined by reference to the highest value bid received.

The purpose of this article is two-fold. The first is to provide a close look at how an expert valuation approach has been applied in the cross-class cramdown context under Chapter 11 in the US, and the broader implications that such an approach has had on the restructuring dynamics among stakeholders in large Chapter 11 cases. With the aid of some empirical research, it is suggested that an expert valuation approach has been relatively successful in the US and concerns expressed by English academics that such an approach may confer excessive bargaining power on junior creditors and shareholders may be overstated. The second is to shed light on how a market testing approach is likely to operate in practice and the resultant difficulties that may arise. Overall, it is posited that an expert valuation approach should be preferred where a going concern valuation of the debtor is required for the purposes of the restructuring plan.

This article proceeds in six parts. Part II provides a brief overview of the CIGA and the key similarities and differences between the restructuring plan and the scheme. Part III discusses the legal significance of the genuine economic interest principle and the cross-class cramdown mechanism under the restructuring plan framework. Part IV details the application of an expert valuation approach by the US bankruptcy courts, the standard valuation methodologies adopted under such an approach, and the impact that the uncertainty in valuation outcomes engendered under such an approach has had on the restructuring dynamics in a large Chapter 11 case. Part V weighs the likely merits and disadvantages of both valuation approaches in the UK. Part VI concludes.

The use of several terms throughout this article should be clarified. The term 'debtor' shall be used to refer to a company undergoing a restructuring procedure (whether a restructuring plan under Part 26A, scheme or Chapter 11). The term 'plan' shall be taken to refer to a plan of reorganisation under Chapter 11, whereas the term 'restructuring plan' shall refer to the restructuring plan under Part 26A. Finally, the term 'enterprise value' shall refer to the total value of a debtor (i.e. the sum of its equity value and its net debt).[4]

II. Overview of the CIGA and the UK Restructuring Plan

The CIGA, which received royal assent on 25 June 2020, represents a sea change in the UK corporate restructuring landscape. Apart from a set of temporary measures to support companies through the economic turmoil wrought by the COVID-19 pandemic, three permanent measures have been enacted: a standalone moratorium, provisions prohibiting the operation of *ipso facto* (or termination) clauses, and a new restructuring plan contained in Part 26A.

While each permanent measure is significant, the focus of this article will be on the restructuring plan for several reasons. First, the restructuring plan framework contains a cross-class cramdown mechanism under section 901G which is unprecedented in English law.[5] Unlike a 'normal' cramdown which allows for dissentient creditors *within* a class to be bound by a proposed scheme or plan, a cross-class cramdown allows entire dissentient *classes* of creditors to be bound by a proposed restructuring plan. Second, as will be explored in greater detail below, a genuine economic interest principle has been introduced in certain provisions of Part 26A. More specifically, section 901C(5) provides that creditors whose rights are affected under a proposed restructuring plan may be excluded from participating and voting at the class meetings if they do not have a genuine economic interest in the debtor. Both the cross-class cramdown mechanism and the genuine economic interest principle will invariably raise disputes over a debtor's enterprise value, a subject area which remains relatively underexplored in English restructuring law.

At this juncture, a brief introduction of the restructuring plan framework is apposite. The restructuring plan is built upon the architecture of the English scheme. This is to allow the courts to tap upon the well-established body of jurisprudence of the latter in interpreting the provisions of Part 26A.[6] Both the restructuring plan and the English scheme envisage a three-

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[4] See Kerry O'Rourke, 'Valuation Uncertainty in Chapter 11 Reorganizations' (2005) 2005 *Columbia Business Law Review* 403 ('Valuation Uncertainty') at 404.
[5] CA 2006, s 901G.
[6] See Department for Business, Energy & Industrial Strategy, 'Government response: Insolvency and Corporate Governance', 26 August 2018 ('Government Response') at para 5.134

stage process which involve a compromise or arrangement between a debtor and its creditors. First, the debtor makes a court application to convene the meeting of its creditors ('Convening Hearing'). At the Convening Hearing, the court is primarily concerned with the question of how the creditors ought to be classified and other jurisdictional issues that may arise.[7] Second, the debtor convenes the relevant meeting(s) where the proposed scheme or restructuring plan is considered and voted on by the creditors. Third, if the scheme or restructuring plan is approved by the requisite statutory majorities, the debtor applies for court sanction of the scheme or restructuring plan ('Sanction Hearing'). At this stage, the court has a general discretion in determining whether to sanction the proposed scheme or restructuring plan.[8] The court is required to consider, *inter alia*, whether the scheme or restructuring plan is a fair one which a creditor could reasonably approve and whether the majority was coercing the minority in order to promote interests which are adverse to the class that they purported to represent.[9]

There are several important differences between the restructuring plan and the English scheme. Two – the cross-class cramdown mechanism and the genuine economic interest principle – have already been mentioned and will be discussed in greater detail below. The third difference is that, unlike a scheme where no insolvency threshold is imposed, a debtor which wishes to propose a restructuring plan must prove that it 'has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern' and that the purpose of the proposed restructuring plan is to address these financial difficulties.[10] This is a very low threshold which is intended to encourage and allow debtors to address their financial difficulties at an early stage with the use of the restructuring plan.

Finally, there is no numerosity requirement for a restructuring plan to be approved. Section 901F(1) provides that the approval of a class of creditors to a proposed restructuring plan is

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<https://www.gov.uk/government/consultations/insolvency-and-corporate-governance> (accessed 15 January 2021) and Department for Business, Energy & Industrial Strategy, 'Corporate Insolvency and Governance Act 2020 – Explanatory Notes', 25 June 2020 ('Explanatory Notes') at paras 13-14.

7 See Practice Statement (Companies: Schemes of Arrangement under Part 26 and Part 26A of the Companies Act 2006) and *Re Virgin Atlantic Airways Limited* [2020] EWHC 2191 (Ch) ('*Virgin Atlantic* (convening)').

8 See, for example, *Re British Aviation Insurance Co Ltd* [2006] 1 BCLC 665 at [69] and *Re Virgin Atlantic Airways Ltd* [2020] EWHC 2376 (Ch) ('*Virgin Atlantic* (sanction)') at [51]-[52].

9 See *Virgin Atlantic* (sanction) (n 8) at [51]-[52].

10 CA 2006, s 901A. For a critical evaluation of this threshold requirement, see Riz Mokal, 'The Difficulties with "Financial Difficulties": The Threshold Conditions for the New Part 26A Process' 35 *Journal of International Banking & Financial Law* 662.

obtained as long as it has been approved by a number representing three-fourths in value of the creditors present and voting at the relevant class meeting. By contrast, a scheme further requires the consent of at least a majority in number of the creditors present and voting at the relevant class meeting.[11]

III. Valuation Issues in the Restructuring Plan

Central to any corporate restructuring procedure is the issue of how a debtor ought to be valued. Fundamentally, a debtor's enterprise value determines the size of the asset pie that may be available for distribution to all creditors and other stakeholders. In the context of the restructuring plan, a debtor's enterprise value is significant for two other purposes. The first is in determining whether creditors have a genuine economic interest in a debtor. Second, it is also significant in determining whether the cross-class cramdown mechanism in section 901F may be invoked. Both will be discussed in turn below.

A. Genuine Economic Interest

Part 26A draws a clear distinction between creditors with a genuine economic interest and those without. The issue of whether creditors have a genuine economic interest in the debtor can arise for consideration at two stages of the restructuring plan process.

(a) Generally, creditors whose rights are affected by the proposed restructuring plan ('affected creditors') must be permitted to participate in the relevant class meeting.[12] However, section 901C(4) allows the court to, upon the debtor's application at the Convening Hearing, order an entire class of affected creditors to be excluded from participating and voting on the proposed restructuring plan on the basis that none of the members of that creditor class has a genuine economic interest in the debtor.

(b) Where the cross-class cramdown mechanism is sought to be invoked at the Sanction Hearing, a fundamental requirement is that the proposed restructuring

[11] CA 2006, s 899(1).
[12] CA 2006, s 901C(3).

plan must have been approved by at least one class of creditors.[13] Section 901G(5) provides that the votes of those who will not receive a payment, or who do not have a genuine economic interest in the debtor, in the event of the relevant alternative, are excluded in determining whether the approval of a creditor class has been obtained. The 'relevant alternative' is defined to mean 'whatever the court considers would be most likely to occur in relation to the company' if the proposed restructuring plan were not sanctioned.[14]

There is no legislative guidance as to the meaning of the term 'genuine economic interest'. However, it is clear that the term has its roots in the 'economic interest' principle in the context of a scheme, which establishes that that it is not necessary for a debtor proposing a scheme to consult any class of creditors which has no economic interest in the debtor.[15] To assess whether creditors have an economic interest in the debtor, the courts have sought to determine whether these creditors are 'in the money' based on the most likely alternative to the proposed scheme, a concept which is substantively similar to the relevant alternative scenario.[16] In this regard, large debt restructurings in the UK have often been carried out via a scheme paired with a pre-packaged administration (i.e. a transfer scheme) where the assets and business of the debtor are transferred into a new company or corporate group.[17] The 'economic interest' principle is particularly important in this context as it enables a *de facto* cross-class cramdown of out-of-the-money creditors. The claims held by these creditors against the debtor are, strictly speaking, left untouched but are effectively compromised as they are left behind with the asset-stripped debtor which has no way of satisfying them.

Whether the addition of the word 'genuine' is intended to narrow or alter the scope of the 'economic interest' principle remains the subject of judicial clarification. Nonetheless, on first reading, section 901C(4) appears to provide for a more streamlined version of the aforementioned practice involving the twinning of a scheme and a pre-packaged administration. As stated above, as a general rule, all affected creditors have a right to participate and vote at the relevant class meeting on the proposed restructuring plan. Section 901C(4) provides for a significant exception to this general rule where a class of affected creditors may be excluded

[13] CA 2006, s 901G(5).
[14] CA 2006, s 901G(4).
[15] See, for example, *Re Bluebrook Ltd* [2010] 1 BCLC 338 ('*Bluebrook*') at [24]-[25].
[16] *Ibid*. See also *Re MyTravel Group plc* [2005] 2 BCLC 123 at [55]-[58].
[17] See the discussion of *Bluebrook* below.

from such participation if it is shown that the class consists only of out-of-the-money creditors. In other words, a *de facto* cross-class cramdown of a class of out-of-the-money creditors may be achieved under a restructuring plan without the need for a pre-packaged administration and the costs and complexities that this can entail.[18]

The term 'genuine economic interest' can also be found in section 901G(5), which bears relevance when the court is required to determine whether a cross-class cramdown under section 901G should be permitted. While section 901C(4) requires a consideration of whether an *entire class* of creditors has a right to participate in the relevant class meetings at the Convening Stage, section 901G(5) provides that the votes of creditors without a genuine economic interest[19] in the debtor must be discounted in determining whether the three-fourths value majority requirement is met in relation to a specific class of creditors. It also bears noting that section 901G(5) expressly requires the question of whether creditors have a genuine economic interest in the debtor to be resolved by reference to 'the relevant alternative'. Although section 901C(4) is silent on this, it is highly likely that the courts will also resolve the same issue on the basis of the relevant alternative as this would ensure consistency with the approach adopted for section 901G(5).

B. Cross-class cramdown

A debtor's enterprise value is also relevant in determining whether a cross-class cramdown under section 901G may be permitted. The availability of a cross-class cramdown mechanism under the new restructuring plan renders it a particularly powerful debt restructuring tool in the UK. In determining whether the cross-class cramdown mechanism may be invoked, two requirements must be satisfied:

(a) First, none of the members of the dissenting class(es) of creditors would be any worse off than they would be in the event of the 'relevant alternative',[20] which

[18] See, for example, Jennifer Payne, *Schemes of Arrangement: Theory, Structure and Operation* (Cambridge: Cambridge University Press, 2014) at 264 and Geoff O'Dea, 'Craving a Cram-down: Why English Insolvency Law Needs Reforming' (2009) 10 *Journal of International Banking & Financial Law* 583.
[19] Section 901G(5) makes reference not just to creditors who have a genuine economic interest in the debtor but also those 'who would receive a payment'. This difference in phrasing from section 901C(4) is unlikely to be material as creditors 'who would receive a payment' is likely to be a subset of creditors with a genuine economic interest in the debtor.
[20] CA 2006, s 901G(3).

is defined to mean whatever the court considers would be most likely to occur in relation to the debtor if the proposed restructuring plan were not sanctioned.[21]

(b) Second, the proposed restructuring plan must have been approved by at least one class of creditors.[22] In determining whether the three-fourths value majority is met, the votes of creditors who, in the event of the relevant alternative, do not have a genuine economic interest in the debtor are excluded.

Notwithstanding the satisfaction of the aforementioned requirements, the court retains an absolute discretion whether or not to sanction the proposed restructuring plan and it may refuse sanction on the basis that it would not be just and equitable to do so.[23]

The cross-class cramdown mechanism draws inspiration from Chapter 11. However, the requirements for a cross-class cramdown under either Chapter 11 or the restructuring plan to be approved are different. The crux of the cross-class cramdown under Chapter 11 is the 'fair and equitable' requirement, which incorporates the two-pronged absolute priority rule ('APR').[24] First, a dissenting class of creditors must be paid in full before junior creditors or equity holders may receive any distribution under the restructuring plan. Second, a senior class may not receive more than a hundred percent of their claim where a dissenting junior class is not paid in full. The APR is an integral form of creditor protection under Chapter 11: it seeks to restrict, *inter alia*, the usurpation of priority by the owners of a debtor (i.e. its shareholders) to the detriment of the debtor's creditors.[25]

The APR was included in the initial draft proposal of the restructuring plan.[26] In a subsequent published draft proposal, the UK Government shifted to a more flexible implementation of the APR, which would allow for derogation from the APR where it is shown that such derogation

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[21] CA 2006, s 901G(4).
[22] CA 2006, s 901G(5). As alluded to by Justice Snowden in *Virgin Atlantic* (sanction) (n 8), this requirement may give rise to class manipulation issues. For a discussion of such issues in the context of the restructuring plan, see Riz Mokal, 'The Two Conditions for the Part 26A Cram Down' (2020) 35 *Journal of Banking & Financial Law* 730.
[23] See Explanatory Notes (n 6) at para 192.
[24] 11 U.S.C § 1129(b)(2).
[25] See, for example, American Bankruptcy Institute Commission to Study the Reform of Chapter 11, 'Final Report and Recommendations' (2014) ('ABI Commission Report') at 229-30.
[26] See Insolvency Service, 'A Review of the Corporate Insolvency Framework: A Consultation on Options for Reform' (May 2016) at para 9.32 <https://www.gov.uk/government/consultations/a-review-of-the-corporate-insolvency-framework> (accessed 15 January 2021).

is both necessary to achieve the aims of the proposed restructuring and would also be just and equitable in the circumstances.[27] The misgivings that the UK Government had about a strict implementation of the APR were clear. It noted that the APR has been described as 'inflexible and often a barrier to a debtor's successful reorganization',[28] and also that the APR may be subject to abuse because of potential blocking or holdout behaviour by 'predatory market players'.[29] Similar concerns have also been raised by European officials in the lead up to the enactment of the EU Restructuring Directive,[30] which undoubtedly have had an impact on the UK Government's eventual decision to remove the APR from the restructuring plan framework.

Instead of the APR, the UK Government introduced a 'best interests' test to determine whether a cross-class cramdown should be permitted. Under section 901G(3), the court must be satisfied that none of the members of the dissenting class(es) of creditors will be worse off under the proposed restructuring plan compared to the relevant alternative scenario before a restructuring plan may be crammed down on dissenting creditor classes. As will be seen in the next Part, this is a variation of the 'best interests' test under Chapter 11, which requires the court to be satisfied that each creditor or equity holder in *all* affected classes will not receive less under the plan than what they would receive in a liquidation of the debtor. Both the APR and the best interests test are forms of creditor protection, but they function in different ways. The 'best interests' test under section 901G(3) protects the value of the entitlements of the creditors under the relevant alternative scenario while the APR serves as a 'baseline' for determining the fairness of the distributions contemplated under the proposed plan.[31] Both will require a valuation of the debtor to determine whether the relevant test or rule is satisfied.

C. Taking Stock

Thus far, we have established the legal significance of a debtor's enterprise value in the context of a restructuring plan. First, at the Convening Hearing, a determination of whether a class of creditors has a genuine economic interest in the debtor may be required to ascertain the class's

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[27] See Government Response (n 6) at paras 5.164-65.
[28] *Ibid* at para 5.160 (citations omitted).
[29] *Ibid* at para 5.162.
[30] See General Approach of the Council of the EU on the Proposal for a Directive on preventive restructuring frameworks at 5 <http://data.consilium.europa.eu/doc/document/ST-12536-2018-INIT/en/pdf> (accessed 15 January 2021).
[31] See Stephan Madaus, 'Is the Relative Priority Rule right for your jurisdiction?' (20 January 2020) at 1 < https://stephanmadaus.de/wp-content/uploads/2020/01/Is-the-Relative-Priority-Rule-right-for-your-jurisdiction-%E2%80%93-Madaus-WP-2020-1-1.pdf> (accessed 15 January 2021).

entitlement to participate and vote on the proposed restructuring plan. This is likely to be determined with reference to the relevant alternative scenario. Second, at the Sanction Hearing, a debtor's enterprise value bears relevance in determining whether the proposed restructuring plan is in the best interests of the members of the dissenting class(es) on the basis of the relevant alternative scenario, and whether creditors within a certain class has a genuine economic interest in the debtor.

In the majority of restructuring plans, a determination of the relevant alternative scenario is likely to be a straightforward matter. Evidence that the debtor is facing significant liabilities that will fall due in the short- to medium-term without a reasonable prospect of repayment and/or evidence that aggrieved creditors are likely to take enforcement action would constitute sufficient proof that the relevant alternative scenario is one of liquidation or administration. Such cases would entail a valuation based on either a piecemeal sale or, in more limited circumstances, a going concern sale of the debtor's assets.[32]

However, there will also be cases where the relevant alternative scenario involves the continuation of the debtor as a going concern. As noted earlier, the imposition of a low 'insolvency' threshold for entry into a restructuring plan is intended to encourage timely resolution of financial distress.[33] As such, a proportion of debtors looking to propose a restructuring plan is likely to be in a healthy financial state where a failure to enter into a restructuring plan is not necessarily fatal to their restructuring prospects or their ability to continue as a going concern. In such circumstances, it would be more appropriate for the courts to adopt a going concern valuation of the debtor.

This then raises the question – how should such a going concern valuation be conducted? Unfortunately, the courts have not provided any definitive answers whether in the context of the scheme or the restructuring plan. In *Virgin Atlantic*,[34] the only reported restructuring plan at the date of writing, the court was not required to resolve any issues concerning the debtor's valuation. In the context of the scheme, those familiar with the UK restructuring scene are likely to be well-acquainted with the oft-cited decision in *Bluebrook*. A principal issue in that case concerned whether the mezzanine lenders, whose claims against the debtors were

[32] See, for example, Best Practices (n 3) at 35.
[33] CA 2006, s 901A.
[34] See *Virgin Atlantic* (convening) (n 7) and *Virgin Atlantic* (sanction) (n 8).

subordinated to those of the senior lenders, had an economic interest in the debtors. This in turn required the court to determine whether the value of the mezzanine lenders' claims exceeded or fell short of the debtor's enterprise value. In other words, a determination of whether the mezzanine lenders were 'in the money' had to be made.

In support of their position, the debtors procured three valuation exercises which sought to show that their value was significantly less than the amount required for the senior creditors to be paid in full. Two in particular should be highlighted. First, a valuation report was prepared by PricewaterhouseCoopers LLP ('PwC') which carried out a valuation of the Bluebrook Group on a going concern basis ('PwC Report'). Several valuation methodologies were adopted in the PwC Report, including a discounted cash flow ('DCF') analysis, a comparables analysis which involved a comparison of Bluebrook to comparable publicly traded companies and comparable transactions within the industry, and a leveraged buy-out analysis.[35] As will be discussed in greater detail below, this is broadly similar to the expert valuation approach adopted by the US bankruptcy courts which relies on the use of certain standard valuation methodologies. Second, the board of the Bluebrook Group instructed Rothschild, a financial advisory group, to pursue a third party sales process with a view to procuring a buyer for the Bluebrook Group. This process produced only one indicative offer which the board did not consider to be of a worthwhile level of cash to take further.

At the same time, the mezzanine lenders produced a valuation report produced by LEK Consulting ('LEK Report') which, unsurprisingly, purported to show that the '[debtors'] business is extremely sound and profitable.'[36] The main valuation methodology adopted in the LEK Report was a Monte Carlo methodology, which 'involves repeated calculation of the DCF valuation, using random sampling of input and assumptions, and then aggregating the result into a distribution of the probabilities of different valuation outcomes to show the relevant likelihood of this potential set of outcomes.'[37] Ultimately, Justice Mann accepted the valuation evidence given by the debtors over the LEK Report. This was primarily because Justice Mann considered the Monte Carlo methodology adopted to be a 'robotic' and 'mechanical' exercise

[35] A more detailed explanation of the various valuation methodologies, including the DCF analysis, is set out below.
[36] See *Bluebrook* (n 15) at [19].
[37] *Ibid* at [20].

which appeared to produce 'a range of possibilities', as opposed to a range of values that was 'professionally assessed'.[38]

Apart from a general disinclination towards the Monte Carlo methodology, however, it is difficult to draw any clear valuation principles from the decision in *Bluebrook*. Where a going concern valuation is required in the context of the restructuring plan, what forms of valuation evidence are admissible and how much weight should we attribute to them? As established above, the approach that the courts adopt in the UK can have significant distributional consequences for the various creditor groups and shareholders implicated in a restructuring. Before we consider which approach should be adopted in the UK, it would be apposite to consider the expert valuation approach that is adopted by the US bankruptcy courts in resolving valuation issues in Chapter 11 and how it has fared.

IV. The US Approach towards Valuation Issues in Chapter 11

Companies which are financially distressed may utilise Chapter 11 to undergo a formal debt restructuring in the US. Painting in broad strokes, a Chapter 11 case involves a three-stage process similar to that of a scheme or a restructuring plan. First, a Chapter 11 case is generally initiated by the debtor[39] and it is presumed that its existing management will remain in control during the reorganisation process.[40] At this stage, the court may also appoint official committees of unsecured creditors and equity holders,[41] which can perform the function of a 'statutory watchdog'.[42] Second, the proposed plan must be approved by the requisite majorities (i.e. a majority in number representing two-thirds in value) of each 'impaired' class of creditors or equity holders.[43] It bears noting that unimpaired classes do not have to vote on the plan because they are conclusively presumed to have accepted the plan.[44] The same applies to

[38] *Ibid* at [43]-[45].
[39] 11 U.S.C § 301. While rare, it is possible for a Chapter 11 case to be initiated by the debtor's creditors if certain requirements are met: 11 U.S.C § 303.
[40] 11 U.S.C § 1101.
[41] 11 U.S.C § 1102(a).
[42] See Michelle M Harner & Jamie Marincic, 'Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations' 64 *Vanderbilt Law Review* 749 at 761. Ad hoc committees of unsecured creditors or equity holders may also be formed.
[43] 11 U.S.C § 1122. An impaired creditor or equity holder refers to one whose contractual rights are to be modified or who will be paid less than the full value of their claims under the proposed plan.
[44] 11 U.S.C § 1126(f).

impaired classes who do not receive anything under the plan as they are presumed to have rejected the plan.[45]

The third stage involves a consideration of whether the proposed plan should be confirmed. The debtor's enterprise value lies at the heart of plan confirmations. Among other things, a valuation of the debtor is necessary to determine whether the proposed plan is feasible[46] and whether it is in the 'best interests' of each impaired class.[47] As explained earlier, the 'best interests' test in Chapter 11 requires the court to be satisfied that each creditor or equity holder in an impaired class will not receive less under the plan than what they would receive in a liquidation of the debtor. Further, where a cross-class cramdown is required for the confirmation of a non-consensual plan, the court must be satisfied that the plan is fair and equitable in respect of each dissenting impaired class.[48] In other words, a cross-class cramdown on dissenting classes of creditors and/or equity holders under Chapter 11 requires strict adherence to the APR.

Determining whether there has been adherence to (or an abrogation from) the APR can be challenging. In large corporate Chapter 11 cases, senior creditors often receive a substantial equity stake in the reorganised debtor as part of the plan. The debtor's enterprise value takes on special significance in this context because it determines whether senior creditors will be paid more than the full value of their accepted claims and, consequently, whether the second prong of the APR is violated. Nonetheless, this is not to say that the bankruptcy courts are often required to confirm non-consensual plans. Indeed, it is widely accepted that an important policy of Chapter 11 is to encourage consensual resolutions.[49] Under Chapter X, a predecessor to Chapter 11, a plan could only be confirmed if the APR were satisfied in respect of all classes of claims, which necessitated a costly judicial valuation in all cases.[50] The limiting of the APR to cases involving non-consensual plans was therefore intended to facilitate out-of-court settlements by permitting senior claimants the freedom to take less than full payment of their

[45] 11 U.S.C § 1126(g).
[46] 11 U.S.C § 1129(a)(11).
[47] 11 U.S.C § 1129(a)(7)(A)(ii).
[48] 11 U.S.C § 1129(b). Apart from the 'fair and equitable' requirement, the court must also be satisfied that at least one impaired class has accepted the plan and the plan does not discriminate unfairly with respect to each dissenting impaired class: 11 U.S.C § 1129(b)(1).
[49] See, for example, ABI Commission Report (n 25) at 199.
[50] See, for example, Lynn M Lopucki & William C Whitford, 'Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies' (1990) 139 *University of Pennsylvania Law Review* 125 ('Bargaining over Equity's Share') at 132.

claims.[51] As will be discussed below, it appears that the confirmation of consensual plans has been the norm rather than the exception in Chapter 11 cases.

A. Valuation Methodologies

The Bankruptcy Code does not prescribe how the courts should value a debtor or the forms of valuation evidence that should be admitted to resolve the various valuation issues that may arise in a Chapter 11 case. Instead, the principles underlying the resolution of such valuation issues have been left to be determined and developed by the US bankruptcy courts. In the context of the fair and equitable requirement, it is well-established that the debtor should be valued as a going concern, where its future earning capacity can be taken into account, rather than on a liquidation basis.[52] This stands in contrast with the English approach which requires the court to first determine what the relevant alternative scenario would be. The rationale for the US approach is clear. The central purpose of a Chapter 11 reorganisation is to preserve the going concern value of the debtor and to avoid a forced sale of its assets.[53] It would therefore be incongruous if the debtor were then to be valued on a liquidation basis.

Historically, the courts have eschewed reliance on market evidence – such as market prices derived from auctions of the debtor's business or the publicly traded securities of the debtor – in establishing a debtor's enterprise value in the cross-class cramdown context.[54] This has been largely because of a judicial perception that Chapter 11 debtors are consistently undervalued because of the 'taint' of bankruptcy and the 'prospect of lean years for the [debtor] in the immediate future'.[55] Further, the courts also hold the view that the market underestimates the advantages of the Chapter 11 process in rehabilitating a debtor including, for instance, the power to reject unwanted contracts during the Chapter 11 process.[56] Consequently, the courts have primarily relied on expert valuation evidence to establish a debtor's enterprise value. In

[51] *Ibid* at 132-33.
[52] See, for example, *Consolidated Rock Products Co v Du Bois*, 312 US 510 (1941) at 526, *In re Equity Funding Corp*, 391 F Supp 768 (1975) and Isaac M Pachulski, 'The Cram Down and Valuation under Chapter 11 of the Bankruptcy Code' (1980) 58 *North Carolina Law Review* 925 ('The Cram Down') at 939.
[53] *Ibid*.
[54] See, for example, *In re Exide Technologies*, 303 BR 48 (2003) ('*Exide*') and *In re Mirant Corp*, 334 BR 800 (2005) ('*Mirant*').
[55] See *Exide* (n 54) at 65-66.
[56] See *Mirant* (n 54) at 832-33.

this regard, three standard valuation methodologies have been adopted, namely, the DCF analysis, the comparable companies analysis and the comparable transactions analysis.[57]

Before turning to a brief discussion of each of the three valuation methodologies, it is worth noting that the courts have endorsed the use of market evidence in determining the value of a debtor for other purposes under Chapter 11. In the context of fraudulent transfers, for example, the Court of Appeals in *VFB LLC v Campbell Soup Co* has commented that '[a]bsent some reason to distrust it, the market price is "a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses."'[58] Likewise, in *Re Iridium Operating LLC*, the court endorsed the decision in *VFB LLC* and stated that 'the public trading market constitutes an impartial gauge of investor confidence and remains the best and most unbiased measure of fair market value and, when available to the Court, is the preferred standard of valuation.'[59] The rationale for a distinctly different approach in the cross-class cramdown context is readily explicable. In determining whether the fair and equitable requirement is satisfied, the court is required to undertake a forward-looking valuation rather than a backwards-looking one because the purpose of the Chapter 11 reorganisation is to preserve the going concern value of the debtor. As such, while market evidence can be pertinent and potentially reliable where a backwards-looking valuation is required, such evidence may not fully capture the value of the future earning capacity of the reorganised debtor given the potential for the markets to underestimate the value of a debtor in Chapter 11 or in financial distress generally.

The first valuation methodology that will be discussed is the DCF analysis. A DCF analysis aims to calculate a debtor's enterprise value based on an estimate of its future cash flows discounted to present value. The DCF analysis involves three main components. The first is a projection of the debtor's cash flows over a discrete time period, which is typically three to five years ('projection period'). This projection is typically prepared by the management of the debtor.[60] The second component is the terminal value of the debtor, which represents the

[57] See, for example, Valuation Uncertainty (n 4) at 419-20, Michael Simkovic, 'The Evolution of Valuation in Bankruptcy' (2017) 19 *American Bankruptcy Law Journal* 299 at 300 and Christopher S Sontchi, 'Valuation Methodologies: A Judge's View' (2012) 20 *ABI Law Review* 1 ('A Judge's View') at 2 & 14.
[58] See *VFB LLC v Campbell Soup Co*, 482 F.3d 624 (2007) ('*VFB LLC*') at 632-33.
[59] 373 BR 283 (2007) at 293.
[60] See A Judge's View (n 57) at 8 and Stan Bernstein et al, 'Squaring Bankruptcy Valuation with *Daubert* Demands' (2008) 16 *ABI Law Review* 161 ('Squaring Bankruptcy Valuation') at 187-88.

estimated value of the debtor from the end of the projection period into perpetuity.[61] The third component is the discount rate, which is typically the weighted average cost of capital ('WACC'). The WACC reflects the cost of capital of the debtor based on its particular combination of debt and equity financing. The projected cash flows and terminal value are then discounted based on the appropriate discount rate and summed up to determine the debtor's enterprise value.

While the DCF analysis is a measure of the intrinsic value of a debtor based on its fundamentals, the comparable companies analysis and the comparable transactions analysis are approaches to relative valuation. In other words, the debtor's enterprise value is determined by reference to the market value of comparable businesses on the market. The comparable companies analysis estimates enterprise value by applying valuation multiples of similar companies to the debtor. The first and most crucial step is the selection of a set of comparable companies. Comparability is determined by comparing characteristics such as size, growth, mix of businesses, bankruptcy status, profitability, leverage and cost structure. Further, this exercise typically involves public companies as they are the only companies which financial information is readily available.[62] Next, a valuation multiple is derived based on the ratio of the total enterprise value of each comparable company to a performance metric (typically revenues, EBITDA[63] or EBIT[64]), which is then applied to the same performance metric of the debtor to determine its enterprise value. The comparable transaction analysis follows broadly similar steps, save that a debtor's enterprise value is determined based on the prices paid to acquire comparable entities through a publicly reported merger or acquisition.

B. Valuation Uncertainty and its Implications for the Chapter 11 Process

The valuation of a debtor is as much of an art as it is a science.[65] The accuracy of enterprise values derived from the standard valuation methodologies depend significantly on subjective

[61] The use of a terminal value is necessary because it becomes increasingly difficult to project the debtor's future cash flows over a longer period of time.
[62] See A Judge's View (n 57) at 11. However, experts may sometimes use valuation multiples derived from private companies collected in proprietary databases: see Squaring Bankruptcy Valuation (n 60) at 196-97.
[63] This is an abbreviation of the term 'earnings before interests, taxes, depreciation and amortisation'.
[64] This is an abbreviation of the term 'earnings before interests and taxes'.
[65] See, for example, the views expressed by the various panellists at the VALCON Field Hearing (n 77), ABI Commission Report (n 25) at 198, Michael T Roberts, 'The Bankruptcy Discount: Profiting at the Expense of Others in Chapter 11' (2013) 21 *ABI Law Review* 157 and Michael Simkovic & Benjamin S

judgments made by valuation experts.[66] For instance, the projection of a debtor's future cash flows and the selection of an appropriate discount rate in the context of a DCF analysis requires an expert to make subjective assumptions and predictions, which can give rise to substantial (and often reasonable) disagreement between parties.[67] While the comparable company analysis and comparable transaction analysis involve the making of less assumptions relative to a DCF analysis, there is also considerable room for expert discretion in, *inter alia*, the selection of comparable companies or transactions, and the adjustments that are made to the valuation multiples to account for relevant differences between the comparables used and the debtor.[68] The fact that the standard valuation methodologies depend heavily on subjective assumptions and inputs means that there can be considerable uncertainty surrounding both the debtor's actual enterprise value and the enterprise value that the judge ultimately attributes to the debtor.

Such valuation uncertainty is further compounded by the fact that creditors and equity holders have a strong incentive to distort enterprise value.[69] Senior claimants (i.e. senior creditors and junior creditors) who are to receive equity in the reorganised debtor would prefer a lower valuation because it increases the proportion of equity that they are expected to receive. In contrast, junior claimants (i.e. junior creditors and equity holders) are incentivised to favour a higher valuation as it would support their claim for a larger payout and/or equity stake in the reorganised debtor. The inherent subjectivity of the valuation methodologies provide scope for experts to skew valuation evidence in their clients' favour as long as it is within the realm of plausibility.[70] The challenge of such a task and the high stakes that are involved have been

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Kaminetzky, 'Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution' (2011) 1 *Columbia Business Law Review* 118 ('Leveraged Buyout Bankruptcies') at 149.

66 See Leveraged Buyout Bankruptcies (n 65) at 141.

67 See, for example, Douglas G Baird & Donald S Bernstein, 'Absolute Priority, Valuation Uncertainty and the Reorganization Bargain' (2006) 115 *Yale Law Journal* 1930 ('Reorganization Bargain') at 1942.

68 See, for example, Squaring Bankruptcy Valuation (n 60) at 196 and Leveraged Buyout Bankruptcies (n 65) at 148-49.

69 See Stuart C Gilson et al, 'Valuation of Bankrupt Firms' (2000) 13 *The Review of Financial Studies* 43 ('Valuation of Bankrupt Firms') at 65-67, Valuation Uncertainty (n 4) at 434-35 and Sarah Paterson, 'Bargaining in Financial Restructuring: Market Norms, Legal Rights and Regulatory Standards' (2014) 14 *Journal of Corporate Legal Studies* 333 ('Bargaining in Financial Restructuring') at 353-54.

70 See *In re Charter Communications*, 419 BR 221 (2009) at 236: '[V]aluation is a malleable concept, tough to measure and tougher to pin down without a host of explanations, sensitivities and qualifiers. Because point of view is an important part of the process, outcomes are also highly dependent on the perspectives and biases of those doing the measuring. When it comes to valuation, there is no revealed, objectively verifiable truth. Values can and do vary, and consistency among valuation experts is rare, especially in the context of high stakes litigation.'

aptly described by the court in *In re Mirant Corp* which, after noting the incentives of the various experts to favour their clients' interests, stated as follows:

> "Should Mirant Group be overvalued, harm to the creditors represented by the Corp. Committee would result. Thus, experts retained by the Corp. Committee should be cautious, even conservative, in valuing Mirant Group—certainly such experts would avoid being too optimistic about the enterprise's future. Experts for the Equity Committee and Phoenix may be expected to take an opposite view. This does not totally taint the testimony of either. It simply means the court must be cautious itself, avoiding undue optimism while at the same time ensuring that assumptions and data used for valuing Mirant Group give full value to the business as rehabilitated through chapter 11."[71]

Collectively, valuation uncertainty and the potential for manipulation of valuation methodologies may have contributed to substantial discrepancies in valuation outcomes. According to an empirical study conducted in 2000 of 63 publicly traded companies emerging from Chapter 11, judicial estimates of enterprise value are unbiased, but are generally imprecise: valuation errors can vary from less than twenty percent to greater than 250 percent relative to the market value of the debtors sampled.[72] Therefore, it comes as no surprise that, misvaluations can, and do, occur in practice. A prominent example of this involved the Chapter 11 reorganisation of Exide Technologies between 2002 and 2003. A principal point of contention raised at the plan confirmation hearing concerned the enterprise value of the debtor, Exide Technologies. The court found the enterprise value of Exide Technologies to be between US$1.4 billion to US$1.6 billion, which was significantly closer to the value put forward by the unsecured creditors' committee than the debtor.[73] This proved to be a significant overvaluation of Exide Technologies: slightly more than a year after its emergence from

[71] See *Mirant* (n 54) at 815.
[72] See Valuation of Bankrupt Firms (n 69). However, a relatively more recent empirical study concluded that '[t]he judicially-based valuations in reorganization cases were surprisingly accurate predictions of postreorganization trading values: Lynn M LoPucki & Joseph W Doherty, 'Bankruptcy Fire Sales' (2007) 106 *Michigan Law Review* 1 at 10.
[73] See *Exide* (n 54).

Chapter 11, Exide Technologies' enterprise value was US$788 million, a far cry off of the court's valuation.

Notwithstanding the potential for misvaluations, it is also well-established that valuation uncertainty has an important role in shaping the bargaining dynamics among Chapter 11 stakeholders. A recurring theme in the US bankruptcy literature is that there have been persistent deviations from absolute priority in Chapter 11 plans, often in favour of equity holders. Prior to the turn of the century, these deviations from absolute priority have primarily been attributed to, *inter alia*, the superior bargaining position of the debtor's management,[74] and a desire by senior claimants to avoid protracted and costly litigation over a debtor's enterprise value.[75] However, in a landmark article, Baird and Bernstein posit that deviations from absolute priority should be attributed to the uncertainties inherent in the valuation process.[76] In brief, variance in judicial valuation outcomes creates option value for the junior claimants because of the possibility that the court may decide on an enterprise value which puts the junior claimants 'in the money'. In contrast, as junior claimants would always receive nothing when the debtor is valued below the value of the senior claims, they are 'protected' regardless of the extent to which the debtor is 'undervalued' by the bankruptcy judge. The possibility of a judicial valuation which puts junior claimants 'in the money' can therefore incentivise senior claimants to reach an out-of-court settlement with the junior claimants, where the value of the junior claimants' option will be priced into any settlement that the parties reach. Junior claimants who may expect themselves to be 'out of the money' may therefore find themselves in a position to bargain for a payout notwithstanding that those senior to them would not be paid in full.

Baird's and Bernstein's account appears to cohere with prevailing Chapter 11 practice. In 2012, the American Bankruptcy Institute organised a Commission to Study the Reform of Chapter 11 ('ABI Commission'). The ABI Commission co-hosted a field hearing in Las Vegas on

[74] This superior bargaining position arises from, *inter alia*, management's exclusive right to file the initial reorganisation plan under s 1121(b) of the US Bankruptcy Code, and the 'natural information advantage' that they enjoy over creditors: see Allan C Eberhart, 'Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings' (1990) 45 *The Journal of Finance* 1457 ('Security Pricing') at 1459.
[75] See, for example, The Cram Down (n 52) at 965 and Charles D Booth, 'The Cramdown on Secured Creditors: An Impetus Toward Settlement' (1986) 60 *American Bankruptcy Law Journal* 69 at 98 & 104-05.
[76] See Reorganization Bargain (n 67).

February 2013 to discuss the role of valuation in Chapter 11.[77] The general consensus among the distinguished panellists was that a debtor's enterprise value should be determined with reference to the standard valuation methodologies (particularly the DCF analysis), as opposed to market evidence. Further, while the panellists acknowledged the uncertainties and subjectivity inherent in the use of expert valuation evidence, some opined that such valuation uncertainty helped create an environment where parties are encouraged to reach a consensual resolution as opposed to litigating their differences. Crucially, Judge Drain, who had been a bankruptcy judge for the Southern District of New York for ten years at the time, stated that he had only presided over two valuation disputes in large Chapter 11 cases in that duration. Accordingly, while massive valuation trials do occasionally make the headlines,[78] it is clear that they are the exception rather than the norm.[79] Most valuation disputes which may arise prior to the plan confirmation hearing are usually settled rather than litigated, thus avoiding much of the costs and delay that valuation litigation can cause.

The fact that valuation uncertainty has a role to play in facilitating consensus-building among Chapter 11 stakeholders is indeed positive. However, another potential cause for concern that Baird's and Bernstein's account suggests is that valuation uncertainty can force senior claimants to cede value to junior claimants to avoid the need for valuation litigation which can be costly, protracted and even lead to an unfavourable outcome for senior claimants. Indeed, there has been a long-held perception that deviations from absolute priority is a persistent feature of Chapter 11 cases, a view which is premised on a number of empirical studies conducted in the 1980s and 1990s where deviations from absolute priority in favour of equity holders were observed in a significant majority (about 70 to 78 percent) of sample cases.[80]

[77] See VALCON Field Hearing Before the ABI Commission to Study the Reform of Chapter 11 (21 February 2013) ('VALCON Field Hearing'). Transcript of proceedings available online at: http://commission.abi.org/field-hearing-las-vegas-nevada-february-21-2013 (accessed 15 January 2021).

[78] See, for example, a discussion of the Residential Capital and Mirant Corp cases in Douglas G Baird, 'Priority Matters: Absolute Priority, Relative Priority, and the Costs of Bankruptcy' (2017) 165 *University of Pennsylvania Law Review* 785 at 807-08.

[79] See Richard M Hynes, 'Reorganization as Redemption' 6 *Virginia Law & Business Review* 183 at 187-88 & 220 and the testimonies of Judge Drain, Eric Siegert and Peter Kaufman at the VALCON Field Hearing (n 77). See also Robert J Stark et al, 'Market Evidence, Expert Opinion, and the Adjudicated Value of Distressed Businesses' 68 *The Business Lawyer* 1039 at 1057.

[80] See, for example, Bargaining over Equity's Share (n 50), Julian R Franks & Walter N Torous, 'An Empirical Investigation of US Firms in Reorganization' (1989) 44 *The Journal of Finance* 747, Security Pricing (n 74), Lawrence A Weiss, 'Bankruptcy Resolution: Direct Costs and Violations of Priority of Claims (1990) 27 *Journal of Financial Economics* 285 ('Bankruptcy Resolution'), Brian L Betker, 'Management's Incentives, Equity's Bargaining Power, and Deviations from Absolute Priority in Chapter 11 Bankruptcies' (1995) 68 *The Journal of Business* 161 and Elizabeth Tashjian et al, 'Prepacks: An Empirical Analysis of Prepackaged Bankruptcies' (1996) 40 *Journal of Financial Economics* 135.

However, three more recent empirical studies paint a distinctly different picture. In a 2009 study by Ayotte and Morrison, the authors examined 153 Chapter 11 cases listed in the latter half of 2001 and deviations from absolute priority in favour of equity holders were observed in only nine percent of all Chapter 11 cases and in twelve percent of confirmed plans.[81] A comprehensive study done by Bharath et al in 2014 provides more compelling results.[82] The authors examined 626 Chapter 11 reorganisations between 1980 to 2005 and found a significant decline in deviations from absolute priority in favour of equity holders over time. Such deviations were documented in 64.1 percent of cases between 1980 to 1990, 26.4 percent of cases between 1991 to 1999 and 8.7 percent of cases in 2000 to 2005.[83] Similar results were documented in a 2016 study by Capkun and Weiss ('Capkun-Weiss Study'), where deviations from absolute priority in favour of equity holders were documented in 23 percent of 169 Chapter 11 cases filed between January 1993 and March 2004. All three empirical studies attribute the significant decline in deviations from absolute priority in favour of equity holders primarily to the increased control exercised by creditors over the Chapter 11 process, which has shifted the balance of power from equity holders to creditors.[84] More specifically, Ayotte and Morrison posit that senior creditors are able to exercise control in the form of restrictive covenants in DIP financing extended to the debtor, while unsecured creditors can exert control over the Chapter 11 process through the filing of objections and other court motions.[85]

On the other hand, empirical evidence of deviations from absolute priority in favour of unsecured creditors is rather limited. In this regard, the authors of the Capkun-Weiss Study have found such deviations in approximately sixteen percent of the sampled cases.[86] This represents an eight percent increase from a previous study conducted by Weiss in 1990 which

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[81] See Kenneth M Ayotte & Edward R Morrison, 'Creditor Control and Conflict in Chapter 11' (2009) 1 *Journal of Legal Analysis* 511 ('Creditor Control and Conflict') at 522.
[82] Sreedhar T Bharath et al, 'The Changing Nature of Chapter 11', IIM Bangalore Research Paper No 461 ('Changing Nature') <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2443248> (accessed 15 January 2021).
[83] *Ibid* at 19.
[84] See Creditor Control and Conflict (n 81) at 522 and Vedran Capkun & Lawrence A Weiss, 'Bankruptcy Resolution and the Restoration of Priority of Claims', HEC Paris Research Paper No ACC-2016-1160 ('Capkun-Weiss Study') at 3 <https://ssrn.com/abstract=2795069> (accessed 15 January 2021). Bharath et al further suggest that key employee retention plans, which provide financial incentives to management for expeditious resolution of Chapter 11 cases, and the fact that firms filing for Chapter 11 after 1990 are more insolvent than those filing prior to 1990, are additional reasons which explain the decline in frequency of deviations from absolute priority in favour of equity holders: *ibid*.
[85] See Creditor Control and Conflict (n 81).
[86] See Capkun-Weiss Study (n 84) at 12.

found such deviations in three of 37 sample cases (approximately eight percent).[87] The reasons for the frequency of such deviations in favour of unsecured creditors have not generally been explored in the literature, but it is indeed intriguing. A potential reason for the increase observed by the authors of the Capkun-Weiss Study may be the increased control exercisable by unsecured creditors over the Chapter 11 process. However, this must evidently be balanced against the increased, and potentially greater, control that senior creditors can exert over the Chapter 11 process. Regardless of the reasons for such a trend, the key takeaway from these empirical studies is that deviations from absolute priority in favour of junior claimants generally occur much less than widely believed. To the extent that such deviations can be seen as a proxy for the bargaining power of junior claimants, this suggests that the uncertainty inherent in an expert valuation approach does not afford junior claimants a carte blanche to extract value that would otherwise belong to senior claimants.

V. The Appropriate Valuation Approach for the Purposes of the Restructuring Plan

As the ongoing debate in the US and UK restructuring spheres illustrates, we may seek to establish a going concern valuation of a debtor in one of two ways. The first is an expert valuation approach which is preferred by the US bankruptcy courts in the cross-class cramdown context. The second is what may be termed as a market testing approach which seeks to establish a debtor's enterprise value by reference to the highest value bid received for the debtor's business at an auction or a similar sales process.

Although some have viewed the expert valuation approach as being reasonably successful,[88] others have expressed doubts against its continued relevance in the US cross-class cramdown context and its potential transplantation into the UK.[89] The purpose of this Part is therefore to evaluate the merits and potential disadvantages of both approaches and to determine which ought to be adopted for the purposes of the restructuring plan.

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[87] See Bankruptcy Resolution (n 80) at 294-95.

[88] See, for example, the testimonies of the various panellists at the VALCON Field Hearing (n 77) and ABI Commission Report (n 25) at 199-200.

[89] See, for example, Nick Segal, 'Schemes of arrangement and junior Creditors – does the US approach to valuations provide the answer?' (2007) 20 *Insolvency Intelligence* 49 at 52, Jennifer Payne, 'Debt Restructuring in English Law: Lessons from the United States and the Need for Reform' (2014) 130 *Law Quarterly Review* 282 at 304 and the various illuminating pieces by Paterson on this issue including Bargaining in Financial Restructuring (n 69).

A. Expert Valuation Approach

First, a familiar refrain against the adoption of an expert valuation approach in the UK has been that such an approach may confer excessive bargaining power on junior creditors to the detriment of senior creditors.[90] English academics recognise the important role that an expert valuation approach has had in encouraging consensual settlements in Chapter 11. However, they are not entirely convinced that this is wholly beneficial for all stakeholders in a Chapter 11 restructuring. As explored earlier, there is the risk that valuation uncertainty may confer on junior claimants unjustified bargaining power that can allow them to hold up the restructuring process and to extract concessions from senior claimants. However, empirical evidence in the US suggests that such concerns may be overstated: deviations from absolute priority in favour of junior claimants have only been observed in a small minority of cases, suggesting that the ability of junior claimants to extract concessions from senior claimants is significantly limited.

A further point of note is that the costs of official committees of unsecured creditors and equity holders in engaging legal counsel and professional advisors in Chapter 11 are routinely approved by the bankruptcy judge and paid out of the debtor's estate.[91] Conversely, the entitlement of junior creditors to costs in the context of the restructuring plan is uncertain, and it does not appear that there is an established practice for junior creditors to be awarded costs incurred in a UK restructuring (whether in the context of a scheme, administration or otherwise). To that extent, it is suggested that junior creditors may have even less of an incentive to hold up the restructuring process in the context of a UK restructuring plan given that any concessions that they might receive will have to be weighed against the costs that they have to incur in the process.[92]

Second, arguments for or against an expert valuation approach have also revolved around conflicting perspectives on whether the markets are likely to be more accurate assessors of a debtor's enterprise value than the courts would be. From one perspective, it is relatively indisputable that the markets can be imperfect. In times of industry- or economy-wide distress,

[90] *Ibid*.
[91] See, for example, John D. Dyer et al, 'Chapter 11 - "101"' (2004) 23(5) *ABI Journal* 16 at 40 and Valuation Uncertainty (n 4) at 435.
[92] As an aside, this also suggests that junior creditors are likely to be more cost-conscious and vigilant towards instances of over-charging by their professional advisors, which has been a concern noted by US bankruptcy scholars in the context of Chapter 11 plans.

the market price of the debtor's business is likely to be depressed because of, *inter alia*, liquidity constraints of potential investors, particularly those within the same industry as the debtor.[93] Further, even outside times of distress, there may exist a thin market for the debtor's business generally because of, *inter alia*, the specialised nature or the size of the debtor's business, which can prevent a truly competitive bidding process from taking place.[94] This has two implications. First, the veracity of a market testing approach will vary greatly on a case-by-case basis. The second is that the propensity of a market testing approach towards comparatively lower valuation outcomes can result in senior creditors receiving 'too good a deal' at the expense of junior creditors because they are able to capture a portion of the debtor's reorganisation surplus which one may see as rightfully belonging to the junior claimants.

However, there are also those with the opposite view.[95] Sceptics of an expert valuation approach doubt whether judges are better-placed to value a debtor accurately given their lack of significant financial or valuation expertise and the fact that they have, financially speaking, no skin in the game. By contrast, potential investors have a clear financial incentive to get the value of the debtor right given that any misvaluation can affect their bottom line.[96] While these potential investors would be advised by the same investment bankers or financial advisors who would otherwise be called to provide expert valuation evidence before a court, the interest of these experts in this instance would be to provide an accurate valuation of the debtor rather than to advance their client's case in an adversarial setting. Accordingly, while neither the markets nor the judges can be expected to value a debtor with pinpoint precision, some may have more faith in the ability of the markets to price a debtor accurately. Without the aid of considerable empirical evidence, it would be difficult to conclusively determine which approach is likely to lead to more accurate valuations.

B. Market Testing Approach

[93] See Andrei Shleifer & Robert W Vishny, 'Liquidation Values and Debt Capacity: A Market Equilibrium Approach' (1992) 47 *Journal of Finance* 1343 and Michael Crystal & Riz Mokal, 'The Valuation of Distressed Companies – A Conceptual Framework' (2006) 3 *International Corporate Rescue* at 3-4. However, there is conflicting empirical evidence of depressed market prices in times of distress: see James Ang & Nathan Mauck, 'Fire sale acquisitions: Myth vs. reality' (2011) 35 *Journal of Banking & Finance* 532, Seungjoon Oh, 'Fire-sale acquisitions and intra-industry contagion' (2018) 50 *Journal of Corporate Finance* 265.

[94] See Valuation Uncertainty (n 4) at 417-418, discussing the Chapter 11 auction process of Adelphia Communications.

[95] See, for example, Douglas G Baird, 'The Uneasy Case for Corporate Reorganizations' (1986) 15 *Journal of Legal Studies* 127 ('Uneasy Case') at 136-37.

[96] *Ibid*.

While English academics have been quick to point out the potential limitations of an expert valuation approach, comparatively little attention has been paid to evaluating the likely efficacy of a market testing approach in practice. In this regard, it is suggested that there are two primary issues which militate against an adoption of the market testing approach.

The first is that a market testing approach may not always be an accurate representation of the market value of a debtor. It is recalled that the adoption of a market testing approach would entail the conducting of an auction or a similar sales process regardless of whether an actual sale of the debtor is contemplated. This stands in clear contrast with the proposals which have been advanced by bankruptcy scholars in the context of Chapter 11. For instance, Baird has argued that insolvent debtors should be liquidated as a going concern as an alternative to a Chapter 11 reorganisation.[97] In other words, such a proposal would entail a forced sale of debtors which file for Chapter 11. Others have instead advanced more moderate proposals, including the case for a greater reliance on the market prices of a debtor's publicly traded securities (where available) to improve the accuracy of, but not replace completely, the judicial valuation process.[98] The adoption of a market testing approach for the purposes of resolving valuation issues in the restructuring plan would, however, entail something distinctly different from these proposals. In cases where an actual sale of the debtor is not contemplated under the restructuring plan, all that the auction is intended to achieve is for the market to place a value on the debtor in substitution of a judicial valuation. Putting aside other potential limitations of an auction,[99] there is the distinct risk that the adoption of a market testing approach as the default approach can discourage genuine buyers from coming forward with their bids once it is realised that the auction functions merely as a 'staging post' to put a value on the debtor.[100] After all, there would be little reason for a rational investor to incur the costs and time needed

[97] *Ibid*. See also Roe's proposal which would require all debtors to take on an all-equity capital structure post-reorganisation and a valuation of each debtor would be obtained based on a sale of ten percent of its shares to the public: Mark J Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 *Columbia Law Review* 527.

[98] See Cem Demiroglu et al, 'Do Market Prices Improve the Accuracy of Court Valuations in Chapter 11?', Finance Working Paper No 655/2020 <https://ssrn.com/abstract=2693056> (accessed 15 January 2021).

[99] For instance, the disclosure of information relating to the debtor's business, which would be necessary for potential buyers to accurately value the debtor, can potentially reduce the value of the debtor, particularly where some of the potential buyers include the debtor's competitors, suppliers or customers: see Robert G Hansen, 'Auctions of Companies' (2001) 39 *Economic Inquiry* 30 ('Auctions of Companies') at 33.

[100] A similar concern was noted by Paterson: see Bargaining in Financial Restructuring (n 69) at 350.

to conduct the requisite due diligence and valuation of the debtor if a sale of the debtor was never contemplated.

Even if a genuine and competitive auction process is possible in certain cases, one may question whether a market testing approach is likely to lead to more efficient and less costly restructuring outcomes than an expert valuation approach. It is easy to imagine a litany of ways in which the propriety of an auction process may be challenged. For instance, objections may be raised against the timing and duration of the auction process, the number of potential bidders reached out to (e.g. whether the auction conducted is a public auction, a limited auction or a targeted auction), the type of auction adopted (e.g. open bidding or sealed bidding) and the appropriate bidding procedures.[101] Further, as some bids will not be purely cash bids, there can again be reasonable disagreement over the valuation of the non-cash components of these bids.[102] While some minimum procedural standards may be established in future cases, it is clear that the propriety of the auction process that has been conducted in a given case remains largely a fact-intensive inquiry which may require judicial intervention to resolve. We may therefore be concerned that adopting a market testing approach would not eliminate litigious or holdout behaviour. Instead, the locus of dispute simply shifts from the relative reliability of conflicting expert evidence to the propriety of the auction that has been conducted. This would only add to the potential costs of the restructuring plan procedure above and beyond the costs and delay that the conduct of an auction would itself entail.

VI. Conclusion

The newly enacted restructuring plan is likely to be an important restructuring tool in the UK given its flexibility and, more significantly, its ability to resolve deadlocks and hold-out behaviour through the cross-class cramdown mechanism and the power to exclude out-of-the-money creditors (i.e. those without a genuine economic interest in the debtor) from a restructuring plan. However, a corollary of this is that a valuation of the debtor will occupy a

[101] See, for example, James A Croft, 'Unsuccessful or Upset Bidders: While They Lack Standing to Challenge Bankruptcy Auction Results, They May Still Substantially Disrupt Bankruptcy Auction Processes – Part I' (2016) 12 *Pratt's Journal of Bankruptcy Law* 335 and James A Croft, 'Unsuccessful or Upset Bidders: While They Lack Standing to Challenge Bankruptcy Auction Results, They May Still Substantially Disrupt Bankruptcy Auction Processes – Part II' (2016) 12 *Pratt's Journal of Bankruptcy Law* 387.

[102] See Auctions of Companies (n 99) at 32.

central role in the restructuring plan process given the need to ensure that the interests of minority and junior creditors are not unfairly compromised.

English academics have been generally sceptical of a wholesale adoption of the expert valuation approach in the UK restructuring context, citing fears that the uncertainty inherent in such an approach can confer excessive bargaining power on junior creditors which can lead to holdout behaviour and/or unjustified wealth transfers in favour of them. However, empirical evidence in the Chapter 11 context suggests that such fears may be overblown: deviations from absolute priority in favour of junior claimants have featured much less frequently in Chapter 11 cases than widely believed.

Additionally, those critical of an expert valuation approach may have failed to accord sufficient attention or weight to the practical limitations of a market testing approach. We should be concerned that a market testing approach cannot always lead to a genuine auction process, thus casting doubts on the veracity of such an approach in providing an accurate valuation of a debtor. Further, arguments that will likely be raised against the propriety of the auction that has been conducted, particularly by those who would not be paid in full under the proposed restructuring plan, can result in additional costs and delay. Cumulatively, these concerns give rise to significant doubts over whether such an approach would necessarily lead to fairer and more efficient restructuring outcomes relative to an expert valuation approach.