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Views on Valuation Issues

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Coming Valuation Problems of Mortgage-Backed Securities & Credit Default Swaps in Bankruptcy

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I Introduction

These are unprecedented times. Financial firms have reported losses and write-downs on debt securities approaching half a trillion dollars to date since the breakdown of the subprime mortgage market in 2007.¹ At the center of the storm is both the failure of the market for mortgage-backed securities and the nontransparent and unregulated credit default swaps that have exacerbated the systemic risk. The hemorrhaging of the value in mortgage-backed securities has now inflicted the global credit markets toppling pillars of Wall Street, fundamentally changing investment banking as it had heretofore been known, and raising fears of the worst economic collapse since the Great Depression.²

As part of its initial response, the United States government has enacted the Emergency Economic Stabilization Act of 2008 (Pub. L. 110-343) (the “Act”) which aims, in part, to revitalize the market for mortgage-backed securities by enabling the Secretary of the Treasury to purchase up to \$700 billion worth of “troubled assets” through the Troubled Asset Relief Program (“TARP”). TARP is therefore aimed at doing what the market had previously failed to do, set an appropriate price for these securities. Treasury Secretary Henry Paulson, and the other principal authors of the “bailout,” did not set forth in the Act the procedures that will be used to value the assets purchased under TARP. However, the Act does call for the prompt and detailed disclosure of such procedures once they have been established.

But even massive government intervention cannot piece back together working markets overnight. In the meantime, mortgage-backed securities and other “bad debt”

¹ See *JP Morgan Plan to Write Down \$1.5 Billion in Mortgage-Backed Securities*, INT’L HERALD TRIB., Aug. 12, 2008, available at <http://www.iht.com/articles/2008/08/12/business/12jpm.php>.

² See, e.g., Julie Creswell & Ben White, *Wall Street, R.I.P.: The End of an Era, Even at Goldman*, N.Y. TIMES, Sept. 27, 2008, available at <http://www.nytimes.com/2008/09/28/business/28lloyd.html>.

will be subjected to the scrutiny of bankruptcy courts that will be charged with valuing these assets in a number of circumstances.³ This presentation discusses how bankruptcy courts may approach these thorny valuation questions.

II. Mortgage-Backed Securities and Their Valuation

A mortgage-backed security is a debt instrument collateralized by the principal and interest payments on a pool of mortgage loans. Most of these pooled mortgages were “subprime” obligations. The market for these securities expanded rapidly as investors calculated that a substantially sized pool of risky mortgages could be divided into slices or tranches permitting investment grade ratings for the senior tranches. Low interest rates for much of the past decade combined with rising housing prices to cause a flood of liquidity into the market for mortgage-backed securities, raising the market to several trillion dollars in size. A major flaw in this financing device was that the underwriting assumptions were faulty. Default rates for mortgages were calculated at historical levels, but historically mortgage loan underwriting had never included such a large pool of non-credit worthy borrowers.

Mortgage-backed securities were priced according to factors including (i) the type of mortgage and their outstanding principal balances (“OPB”); (ii) the default risk, ascertainable in part by payment histories (see above); (iii) the applicable interest rate for each mortgage; and (iv) the prepayment risk. Prepayment of a loan is termed a risk to the security because most mortgages can be repaid without penalty resulting in a loss of expected future interest payments. Furthermore, prepayment risk is closely related to interest rates because many mortgage holders will prepay to refinance their mortgages in

³ See, e.g., Harold S. Novikoff, *Valuation Issues in Chapter 11 Cases*, SM014 ALI-ABA 185 (Mar. 2007).

order to take advantage of lower rates. The asset's value would also be dependent on its level of subordination to other tranches of debt from the pooled mortgages.

With a robust market for mortgage-backed securities, and the continuing appreciation of house prices created by the liquidity that had poured into the housing market, valuation was less of a concern in pricing the securities. Complex models could be constructed centering around the above-listed information but also incorporating factors such as demographic data, new construction starts, etc. With robust trading taking place, these models could be tested against actual market trends, albeit trends that were heavily affected by the speculative bubble in the mortgage market.⁴

However, starting with the deterioration of the subprime mortgage market in 2007, the mortgage-backed security market began to contract. The interdependencies between mortgage originators and the secondary market began to take its toll. As the secondary market became saturated and large banks and financial institutions began to raise the credit criteria for purchasing pools of mortgage debt, loan originators were no longer able to facilitate homebuyers' easy access to credit. This resulted in the freezing up and decline of home prices, which in turn further constricted the secondary mortgage market.

Complicating the resulting valuation issue was Statement of Financial Accounting Standards No. 157, Fair Value Measurements ("FAS 157"). Promulgated by the Financial Accounting Standards Board for statements as of November 2007, FAS 157 requires companies to determine publicly the value of assets and liabilities according to the price that would be paid for them in an orderly transaction between market

⁴ See, e.g., Jeffrey J. Szafran, *Valuation of Mortgage-Backed Securities & Collateralized Debt Obligations: More Art Than Science*, SN084 ALI-ABA 685 (May 2008).

participants. FAS 157 also requires companies to distinguish between three levels of inputs for their valuations: (i) Level 1 inputs are “quoted prices in active markets for identical assets or liabilities”; (ii) Level 2 inputs are “inputs other than quoted prices included within Level 1 that are observable for the asset or liability”; and (iii) Level 3 inputs are “unobservable inputs for the asset or liability.”⁵

With the market for mortgage-backed securities collapsing in mid and late 2008, large banks and financial institutions were forced to list the value of their holdings as “unobservable” Level 3’s and suffer huge write-downs from the purchase price. For example, Morgan Stanley reported that 7.4% of the firm’s assets were Level 3 as early as the end of the third quarter of 2007, and had to write down \$3.7 billion in the first two months of the fourth quarter because of the declining subprime market.⁶

Where once mortgage-backed securities were valued according to their OPB, type, default risk, interest rate and prepayment risk, they are increasingly valued according to the current depressed market for these assets. The value of FAS 157 and whether or not it should be suspended are issues discussed at length elsewhere. When bankruptcy courts are presented with valuation issues involving mortgage-backed securities, both model-based and FAS 157-driven valuations will likely be presented for consideration by advocates for different interested parties.

III. Credit Default Swaps and Their Valuation

⁵ See, e.g., David B.H. Martin & Lindsay Kitzinger, *Disclosure Implications of Fair Value Accounting & the Subprime Mortgage Crisis*, SP018 ALI-ABA 223 (July 2008).

⁶ See Yalman Onaran & Christine Harper, *Goldman Held Bigger Level 3 Share Than Citi, Merrill*, BLOOMBERG, Nov. 12, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601109&sid=aEpBVhRfNTfU&refer=exclusive>.

A credit default swap is an unregulated, so-called over-the-counter contractual agreement between two parties whereby a protection-buyer pays premiums to a protection-seller in exchange for the protection-seller's promised performance in the event of a reference entity's credit event, such as a default.⁷ Credit default swaps usually are written on standardized forms established by the International Swaps and Derivatives Association, Inc. (ISDA). After such a swap is executed, it can be traded on secondary markets. These markets are also unregulated and have precipitated doubts concerning their ability to appropriately value the risk associated with these arrangements.⁸

Credit default swaps can be used to hedge the protection-buyer's exposure, but they can also be used to speculate on a third party's credit events (speculators, of course, can also hedge their positions causing further market leverage). In the case of speculation, credit default swaps act to amplify the effect of a credit event. With the notional amount currently outstanding in the market for default swaps skyrocketing over the last years to the astronomical level of \$54.6 trillion, and the agreements themselves having an estimated value of \$2 trillion, this amplification rose to a systemic risk in September 2008.⁹

Upon a credit event with respect to the reference entity, the protection-seller is liable for the default payment to the protection-buyer as established by the contract. In addition, the protection-buyer will either have to transmit the reference obligation to the

⁷ Credit default swaps come in a wide variety of forms, some have multiple reference entities (basket swaps), some are pegged to market indexes (index swaps).

⁸ Warren Buffet famously criticized credit default swaps, other swaps such as interest rate swaps and other derivatives as "financial weapons of mass destruction" due to their lack of transparency. See Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, available at <http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html?partner=rssnyt&emc=rss>.

⁹ The ISDA reports "Surveys & Market Statistics" regularly at its website, <http://www.isda.org/> (providing data through mid-year 2008). For comparison, in the middle of 2004, the notional amount

protection-seller (physical settlement) or transmit a cash payment to the protection-seller usually equal to the reference obligation less its recovery value (cash settlement). The protection-buyer and protection-seller then “swap” positions with respect to the reference obligation upon the credit event.

The value of a default swap, therefore, is calculated according to such factors as (i) the premium paid by the protection-buyer; (ii) the remaining payments due; (iii) the default risk of the reference entity; and (iv) the availability of credit. As with mortgage-backed securities, complex models could be, and were, constructed to value these derivatives. With the market for default swaps already shaken,¹⁰ and with a credit crisis globally that threatens untold credit events for an untold number of reference entities, the accuracy of these models and investor confidence in the clouded secondary market for default derivatives is at growing risk.

One of the complicating factors for many credit default swaps is that credit events giving rise to a right to payment for the protection-buyer from the protection-seller often are not tied to a monetary or payment default on the underlying mortgage pool vehicle or other reference obligation. Rather, if the vehicle suffers a ratings downgrade, a credit event occurs, triggering the protection-seller’s obligation to pay. This structure means that actions of credit rating agencies played a particularly significant role in creating credit events across a wide spectrum of credit default swaps.

outstanding of credit default swaps was reported at only \$5.44 trillion. *See also* Moody’s Investors Service, *Credit Default Swaps: Market, Systemic, and Individual Firm Risks in Perspective* (May 2008).

¹⁰ ISDA reports that after years of remarkable growth, the market for credit default swap contracted 12% as of the middle of 2008. Further contraction can be expected as credit markets remain restricted and default risks inflate.

Liquidity risk is also problematic for modeling the risk profile of complex financial instruments, a difficulty compounded by the fact that such models are constructed for and tested against the existing markets in which they operate.¹¹ For example, the collapse of Long-Term Capital Management (LTCM) in late 1990s was also premised in part on the failure of that fund's models to appreciate liquidity risk in the capital markets.¹² Today, however, the fear is that not just one fund or a select group of hedge funds will fail, but that such failure will be amplified by the myriad default swap positions maintained against such an event.¹³ Because the counterparties to these swaps include large banks, insurance companies and brokerage firms, the risk of spiraling credit defaults has become systemic in the entire banking system.

In lieu of these real risks, there is growing pressure for oversight and regulation of the default swap market. On September 26, 2008, Christopher Cox, the Chairman of the Securities and Exchange Commission, issued a press release stating:

Unfortunately, as I reported to Congress this week, a massive hole [in regulation] remains: the approximately \$60 trillion credit default swap (CDS) market, which is regulated by no agency of government. Neither the SEC nor any regulator has authority even to require minimum disclosure. I urge Congress to take swift action to address this.¹⁴

¹¹ See Kwamie Dunbar, *US Corporate Default Swap Valuation: The Market Liquidity Hypothesis and Autonomous Credit Risk*, UNIV. OF CONN. (Jan. 2007).

¹² See THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT, at 12, available at www.treas.gov/press/releases/reports/hedgfund.pdf.

¹³ Moody's Investors Service, *Credit Default Swaps: Market, Systemic, and Individual Firm Risks in Perspective*.

¹⁴ Press Release, U.S. Securities and Exchange Commission, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>.

Calling for co-existent federal regulation, New York state also recently announced that it would begin to regulate the credit default swap market.¹⁵ What the coming regulatory landscape for default swaps will ultimately be, however, remains to be determined. Suffice to say, times are changing.

IV. The Emergency Economic Stabilization Act of 2008

The passage of the Emergency Economic Stabilization Act of 2008 provided its own drama. On Wednesday, September 24, 2008, President George W. Bush addressed the nation stating the “entire economy is in danger” and urging that Congress pass the response proposed by Secretary Paulson. To assuage discomfort with the towering \$700 billion price tag, the president argued that the “government is the one institution with the patience and resources to buy these assets at their current low prices and hold them until markets return to normal.”¹⁶

Five days later, on Monday, September 29, 2008, the House of Representatives spurned the president and defeated Paulson’s revised proposal sending the Dow Jones Industrial Average plummeting 778 points. On Wednesday of that week, the Senate approved the legislation “sweetened” with earmarks and other concessions aimed at winning increased House support. A House revote approved the Act on Friday, October 3, 2008 and the president immediately signed it into law.¹⁷

¹⁵ Press Release, State of New York, Executive Chamber, Governor Paterson Announces Plan to Limit Harm to Markets from Damaging Speculation (Sept. 22, 2008), available at www.ins.state.ny.us/press/2008/p0809224.pdf.

¹⁶ *Transcript: Bush’s Speech*, INT’L HERALD TRIB., Sept. 25, 2008, available at <http://www.iht.com/bin/printfriendly.php?id=16463831>.

¹⁷ See Christopher Stern & Laura Litvan, *Bank-Rescue Plan Wins Approval as House Reverses Vote*, BLOOMBERG, Oct. 3, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aTRUXZrt.eMY&refer=home>.

Soon after the bill was finally signed, Secretary Paulson announced that Neel Kashkari would lead TARP on an interim basis.¹⁸ Kashkari had advised the Secretary on housing issues and was a former vice president at Goldman Sachs Group Inc., where Paulson had also worked. The leader of TARP now heads one of the largest sovereign wealth funds in the world.

The fund is charged with, among other things, buying distressed financial assets from U.S. financial institutions, and it has chosen to proceed by a “reverse auction” procedure whereby those institutions wishing to sell mortgage-backed securities and derivatives offer to sell them to the fund at particular prices. The results of these auctions will make a market, and thus set short term prices and values for the mortgage-backed securities and derivatives. This market, however, is artificial in some senses. If the Treasury as buyer accepts asking prices that are notionally too low, the seller-banks’ capital will be further impaired and the bank will be unable or reluctant to make new loans to third parties. If, on the other hand, the Treasury accepts asking prices that are notionally quite high, it risks depleting the fund’s cash without achieving the policy of recapitalizing banks and unfreezing the credit markets.

The Act is clearly not the only – or even the most significant – response the U.S. government or other world governments will take to the credit crises. Besides explicitly nationalizing Fannie Mae and Freddie Mac and injecting billions of dollars (on more than one occasion) into the world’s largest insurer A.I.G., the U.S. government has now represented its willingness to purchase the short term commercial paper of large businesses and even equity interests in major banks. However, it is the U.S.

¹⁸ See Rebecca Christie, *U.S. Treasury’s Kashkari to Lead Bank Bailout Office*, BLOOMBERG, Oct. 6, 2008, available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=ak5RqnboIhG0&refer=news>.

government's commitment to value and purchase problematic assets off the books of financial institutions which will directly affect court's valuation of these assets should their holders become the subject of bankruptcy proceedings.

The Act requires sweeping disclosure to accompany the sweeping powers it entrusts to the Treasury. Section 101 of the Act enables TARP "to purchase ... troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary." "Troubled assets" are defined as meaning both:

"(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and

(B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress."

Act § 3(9).¹⁹ A credit default swap position is clearly a "financial instrument" that could be purchased under the program, although the likelihood of this actually happening is problematic.²⁰

Both subsections to the definition of "troubled asset" provide that TARP is designed to "promote[] financial market stability." This is echoed in the stated purpose of the Act which is "to immediately provide authority and facilities that the Secretary of

¹⁹ A financial institution, from which trouble assets can be purchased, is also defined in broad terms under the Act meaning "any institution, including, but not limited to, any bank ... security broker or dealer, or insurance company ... but excluding any central bank of, or institution owned by, a foreign government." Act § 3(9).

²⁰ The broad definition of troubled assets also would permit TARP to purchase – as Treasury Paulson has suggested doing – an equity stake in large banks to help spur lending. However, this may trigger executive compensation limits and other corporate governance provisions under the Act. *See* Act § 111.

the Treasury can use to restore liquidity and stability to the financial system of the United States.” Act § 2(1). Even section 113, which seeks to minimize the long-term costs and maximize the benefit for taxpayers, provides that TARP can still take into account “the overall economic benefits of the program, including economic benefits due to improvements in economic activity and the availability of credit” in assessing the appropriate price for purchased assets.

Further, the Act provides that “[b]efore the earlier of the end of the 2-business-day period beginning on the date of the first purchase of troubled assets ... or the end of the 45-day period beginning on the date of enactment of this Act, the Secretary shall publish program guidelines, including ... [m]ethods for pricing and valuing troubled assets.” Act § 101(d). Moreover, section 114 specifically calls for market transparency and provides that “the Secretary shall make available to the public, in electronic form, a description, amounts, and pricing of assets acquired under this Act, within 2 business days of purchase, trade, or other disposition.”

Additionally, section 105(a) of the Act states that every 30 days during the pendency of the program the Secretary shall provide to Congress “a detailed financial statement” including “the valuation or pricing method used for each transaction” during that period. Additional reports concerning “the pricing mechanism” for purchases are required every time commitments to purchase troubled assets reach an interval of \$50 billion. Act § 105(b).

With strict deadlines, it will not be long before the Treasury is required to publish its pricing guidelines. Importantly, the Act does not permit only one loose sketch of TARP’s valuation approach at the outset of the program. Instead, the comprehensive

disclosure required of the Treasury – after every purchase, after every 30 days, after every \$50 billion spent – will allow insight into how the TARP’s pricing calculations arise and change over time. Furthermore, as the program’s main goal is to foster market stability, it is hoped that the TARP will generate sophisticated and transparent pricing procedures which could become a model for other marketplace transactions, but as noted above, the policy goals of recapitalizing financial institutions and unfreezing credit markets are necessarily going to influence the prices paid for the troubled securities.

V. Intersection of Mortgage-Backed Securities with Bankruptcy Law

Some of the largest and most significant new debtors likely will bring with them portfolios of mortgaged-backed securities, the remaining value of which will have to be orderly distributed to creditors.²¹ Bankruptcy courts will be charged with overseeing this process. Challenges to the valuation of these securities in many contexts are unavoidable.

Liquidation of assets always raises valuation concerns. What will be unprecedented in these circumstances, however, is how the federal courts will treat asset sales in a market driven by a single major buyer which is a creature of the federal government – TARP. The bankruptcy bar will have to determine how it will respond.

Three possibilities are: (i) bankruptcy courts could view TARP as simply another market participant; (ii) bankruptcy courts could view TARP as setting the floor of reasonable pricing for an asset; and (iii) bankruptcy courts could endeavor to utilize, to the extent practical, the same standards for valuing mortgage-backed securities as those published under the program.

²¹ See, e.g., *In re Lehman Brothers Holdings Inc.*, Case No. 08-13555 (Bankr. S.D.N.Y.) (JMP); *In re Washington Mutual, Inc.*, Case No. 08-12229 (Bankr. D. Del.) (MFW).

To put it another way, beyond arguing merely over the value of an asset to be liquidated, parties to a dispute may also argue over what approach a court should adopt with respect to TARP's role in the process. Prospective buyers may suggest that TARP should be viewed simply as any other market participant. One can argue that the court's sole role should be making sure the best willing buyer purchases the assets for the benefit of the estate.²² On the other hand, because of TARP's policy goals of recapitalizing financial institutions through these asset purchases, it can also be argued that TARP's valuations are artificially high or low, depending on the circumstances.

VI. Intersection of Credit Default Swaps with Bankruptcy Law

Bankruptcy courts will also be presented with challenges when confronted with credit default swaps on debtors' balance sheets. There are three basic ways in which a bankruptcy filing can affect the holder's position: (i) the reference entity could declare a triggering credit event on the swap; (ii) the protection-buyer could file for bankruptcy; or (iii) the protection-seller could file for bankruptcy. The likelihood of a default of the reference entity should have been researched by both the protection-buyer and the protection-seller as such risk is the primary factor in calculating the value of the swap. But even if there has been thorough research, modeling the risk profile of any reference entity is a tricky business.

Even more important than assessing the likelihood of the occurrence of a credit event by the reference entity is the creditworthiness of the protection-seller, whose assets are liable to cover any such credit event. Because the market for default swaps is currently unregulated, however, there are no mandatory capitalization requirements for

²² See 11 U.S.C. § 363 (requiring highest and best price for asset sales).

swap participants. Further complicating matters is the fact that many swap counterparties have mortgage-backed securities of uncertain worth on their balance sheets.²³

As noted above, market participants use credit default swaps to hedge, to speculate, and to hedge speculation. As such, upon a reference entity's credit event, there may be an insufficient deliverable obligation to complete physical settlement of the swap. However, even if the reference entity's credit event was a bankruptcy filing, the disputes concerning the protection-buyer and protection-seller will be resolved outside of the bankruptcy case of such reference entity because there is simply no privity to the debtor. Moreover, ISDA has become proficient in conducting auctions to settle the value of the deliverable reference obligation.²⁴

A more pressing concern for bankruptcy courts is a default swap counterparty's filing. Swap agreements anticipate that a counterparty may file for protection under the Bankruptcy Code. Such an event constitutes that counterparty's default under the contract and gives rise to certain remedies for the non-defaulting party.²⁵ Like the exemptions provided with respect to securities contracts, § 560 of the Bankruptcy Code specifically protects the exercise of the contractual remedies provided to the non-defaulting swap counterparty. Specifically, upon the filing, § 560 permits the non-defaulting party "to cause the liquidation, termination or acceleration of one or more swap agreements ... or to offset or net out any termination values or payment amounts arising under or in connection with [the default]."

²³ Indeed, under the uncertain market conditions currently prevailing, the London Interbank Offered Rate of interest exceeded the published prime rates of most banks during the week of October 5, 2008, demonstrating the uncertainty among banks as to who is creditworthy.

²⁴ For example, credit default swaps referencing obligations of Fannie Mae, Freddie Mac and Lehman Brothers were settled at auctions directed by ISDA. *See* <http://www.isda.org>.

²⁵ *See* 2002 Master Agreement § 5(a)(vii).

Additionally, § 562(a) of the Bankruptcy Code, added as part of the 2005 amendments, provides that if the debtor does reject or terminate the default swap, the resulting damages will be calculated “as of the earlier of – (1) the date of such rejection; or (2) the date or dates of such liquidation, termination or acceleration.” Importantly, § 562(b) states that “[i]f there are not any commercially reasonable determinants of value” when the swap is rejected, “damages shall be measured as of the earliest subsequent date or dates on which there are commercially reasonable determinants of value.” Section 562(c) provides that in the case of an objection, the party asserting there were no reasonable “determinants of value” available has the burden of establishing that fact. Section 562, however, reads as an invitation for counsel to raise valuation questions when default swaps are at issue.

Two form agreements issued by the ISDA have been widely used in the credit default swap market, the 1992 ISDA Master Agreement (the “1992 Form”) and the 2002 ISDA Master Agreement (the “2002 Form”). The 1992 Form allowed parties to choose remedies upon default. Parties could elect for damages to be calculated by Market Quotation where a defaulting party would be liable for the value quoted by dealers for the swap. Parties could also elect for damages to be calculated by Loss where a defaulting party would be liable for the injury suffered by the non-defaulting party. These remedies both were problematic in that the Market Quotation method could produce an unreasonable result if market conditions were strained and the Loss method was too subjective.

Under the 2002 Form, default remedies are calculated to determine the Close-out Amount. This amount is essentially the cost the non-defaulting party would incur in

replacing the terminated swap, but that calculation must employ “commercially reasonable procedures” and produce a “commercially reasonable result.” While the 2002 Form may have cured the over-subjectivity of the Loss method and the possible wide variances of the Market Quotation method, it could be found to have considerably complicated the valuation inquiry. Calculation of damages now minimally requires investigation of market conditions including how the market would respond to the particular creditworthiness of the non-defaulting party. Furthermore, as credit default swaps are traded and utilized in complex ways, such as with basket and index swaps and the use of default swaps to hedge precisely against other positions, obtaining an exact replication of the swap terminated by the bankruptcy filing upon which to base a damage claim may be so difficult as to raise its cost to a “commercially [un]reasonable result.”

As noted above, the credit default swap market will soon undergo a sea-change of new regulation. If the credit default swap in question utilizes either the Market Quotation method or the Close-out Amount method, valuing the bankruptcy claim of the non-defaulting party will require a familiarity with the new market and market conditions. Furthermore, regardless of what calculation method is employed, § 562 of the Bankruptcy Code may require courts to determine if the current market is capable of providing “commercially reasonable determinants of value.”

When a credit default swap counterparty files for bankruptcy, courts can expect to be forced into the complicated and changing marketplace for this uniquely dangerous derivative. Courts should endeavor to understand the policies behind the forming regulation concerning this market and amplify these policies as appropriate in their decisions to bolster the overall coherence of the regulatory framework.

Should Valuation Have Such a Material Role in Chapter 11?

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I. Introduction

There can be little doubt that valuation plays a central role in chapter 11 bankruptcy cases. The valuation of a reorganizing debtor's business is critical to determining who will own the reorganized debtor.¹ As a function of the absolute priority rule, creditors generally will receive all of the value of the reorganizing debtor unless there is a surplus available for holders of equity interests.² Similarly, if there are senior and junior creditors in a debtor's capital structure, junior creditors will generally not receive a recovery unless there is sufficient value to satisfy in full all senior claims.³

Valuation is key to determining whether there is any surplus value. Thus, the valuation of the common stock of the reorganized debtor will determine whether unsecured creditors and equity security holders are entitled to receive any distribution under a proposed chapter 11 plan of reorganization. Moreover, the dollar amount at which the shares of the reorganized entity is valued will also impact the size of the distribution to which the chapter 11 debtor's creditors and equity holders are legally entitled. For these reasons, valuation is often hotly contested in chapter 11 cases.⁴

Not surprisingly, constituents that stand to receive the bulk of a reorganizing debtor's equity often have an incentive to argue for a lower valuation of the debtor, so as

¹ See, e.g., *Conso. Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 525 (1941) ("Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization.").

² See 11 U.S.C. § 1129(b)(2).

³ See, e.g., *Protective Comm. v. Anderson*, 390 U.S. 414, 441 (1968) ("Since participation by junior interests depends upon the claims of senior interests being fully satisfied, whether a plan of reorganization excluding junior interests is fair and equitable depends upon the value of the reorganized company.").

⁴ Cf. *In re Bush Indus., Inc.*, 315 B.R. 292, 297 (Bankr. W.D.N.Y. 2004) ("Both creditors and stockholders share the same interest in the outcome of a favorable valuation. An inappropriately high valuation will deny to creditors the right to assets without allocation for the interest of equity. On the other hand, an inappropriately low valuation will deny to equity the right to assets after allocation for the interest of creditors.")

to prevent junior creditors or shareholders from taking a portion or a substantial portion of a reorganized debtor's stock. Junior creditors and equity security holders that might otherwise recover nothing under a chapter 11 plan, on the other hand, may have an incentive to lobby the bankruptcy court to value the reorganizing debtor at a higher dollar amount. The Bankruptcy Code does not dictate a particular method for valuation that must be used, and thus, bankruptcy courts have to grapple with the issue on a case-by-case basis.

While it may be difficult to dispute that valuation *does* play a significant role in chapter 11, there is certainly room to debate whether valuation *should* play such a significant role. Such a debate should focus on seven considerations. For one, courts have routinely expressed the view that valuation is an inexact science. Important valuation determinations can be impacted by factors that perhaps should not be part of the equation, such as the credibility and skill of expert witnesses. Valuation outcomes also may be vulnerable to the parochial interests and relative bargaining power of quarreling constituents. Against this backdrop, a chapter 11 debtor's senior management may have the incentive to align itself with the faction of creditors or holders of interests that stands to receive the most common stock under a chapter 11 plan or that otherwise has the most to offer senior management. Senior management may use its opportunity and position to influence the valuation process in favor of the creditor group that will be in the best position to offer management incentives. Finally, there is of course the issue of the accuracy of valuation projections. How often does this number actually turn out to be an accurate forecast of the value of the reorganized debtor's equity?

This article explores these issues. Part II of the article discusses how valuation is an imprecise exercise. This view is primarily expressed through a review of the valuation proceedings in the chapter 11 cases of Mirant Corporation and its affiliated debtors and debtors in possession (“Mirant”). Although the valuation hearing in *Mirant* was one of the longest and most thorough valuation hearings in chapter 11 history, the bankruptcy court nevertheless appeared to be uncomfortable making a final ruling on the issue.

Part III of this article examines how politics may be lurking in the background of valuation disputes. This issue is well illustrated by the valuation battle in the chapter 11 cases of National Gypsum and its affiliated debtors and debtors in possession (“National Gypsum”). In *National Gypsum*, management valued the company at between \$300 million and \$375 million while holders of junior debt valued the company at more than \$600 million.⁵ The plan approved by the bankruptcy court left the junior debt out of the money. Shortly after National Gypsum emerged from bankruptcy, however, management announced a cost-savings plan that certain of the junior debt holders alleged dramatically increased the value of the reorganized debtors’ shares.⁶ Both during the chapter 11 cases and in an unsuccessful post-bankruptcy state court action, holders of the junior debt argued that National Gypsum’s senior management concealed relevant information and purposely undervalued the company, in part because of certain incentives offered by the holders of the senior debt.⁷

The issue of politics was also featured more recently in the chapter 11 cases of Nellson Nutraceutical, Inc. and its affiliated debtors and debtors in possession

⁵ See *Browning v. Prostok*, 165 S.W.3d 336, 340-42 (Tex. 2005).

⁶ See *id.* at 341-42.

⁷ See *id.* at 341-42, 348-49.

(“Nellson”).⁸ In *Nellson*, the Bankruptcy Court for the District of Delaware arrived at an initial figure for the projected enterprise value of the debtors based on weighting the corrected valuation projections of three expert witnesses according to each expert’s credibility.⁹ The court ultimately determined, however, that it was appropriate to revise this initial figure downward because the principal shareholder, with the participation of senior management, had manipulated the preparation of the debtors’ long range business plan to enhance the perceived value of Nellson and because all three experts had relied on this plan in reaching their valuation projections.¹⁰

Part IV of the article attempts to examine the accuracy of valuation projections relating to a reorganizing chapter 11 debtor. We selected twenty of the larger and more recent chapter 11 debtors to emerge as public companies and compared the post-confirmation value of the shares of the reorganized chapter 11 debtors to the projected value of the same shares as expressed in each debtor’s respective disclosure statement. Analysis of this data suggests that valuation projections are often inaccurate.

Finally, Part V of this article ponders whether there is a solution to the problems with valuation discussed in Parts II-IV. Specifically, Part V discusses the concept of “volume weighted average price” (“VWAP”), which may provide a mechanism for valuation based on the trading price of an entity’s shares after emergence from chapter 11. Part V evaluates the VWAP mechanism as a possible solution to sidestep the

⁸ See *In re Nellson Nutraceutical, Inc.*, No. 06-10072 (CSS), 2007 WL 201134, at *19 (Bankr. D. Del. Jan. 18, 2007).

⁹ See *id.* at *41-*42.

¹⁰ See *id.* at *42-*43.

imprecision, inaccuracy and political problems that accompany more traditional methods of valuation.

II. Valuation is an Imprecise Exercise

In *Mirant*, several significant parties in interest disagreed as to the appropriate enterprise valuation of Mirant Corporation and all of its wholly owned or partially owned direct and indirect subsidiaries (the “Mirant Group”).¹¹ The primary parties to the dispute were (i) the debtors, (ii) the official committee of unsecured creditors of Mirant Corporation (the “Corp. Committee”), (iii) the official committee of unsecured creditors of Mirant Corporation’s second tier subsidiary, Mirant Americas Generation LLC (the “MAG Committee”), (iv) the equity committee and (v) a group representing the creditor constituency just senior to the subordinated debt (“Phoenix”).¹² A court-appointed examiner also participated in the valuation proceedings.¹³ The dispute arose when the equity committee filed (i) a motion alleging that the debtors undervalued the Mirant Group in their proposed plan of reorganization and (ii) a complaint asking the court to direct Mirant to call a shareholder meeting.¹⁴

After a status conference and upon a motion filed by the debtors, the bankruptcy court scheduled a three-day hearing on the issue of valuation.¹⁵ In actuality, the Mirant valuation hearing took approximately twenty-seven court days and spanned nearly three

¹¹ *In re Mirant Corp.*, 334 B.R. 800, 804 (Bankr. N.D. Tex. 2005).

¹² *See id.* at 808.

¹³ *See id.* at 811.

¹⁴ *Id.* at 807.

¹⁵ *See id.*; *see also* Second Amended Disclosure Statement Relating to the Debtors’ Second Amended Joint Chapter 11 Plan of Reorganization filed in *In re Mirant Corp., et al.*, Case No. 03-46590 (Bankr. N.D. Tex. Sept. 30, 2005) (the “Mirant Disclosure Statement”), at 73.

months.¹⁶ In all, eighteen parties filed notices of intent to participate in the valuation hearing, five parties participated in discovery, more than one million pages of documents were produced, and eighteen witnesses were deposed.¹⁷

Six parties participated in the valuation hearing and over one thousand exhibits were exchanged among the participating parties.¹⁸ Three fact witnesses and eight expert witnesses testified at the valuation hearing.¹⁹ The testifying experts submitted ten expert reports and hundreds of demonstrative exhibits in support of their position.²⁰ The bankruptcy court heard twenty-five days of live witness testimony.²¹ The bankruptcy court also had the parties submit briefs on certain legal issues relating to valuation, including the impact of recent Supreme Court precedent.²²

To say that the valuation hearing and the preparations leading up to it were of the most extensive of their kind would be an understatement. Nevertheless, the bankruptcy court responded in a rather non-conventional manner. On June 30, 2005, Judge Lynn issued a preliminary ruling in letter form that directed the debtors and their valuation expert to make certain modifications to the debtors' business plan projections and their valuation methodology (the "June 30th Letter"). Judge Lynn explained in the June 30th Letter that the rulings contained therein were binding and that they would be explained in a memorandum opinion that would be issued prior to the confirmation hearing.²³

¹⁶ 334 B.R. at 809; Mirant Disclosure Statement, at 73-74.

¹⁷ 334 B.R. at 809; Mirant Disclosure Statement, at 73.

¹⁸ *Id.* at 74.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² 334 B.R. at 810; Mirant Disclosure Statement, at 74.

²³ June 30th Letter, at 4.

In a second letter ruling dated July 26, 2005 (the “July 26th Letter”) that amended the June 30th Letter, the bankruptcy court acknowledged that the method of communicating its decision was informal.²⁴ The fact that the bankruptcy court responded in such an informal and unorthodox manner after a three month-valuation hearing suggests that the bankruptcy court was hesitant to make a final decision on the evidence before it, and that the court hoped that the parties would settle the issue before confirmation.

The court was clearly uncomfortable to some extent with the valuation calculations submitted by all of the parties.²⁵ In the initial paragraphs of its published valuation opinion, the court stated that “[i]n the case at bar, the court cannot accept unchanged any of the values for Mirant Group that have been placed in evidence.”²⁶ Indeed, Judge Lynn required a dramatic overhaul of the business plan and the debtors’ expert’s valuation methodology, even though he adopted both as the basis for valuation.²⁷ In the decision that Judge Lynn issued in December of 2005 on valuation, he noted that the business plan was “a fair, reasonable projection of future operations of Mirant Group” and that he rejected alternative projections submitted by the equity committee.²⁸ Yet in the June 30th Letter, he acknowledged that he was requiring a significant overhaul of the debtors’ valuation methodology and business plan:

I recognize that the requirements imposed on Debtors and the Blackstone Group by my ruling are substantial. I also

²⁴ See July 26th Letter, at 1 (“As in my June 30 letter, I will not provide the reasoning underlying my conclusions in order to limit the legal effect of this relatively informal method of communication.”).

²⁵ See 334 B.R. at 824.

²⁶ *Id.*

²⁷ *See id.*

²⁸ *Id.* at 824-25.

accept as genuine the concern that a ruling requiring recomputation could lead to further disputes among the parties (though I hope and expect this worry will prove unfounded). However, after considering several alternatives to my ruling, I have determined this is the only way to achieve a result supportable under the evidence.²⁹

Thus, the bankruptcy court refused to adopt, unchanged what it considered to be the most persuasive of the valuation projections and calculations. Moreover, even though the modifications required by the court were time-consuming and labor-intensive, the bankruptcy judge stated that he did not believe that appropriate alternatives existed:

Before concluding this letter, I must acknowledge my dismay at the amount of time necessary to complete recalculation of value. The Corp Committee is quite correct: I had expected a result long before mid-September. However, I see no alternative to proceeding as the VIC proposes. Prior to issuing my June 30 ruling, I attempted to calculate a value using “benchmarks” as suggested by Debtors’ counsel in closing during the valuation hearing. The result (\$10.5 - 11.5 billion) was unsatisfactory in my view because (1) the value would not withstand any sort of careful review (e.g., it accounted for changes in gas prices but not other commodities); and (2) the approximation did not, in my judgment, clearly show that equity was, or was not, in the money. . . .³⁰

There is ample additional evidence that Judge Lynn was reluctant to make a definitive ruling after the extensive valuation proceedings. In both letter rulings and the published valuation decision, Judge Lynn took issue with the experts’ use of data and assumptions. In the July 26th Letter, the court commented on the experts’ use of data in the course of valuation calculations and urged them to use facts currently known to them

²⁹ June 30th Letter, at 4.

³⁰ July 26th Letter, at 3-4.

wherever possible.³¹ The court also wanted the business plan to be updated with more recent forecasts of commodities prices.³² Judge Lynn also addressed the “misperception” that some of the experts seemed to have that “Mirant Group’s value [was] properly set by the market place” and emphasized that the market price of Mirant debt preconfirmation was definitely not an accurate measure of Mirant Group’s value.³³ The court noted, among other things, that the market does not always correctly account for the benefits of bankruptcy.³⁴

In its December 9, 2005 valuation opinion, the bankruptcy court discussed the issue of the motives of certain of the expert witnesses and noted that there was evidence that the equity committee’s and Phoenix’s expert witnesses were acting as advocates rather than as disinterested experts.³⁵ Judge Lynn stopped short of saying that an expert would necessarily act improperly if such expert was influenced by the needs of the party that retained such expert.³⁶ The court nevertheless noted that the potential motives of experts was a reason for courts to be cautious.³⁷

Moreover, before giving its actual ruling, the court in *Mirant* detailed several considerations that made it difficult to value the Mirant Group. For instance, the bankruptcy court emphasized that there were many variables and uncertainties present in

³¹ July 26th Letter, at 2 (“Another general guideline in your work is that, where possible without distorting your valuation methodology, you should utilize facts currently known. The limitations on the use of data that is not disputable but was not available during the valuation hearing is that, if use of that data requires making new assumptions that do not automatically flow from the data, the new data should not be used.”).

³² See 334 B.R. at 829.

³³ *Id.* at 832.

³⁴ See *id.* at 834.

³⁵ See *id.* at 814.

³⁶ *Id.* at 815.

³⁷ *Id.*

the valuation estimates.³⁸ Judge Lynn also observed that there were “peculiar problems” that made it challenging to value a company in the debtors’ industry, which, according to testimony, was a cyclical industry that had not gone through a full cycle.³⁹

Furthermore, Judge Lynn prefaced his ruling with comments that evidenced a lack of faith in valuation generally. At one point in the opinion he commented on the reliability of valuation methodology generally and cited several cases with language that highlighted the limits and lack of precision of the valuation exercise.⁴⁰ He also questioned some of the methodology commonly employed in determining valuation.⁴¹ Among other things, Judge Lynn seemed troubled by the fact that “[c]ash flows are not updated regularly . . . to reflect broken assumptions” and that “[s]tock prices of comparables for just one day are used in calculating multiples.”⁴² In the closing remarks of his opinion, Judge Lynn again expressed a lack of confidence in the valuation process and highlighted its inherent limitations:

At best, the valuation of an enterprise like Mirant Group is an exercise in educated guesswork. At worst it is not much more than crystal ball gazing. There are too many variables, too many moving pieces in the calculation of value of Mirant Group for the court to have great confidence that the result of the process will prove accurate in the future. Moreover, the court is constrained by the need to defer to experts and, in proper circumstances, to Debtors’ management.⁴³

³⁸ 334 B.R. at 818.

³⁹ *Id.* at 818-19.

⁴⁰ 334 B.R. at 818.

⁴¹ *See id.* at 819.

⁴² *Id.*

⁴³ *Id.* at 848.

Judge Lynn was certainly not the first judge to point out that valuation is more of an art than a science.⁴⁴ If, however, the *Mirant* bankruptcy court questioned whether a fair result could be reached after an extensive hearing where advocates on both sides were given the opportunity to present evidence and conduct cross examination, how much confidence can other bankruptcy courts have in valuation outcomes derived from less extensive efforts?

III. Politics May Impact the Outcome of Valuation Disputes

Another problem that may plague valuation disputes is the potential for politics to creep into the process and affect the valuation evidence or outcomes. This was a prominent issue in the contentious valuation dispute in the *National Gypsum* bankruptcy proceedings. There, a committee comprised of unsecured bondholders and trade creditors battled with the debtors' management over management's valuation evidence.⁴⁵ Later, some of the bondholders brought a post-confirmation state court action against the debtors' management alleging that members of management breached their fiduciary duties by intentionally undervaluing the company during the chapter 11 proceedings.⁴⁶

Under a proposed plan that National Gypsum filed with the bankruptcy court, National Gypsum was valued at \$350 million.⁴⁷ The debtors' proposed plan also provided that National Gypsum's current officers and directors would stay on as the

⁴⁴ See, e.g., *Union Bank of Switz. v. Deutsche Fin. Servs. Corp.*, No. 98 Civ. 3251(HB), 2000 WL 178278, at *8 (S.D.N.Y. Feb. 16, 2000) ("Put another way, 'the determination of the 'fair valuation' of the debtor's assets at a specific time is at best an inexact science, and may often be impossible.'" (quoting *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980)); *Boyle v. Wells (In re Gustav Schaeffer 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."))

⁴⁵ See 165 S.W.3d at 339.

⁴⁶ *Id.*

⁴⁷ *Id.* at 340.

initial management team for the reorganized debtor, a newly created entity (“New NGC”).⁴⁸ Under the same proposed plan, the lion’s share of the New NGC stock would go to the holders of senior notes and senior debentures (collectively, the “Senior Bondholders”), and holders of junior bonds (the “Junior Bondholders”) would only receive warrants to purchase New NGC stock.⁴⁹

Earlier in the cases, an official committee comprised of holders of unsecured bond and trade debt (the “BT Committee”) had moved for the appointment of a chapter 11 trustee alleging that “[m]anagement intentionally understated all its forecasts to hide its objective views of the company and to hide the company’s value.”⁵⁰ Moreover, the BT Committee asserted that “this manipulation [was] a weapon [m]anagement has used to try to eliminate the consensual plan forged by the BT Committee and to promote a war between the senior and junior bondholders.”⁵¹ The bankruptcy court ultimately denied the BT Committee’s motion to appoint a chapter 11 trustee on the basis that the BT Committee did not meet its burden of proof on the issue of whether National Gypsum’s management purposely manipulated National Gypsum’s business plan.⁵²

After National Gypsum filed its proposed plan, the BT Committee filed an objection and proposed a competing plan that valued New NGC at \$630 million.⁵³ In its objection, the BT Committee accused National Gypsum’s management of knowingly

⁴⁸ *Id.* at 341.

⁴⁹ *See id.*

⁵⁰ *Id.* at 348-49 (citation omitted).

⁵¹ 165 S.W.3d at 349 (citation omitted).

⁵² *Id.*

⁵³ *Id.* at 341.

misrepresenting National Gypsum's future business prospects and value. Specifically, the BT Committee alleged:

[i]n exchange for greater than 100% recovery and control of the reorganized company's board of directors, certain post petition acquirors of Senior Notes . . . publicly accepted the [National Gypsum] Plan, including its management-entrenchment and enrichment provisions. Hence, management deceived [National Gypsum's] creditors with a misrepresentation of the value of the company to coax a small creditor faction into supporting its plan and opposing the BT Plan.⁵⁴

Ultimately, the bankruptcy court found that the BT Committee failed to prove its proposed valuation, refused to confirm the BT Committee's plan, and approved the debtors' plan after finding that it had been solicited in good faith.⁵⁵ Shortly thereafter, New NGC announced a new cost-savings plan pursuant to which annual expenses would be reduced by \$30 to \$40 million dollars.⁵⁶ This announcement came roughly one month after the expiration of the 180-day period during which an interested party could challenge the bankruptcy confirmation order on the ground that it was procured by fraud.⁵⁷

Following this announcement, certain of the Junior Bondholders brought a state court action against National Gypsum's former officers and directors, their financial advisor and one of the Senior Bondholders.⁵⁸ Counts for breach of fiduciary duties, actual fraud, constructive fraud, and civil conspiracy were brought against all of the

⁵⁴ *Id.*

⁵⁵ *Id.* at 341, 349.

⁵⁶ 165 S.W.3d at 341.

⁵⁷ *Id.*; *see also* 11 U.S.C. § 1144.

⁵⁸ 165 S.W.3d at 341.

defendants.⁵⁹ The plaintiffs further sought recovery against the former directors and officers and their financial advisor for gross negligence.⁶⁰ Alternative claims were also brought against the financial advisor and the Senior Bondholder defendant for participating, aiding, assisting, and/or inducing breach of fiduciary duties.⁶¹

According to the plaintiffs, the Senior Bondholders, National Gypsum's former officers and directors, and their financial advisors intentionally undervalued New NGC by hiding their intention to significantly reduce the company's operating expenses.⁶² The plaintiffs alleged that even though National Gypsum's former officers and directors were fully aware of the cost-savings plan that would be announced after bankruptcy, they represented that New NGC was worth between \$300 million and \$375 million based on their purported "best estimate and intention of how the company would operate once out of bankruptcy."⁶³ According to the plaintiffs, however, the cost-savings plan increased the valuation of New NGC's stock from \$350 million to almost \$1 billion, and had the cost-savings plan been disclosed, the Junior Bondholders would have received a larger distribution. Thus, the plaintiffs argued, the Senior Bondholders received a windfall.⁶⁴

The plaintiffs further alleged that the officers and directors stayed in their positions in New NGC and received other incentives in exchange for their role in hiding the cost-savings plan.⁶⁵ The trial court granted summary judgment in favor of the defendants in the spring of 1999, but the Texas Court of Appeals reversed the summary

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* at 341-42.

⁶³ *Id.* at 342 (citation omitted).

⁶⁴ 165 S.W.3d at 342.

⁶⁵ *Id.*

judgment order that was granted in favor of certain former officers and directors that had not already settled with the plaintiffs.⁶⁶ These former officers and directors appealed arguing, among other things, that the state court claims constituted an impermissible collateral attack on the final judgment of the bankruptcy court.⁶⁷

The Texas Supreme Court agreed with this argument.⁶⁸ The court reasoned that the interests of the Junior Bondholders were represented in the chapter 11 proceedings by the BT Committee, which raised the same allegations of intentional undervaluation and fraud against National Gypsum's management as part of its unsuccessful attempts to get a chapter 11 trustee appointed to replace management and to block confirmation of National Gypsum's proposed plan of reorganization.⁶⁹ Thus, since the fraudulent conduct at issue was not the kind that prevented the Junior Bondholders from presenting their legal rights in the bankruptcy proceedings, the Texas Supreme Court held that the state court action was an impermissible collateral attack on the bankruptcy court's confirmation order.⁷⁰

Whether or not the management in *National Gypsum* actually did conspire with the Senior Bondholders to manipulate the valuation projections, the case is nonetheless illustrative of how even the perception of political influence can cause participants in chapter 11 proceedings to lose confidence in the valuation process. Because the Bankruptcy Code gives a chapter 11 debtor the exclusive right to file and solicit a chapter

⁶⁶ *Id.* at 343.

⁶⁷ *Id.* at 343.

⁶⁸ *Id.* at 351.

⁶⁹ *See id.* at 348-49.

⁷⁰ *See* 165 S.W.3d at 349.

11 plan early in the case,⁷¹ however, the Bankruptcy Code sets the stage for a debtor's management to control the plan process, a critical component of which is the valuation of the reorganized debtor.

Thus, as a practical matter, a chapter 11 debtor's senior management can have a major impact on experts' estimates with respect to valuation.⁷² Indeed, experts may make their estimates as to a company's value based primarily or exclusively on sources that senior management has prepared and discussions with management. In *Mirant*, the debtors' financial adviser, The Blackstone Group, inserted a disclaimer in its expert report providing that "in preparing the Valuation, Blackstone reviewed and discussed the Company's operating and financial projections with senior management" and that Blackstone "neither independently verified nor opined on the Company's underlying business or strategic decisions."⁷³

The bankruptcy court in *Mirant* specifically found that the Blackstone report was the most reliable of the expert reports concerning valuation.⁷⁴ Moreover, Judge Lynn

⁷¹ See 11 U.S.C. § 1121.

⁷² Management's influence and control in the valuation process is illustrated well by certain *dicta* in *Statutory Comm. of Unsecured Creditors v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007), that suggests that valuation evidence submitted by management might be given greater weight in certain circumstances. The valuation discussion in *Iridium* took place in the context of determining the "fair value" and solvency of the debtors for the purposes of evaluating alleged prepetition preferential transfers. The court found that independent market analysis by investment bankers and accounting firms, among others, supported the reasonableness of the debtors' cash flow projections in their business plan, despite the subsequent demise of the company less than nine months after its launch. *Id.* at 348-49. The creditors' committee, which was seeking recovery of approximately \$3.4 billion in alleged preferential transfers, presented evidence that it believed demonstrated the debtors were actually insolvent at the time they made the projections. However, the court determined that the creditors' committee's experts did not adequately explain or rebut the debtors' projections and market valuations that contradicted their opinion. *Id.* at 350-51. The court reasoned that, "[w]here alternative projections 'are no better supported by the evidence than are those in the Business Plan,' the projections in management's business plan should be used in the [Discounted Cash Flow analysis]." *Id.* at 351 (citing *Mirant*, 334 B.R. at 825).

⁷³ Expert Valuation Report of Timothy R. Coleman dated February 25, 2005 submitted in *In re Mirant Corp., et al.*, Case No. 03-46590 (Bankr. N.D. Tex. 2005), at 7.

⁷⁴ 334 B.R. at 830.

found that “Debtors and Debtors’ management were not influenced in the valuation process by reason of any commitment to a creditor constituency to the detriment of equity owners; rather Debtors have properly attended to their fiduciary duties to all constituencies.”⁷⁵ To the extent that the disclaimer in the Blackstone report is typical, however, it highlights that experts giving valuation opinions often need to rely on the work and impressions of a chapter 11 debtor’s senior management. Consequently, when politics permeates a valuation dispute, management may be in the position to effectuate the agenda of the party with which it is aligned.

It may be difficult to estimate how often politics actually infiltrates valuation in bankruptcy. The issue arose again, however, in the Nellson bankruptcy.⁷⁶ In January of 2007, the Bankruptcy Court for the District of Delaware issued an unpublished decision as to the appropriate enterprise value for Nellson.⁷⁷ The court noted that it excluded the valuation report and testimony of the debtors’ expert as unreliable under rule 702 of the Federal Rules of Evidence in an earlier order.⁷⁸ Thus, the bankruptcy court only focused on the reports and testimony of an expert for the official committee of unsecured creditors, an expert for an agent of first and second lien lenders, and an expert for an ad hoc committee of first lien lenders.

The court made several adjustments to three experts’ valuation conclusions based on unsubstantiated judgments and/or errors in methodology, assumptions and/or calculations, and then assigned a weight to the experts’ conclusions based on an

⁷⁵ *Id.*

⁷⁶ *See Nellson*, 2007 WL 201134, at *19.

⁷⁷ *Id.* at *43.

⁷⁸ *Id.* at *14, n.3; *see also In re Nellson Nutraceutical, Inc.*, 356 B.R. 364 (Bankr. D. Del. 2006) (memorandum opinion on exclusion of testimony of debtors’ expert under Rule 702 of the Federal Rules of Evidence).

assessment, *inter alia*, of each expert's credibility.⁷⁹ Importantly, however, the bankruptcy court also determined that it had to make a further downward adjustment of its initial figure for Nellson's enterprise value because all three experts based their analysis on numbers that had been manipulated upward by Nellson's principal shareholder ("Fremont") with the participation of senior management.⁸⁰

The court explained that before the petition date but following the default of financial covenants under its loan agreements, Nellson's management spent months researching and preparing a long range business plan that was ultimately presented to lenders in November of 2005 and revised downward in December of 2005 to reflect the loss of a major customer.⁸¹ Nellson filed for chapter 11 protection on January 28, 2006.⁸² The debtors' management prepared a further downwardly revised long range business plan in February of 2006 but was later directed by executives of Fremont who sat on the board at Nellson to abandon this plan and instead to layer transformation and growth concepts into a business plan for Nellson.⁸³ Around this time, board members that were executives at Fremont raised the issue of increasing the compensation for Nellson's interim president (who at times expressed disagreement with Fremont's directed revisions to the business plan) and his management team and at times issued veiled threats making the interim president feel that his job was in jeopardy if he did not capitulate to Fremont's wishes.⁸⁴

⁷⁹ See *Nellson*, 2007 WL 201134, at *19-*42.

⁸⁰ See *id.* at *19.

⁸¹ See *id.* at *6-8.

⁸² See *Nellson*, 2007 WL 201134, at *2.

⁸³ See *id.* at *11-*12.

⁸⁴ See *id.* at *11.

Freemont and its executives on the Nellson board were extensively involved in the preparation of the new long range business plan, which was prepared in less than a month's time and finalized in May of 2006.⁸⁵ Notwithstanding certain warnings and disagreement from management as to the proposed budget numbers and valuation analyses and the fact the Nellson's financial performance was declining, the May of 2006 plan was far more optimistic, providing substantially higher revenue and EBITDA projections than the earlier plans.⁸⁶ The rosier projections were based in large part on the incorporation of transformational and growth ideas that did not appear to be supported by any market research or customer surveys.⁸⁷ There were also other questionable features of the plan including a new unsubstantiated "unallocated revenue" category that was apparently created to preserve the higher numbers in the plan, the last minute elimination of tens of millions of dollars in projected capital expenditures and the sudden unexplained inclusion of a fiscal year 2011.⁸⁸

Concluding its analysis, the bankruptcy court stated "**[i]n sum, Fremont utilized its control over Nellson to manipulate both the business planning and valuation processes to come up with an artificially inflated enterprise value in order to claim some residual value for their existing equity position.**"⁸⁹ Although members of management seemed reluctant at times to assist with the optimistic forecasts in light of Nellson's poor financial performance, they ultimately seemed to be pressured to participate by Nellson's principal shareholder that had control over their employment and

⁸⁵ See *id.* at *12.

⁸⁶ See *id.* at *12-*14.

⁸⁷ See *id.* at *15.

⁸⁸ See *Nellson*, 2007 WL 201134, at *16-*17.

⁸⁹ *Id.* (emphasis in original).

compensation and had the incentive to inflate projections. Thus, it seems that politics played a significant role in distorting the valuation process in *Nellson* ultimately making the bankruptcy court feel compelled to make adjustments to the conclusions of experts that “*justly relied*” on the “*deliberately inaccurate information provided by the Debtors.*”⁹⁰

The vulnerability of valuation to politics and warring parties’ parochial interests is another reason why valuation perhaps should not play such a dispositive role in determining the distributions creditors and holders of interests are entitled to receive under a chapter 11 plan. Although valuation is designed to fairly determine how to slice up the pie, it certainly cannot be completely insulated from the self-interest of the participants.

IV. Valuation Projections Are Frequently Inaccurate

As mentioned above, valuation is a threshold determination from which critical decisions in chapter 11 reorganizations are made and it materially affects the substantive rights of creditors and other interested parties. The emphasis placed on valuation outcomes in chapter 11 cases, however, may often be unwarranted as valuation projections are frequently inaccurate. Undoubtedly, because projections are made without the benefit of hindsight, most bankruptcy courts must accept the built in limitations of valuation to some degree. But how much inaccuracy should be tolerated?

In trying to get a sense of how often valuation projections miss the mark, we compared the post-confirmation value of the shares of reorganized chapter 11 debtors that emerged as public companies in some of the larger and more recent cases to the projected

⁹⁰ See *id.* at *1 (emphasis in original).

value of the same shares as expressed in each debtor's respective disclosure statement.⁹¹

⁹¹ *In re Worldcom, Inc., et. al.*, Case No. 02-13533, Debtors' Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code, at 86 [Docket No. 6108], approved by order entered 05/28/2003 [Docket No. 6110]; *In re Global Crossing, Ltd., et. al.*, Case No. 02-40188, Disclosure Statement for Debtors' Joint Plan of Reorganization, at 47 [Docket No. 1991], approved by order entered 10/22/2002 [Docket No. 2030]; *In re UAL Corp., et. al.*, Case No. 02-48191, First Amended Disclosure Statement for Reorganizing Debtors' First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code, at 2, 191 [Docket No. 13279], approved by order entered 10/21/2005 [Docket No. 13285]; *In re Delta Air Lines, Inc., et. al.*, Case No. 05-17923, Disclosure Statement for Debtors' Joint Plan of Reorganization under Chapter 11 of the United States Bankruptcy Code, at 143 [Docket No. 4494, ex. A], approved by order entered 02/07/2007 [Docket No. 4494]; *In re Kmart Corp., et. al.*, Case No. 02-02474, Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession, Appendix D, at 1 [Docket No. 8925], approved by order entered 02/26/2003 [Docket No. 8918]; *In re Northwest Airlines Corp., et. al.*, Case No. 05-17930, Disclosure Statement with Respect to Debtors' First Amended Joint and Consolidated Plan of Reorganization under Chapter 11 of the Bankruptcy Code, at 58 [Docket No. 5742], approved by order entered 03/30/2007 [Docket No. 5736]; *In re NRG Energy, Inc., et. al.*, Case No. 03-13024, Third Amended Disclosure Statement for Debtors' Second Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code, at 86 [Docket No. 510], approved by order entered 10/17/2003 [Docket No. 773]; *In re US Airways Group, Inc., et. al.* (2002), Case No. 02-83984, Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of US Airways Group, Inc. and its Affiliated Debtors and Debtors-in-Possession, ex. D, at 4 [Docket No. 2068, ex. G], approved by order entered 01/17/2003 [Docket No. 2068]; *In re US Airways Group, Inc., et. al.* (2004), Case No. 04-13819, Second Amended Disclosure Statement with Respect to Joint Plan of Reorganization of US Airways, Inc. and its Affiliated Debtors and Debtors-in-Possession, at D-3 [Docket No. 2794, ex. A], approved by order entered 08/09/2005 [Docket No. 2794]; *In re Owens Corning, et. al.*, Case No. 00-03837, Disclosure Statement with Respect to Sixth Amended Joint Plan of Reorganization for Owens Corning and its Affiliated Debtors and Debtors-In-Possession (As Modified), at 293 [Docket No. 18339], approved by order entered 07/11/2006 [Docket No. 18348]; *In re Williams Commc'ns Group, et. al.*, Case No. 02-11957, Second Amended Disclosure Statement with Respect to Second Amended Joint Chapter 11 Plan of Reorganization of Williams Communications Group, Inc. and CG Austria, Inc., at 53, 68 [Docket No. 267], approved by order entered 08/13/2002 [Docket No. 264]; *Loewen Group Int'l, Inc., et. al.*, Case No. 99-1244, Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Fourth Amended Joint Plan of Reorganization of Loewen Group International, Inc., its Parent Corporation and Certain of their Debtor Subsidiaries, at 112 [Docket No. 7853], approved by order entered 09/04/2001 [Docket No. 7913]; *In re Petroleum Geo-Servs. ASA*, Case No. 03-14786, Disclosure Statement for First Amended Plan of Reorganization for Petroleum Geo-Services ASA, at 11, 12 [Docket No. 104], approved by order entered 09/10/2003 [Docket No. 105]; *In re Armstrong World Indus., Inc., et. al.*, Case No. 00-04471, Disclosure Statement for the Fourth Amended Plan of Reorganization of Armstrong World Industries, Inc., at 102 [Docket No. 4801], approved by order entered 06/02/2003 [Docket No. 4885]; *In re Kaiser Aluminum Corp., et. al.*, Case No. 02-10429, Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Second Amended Joint Plan of Reorganization, at 158 [Docket No. 7311], approved by order entered 9/8/2005 [Docket No. 7320]; *In re Winn-Dixie Stores, Inc., et. al.*, Case No. 05-03817-3F1, Disclosure Statement With Respect to Joint Plan of Reorganization of Winn-Dixie Stores, Inc. and Affiliated Debtors, at 117 [Docket No. 10057], approved by order entered 08/04/2006 [Docket No. 9917]; *In re Loral Space & Commc'ns Ltd., et. al.*, Case No. 03-41710, Disclosure Statement for Debtors' Fourth Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, at 93 [Docket No. 2074], approved by order entered June 3, 2005 [Docket No. 2076]; *In re Northwestern Corp.*, Case No. 03-12872, Second Amended and Restated Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Plan of Reorganization of the Debtor, at 94 [Docket No. 2021], approved by order entered 9/2/2004 [Docket No. 2033]; *In re RCN Corporation, et. al.*, Case No. 04-13638, Disclosure Statement With Respect To The Joint Plan Of Reorganization Of RCN Corporation And Certain Subsidiaries, at 78 [Docket No. 300], approved by order entered 10/13/2004 [Docket No. 296]; *In re Leap Wireless Int'l, Inc.*,

To select the group of former chapter 11 debtors for which to gather data, we began with a list of large chapter 11 bankruptcy filings from the last 10 years.⁹² Debtors were excluded if they: (i) sold substantially all of their assets in a section 363 sale, (ii) were bought by a private company through a chapter 11 plan, or (iii) otherwise did not emerge from their chapter 11 cases. Debtors were also excluded from the list if the data set forth was not reasonably accessible or available. Furthermore, several debtors were excluded because their disclosure statements did not include projected equity valuations. Finally, in order to ensure several quarterly post-emergence trading prices and to avoid having the results skewed by the unorthodox nature of the market as of late, debtors were excluded if they emerged from chapter 11 less than eighteen months ago.

Historical stock prices were obtained using Bloomberg L.P. The 1Q, 2Q, 3Q, and 4Q historical prices in the chart below correspond to the first four quarterly periods that occurred after the effective date of each debtor's plan.⁹³ Further, certain of the debtors' disclosure statements only contained a total projected equity valuation range. In these cases, we were able to calculate the projected equity value per share by dividing the total projected equity valuation range by the number of shares issued on the effective date.

et. al., Case No. 03-03470, Disclosure Statement Accompanying Fifth Amended Joint Plan of Reorganization dated as of July 30, 2003, at 63 [Docket No. 479, ex. C], approved by order entered 07/31/2003 [Docket No. 487].

⁹² To obtain a representative list of large, recent companies that emerged from chapter 11, we considered the largest 20 non-financial chapter 11 bankruptcy debtors of all time, all debtors that filed for chapter 11 protection between 2000-2002 with over \$4 billion dollars in assets, and all debtors that filed for chapter 11 protection between 2003-2006 with over \$2 billion dollars in assets.

⁹³ If the first financial quarter was less than one month from when the company emerged, we used the following financial quarter as the first quarter.

The number of shares issued and outstanding on the effective date was obtained in a subsequent report filed with the Securities and Exchange Commission.⁹⁴

Debtor	Assets				1Q	2Q	3Q	4Q
	in Billions	Emerged	Projected Value					
WorldCom, Inc. ⁹⁵	\$103	4/20/2004	20.29 - 29.71 (25.00)		14.43	16.75	20.16	24.90
Global Crossing, Ltd.	\$30	12/9/2003	10.16		20.00	15.60	16.52	18.14
UAL Corporation	\$25	2/1/2006	15.00		39.93	31.02	26.57	44.00
Delta Airlines, Inc.	\$21	4/30/2007	38.08 - 48.61		19.70	17.95	14.89	8.60
Kmart Corporation	\$14	5/6/2003	8.74 - 17.43		26.90	24.93	23.95	41.48
Northwest Airlines Corporation	\$14	5/31/2007	33.04 - 38.68		22.20	17.80	14.51	8.99
NRG Energy, Inc.	\$10.8	12/4/2003	21.83 - 26.24		21.90	22.20	24.80	26.94
U.S. Airways Group, Inc. (2002)	\$8	3/31/2003	8.30		6.00	6.22	4.48	2.35
U.S. Airways Group (2004)	\$8	9/27/2005	18 - 33 (25.5)		37.14	40.00	50.54	44.33
Owens Corning	\$6.4	10/31/2006	26.51 - 34.13		29.90	31.86	33.63	25.05
Williams Communications Groups ⁹⁶	\$6	10/15/2002	7.59 - 12.41 (10.00)		15.79	12.60	14.82	16.05
Loewen Group International, Inc. ⁹⁷	\$4.6	1/2/2002	17.17		8.90	7.58	6.50	4.74
Petroleum Geo-Services ASA	\$4.3	11/5/2003	16.00		3.65	4.52	4.08	4.85
Armstrong World Industries, Inc.	\$4.1	10/4/2006	24.66 - 35.30 (30.00)		42.39	50.85	50.15	40.59
Kaiser Aluminum Corporation	\$3.3	7/6/2006	17.00 - 20.75 (19.00)		44.34	55.98	78.00	72.88
Winn-Dixie Stores, Inc.	\$2.6	11/21/2006	11.39 - 16.30		13.50	17.65	29.30	18.72
Loral Space & Communications Ltd.	\$2.6	11/22/2005	19.40 - 30.95		28.28	28.75	28.36	26.32
Northwestern Corporation	\$2.6	11/1/2004	17.61 - 22.39 (20.00)		28.00	26.37	31.52	30.19
RCN Corporation	\$2.3	12/22/2004	17.22 - 22.76		19.90	23.09	21.22	23.45
Leap Wireless International Inc.	\$2.1	8/17/2004	2.22 - 4.27		22.00	27.00	26.05	27.75

This data suggests that valuation projections are frequently off target. While a few debtors accurately projected the equity value of their reorganized companies over the first four quarters after emerging from bankruptcy, most projections missed the mark significantly. In nearly a quarter of the cases, the debtor's projected equity value was off by more than 100 percent. In approximately half of the cases, the actual equity values were closer to the projections, but still off by a significant amount over all four quarters.

⁹⁴ We located the number of outstanding shares on the effective date for certain debtors in the following filings with the Securities and Exchange Commission: Delta Air Lines, Inc., Quarterly Report (Form 10-Q), at 3, 6 (Aug. 2, 2007); Northwest Airlines Corporation, Quarterly Report (Form 10-Q), at 6 (Aug. 9, 2007); NRG Energy, Inc., Quarterly Report (Form 10-Q), at 5 (May 10, 2004); Leap Wireless International, Inc., Quarterly Report (Form 10-Q), at 1 (Nov. 22, 2004); RCN Corporation, Quarterly Report (Form 10-Q), at 1 (Jun. 28, 2005).

⁹⁵ WorldCom, Inc. emerged as MCI, Inc.

⁹⁶ Williams Communications Group, Inc. emerged as WiTel Communications Corporation, Inc.

⁹⁷ Loewen Group International, Inc. emerged as Alderwoods Group Inc.

As this data demonstrates, notwithstanding the time, resources and expense that bankruptcy courts and chapter 11 participants invest to derive valuation outcomes, these projections will often be inaccurate. Yet courts and other participants in chapter 11 cases routinely rely on these estimates as a cornerstone for deciding how to carve up the debtor's assets for distribution. If the historical data from larger studies with more formal controls reveals the same result – that valuation projections are consistently poor proxies for the ultimate value of a reorganized entity – a legitimate argument can be made that a sounder basis for decision making in the chapter 11 process should be developed.

V. Can a Method That Ties Valuation to Post-Effective Date Trading Prices Solve These Problems?

Is there any way to fix the problems associated with valuation? Is there a mechanism that can accomplish the objectives of valuation without the accompanying inaccuracy, imprecision and vulnerability to politics? One possible solution to the pitfalls of traditional valuation methods is to let the market set the value of the debtor's shares after the debtor emerges from bankruptcy.

Volume weighted average price (“VWAP”) is generally described as a form of algorithmic trading.⁹⁸ VWAP is generally calculated by adding up the dollar value of all of the shares that are traded over a specific period of time, and dividing that sum by the total number of shares traded over the time horizon. If a mechanism modeled after VWAP were used for valuation purposes in bankruptcy, the market would determine what the shares of the reorganized entity are worth, and it may obviate the need for educated guesswork. Using VWAP in this context may also eliminate the inaccuracies,

⁹⁸ Sham M. Kakade, Michael Kearns, Yishay Mansour, and Luis E. Ortiz, *Competitive Algorithms for VWAP and Limit Order Trading*, Abstract for EC '04, May 17-20, 2004, at 1 (available at <http://www.cis.upenn.edu/~mkearns/papers/vwap.pdf>).

expense and investment of time associated with valuation projections and shield the process from politics.

VWAP has been used in the bankruptcy context as a post-confirmation pricing mechanism in two recent cases. VWAP was used in the chapter 11 cases of Adelphia Communications, Inc. and its affiliated debtors and debtors in possession (“Adelphia”).⁹⁹ Dana Corporation, Inc. and its affiliated debtors and debtors in possession (“Dana”) also used VWAP in their chapter 11 cases.¹⁰⁰

In *Adelphia*, VWAP was used as part of a larger mechanism to value the shares of Time Warner Cable (“TWC”) stock that were distributed under the debtors’ plan of reorganization.¹⁰¹ Although shares of TWC stock were distributed to parties on the effective date based on a deemed valuation of the stock, some of the shares were held back and a post-confirmation market test was administered.¹⁰² During the test period, the plan administrator was required to calculate the VWAP daily price for the stock.¹⁰³ At the conclusion of the test period, this information could then be used to calculate any

⁹⁹ See *In re Adelphia Commc’ns Corp.*, Case No. 02-41729 (REG), Second Disclosure Statement Supplement Relating to Fifth Amended Joint Chapter 11 Plan for Adelphia Communications Corporation and Certain Affiliated Debtors, at 93-94 [Docket No. 12198, ex. C] (the “Adelphia Disclosure Statement Supplement”), approved by order dated 10/17/2006 [Docket No. 12202]; *In re Adelphia Commc’ns Corp.*, Case No. 02-41729 (REG), Plan Administrator Agreement by and Among Adelphia Communications Corporation and all of its Affiliated Debtors-in-Possession, The Official Committee of Unsecured Creditors and Quest Turnaround Advisors, L.L.C., dated as of February 12, 2007 (the “Adelphia Plan Administrator Agreement”) § 2.15.

¹⁰⁰ See *In re Dana Corp., Inc.*, Case No. 06-10354 (BRL), Third Amended Disclosure Statement With Respect to Third Amended Joint Plan of Reorganization of Debtors and Debtors in Possession (the “Dana Disclosure Statement”), dated October 23, 2007, at 55 [Docket No. 6669], approved by order entered 10/23/2007 [Docket No. 6673].

¹⁰¹ See Adelphia Disclosure Statement Supplement, at 93 (noting that the value to be used to calculate the amounts of releases from the holdback of TWC stock would be “the volume weighted average trading price per share of TWC Class A Common Stock during the Test Period.”)

¹⁰² See *id.* (“The True-Up Holdback will be funded on the Effective Date by withholding amounts otherwise payable in respect of initial Effective Date distributions . . .”).

¹⁰³ See Adelphia Plan Administrator Agreement § 2.15.

necessary adjustments with respect to distributions.¹⁰⁴ Thus, if the post confirmation test as measured by the application of VWAP indicated that the original deemed value of the TWC shares was an inaccurate projection, certain recipients under the plan could be “trued up” with the shares that remained in the holdback.¹⁰⁵

In *Dana*, VWAP was used to determine the value of new shares of stock in the reorganized debtors.¹⁰⁶ Under the terms of the plan, the lead plan investor, Centerbridge Partners, L.P., received preferred stock in exchange for its investment in the debtors. Under certain predefined circumstances, shares of preferred stock were convertible to new common stock.¹⁰⁷ The conversion price for these shares depended upon, *inter alia*, the VWAP of new common stock over a 20-day time window.¹⁰⁸ The Dana Disclosure Statement further provided that if, after such conversion, the holders of the converted stock owned a percentage of the new common shares that exceeded pre-defined

¹⁰⁴ See Adelpia Disclosure Statement Supplement, at 93.

¹⁰⁵ *Id.* (“The Plan contemplates the creation of a true-up reserve on the Effective Date consisting of TWC Class A Common Stock (or Cash to the extent there is not sufficient stock available) that is intended, subject to certain limitations, to be sufficient to permit the upward or downward adjustment of the total number of shares received by creditors of the Subsidiary Debtors based upon a Market Value of the TWC Class A Common Stock that is up to twenty percent higher or lower than the Deemed Value used for initial Distributions under the Plan.”)

¹⁰⁶ Dana Disclosure Statement, at 55.

¹⁰⁷ *Id.* at 55.

¹⁰⁸ *Id.* Specifically, the Dana Disclosure Statement provides as follows:

Subject to a collar based on a total enterprise value of New Dana Holdco of between \$3.15 billion and \$3.5 billion as described in subsections (i) and (ii) below, **the price at which each share of New Preferred Stock will be convertible into New Dana Holdco Common Stock will be 83% of its distributable market equity value per share, which is the per share value of the New Dana Holdco Common Stock determined by calculating the 20-day volume weighted average trading price of such common stock on the principal exchange or over-the-counter market on which it trades (using the 22 trading days beginning on and including the first trading day after the Effective Date but disregarding the days with the highest and lowest volume weighted average sale price during such period).** . . .

Id. at 55 (emphasis added).

limitations, adjustments would be made so that ownership of the reorganized debtors would not shift immediately post-confirmation.¹⁰⁹

Although VWAP was used in *Adelphia* and *Dana*, bankruptcy judges may not all be comfortable abandoning traditional valuation methods in favor of post-confirmation trading valuation. Moreover, the use of VWAP or a method similar thereto may present its own set of legal and practical problems. For instance, it would likely require more post-confirmation supervision from the bankruptcy court and it may delay the distribution of plan consideration. Using VWAP may also make it difficult for a plan proponent to establish that the standards for confirmation under section 1129 of the Bankruptcy Code (*i.e.*, the fair and equitable test) have been satisfied. Nonetheless, skeptics of the traditional valuation process may want to consider investigating VWAP or alternative methodologies that may be less prone to the weaknesses that undermine the fairness that valuation is designed to achieve.

VI. Final Thoughts

Inevitably, any system that is used to determine whether constituents in a chapter 11 case are entitled to recovery and the size of such recovery will draw criticism. Moreover, any such mechanism will have to balance the need for accuracy, fairness and precision against efficiency and finality. Nevertheless, it is easy to understand how participants in the chapter 11 process may lack confidence in valuation and be concerned over the emphasis and reliance placed on valuation outcomes.

¹⁰⁹ *Id.*

Should Valuation Have Such a Material Role in Chapter 11?

*Delaware Views from the Bench:
Views on Valuation Issues
November 3, 2008*

Valuation Plays a Central Role in Chapter 11

- **Valuation works in tandem with the Absolute Priority Rule to determine whether and how much junior creditors and holders of equity interests will recover under a chapter 11 plan.**
- **Valuation is frequently hotly contested in chapter 11 proceedings.**

Valuation Plays a Central Role in Chapter 11 (continued)

Should Valuation Play Such a Significant Role in Reorganizations When:

- Valuation is an Imprecise Exercise
- Politics May Impact the Outcome of Valuation Disputes
- Valuation Projections Are Frequently Inaccurate

Valuation is an Imprecise Exercise

Mirant Valuation Proceedings

- Hearing took twenty-seven court days over three months
- Five parties participated in discovery
- More than one million pages of documents were produced
- Eighteen witnesses were deposed
- Six parties participated in the valuation hearing
- Three fact witnesses and eight expert witnesses testified
- Testifying experts submitted ten expert reports and hundreds of exhibits
- Parties briefed certain legal issues

Valuation is an Imprecise Exercise (continued)

The bankruptcy court in *Mirant* appeared reluctant to make a final ruling on valuation.

- Issued two informal preliminary letter rulings
- Required extensive modifications to the business plan and valuation calculations
- Expressed lack of confidence in valuation generally in subsequent memorandum opinion

Valuation is an Imprecise Exercise (continued)

In his opinion, Judge Lynn expressed a lack of confidence in the valuation process, called it “an exercise in guesswork,” and highlighted its inherent limitations:

- Too many variables
- Too many moving pieces
- Constrained by deference to experts and Debtor’s management

Politics May Impact the Outcome of Valuation Disputes

- **Management may have the incentive to align itself either with constituents that are likely to receive the most common stock under a chapter 11 plan or that otherwise have the most to offer senior management.**
- **Management may use its opportunity and position to influence the valuation process in favor of the creditor group offering the greatest incentives.**
- **Exclusivity under 11 U.S.C. § 1121 may exacerbate this problem.**

Politics May Impact the Outcome of Valuation Disputes (continued)

- In *National Gypsum*, management valued the company at between \$300 million and \$375 million while holders of junior debt valued the company at more than \$600 million.
- The approved plan left the junior debt out of the money.
- Shortly after *National Gypsum* emerged from bankruptcy, however, management announced a cost-savings plan.
- Junior debt argued that *National Gypsum*'s senior management concealed relevant information and purposely undervalued the company, in part because of certain incentives offered by the holders of the senior debt.

Politics May Impact the Outcome of Valuation Disputes (continued)

- In *Nellson Nutraceutical*, the court found that the debtors' principal shareholder, with the participation of management, utilized its control over *Nellson* to artificially inflate enterprise value in order to claim some residual value for their existing equity position.
- This distorted the valuation process because all three experts whose opinion the court considered relied on the plan prepared by management.

Valuation Projections Are Frequently Inaccurate

We selected twenty of the larger and more recent chapter 11 debtors to emerge as public companies and compared the post-confirmation value of the shares of the reorganized chapter 11 debtors to the projected value of the same shares as expressed in each debtor's respective disclosure statement.

Valuation Projections Are Frequently Inaccurate (continued)

While a few debtors accurately projected the equity value of their reorganized companies over the first four quarters after emerging from bankruptcy, most projections missed the mark significantly.

- **In nearly a quarter of the cases, the debtor's projected equity value was off by more than 100 percent.**
- **In approximately half of the cases, the actual equity values were closer to the projections, but still off by a significant amount over all four quarters.**

Solutions

Is there a mechanism that can accomplish the objectives of valuation without the accompanying inaccuracy, imprecision and vulnerability to politics?

Solutions (continued)

One possible solution to the pitfalls of traditional valuation methods is to let the market set the value of the debtor's shares after the debtor emerges from bankruptcy.

- **Volume weighted average price (“VWAP”)**
- **Used in *Adelphia* as part of a larger mechanism to value the shares of Time Warner Cable stock that was distributed under the plan of reorganization**
- **Used in *Dana* to determine price at which shares of preferred stock that lead plan investor received in exchange for its investment were convertible into new common stock**

Solutions (continued)

- **Bankruptcy judges and chapter 11 participants may not feel comfortable abandoning traditional valuation methods in favor of VWAP or another post-emergence market mechanism.**
- **Use of VWAP or another post-emergence market mechanism may present its own set of legal and practical problems.**

Final Thoughts

Was Judge Lynn right to be concerned?

Should Valuation Have Such a Material Role in Chapter 11?

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I. Introduction

There can be little doubt that valuation plays a central role in chapter 11 bankruptcy cases. The valuation of a reorganizing debtor's business is critical to determining who will own the reorganized debtor.¹ As a function of the absolute priority rule, creditors generally will receive all of the value of the reorganizing debtor unless there is a surplus available for holders of equity interests.² Similarly, if there are senior and junior creditors in a debtor's capital structure, junior creditors will generally not receive a recovery unless there is sufficient value to satisfy in full all senior claims.³

Valuation is key to determining whether there is any surplus value. Thus, the valuation of the common stock of the reorganized debtor will determine whether unsecured creditors and equity security holders are entitled to receive any distribution under a proposed chapter 11 plan of reorganization. Moreover, the dollar amount at which the shares of the reorganized entity is valued will also impact the size of the distribution to which the chapter 11 debtor's creditors and equity holders are legally entitled. For these reasons, valuation is often hotly contested in chapter 11 cases.⁴

Not surprisingly, constituents that stand to receive the bulk of a reorganizing debtor's equity often have an incentive to argue for a lower valuation of the debtor, so as

¹ See, e.g., *Conso. Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 525 (1941) ("Findings as to the earning capacity of an enterprise are essential to a determination of the feasibility as well as the fairness of a plan of reorganization.").

² See 11 U.S.C. § 1129(b)(2).

³ See, e.g., *Protective Comm. v. Anderson*, 390 U.S. 414, 441 (1968) ("Since participation by junior interests depends upon the claims of senior interests being fully satisfied, whether a plan of reorganization excluding junior interests is fair and equitable depends upon the value of the reorganized company.").

⁴ Cf. *In re Bush Indus., Inc.*, 315 B.R. 292, 297 (Bankr. W.D.N.Y. 2004) ("Both creditors and stockholders share the same interest in the outcome of a favorable valuation. An inappropriately high valuation will deny to creditors the right to assets without allocation for the interest of equity. On the other hand, an inappropriately low valuation will deny to equity the right to assets after allocation for the interest of creditors.")

to prevent junior creditors or shareholders from taking a portion or a substantial portion of a reorganized debtor's stock. Junior creditors and equity security holders that might otherwise recover nothing under a chapter 11 plan, on the other hand, may have an incentive to lobby the bankruptcy court to value the reorganizing debtor at a higher dollar amount. The Bankruptcy Code does not dictate a particular method for valuation that must be used, and thus, bankruptcy courts have to grapple with the issue on a case-by-case basis.

While it may be difficult to dispute that valuation *does* play a significant role in chapter 11, there is certainly room to debate whether valuation *should* play such a significant role. Such a debate should focus on seven considerations. For one, courts have routinely expressed the view that valuation is an inexact science. Important valuation determinations can be impacted by factors that perhaps should not be part of the equation, such as the credibility and skill of expert witnesses. Valuation outcomes also may be vulnerable to the parochial interests and relative bargaining power of quarreling constituents. Against this backdrop, a chapter 11 debtor's senior management may have the incentive to align itself with the faction of creditors or holders of interests that stands to receive the most common stock under a chapter 11 plan or that otherwise has the most to offer senior management. Senior management may use its opportunity and position to influence the valuation process in favor of the creditor group that will be in the best position to offer management incentives. Finally, there is of course the issue of the accuracy of valuation projections. How often does this number actually turn out to be an accurate forecast of the value of the reorganized debtor's equity?

This article explores these issues. Part II of the article discusses how valuation is an imprecise exercise. This view is primarily expressed through a review of the valuation proceedings in the chapter 11 cases of Mirant Corporation and its affiliated debtors and debtors in possession (“Mirant”). Although the valuation hearing in *Mirant* was one of the longest and most thorough valuation hearings in chapter 11 history, the bankruptcy court nevertheless appeared to be uncomfortable making a final ruling on the issue.

Part III of this article examines how politics may be lurking in the background of valuation disputes. This issue is well illustrated by the valuation battle in the chapter 11 cases of National Gypsum and its affiliated debtors and debtors in possession (“National Gypsum”). In *National Gypsum*, management valued the company at between \$300 million and \$375 million while holders of junior debt valued the company at more than \$600 million.⁵ The plan approved by the bankruptcy court left the junior debt out of the money. Shortly after National Gypsum emerged from bankruptcy, however, management announced a cost-savings plan that certain of the junior debt holders alleged dramatically increased the value of the reorganized debtors’ shares.⁶ Both during the chapter 11 cases and in an unsuccessful post-bankruptcy state court action, holders of the junior debt argued that National Gypsum’s senior management concealed relevant information and purposely undervalued the company, in part because of certain incentives offered by the holders of the senior debt.⁷

The issue of politics was also featured more recently in the chapter 11 cases of Nellson Nutraceutical, Inc. and its affiliated debtors and debtors in possession

⁵ See *Browning v. Prostok*, 165 S.W.3d 336, 340-42 (Tex. 2005).

⁶ See *id.* at 341-42.

⁷ See *id.* at 341-42, 348-49.

(“Nellson”).⁸ In *Nellson*, the Bankruptcy Court for the District of Delaware arrived at an initial figure for the projected enterprise value of the debtors based on weighting the corrected valuation projections of three expert witnesses according to each expert’s credibility.⁹ The court ultimately determined, however, that it was appropriate to revise this initial figure downward because the principal shareholder, with the participation of senior management, had manipulated the preparation of the debtors’ long range business plan to enhance the perceived value of Nellson and because all three experts had relied on this plan in reaching their valuation projections.¹⁰

Part IV of the article attempts to examine the accuracy of valuation projections relating to a reorganizing chapter 11 debtor. We selected twenty of the larger and more recent chapter 11 debtors to emerge as public companies and compared the post-confirmation value of the shares of the reorganized chapter 11 debtors to the projected value of the same shares as expressed in each debtor’s respective disclosure statement. Analysis of this data suggests that valuation projections are often inaccurate.

Finally, Part V of this article ponders whether there is a solution to the problems with valuation discussed in Parts II-IV. Specifically, Part V discusses the concept of “volume weighted average price” (“VWAP”), which may provide a mechanism for valuation based on the trading price of an entity’s shares after emergence from chapter 11. Part V evaluates the VWAP mechanism as a possible solution to sidestep the

⁸ See *In re Nellson Nutraceutical, Inc.*, No. 06-10072 (CSS), 2007 WL 201134, at *19 (Bankr. D. Del. Jan. 18, 2007).

⁹ See *id.* at *41-*42.

¹⁰ See *id.* at *42-*43.

imprecision, inaccuracy and political problems that accompany more traditional methods of valuation.

II. Valuation is an Imprecise Exercise

In *Mirant*, several significant parties in interest disagreed as to the appropriate enterprise valuation of Mirant Corporation and all of its wholly owned or partially owned direct and indirect subsidiaries (the “Mirant Group”).¹¹ The primary parties to the dispute were (i) the debtors, (ii) the official committee of unsecured creditors of Mirant Corporation (the “Corp. Committee”), (iii) the official committee of unsecured creditors of Mirant Corporation’s second tier subsidiary, Mirant Americas Generation LLC (the “MAG Committee”), (iv) the equity committee and (v) a group representing holders of subordinated debt (“Phoenix”).¹² A court-appointed examiner also participated in the valuation proceedings.¹³ The dispute arose when the equity committee filed (i) a motion alleging that the debtors undervalued the Mirant Group in their proposed plan of reorganization and (ii) a complaint asking the court to direct Mirant to call a shareholder meeting.¹⁴

After a status conference and upon a motion filed by the debtors, the bankruptcy court scheduled a three-day hearing on the issue of valuation.¹⁵ In actuality, the Mirant valuation hearing took approximately twenty-seven court days and spanned nearly three

¹¹ *In re Mirant Corp.*, 334 B.R. 800, 804 (Bankr. N.D. Tex. 2005).

¹² *See id.* at 808.

¹³ *See id.* at 811.

¹⁴ *Id.* at 807.

¹⁵ *See id.*; *see also* Second Amended Disclosure Statement Relating to the Debtors’ Second Amended Joint Chapter 11 Plan of Reorganization filed in *In re Mirant Corp., et al.*, Case No. 03-46590 (Bankr. N.D. Tex. Sept. 30, 2005) (the “Mirant Disclosure Statement”), at 73.

months.¹⁶ In all, eighteen parties filed notices of intent to participate in the valuation hearing, five parties participated in discovery, more than one million pages of documents were produced, and eighteen witnesses were deposed.¹⁷

Six parties participated in the valuation hearing and over one thousand exhibits were exchanged among the participating parties.¹⁸ Three fact witnesses and eight expert witnesses testified at the valuation hearing.¹⁹ The testifying experts submitted ten expert reports and hundreds of demonstrative exhibits in support of their position.²⁰ The bankruptcy court heard twenty-five days of live witness testimony.²¹ The bankruptcy court also had the parties submit briefs on certain legal issues relating to valuation, including the impact of recent Supreme Court precedent.²²

To say that the valuation hearing and the preparations leading up to it were of the most extensive of their kind would be an understatement. Nevertheless, the bankruptcy court responded in a rather non-conventional manner. On June 30, 2005, Judge Lynn issued a preliminary ruling in letter form that directed the debtors and their valuation expert to make certain modifications to the debtors' business plan projections and their valuation methodology (the "June 30th Letter"). Judge Lynn explained in the June 30th Letter that the rulings contained therein were binding and that they would be explained in a memorandum opinion that would be issued prior to the confirmation hearing.²³

¹⁶ 334 B.R. at 809; Mirant Disclosure Statement, at 73-74.

¹⁷ 334 B.R. at 809; Mirant Disclosure Statement, at 73.

¹⁸ *Id.* at 74.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² 334 B.R. at 810; Mirant Disclosure Statement, at 74.

²³ June 30th Letter, at 4.

In a second letter ruling dated July 26, 2005 (the “July 26th Letter”) that amended the June 30th Letter, the bankruptcy court acknowledged that the method of communicating its decision was informal.²⁴ The fact that the bankruptcy court responded in such an informal and unorthodox manner after a three month-valuation hearing suggests that the bankruptcy court was hesitant to make a final decision on the evidence before it, and that the court hoped that the parties would settle the issue before confirmation.

The court was clearly uncomfortable to some extent with the valuation calculations submitted by all of the parties.²⁵ In the initial paragraphs of its published valuation opinion, the court stated that “[i]n the case at bar, the court cannot accept unchanged any of the values for Mirant Group that have been placed in evidence.”²⁶ Indeed, Judge Lynn required a dramatic overhaul of the business plan and the debtors’ expert’s valuation methodology, even though he adopted both as the basis for valuation.²⁷ In the decision that Judge Lynn issued in December of 2005 on valuation, he noted that the business plan was “a fair, reasonable projection of future operations of Mirant Group” and that he rejected alternative projections submitted by the equity committee.²⁸ Yet in the June 30th Letter, he acknowledged that he was requiring a significant overhaul of the debtors’ valuation methodology and business plan:

I recognize that the requirements imposed on Debtors and the Blackstone Group by my ruling are substantial. I also

²⁴ See July 26th Letter, at 1 (“As in my June 30 letter, I will not provide the reasoning underlying my conclusions in order to limit the legal effect of this relatively informal method of communication.”).

²⁵ See 334 B.R. at 824.

²⁶ *Id.*

²⁷ *See id.*

²⁸ *Id.* at 824-25.

accept as genuine the concern that a ruling requiring recomputation could lead to further disputes among the parties (though I hope and expect this worry will prove unfounded). However, after considering several alternatives to my ruling, I have determined this is the only way to achieve a result supportable under the evidence.²⁹

Thus, the bankruptcy court refused to adopt, unchanged what it considered to be the most persuasive of the valuation projections and calculations. Moreover, even though the modifications required by the court were time-consuming and labor-intensive, the bankruptcy judge stated that he did not believe that appropriate alternatives existed:

Before concluding this letter, I must acknowledge my dismay at the amount of time necessary to complete recalculation of value. The Corp Committee is quite correct: I had expected a result long before mid-September. However, I see no alternative to proceeding as the VIC proposes. Prior to issuing my June 30 ruling, I attempted to calculate a value using “benchmarks” as suggested by Debtors’ counsel in closing during the valuation hearing. The result (\$10.5 - 11.5 billion) was unsatisfactory in my view because (1) the value would not withstand any sort of careful review (e.g., it accounted for changes in gas prices but not other commodities); and (2) the approximation did not, in my judgment, clearly show that equity was, or was not, in the money. . . .³⁰

There is ample additional evidence that Judge Lynn was reluctant to make a definitive ruling after the extensive valuation proceedings. In both letter rulings and the published valuation decision, Judge Lynn took issue with the experts’ use of data and assumptions. In the July 26th Letter, the court commented on the experts’ use of data in the course of valuation calculations and urged them to use facts currently known to them

²⁹ June 30th Letter, at 4.

³⁰ July 26th Letter, at 3-4.

wherever possible.³¹ The court also wanted the business plan to be updated with more recent forecasts of commodities prices.³² Judge Lynn also addressed the “misperception” that some of the experts seemed to have that “Mirant Group’s value [was] properly set by the market place” and emphasized that the market price of Mirant debt preconfirmation was definitely not an accurate measure of Mirant Group’s value.³³ The court noted, among other things, that the market does not always correctly account for the benefits of bankruptcy.³⁴

In its December 9, 2005 valuation opinion, the bankruptcy court discussed the issue of the motives of certain of the expert witnesses and noted that there was evidence that the equity committee’s and Phoenix’s expert witnesses were acting as advocates rather than as disinterested experts.³⁵ Judge Lynn stopped short of saying that an expert would necessarily act improperly if such expert was influenced by the needs of the party that retained such expert.³⁶ The court nevertheless noted that the potential motives of experts was a reason for courts to be cautious.³⁷

Moreover, before giving its actual ruling, the court in *Mirant* detailed several considerations that made it difficult to value the Mirant Group. For instance, the bankruptcy court emphasized that there were many variables and uncertainties present in

³¹ July 26th Letter, at 2 (“Another general guideline in your work is that, where possible without distorting your valuation methodology, you should utilize facts currently known. The limitations on the use of data that is not disputable but was not available during the valuation hearing is that, if use of that data requires making new assumptions that do not automatically flow from the data, the new data should not be used.”).

³² See 334 B.R. at 829.

³³ *Id.* at 832.

³⁴ See *id.* at 834.

³⁵ See *id.* at 814.

³⁶ *Id.* at 815.

³⁷ *Id.*

the valuation estimates.³⁸ Judge Lynn also observed that there were “peculiar problems” that made it challenging to value a company in the debtors’ industry, which, according to testimony, was a cyclical industry that had not gone through a full cycle.³⁹

Furthermore, Judge Lynn prefaced his ruling with comments that evidenced a lack of faith in valuation generally. At one point in the opinion he commented on the reliability of valuation methodology generally and cited several cases with language that highlighted the limits and lack of precision of the valuation exercise.⁴⁰ He also questioned some of the methodology commonly employed in determining valuation.⁴¹ Among other things, Judge Lynn seemed troubled by the fact that “[c]ash flows are not updated regularly . . . to reflect broken assumptions” and that “[s]tock prices of comparables for just one day are used in calculating multiples.”⁴² In the closing remarks of his opinion, Judge Lynn again expressed a lack of confidence in the valuation process and highlighted its inherent limitations:

At best, the valuation of an enterprise like Mirant Group is an exercise in educated guesswork. At worst it is not much more than crystal ball gazing. There are too many variables, too many moving pieces in the calculation of value of Mirant Group for the court to have great confidence that the result of the process will prove accurate in the future. Moreover, the court is constrained by the need to defer to experts and, in proper circumstances, to Debtors’ management.⁴³

³⁸ 334 B.R. at 818.

³⁹ *Id.* at 818-19.

⁴⁰ 334 B.R. at 818.

⁴¹ *See id.* at 819.

⁴² *Id.*

⁴³ *Id.* at 848.

Judge Lynn was certainly not the first judge to point out that valuation is more of an art than a science.⁴⁴ If, however, the *Mirant* bankruptcy court questioned whether a fair result could be reached after an extensive hearing where advocates on both sides were given the opportunity to present evidence and conduct cross examination, how much confidence can other bankruptcy courts have in valuation outcomes derived from less extensive efforts?

III. Politics May Impact the Outcome of Valuation Disputes

Another problem that may plague valuation disputes is the potential for politics to creep into the process and affect the valuation evidence or outcomes. This was a prominent issue in the contentious valuation dispute in the *National Gypsum* bankruptcy proceedings. There, a committee comprised of unsecured bondholders and trade creditors battled with the debtors' management over management's valuation evidence.⁴⁵ Later, some of the bondholders brought a post-confirmation state court action against the debtors' management alleging that members of management breached their fiduciary duties by intentionally undervaluing the company during the chapter 11 proceedings.⁴⁶

Under a proposed plan that National Gypsum filed with the bankruptcy court, National Gypsum was valued at \$350 million.⁴⁷ The debtors' proposed plan also provided that National Gypsum's current officers and directors would stay on as the

⁴⁴ See, e.g., *Union Bank of Switz. v. Deutsche Fin. Servs. Corp.*, No. 98 Civ. 3251(HB), 2000 WL 178278, at *8 (S.D.N.Y. Feb. 16, 2000) ("Put another way, 'the determination of the "fair valuation" of the debtor's assets at a specific time is at best an inexact science, and may often be impossible.'" (quoting *Constructora Maza, Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980)); *Boyle v. Wells (In re Gustav Schaeffer 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."))

⁴⁵ See 165 S.W.3d at 339.

⁴⁶ *Id.*

⁴⁷ *Id.* at 340.

initial management team for the reorganized debtor, a newly created entity (“New NGC”).⁴⁸ Under the same proposed plan, the lion’s share of the New NGC stock would go to the holders of senior notes and senior debentures (collectively, the “Senior Bondholders”), and holders of junior bonds (the “Junior Bondholders”) would only receive warrants to purchase New NGC stock.⁴⁹

Earlier in the cases, an official committee comprised of holders of unsecured bond and trade debt (the “BT Committee”) had moved for the appointment of a chapter 11 trustee alleging that “[m]anagement intentionally understated all its forecasts to hide its objective views of the company and to hide the company’s value.”⁵⁰ Moreover, the BT Committee asserted that “this manipulation [was] a weapon [m]anagement has used to try to eliminate the consensual plan forged by the BT Committee and to promote a war between the senior and junior bondholders.”⁵¹ The bankruptcy court ultimately denied the BT Committee’s motion to appoint a chapter 11 trustee on the basis that the BT Committee did not meet its burden of proof on the issue of whether National Gypsum’s management purposely manipulated National Gypsum’s business plan.⁵²

After National Gypsum filed its proposed plan, the BT Committee filed an objection and proposed a competing plan that valued New NGC at \$630 million.⁵³ In its objection, the BT Committee accused National Gypsum’s management of knowingly

⁴⁸ *Id.* at 341.

⁴⁹ *See id.*

⁵⁰ *Id.* at 348-49 (citation omitted).

⁵¹ 165 S.W.3d at 349 (citation omitted).

⁵² *Id.*

⁵³ *Id.* at 341.

misrepresenting National Gypsum's future business prospects and value. Specifically, the BT Committee alleged:

[i]n exchange for greater than 100% recovery and control of the reorganized company's board of directors, certain post petition acquirors of Senior Notes . . . publicly accepted the [National Gypsum] Plan, including its management-entrenchment and enrichment provisions. Hence, management deceived [National Gypsum's] creditors with a misrepresentation of the value of the company to coax a small creditor faction into supporting its plan and opposing the BT Plan.⁵⁴

Ultimately, the bankruptcy court found that the BT Committee failed to prove its proposed valuation, refused to confirm the BT Committee's plan, and approved the debtors' plan after finding that it had been solicited in good faith.⁵⁵ Shortly thereafter, New NGC announced a new cost-savings plan pursuant to which annual expenses would be reduced by \$30 to \$40 million dollars.⁵⁶ This announcement came roughly one month after the expiration of the 180-day period during which an interested party could challenge the bankruptcy confirmation order on the ground that it was procured by fraud.⁵⁷

Following this announcement, certain of the Junior Bondholders brought a state court action against National Gypsum's former officers and directors, their financial advisor and one of the Senior Bondholders.⁵⁸ Counts for breach of fiduciary duties, actual fraud, constructive fraud, and civil conspiracy were brought against all of the

⁵⁴ *Id.*

⁵⁵ *Id.* at 341, 349.

⁵⁶ 165 S.W.3d at 341.

⁵⁷ *Id.*; *see also* 11 U.S.C. § 1144.

⁵⁸ 165 S.W.3d at 341.

defendants.⁵⁹ The plaintiffs further sought recovery against the former directors and officers and their financial advisor for gross negligence.⁶⁰ Alternative claims were also brought against the financial advisor and the Senior Bondholder defendant for participating, aiding, assisting, and/or inducing breach of fiduciary duties.⁶¹

According to the plaintiffs, the Senior Bondholders, National Gypsum's former officers and directors, and their financial advisors intentionally undervalued New NGC by hiding their intention to significantly reduce the company's operating expenses.⁶² The plaintiffs alleged that even though National Gypsum's former officers and directors were fully aware of the cost-savings plan that would be announced after bankruptcy, they represented that New NGC was worth between \$300 million and \$375 million based on their purported "best estimate and intention of how the company would operate once out of bankruptcy."⁶³ According to the plaintiffs, however, the cost-savings plan increased the valuation of New NGC's stock from \$350 million to almost \$1 billion, and had the cost-savings plan been disclosed, the Junior Bondholders would have received a larger distribution. Thus, the plaintiffs argued, the Senior Bondholders received a windfall.⁶⁴

The plaintiffs further alleged that the officers and directors stayed in their positions in New NGC and received other incentives in exchange for their role in hiding the cost-savings plan.⁶⁵ The trial court granted summary judgment in favor of the defendants in the spring of 1999, but the Texas Court of Appeals reversed the summary

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.* at 341-42.

⁶³ *Id.* at 342 (citation omitted).

⁶⁴ 165 S.W.3d at 342.

⁶⁵ *Id.*

judgment order that was granted in favor of certain former officers and directors that had not already settled with the plaintiffs.⁶⁶ These former officers and directors appealed arguing, among other things, that the state court claims constituted an impermissible collateral attack on the final judgment of the bankruptcy court.⁶⁷

The Texas Supreme Court agreed with this argument.⁶⁸ The court reasoned that the interests of the Junior Bondholders were represented in the chapter 11 proceedings by the BT Committee, which raised the same allegations of intentional undervaluation and fraud against National Gypsum's management as part of its unsuccessful attempts to get a chapter 11 trustee appointed to replace management and to block confirmation of National Gypsum's proposed plan of reorganization.⁶⁹ Thus, since the fraudulent conduct at issue was not the kind that prevented the Junior Bondholders from presenting their legal rights in the bankruptcy proceedings, the Texas Supreme Court held that the state court action was an impermissible collateral attack on the bankruptcy court's confirmation order.⁷⁰

Whether or not the management in *National Gypsum* actually did conspire with the Senior Bondholders to manipulate the valuation projections, the case is nonetheless illustrative of how even the perception of political influence can cause participants in chapter 11 proceedings to lose confidence in the valuation process. Because the Bankruptcy Code gives a chapter 11 debtor the exclusive right to file and solicit a chapter

⁶⁶ *Id.* at 343.

⁶⁷ *Id.* at 343.

⁶⁸ *Id.* at 351.

⁶⁹ *See id.* at 348-49.

⁷⁰ *See* 165 S.W.3d at 349.

11 plan early in the case,⁷¹ however, the Bankruptcy Code sets the stage for a debtor's management to control the plan process, a critical component of which is the valuation of the reorganized debtor.

Thus, as a practical matter, a chapter 11 debtor's senior management can have a major impact on experts' estimates with respect to valuation.⁷² Indeed, experts may make their estimates as to a company's value based primarily or exclusively on sources that senior management has prepared and discussions with management. In *Mirant*, the debtors' financial adviser, The Blackstone Group, inserted a disclaimer in its expert report providing that "in preparing the Valuation, Blackstone reviewed and discussed the Company's operating and financial projections with senior management" and that Blackstone "neither independently verified nor opined on the Company's underlying business or strategic decisions."⁷³

The bankruptcy court in *Mirant* specifically found that the Blackstone report was the most reliable of the expert reports concerning valuation.⁷⁴ Moreover, Judge Lynn

⁷¹ See 11 U.S.C. § 1121.

⁷² Management's influence and control in the valuation process is illustrated well by certain *dicta* in *Statutory Comm. of Unsecured Creditors v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007), that suggests that valuation evidence submitted by management might be given greater weight in certain circumstances. The valuation discussion in *Iridium* took place in the context of determining the "fair value" and solvency of the debtors for the purposes of evaluating alleged prepetition preferential transfers. The court found that independent market analysis by investment bankers and accounting firms, among others, supported the reasonableness of the debtors' cash flow projections in their business plan, despite the subsequent demise of the company less than nine months after its launch. *Id.* at 348-49. The creditors' committee, which was seeking recovery of approximately \$3.4 billion in alleged preferential transfers, presented evidence that it believed demonstrated the debtors were actually insolvent at the time they made the projections. However, the court determined that the creditors' committee's experts did not adequately explain or rebut the debtors' projections and market valuations that contradicted their opinion. *Id.* at 350-51. The court reasoned that, "[w]here alternative projections 'are no better supported by the evidence than are those in the Business Plan,' the projections in management's business plan should be used in the [Discounted Cash Flow analysis]." *Id.* at 351 (citing *Mirant*, 334 B.R. at 825).

⁷³ Expert Valuation Report of Timothy R. Coleman dated February 25, 2005 submitted in *In re Mirant Corp., et al.*, Case No. 03-46590 (Bankr. N.D. Tex. 2005), at 7.

⁷⁴ 334 B.R. at 830.

found that “Debtors and Debtors’ management were not influenced in the valuation process by reason of any commitment to a creditor constituency to the detriment of equity owners; rather Debtors have properly attended to their fiduciary duties to all constituencies.”⁷⁵ To the extent that the disclaimer in the Blackstone report is typical, however, it highlights that experts giving valuation opinions often need to rely on the work and impressions of a chapter 11 debtor’s senior management. Consequently, when politics permeates a valuation dispute, management may be in the position to effectuate the agenda of the party with which it is aligned.

It may be difficult to estimate how often politics actually infiltrates valuation in bankruptcy. The issue arose again, however, in the Nellson bankruptcy.⁷⁶ In January of 2007, the Bankruptcy Court for the District of Delaware issued an unpublished decision as to the appropriate enterprise value for Nellson.⁷⁷ The court noted that it excluded the valuation report and testimony of the debtors’ expert as unreliable under rule 702 of the Federal Rules of Evidence in an earlier order.⁷⁸ Thus, the bankruptcy court only focused on the reports and testimony of an expert for the official committee of unsecured creditors, an expert for an agent of first and second lien lenders, and an expert for an ad hoc committee of first lien lenders.

The court made several adjustments to three experts’ valuation conclusions based on unsubstantiated judgments and/or errors in methodology, assumptions and/or calculations, and then assigned a weight to the experts’ conclusions based on an

⁷⁵ *Id.*

⁷⁶ *See Nellson*, 2007 WL 201134, at *19.

⁷⁷ *Id.* at *43.

⁷⁸ *Id.* at *14, n.3; *see also In re Nellson Nutraceutical, Inc.*, 356 B.R. 364 (Bankr. D. Del. 2006) (memorandum opinion on exclusion of testimony of debtors’ expert under Rule 702 of the Federal Rules of Evidence).

assessment, *inter alia*, of each expert's credibility.⁷⁹ Importantly, however, the bankruptcy court also determined that it had to make a further downward adjustment of its initial figure for Nellson's enterprise value because all three experts based their analysis on numbers that had been manipulated upward by Nellson's principal shareholder ("Fremont") with the participation of senior management.⁸⁰

The court explained that before the petition date but following the default of financial covenants under its loan agreements, Nellson's management spent months researching and preparing a long range business plan that was ultimately presented to lenders in November of 2005 and revised downward in December of 2005 to reflect the loss of a major customer.⁸¹ Nellson filed for chapter 11 protection on January 28, 2006.⁸² The debtors' management prepared a further downwardly revised long range business plan in February of 2006 but was later directed by executives of Fremont who sat on the board at Nellson to abandon this plan and instead to layer transformation and growth concepts into a business plan for Nellson.⁸³ Around this time, board members that were executives at Fremont raised the issue of increasing the compensation for Nellson's interim president (who at times expressed disagreement with Fremont's directed revisions to the business plan) and his management team and at times issued veiled threats making the interim president feel that his job was in jeopardy if he did not capitulate to Fremont's wishes.⁸⁴

⁷⁹ See *Nellson*, 2007 WL 201134, at *19-*42.

⁸⁰ See *id.* at *19.

⁸¹ See *id.* at *6-8.

⁸² See *Nellson*, 2007 WL 201134, at *2.

⁸³ See *id.* at *11-*12.

⁸⁴ See *id.* at *11.

Freemont and its executives on the Nellson board were extensively involved in the preparation of the new long range business plan, which was prepared in less than a month's time and finalized in May of 2006.⁸⁵ Notwithstanding certain warnings and disagreement from management as to the proposed budget numbers and valuation analyses and the fact the Nellson's financial performance was declining, the May of 2006 plan was far more optimistic, providing substantially higher revenue and EBITDA projections than the earlier plans.⁸⁶ The rosier projections were based in large part on the incorporation of transformational and growth ideas that did not appear to be supported by any market research or customer surveys.⁸⁷ There were also other questionable features of the plan including a new unsubstantiated "unallocated revenue" category that was apparently created to preserve the higher numbers in the plan, the last minute elimination of tens of millions of dollars in projected capital expenditures and the sudden unexplained inclusion of a fiscal year 2011.⁸⁸

Concluding its analysis, the bankruptcy court stated "**[i]n sum, Fremont utilized its control over Nellson to manipulate both the business planning and valuation processes to come up with an artificially inflated enterprise value in order to claim some residual value for their existing equity position.**"⁸⁹ Although members of management seemed reluctant at times to assist with the optimistic forecasts in light of Nellson's poor financial performance, they ultimately seemed to be pressured to participate by Nellson's principal shareholder that had control over their employment and

⁸⁵ See *id.* at *12.

⁸⁶ See *id.* at *12-*14.

⁸⁷ See *id.* at *15.

⁸⁸ See *Nellson*, 2007 WL 201134, at *16-*17.

⁸⁹ *Id.* (emphasis in original).

compensation and had the incentive to inflate projections. Thus, it seems that politics played a significant role in distorting the valuation process in *Nellson* ultimately making the bankruptcy court feel compelled to make adjustments to the conclusions of experts that “*justly relied*” on the “*deliberately inaccurate information provided by the Debtors.*”⁹⁰

The vulnerability of valuation to politics and warring parties’ parochial interests is another reason why valuation perhaps should not play such a dispositive role in determining the distributions creditors and holders of interests are entitled to receive under a chapter 11 plan. Although valuation is designed to fairly determine how to slice up the pie, it certainly cannot be completely insulated from the self-interest of the participants.

IV. Valuation Projections Are Frequently Inaccurate

As mentioned above, valuation is a threshold determination from which critical decisions in chapter 11 reorganizations are made and it materially affects the substantive rights of creditors and other interested parties. The emphasis placed on valuation outcomes in chapter 11 cases, however, may often be unwarranted as valuation projections are frequently inaccurate. Undoubtedly, because projections are made without the benefit of hindsight, most bankruptcy courts must accept the built in limitations of valuation to some degree. But how much inaccuracy should be tolerated?

In trying to get a sense of how often valuation projections miss the mark, we compared the post-confirmation value of the shares of reorganized chapter 11 debtors that emerged as public companies in some of the larger and more recent cases to the projected

⁹⁰ See *id.* at *1 (emphasis in original).

value of the same shares as expressed in each debtor's respective disclosure statement.⁹¹

⁹¹ *In re Worldcom, Inc., et al.*, Case No. 02-13533, Debtors' Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code, at 86 [Docket No. 6108], approved by order entered 05/28/2003 [Docket No. 6110]; *In re Global Crossing, Ltd., et al.*, Case No. 02-40188, Disclosure Statement for Debtors' Joint Plan of Reorganization, at 47 [Docket No. 1991], approved by order entered 10/22/2002 [Docket No. 2030]; *In re UAL Corp., et al.*, Case No. 02-48191, First Amended Disclosure Statement for Reorganizing Debtors' First Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the United States Bankruptcy Code, at 2, 191 [Docket No. 13279], approved by order entered 10/21/2005 [Docket No. 13285]; *In re Delta Air Lines, Inc., et al.*, Case No. 05-17923, Disclosure Statement for Debtors' Joint Plan of Reorganization under Chapter 11 of the United States Bankruptcy Code, at 143 [Docket No. 4494, ex. A], approved by order entered 02/07/2007 [Docket No. 4494]; *In re Kmart Corp., et al.*, Case No. 02-02474, Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of Kmart Corporation and its Affiliated Debtors and Debtors-in-Possession, Appendix D, at 1 [Docket No. 8925], approved by order entered 02/26/2003 [Docket No. 8918]; *In re Northwest Airlines Corp., et al.*, Case No. 05-17930, Disclosure Statement with Respect to Debtors' First Amended Joint and Consolidated Plan of Reorganization under Chapter 11 of the Bankruptcy Code, at 58 [Docket No. 5742], approved by order entered 03/30/2007 [Docket No. 5736]; *In re NRG Energy, Inc., et al.*, Case No. 03-13024, Third Amended Disclosure Statement for Debtors' Second Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code, at 86 [Docket No. 510], approved by order entered 10/17/2003 [Docket No. 773]; *In re US Airways Group, Inc., et al.* (2002), Case No. 02-83984, Disclosure Statement with Respect to First Amended Joint Plan of Reorganization of US Airways Group, Inc. and its Affiliated Debtors and Debtors-in-Possession, ex. D, at 4 [Docket No. 2068, ex. G], approved by order entered 01/17/2003 [Docket No. 2068]; *In re US Airways Group, Inc., et al.* (2004), Case No. 04-13819, Second Amended Disclosure Statement with Respect to Joint Plan of Reorganization of US Airways, Inc. and its Affiliated Debtors and Debtors-in-Possession, at D-3 [Docket No. 2794, ex. A], approved by order entered 08/09/2005 [Docket No. 2794]; *In re Owens Corning, et al.*, Case No. 00-03837, Disclosure Statement with Respect to Sixth Amended Joint Plan of Reorganization for Owens Corning and its Affiliated Debtors and Debtors-In-Possession (As Modified), at 293 [Docket No. 18339], approved by order entered 07/11/2006 [Docket No. 18348]; *In re Williams Commc'ns Group, et al.*, Case No. 02-11957, Second Amended Disclosure Statement with Respect to Second Amended Joint Chapter 11 Plan of Reorganization of Williams Communications Group, Inc. and CG Austria, Inc., at 53, 68 [Docket No. 267], approved by order entered 08/13/2002 [Docket No. 264]; *Loewen Group Int'l, Inc., et al.*, Case No. 99-1244, Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Fourth Amended Joint Plan of Reorganization of Loewen Group International, Inc., its Parent Corporation and Certain of their Debtor Subsidiaries, at 112 [Docket No. 7853], approved by order entered 09/04/2001 [Docket No. 7913]; *In re Petroleum Geo-Servs. ASA*, Case No. 03-14786, Disclosure Statement for First Amended Plan of Reorganization for Petroleum Geo-Services ASA, at 11, 12 [Docket No. 104], approved by order entered 09/10/2003 [Docket No. 105]; *In re Armstrong World Indus., Inc., et al.*, Case No. 00-04471, Disclosure Statement for the Fourth Amended Plan of Reorganization of Armstrong World Industries, Inc., at 102 [Docket No. 4801], approved by order entered 06/02/2003 [Docket No. 4885]; *In re Kaiser Aluminum Corp., et al.*, Case No. 02-10429, Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Second Amended Joint Plan of Reorganization, at 158 [Docket No. 7311], approved by order entered 9/8/2005 [Docket No. 7320]; *In re Winn-Dixie Stores, Inc., et al.*, Case No. 05-03817-3F1, Disclosure Statement With Respect to Joint Plan of Reorganization of Winn-Dixie Stores, Inc. and Affiliated Debtors, at 117 [Docket No. 10057], approved by order entered 08/04/2006 [Docket No. 9917]; *In re Lorai Space & Commc'ns Ltd., et al.*, Case No. 03-41710, Disclosure Statement for Debtors' Fourth Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, at 93 [Docket No. 2074], approved by order entered June 3, 2005 [Docket No. 2076]; *In re Northwestern Corp.*, Case No. 03-12872, Second Amended and Restated Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code for the Plan of Reorganization of the Debtor, at 94 [Docket No. 2021], approved by order entered 9/2/2004 [Docket No. 2033]; *In re RCN Corporation, et al.*, Case No. 04-13638, Disclosure Statement With Respect To The Joint Plan Of Reorganization Of RCN Corporation And Certain Subsidiaries, at 78 [Docket No. 300], approved by order entered 10/13/2004 [Docket No. 296]; *In re Leap Wireless Int'l, Inc.*,

To select the group of former chapter 11 debtors for which to gather data, we began with a list of large chapter 11 bankruptcy filings from the last 10 years.⁹² Debtors were excluded if they: (i) sold substantially all of their assets in a section 363 sale, (ii) were bought by a private company through a chapter 11 plan, or (iii) otherwise did not emerge from their chapter 11 cases. Debtors were also excluded from the list if the data set forth was not reasonably accessible or available. Furthermore, several debtors were excluded because their disclosure statements did not include projected equity valuations. Finally, in order to ensure several quarterly post-emergence trading prices and to avoid having the results skewed by the unorthodox nature of the market as of late, debtors were excluded if they emerged from chapter 11 less than eighteen months ago.

Historical stock prices were obtained using Bloomberg L.P. The 1Q, 2Q, 3Q, and 4Q historical prices in the chart below correspond to the first four quarterly periods that occurred after the effective date of each debtor's plan.⁹³ Further, certain of the debtors' disclosure statements only contained a total projected equity valuation range. In these cases, we were able to calculate the projected equity value per share by dividing the total projected equity valuation range by the number of shares issued on the effective date.

et. al., Case No. 03-03470, Disclosure Statement Accompanying Fifth Amended Joint Plan of Reorganization dated as of July 30, 2003, at 63 [Docket No. 479, ex. C], approved by order entered 07/31/2003 [Docket No. 487].

⁹² To obtain a representative list of large, recent companies that emerged from chapter 11, we considered the largest 20 non-financial chapter 11 bankruptcy debtors of all time, all debtors that filed for chapter 11 protection between 2000-2002 with over \$4 billion dollars in assets, and all debtors that filed for chapter 11 protection between 2003-2006 with over \$2 billion dollars in assets.

⁹³ If the first financial quarter was less than one month from when the company emerged, we used the following financial quarter as the first quarter.

The number of shares issued and outstanding on the effective date was obtained in a subsequent report filed with the Securities and Exchange Commission.⁹⁴

Debtor	Assets		Projected Value	1Q	2Q	3Q	4Q
	in Billions	Emerged					
WorldCom, Inc. ⁹⁵	\$103	4/20/2004	20.29 - 29.71 (25.00)	14.43	16.75	20.16	24.90
Global Crossing, Ltd.	\$30	12/9/2003	10.16	20.00	15.60	16.52	18.14
UAL Corporation	\$25	2/1/2006	15.00	39.93	31.02	26.57	44.00
Delta Airlines, Inc.	\$21	4/30/2007	38.08 - 48.61	19.70	17.95	14.89	8.60
Kmart Corporation	\$14	5/6/2003	8.74 - 17.43	26.90	24.93	23.95	41.48
Northwest Airlines Corporation	\$14	5/31/2007	33.04 - 38.68	22.20	17.80	14.51	8.99
NRG Energy, Inc.	\$10.8	12/4/2003	21.83 - 26.24	21.90	22.20	24.80	26.94
U.S. Airways Group, Inc. (2002)	\$8	3/31/2003	8.30	6.00	6.22	4.48	2.35
U.S. Airways Group (2004)	\$8	9/27/2005	18 - 33 (25.5)	37.14	40.00	50.54	44.33
Owens Corning	\$6.4	10/31/2006	26.51 - 34.13	29.90	31.86	33.63	25.05
Williams Communications Groups ⁹⁶	\$6	10/15/2002	7.59 - 12.41 (10.00)	15.79	12.60	14.82	16.05
Loewen Group International, Inc. ⁹⁷	\$4.6	1/2/2002	17.17	8.90	7.58	6.50	4.74
Petroleum Geo-Services ASA	\$4.3	11/5/2003	16.00	3.65	4.52	4.08	4.85
Armstrong World Industries, Inc.	\$4.1	10/4/2006	24.66 - 35.30 (30.00)	42.39	50.85	50.15	40.59
Kaiser Aluminum Corporation	\$3.3	7/6/2006	17.00 - 20.75 (19.00)	44.34	55.98	78.00	72.88
Winn-Dixie Stores, Inc.	\$2.6	11/21/2006	11.39 - 16.30	13.50	17.65	29.30	18.72
Loral Space & Communications Ltd.	\$2.6	11/22/2005	19.40 - 30.95	28.28	28.75	28.36	26.32
Northwestern Corporation	\$2.6	11/1/2004	17.61 - 22.39 (20.00)	28.00	26.37	31.52	30.19
RCN Corporation	\$2.3	12/22/2004	17.22 - 22.76	19.90	23.09	21.22	23.45
Leap Wireless International Inc.	\$2.1	8/17/2004	2.22 - 4.27	22.00	27.00	26.05	27.75

This data suggests that valuation projections are frequently off target. While a few debtors accurately projected the equity value of their reorganized companies over the first four quarters after emerging from bankruptcy, most projections missed the mark significantly. In nearly a quarter of the cases, the debtor's projected equity value was off by more than 100 percent. In approximately half of the cases, the actual equity values were closer to the projections, but still off by a significant amount over all four quarters.

⁹⁴ We located the number of outstanding shares on the effective date for certain debtors in the following filings with the Securities and Exchange Commission: Delta Air Lines, Inc., Quarterly Report (Form 10-Q), at 3, 6 (Aug. 2, 2007); Northwest Airlines Corporation, Quarterly Report (Form 10-Q), at 6 (Aug. 9, 2007); NRG Energy, Inc., Quarterly Report (Form 10-Q), at 5 (May 10, 2004); Leap Wireless International, Inc., Quarterly Report (Form 10-Q), at 1 (Nov. 22, 2004); RCN Corporation, Quarterly Report (Form 10-Q), at 1 (Jun. 28, 2005).

⁹⁵ WorldCom, Inc. emerged as MCI, Inc.

⁹⁶ Williams Communications Group, Inc. emerged as WilTel Communications Corporation, Inc.

⁹⁷ Loewen Group International, Inc. emerged as Alderwoods Group Inc.

As this data demonstrates, notwithstanding the time, resources and expense that bankruptcy courts and chapter 11 participants invest to derive valuation outcomes, these projections will often be inaccurate. Yet courts and other participants in chapter 11 cases routinely rely on these estimates as a cornerstone for deciding how to carve up the debtor's assets for distribution. If the historical data from larger studies with more formal controls reveals the same result – that valuation projections are consistently poor proxies for the ultimate value of a reorganized entity – a legitimate argument can be made that a sounder basis for decision making in the chapter 11 process should be developed.

V. Can a Method That Ties Valuation to Post-Effective Date Trading Prices Solve These Problems?

Is there any way to fix the problems associated with valuation? Is there a mechanism that can accomplish the objectives of valuation without the accompanying inaccuracy, imprecision and vulnerability to politics? One possible solution to the pitfalls of traditional valuation methods is to let the market set the value of the debtor's shares after the debtor emerges from bankruptcy.

Volume weighted average price (“VWAP”) is generally described as a form of algorithmic trading.⁹⁸ VWAP is generally calculated by adding up the dollar value of all of the shares that are traded over a specific period of time, and dividing that sum by the total number of shares traded over the time horizon. If a mechanism modeled after VWAP were used for valuation purposes in bankruptcy, the market would determine what the shares of the reorganized entity are worth, and it may obviate the need for educated guesswork. Using VWAP in this context may also eliminate the inaccuracies,

⁹⁸ Sham M. Kakade, Michael Kearns, Yishay Mansour, and Luis E. Ortiz, *Competitive Algorithms for VWAP and Limit Order Trading*, Abstract for EC '04, May 17-20, 2004, at 1 (available at <http://www.cis.upenn.edu/~mkearns/papers/vwap.pdf>).

expense and investment of time associated with valuation projections and shield the process from politics.

VWAP has been used in the bankruptcy context as a post-confirmation pricing mechanism in two recent cases. VWAP was used in the chapter 11 cases of Adelphia Communications, Inc. and its affiliated debtors and debtors in possession (“Adelphia”).⁹⁹ Dana Corporation, Inc. and its affiliated debtors and debtors in possession (“Dana”) also used VWAP in their chapter 11 cases.¹⁰⁰

In *Adelphia*, VWAP was used as part of a larger mechanism to value the shares of Time Warner Cable (“TWC”) stock that were distributed under the debtors’ plan of reorganization.¹⁰¹ Although shares of TWC stock were distributed to parties on the effective date based on a deemed valuation of the stock, some of the shares were held back and a post-confirmation market test was administered.¹⁰² During the test period, the plan administrator was required to calculate the VWAP daily price for the stock.¹⁰³ At the conclusion of the test period, this information could then be used to calculate any

⁹⁹ See *In re Adelphia Commc’ns Corp.*, Case No. 02-41729 (REG), Second Disclosure Statement Supplement Relating to Fifth Amended Joint Chapter 11 Plan for Adelphia Communications Corporation and Certain Affiliated Debtors, at 93-94 [Docket No. 12198, ex. C] (the “Adelphia Disclosure Statement Supplement”), approved by order dated 10/17/2006 [Docket No. 12202]; *In re Adelphia Commc’ns Corp.*, Case No. 02-41729 (REG), Plan Administrator Agreement by and Among Adelphia Communications Corporation and all of its Affiliated Debtors-in-Possession, The Official Committee of Unsecured Creditors and Quest Turnaround Advisors, L.L.C., dated as of February 12, 2007 (the “Adelphia Plan Administrator Agreement”) § 2.15.

¹⁰⁰ See *In re Dana Corp., Inc.*, Case No. 06-10354 (BRL), Third Amended Disclosure Statement With Respect to Third Amended Joint Plan of Reorganization of Debtors and Debtors in Possession (the “Dana Disclosure Statement”), dated October 23, 2007, at 55 [Docket No. 6669], approved by order entered 10/23/2007 [Docket No. 6673].

¹⁰¹ See Adelphia Disclosure Statement Supplement, at 93 (noting that the value to be used to calculate the amounts of releases from the holdback of TWC stock would be “the volume weighted average trading price per share of TWC Class A Common Stock during the Test Period.”)

¹⁰² See *id.* (“The True-Up Holdback will be funded on the Effective Date by withholding amounts otherwise payable in respect of initial Effective Date distributions . . .”).

¹⁰³ See Adelphia Plan Administrator Agreement § 2.15.

necessary adjustments with respect to distributions.¹⁰⁴ Thus, if the post confirmation test as measured by the application of VWAP indicated that the original deemed value of the TWC shares was an inaccurate projection, certain recipients under the plan could be “trued up” with the shares that remained in the holdback.¹⁰⁵

In *Dana*, VWAP was used to determine the value of new shares of stock in the reorganized debtors.¹⁰⁶ Under the terms of the plan, the lead plan investor, Centerbridge Partners, L.P., received preferred stock in exchange for its investment in the debtors. Under certain predefined circumstances, shares of preferred stock were convertible to new common stock.¹⁰⁷ The conversion price for these shares depended upon, *inter alia*, the VWAP of new common stock over a 20-day time window.¹⁰⁸ The Dana Disclosure Statement further provided that if, after such conversion, the holders of the converted stock owned a percentage of the new common shares that exceeded pre-defined

¹⁰⁴ See Adelphia Disclosure Statement Supplement, at 93.

¹⁰⁵ *Id.* (“The Plan contemplates the creation of a true-up reserve on the Effective Date consisting of TWC Class A Common Stock (or Cash to the extent there is not sufficient stock available) that is intended, subject to certain limitations, to be sufficient to permit the upward or downward adjustment of the total number of shares received by creditors of the Subsidiary Debtors based upon a Market Value of the TWC Class A Common Stock that is up to twenty percent higher or lower than the Deemed Value used for initial Distributions under the Plan.”)

¹⁰⁶ Dana Disclosure Statement, at 55.

¹⁰⁷ *Id.* at 55.

¹⁰⁸ *Id.* Specifically, the Dana Disclosure Statement provides as follows:

Subject to a collar based on a total enterprise value of New Dana Holdco of between \$3.15 billion and \$3.5 billion as described in subsections (i) and (ii) below, **the price at which each share of New Preferred Stock will be convertible into New Dana Holdco Common Stock will be 83% of its distributable market equity value per share, which is the per share value of the New Dana Holdco Common Stock determined by calculating the 20-day volume weighted average trading price of such common stock on the principal exchange or over-the-counter market on which it trades (using the 22 trading days beginning on and including the first trading day after the Effective Date but disregarding the days with the highest and lowest volume weighted average sale price during such period). . . .**

Id. at 55 (emphasis added).

limitations, adjustments would be made so that ownership of the reorganized debtors would not shift immediately post-confirmation.¹⁰⁹

Although VWAP was used in *Adelphia* and *Dana*, bankruptcy judges may not all be comfortable abandoning traditional valuation methods in favor of post-confirmation trading valuation. Moreover, the use of VWAP or a method similar thereto may present its own set of legal and practical problems. For instance, it would likely require more post-confirmation supervision from the bankruptcy court and it may delay the distribution of plan consideration. Using VWAP may also make it difficult for a plan proponent to establish that the standards for confirmation under section 1129 of the Bankruptcy Code (*i.e.*, the fair and equitable test) have been satisfied. Nonetheless, skeptics of the traditional valuation process may want to consider investigating VWAP or alternative methodologies that may be less prone to the weaknesses that undermine the fairness that valuation is designed to achieve.

VI. Final Thoughts

Inevitably, any system that is used to determine whether constituents in a chapter 11 case are entitled to recovery and the size of such recovery will draw criticism. Moreover, any such mechanism will have to balance the need for accuracy, fairness and precision against efficiency and finality. Nevertheless, it is easy to understand how participants in the chapter 11 process may lack confidence in valuation and be concerned over the emphasis and reliance placed on valuation outcomes.

¹⁰⁹ *Id.*