How to Value Debt

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AMERICAN BANKRUPTCY INSTITUTE

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The Qualitative Valuation of Debt

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The Qualitative Valuation of Debt

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I. Why is Debt Valuation Important?

Absolute Priority Rule

Pursuant to the Absolute Priority Rule, senior creditors must receive "payment in full" prior to any distribution to junior holders.

"Clearly those [senior] priority rights are not recognized, in cases where stockholders are participating in the plan, if creditors are given only a face amount of inferior securities equal to the face amount of their claims…. If they receive less than full compensatory treatment, some of their property rights will be appropriated for the benefit of the stockholders without compensation. That is not permissible." *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510, 528-29 (1941).

Relevant Statutory Provisions

- § 1129(b)(1): "… the plan does not discriminate unfairly, and is ***fair and equitable*** with respect to each class of claims or interests that is impaired under, and has not accepted the plan."

- § 1129(b)(2) provides that a Chapter 11 plan is "fair and equitable":
  - with respect to **secured creditors**, if the plan provides (1) "… that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, ***of a value***, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property," or (2) "… for the realization by such holders of the ***indubitable equivalent*** of such claims."
  - with respect to **unsecured creditors**, if the plan provides that such holders "receive or retain under the plan on account of such claim property ***of a value***, as of the effective date of the plan, equal to the allowed amount of such claim" or junior holders do not receive or retain any amounts on account of such junior claims or interests.

Cram Down Distributions

In contested cases, Sections 1129(b)(1) & (2) require the bankruptcy court to value the distributions made to creditors.

Simply put, securities that trade below par may represent value "appropriate for the benefit of stockholders without compensation".

II. Valuing Debt Securities: Extrinsic and Intrinsic Valuation

Valuing Debt Securities

Two Means of Valuing a Security

- Extrinsic – a market-based valuation of the security
- Intrinsic – evaluation of the business and the terms of the security to determine the value of the security

Market Price or Long Term Price?

Is the market price relevant for determining "payment in full" or should the focus be on the long term value of the instrument?

"[P]riorities in large-scale financial reorganization are considered satisfied if the old claimholders are merely given new claims whose *face* value is equal to the face value of their old claims. Courts have generally not looked at the actual market value of new claims in deciding whether or not the terms of reorganization are consistent with the satisfaction of priorities." Jerold B. Warner, *Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims*, 4 JOURNAL OF FINANCIAL ECONOMICS 239, 240 (1977).

In re Barrington Oaks General Partnership, 15 B.R. 952, 965 (Bankr. D. Utah 1981).

- "Not only is *reorganization value* different from *valuation by the market* … but it can be understood fully only when contrasted with market value. So also is the worth of the new securities issued under a plan not to be tested by reference to market quotations because that yardstick is patently inconsistent with predicating the plan on reorganization values."
- "In short, reorganization value is what some appraisers believe the current market value of the distressed company ought to be if the present were like the future they foresee. It is thus a liberalization of market price corresponding with some expert opinions about the inherent value of the enterprise."

"Extrinsic" Approaches to Valuation

- **Market pricing** plays a key role in the valuation component of many aspects of Chapter 11, including fraudulent conveyance and claim allowance litigation.
- **Accounting principles** such as fair value of debt instruments were developed with the objective of providing information that will best serve the interests of investors and businesses.
    - **FASB 157** provides that fair value of a debt instrument is determined based upon the exchange price in an orderly transaction between market participants. The transaction to sell is a hypothetical transaction at the measurement date, considered from the perspective of the participant that is selling (i.e., the exit price)
    - **FASB 157** emphasizes that fair value is a market-based measurement, not an entity specific measurement

Should courts be following a similar approach and valuing a debt security based upon potential exchange prices?

Expected Market Trading Prices

Should a court use ***expected market trading prices*** to determine the worth of a particular debt security to be issued under a Chapter 11 plan?

What metrics and approaches are used by analysts to determine forward looking pricing of securities?

Should market trading prices be considered if the market is experiencing significant illiquidity or volatility? What assumptions about market volatility and liquidity are correct for a newly issued security?

"As Issued" Pricing Issues

"As issued" pricing may not always be right.

Will this be another battle of the experts?

Are there company specific reasons that a security may not trade post-bankruptcy?

Often, securities are issued without ratings, reducing the pool of potential purchasers of the security and thereby potentially not giving an accurate view of the market. How should the court view the market?

If securities were rated (e.g., Moody's, S&P, Fitch), should that impact the analysis of payment in full? What happens if ratings agencies differ in their grades?

Intrinsic Valuation of Debt Securities

Assuming that a security will not trade at par when the reorganization is consummated, *does that necessarily mean that the intrinsic value of the security does not constitute payment in full?*

The Supreme Court has stated that:

> "A requirement that dollar values be placed on what each security holder surrenders and on what he receives would create an illusion of certainty where none exists and would place an impracticable burden on the whole reorganization process." *Group of Institutional Investors v. Chicago, M., St. P. & P.D. Co.*, 318 U.S. 523, 565 (1943).

Risk Allocation

Chapter 11 plan cram-down litigations (and the resulting published decisions) generally center on the appropriate interest rate, amortization schedule and tenor of a debt instrument when determining payment in full. (See, e.g., *Till, Momentive,* etc.)

Federal National Mortgage v. Village Green I, GP, 2014 WL 288974 (W.D. Tenn. 2014)

> Fannie Mae appealed the bankruptcy court's confirmation of the debtor's plan of reorganization, arguing that the bankruptcy court only considered the arithmetic requirements of the fair and equitable standard (interest rate, etc.), but failed to consider how the plan's modifications to the loan documents improperly shifted the risk to Fannie Mae.
>
> "[A] plan must be fair and equitable in a broad sense, as well as in the particular manner specified in 11 U.S.C. § 1129(b)(2) … the requirements of section 1129(b)(2)(A) are not the sole test for a determination that a plan of reorganization is fair and equitable. The Court's task is to determine whether the entire plan in the context of the rights of the creditors under state law and the particular facts and circumstances is fair and equitable."

How should a court evaluate risk allocation between parties in determining whether a cram down security is fair and equitable?

What import, if any, do the prepetition arrangements have in evaluating risk allocation?

Legal Standards

In American Trailer and Storage, Inc., 419 B.R. 412 (Bankr. W.D. Mo. 2009).

A secured creditor objected to a plan of reorganization because the plan did not include certain financial and restrictive covenants that were in the original loan agreement. Without these covenants, the secured creditor argued that it was essentially stripped of its lien and left with "nothing more than a naked security interest."

"[T]he question of whether modification of loan documents is appropriate requires consideration of: (1) whether the proposed terms and covenants unduly harm the secured creditor with respect to its collateral position; and (2) whether the inclusion of terms and conditions from the pre-bankruptcy loan documents would unduly impair the debtor's ability to reorganize."

The court held that the absence of the covenants did not *unduly harm* the creditor's strong collateral position. The substantial equity cushion and "Events of Default" provisions in the plan were "more than sufficient to protect [its] collateral." Furthermore, if the financial ratio covenants were left in the plan, they would *impair* the debtor's ability to reorganize because the debtor would be in default as soon as it emerged from bankruptcy.

What analysis should be used to determine whether the secured lender's position is "unduly impaired"?

Should it matter that the debtor could not otherwise reorganize? Should the secured lender have to bear the risk of loss?

Momentive

In re MPM Silicones, LLC, et al., 2014 WL 4436335 (Bankr. S.D.N.Y. 2014)

In addition to the arguments raised by the noteholders about the interest rate, the noteholders argued that the collateral coverage and the covenants in the replacement notes were inadequate because they fell short of those in the market exit credit facilities and that the risk of default of the new notes was too high.

The debtors argued that the terms of the replacement notes, including the covenants, were substantially similar to those in the market exit credit facilities.

Judge Drain rejected the noteholders' arguments

- The court found that the noteholders did not effectively challenge the debtors' projections or valuation.
- On collateral coverage, the court determine that based on the company's projections, the replacement notes would be repaid in full and therefore the collateral coverage was sufficient. Gross debt leverage decreased from 17.8% (prepetition) to 5.6%.
- The court rejected the risk of default argument because it found the debtors' projections and valuation to be credible and supported their view.
- On the covenants, with no further analysis, the court found that they were "not materially different on an economic basis from the covenants in the proposed refinancing facilities."

The decision is subject to an appeal.

Other Intrinsic Components

How do other components of a cram-down note affect the fair and equitable analysis?

- Covenants
  - Negative Covenants
    - Debt incurrence
    - Lien incurrence
    - Investments
    - Debt buybacks
    - Capital expenditures
  - Financial Covenants
    - Leverage
    - Fixed-charge coverage
    - Minimum liquidity
    - Net worth
- Collateral Package
- Voting Requirements

How should a court evaluate modifications to covenants and their effect on the value of the security?

How important is the prepetition covenant package in determining whether the post-consummation covenant package is fair and equitable?

Should a substantial equity cushion obviate the need for protective covenants, such as investment limitations, capital expenditures or dividends?

III. Patriot Coal – A Case Study

Patriot Coal – A Case Study

Comparison Of Provisions In The Securities Issued Under The Plan†

	1st Lien	1.5 Lien	2nd Lien
Amount	Up to $401.2M	Up to $115M	$229M
Rate (cash/PIK)	Tranche B-1 Term Loan and Single Tranche Term Loan: 13.5% cash; Tranche B-2 Term Loan: 14.5% cash	5% cash and 7% PIK Issued at $35M discount to par	6.5% PIK plus cash of 2.0%:2016 2.5%:2017 3.5%:2018 4.5%:2019 5.5%:2020 6.5%:2021
Maturity	5 years	5 years	5.5 years
Amortization	Annual: 1.0% of initial aggregate principal starting in Q1 2017	Annual: 1.0% of initial aggregate principal starting in Q1 2017	None
Events of Default / Covenants	Standard provisions	Standard provisions	Cushions are 20% greater than thresholds in 1/1.5 Lien
Financial Covenants	Net leverage ratio maintenance (first test at end of quarter ended 6/30) with 50% cushion	Net leverage ratio (first test at end of quarter ended 6/30) maintenance with 50% cushion	None
Call Protection	Year 1: 5.0%, Year 2: 2.5%, Year 3: 1.0%, Year 4+: 0.0%	None	None

† Source: *Notice of Filing of Second Amended Plan Supplement, In re Patriot Coal Corp., et al.*, Case No. 15-32450 (Docket No. 1593).

Patriot Coal – A Case Study

Coal Company Debt Trading Levels / Implied Yields

	Alliance RP Sr. Notes	Westmoreland 1st Secured Notes	Peabody 2nd Lien Notes	Foresight Sr. Notes	Cloud Peak Sr. Notes		Murray 2nd Lien Notes	Peabody Sr. Notes				Arch 2nd Lien Notes	Arch Sr. Notes			
Description																
Maturity	2018	2022	2022	2021	2019	2024	2021	2018	2020	2021	2026	2019	2019	2019	2020	2021
Coupon	6.72%	8.75%	10.00%	7.38%	8.50%	6.38%	11.25%	6.00%	6.50%	6.25%	7.88%	8.00%	7.00%	9.88%	7.38%	7.25%
Lien Status	1st Lien	1st Lien	2nd Lien	Unsec.	Unsec.	Unsec.	2nd Lien	Unsec.	Unsec.	Unsec.	Unsec.	2nd Lien	Unsec.	Unsec.	Unsec.	Unsec.
Face Amount	$145	$350	$977	$596	$300	$200	$1,300	$1,519	$650	$1,340	$248	$350	$1,000	$165	$500	$1,000
Credit Stats																
2016E EBITDA(1)	$761	$237	$684	$378	$101	$101	$630	$684	$684	$684	$684	$254	$254	$254	$254	$254
Cumulative Gross Debt(2)	$857	$775	$2,257	$1,504	$500	$500	$3,467	$6,353	$6,053	$6,053	$6,853	$2,233	$5,098	$5,098	$5,098	$5,098
Cumulative Leverage(2)	1.1x	3.3x	3.4x	4.0x	5.0x	5.0x	5.5x	8.8x	8.8x	8.8x	8.8x	8.8x	20.1x	20.1x	23.1x	20.1x
Cumulative Interest Exp.(3)	$71	$100	$196	$113	$51	$51	$106	$451	$451	$451	$451	$181	$198	$198	$198	$198
Cumulative Int. Coverage(3)	25.6x	2.4x	3.5x	3.3x	2.0x	2.0x	2.1x	1.5x	1.5x	1.5x	1.5x	1.4x	[illegible]	[illegible]	[illegible]	[illegible]
Total Gross Debt	$857	$779	$6,455	$1,509	$500	$500	$3,467	$6,455	$6,455	$6,455	$6,455	$5,146	$5,146	$5,146	$5,146	$5,146
Total Leverage	1.1x	3.3x	9.4x	4.0x	5.0x	5.0x	5.5x	9.4x	9.4x	9.4x	9.4x	20.3x	20.3x	20.3x	20.3x	20.3x
Pricing																
Trading Price(4)	100.1%	56.3%	41.3%	76.3%	69.1%	60.7%	53.5%	35.4%	26.9%	26.5%	26.2%	12.8%	10.0%	14.8%	11.0%	8.3%
Yield to Maturity(4)	3.6%	11.9%	32.0%	13.9%	19.5%	14.6%	28.2%	47.8%	43.4%	37.7%	33.3%	106.7%	108.2%	96.4%	88.4%	94.7%

Murray's credit statistics are based on 2015E EBITDA; 2016 EBITDA is likely to be significantly lower, resulting in higher leverage and lower interest coverage

Pro forma Blackhawk will be leveraged at 4.5x gross / 4.0x net, based on 2016E EBITDA of $167 million; cash interest coverage in 2016 projected at approximately 2.4x

Yield likely driven by the 6 turns of additional leverage below Peabody's 2nd lien notes

(1) Estimates per Bloomberg. Murray EBITDA represents 2015E EBITDA per Debtwire.
(2) Represents debt and leverage through the displayed debt security.
(3) Represents interest expense and coverage through the displayed debt security. Interest expense for Alliance, Peabody, Murray and Arch based on Consensus estimates. Interest expense for Westmoreland, Foresight and Cloud Peak based on annualized 1H2015 interest expense.
(4) Bloomberg as of September 18, 2015.

Patriot Coal – A Case Study

Illustrative Trading Analysis of New Blackhawk Second Lien Loan

Terms of the second lien loan were:

- 6 year maturity
- No amortization
- 2% cash / 5% PIK in years 1 and 2
- 3% / 4% / 5% / 6% cash and 5% PIK in years 3 / 4 / 5 / 6
- New Blackhawk first lien and 1.5 lien term loans are priced to yield 15.8% and 22.3%, respectively

Trading Value of Second Lien

Illustrative Required Yield	Illustrative Trading Value
22.0%	54%
23.0%	51%
24.0%	49%
25.0%	47%
26.0%	45%
27.0%	43%
28.0%	41%

Appendix: Additional Cases

Appendix

Intrinsic Valuation of Debt Security: *Components of a cram-down note that affect the fair and equitable analysis* (**Covenants**)

- "The covenants to be included in the loan documents of a cramdown ***need not precisely track*** the covenants in the parties' existing loan agreement. Yet the covenants should not leave the lender so bare of protection as to greatly increase the risk or require corresponding increase in the interest rate." *In re P.J. Keating Co.*, 168 B.R. 464, 473 (Bankr. D. Mass. 1994).

  The court concluded that the debtor's plan could not be confirmed due in large part to the proposed elimination of a covenant in the existing loan agreement prohibiting **stock redemption**. However, the court noted that, "it might be appropriate to modify the existing covenants … dealing with matter such as **net worth**, **earnings**, and **capital expenditures**."

- The most fundamental aspect of a new term loan is that it must not "**unduly shift the risk** relating to operations and financial performance of the reorganized debtor, and must be fair and equitable to the secured creditor." *In re TCI 2 Holdings, LLC*, 428 B.R. 117, 166 (Bankr. D.N.J. 2010).

Appendix

- In *In re Beare Co.*, a bankruptcy court found that a debtor's proposed modification of its pre-petition loan agreement was fair and equitable. The court noted that "[t]he Debtor in Possession proposes to leave in place all security documents and debt obligations." The court also found that "the modification of the original loan agreement to eliminate certain covenants and ratios is not unfair under the particular facts of this case and will not significantly limit the Bank's rights under state law." The court did, however, require the debtor to continue providing its secured creditor with monthly financial information, as it had been doing on a weekly basis throughout the course of the Chapter 11 case. *In re Beare Co.*, 177 B.R. 886, 890 (Bankr. W.D. Tenn. 1994).

- In *In re Western Real Estate Fund, Inc.*, the creditors argued that the terms of the plan note "deprive them of their bargained for rights against debtors and the property securing their debt instruments to such an extent as to constitute a deprivation of their respective liens." The court held that, "[W]hile [i]t is clear that the terms of the plan note, as compared to the terms and conditions of the respective debt instruments originally executed by the debtors to the various creditors are far less stringent with respect to the rights of creditors … such modifications … neither individually nor collectively rise to the level of a deprivation of the creditor's lien securing its claim." *In re Western Real Estate Fun, Inc.*, 75 B.R. 580, 587 (Bankr. W.D. Okla. 1987).

Appendix

Intrinsic Valuation of Debt Security: *Components of a cram-down note that affect the fair and equitable analysis* (**Collateral Package**)

- "[N]ew collateral with a value projected to be equal to, or even more than, the original collateral is not 'completely compensatory' if the new collateral is so much riskier than the original collateral that there is a substantially greater likelihood that the secured creditor will not get paid." *In re Sparks*, 171 B.R. 860, 866 (Bankr. N.D. Ill. 1994). Even if substituted or modified collateral is more valuable, it is not the indubitable equivalent if it imposes increase risk on the creditor. *Id.*

- In *In re Hoffman*, the bankruptcy court said, "Generally, the source of a creditor's interest in collateral is in the terms and conditions contained in a security agreement reached with the debtor. Alternation of those terms and conditions disrupts the creditor's rights and interests in collateral. In that connection, this Court will not allow substantial disruption of bargained-for rights which accompany interest in property and collateral." The court held that "the Plan does not provide fair and equitable treatment of the Government's claims where its provisions substantially vary the terms and conditions of the original agreements made with the Government." *In re Hoffman*, 52 B.R. 212 (Bankr. D.N.D. 1985).

Appendix

Intrinsic Valuation of Debt Security: *Components of a cram-down note that affect the fair and equitable analysis* (**Voting Requirements**)

- In *In re Sparks*, the mortgagee (MetLife) objected to the proposed Chapter 11 plan providing for partial conversion of mortgaged properties from apartment complex to condominium project. The bankruptcy court held that the proposed conversion was not fair and equitable with respect to the mortgagee because it would deny the mortgagee the "indubitable equivalent" of its claim.

- The court's holding demonstrates that the ability of a creditor to foreclose (as well as maintain control over the property) is an important factor. Specifically, in this case, the conversion would introduce new entities into the relationship between MetLife and the Debtor. There would be unit owners and a condominium association, which would ow the extensive grounds free of MetLife's lien. Although the Debtor argues that MetLife would have ways to deal with those interests, it is clear that MetLife's right to foreclose its mortgage would be complicated by the need to deal with the new entities and ownership structure. There is a difference between having a lien on a fee simple title and having a collection of rights. *In re Sparks*, 171 B.R. 860 (Bankr. N.D. Ill. 1994).