AMERICAN BANKRUPTCY INSTITUTE

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How to Value Debt

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Hon. Michael E. Wiles
U.S. Bankruptcy Court (S.D.N.Y.)

CONCURRENT SESSION

2019

HOW TO VALUE DEBT

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I. DEBT AS AN ASSET

- A. Many only see debt on the "liability" side of a balance sheet
  - 1. Current Liabilities
  - 2. Non-current Liabilities
- B. Debt can also appear on the "asset side" of a balance sheet
  - 1. It is an asset in the hands of the payor (creditor)
  - 2. Current assets (receivables and short-term debt)
  - 3. Other assets (notes receivables)
  - 4. Marketable securities (publicly traded bonds)

I. DEBT AS AN ASSET

- C. Capitalized leases
  - 1. These are also cash-flow streams
  - 2. Discussion of whether a capitalized lease is debt or not is beyond this presentation

II. "PRESENT VALUE" OF DEBT

- A. Basic premise
  - 1. "A dollar today is worth more than a dollar received next year"
  - 2. A mathematical formula will calculate the value today of a stream of payments to be received in the future

II. "PRESENT VALUE" OF DEBT

- B. Other factors that can influence the value of the debt in the creditor's hands, including
  - 1. Interest accrual rate and payment rate;
  - 2. Maturity date;
  - 3. Debt covenants (heavy or "covenant light");
  - 4. Type and value of collateral securing repayment; and,
  - 5. Risk of repayment default.
- C. In re Till and its progeny – generally requires parties to start with the "prime rate" and then increase the rate to adjust for risk of non-payment *Till v. SCS Credit Corp.,* 541 U.S. 465, 124 S. Ct. 1951 (2004).

III. VALUE OF DEBT IN THE 11 U.S.C. § 1129 CONTEXT

- A. Multiple sub-parts of 11 U.S.C. § 1129 address the present value of payments in plan confirmation hearings
  - 1. Key phrase in 11 U.S.C. § 1129 is "of a value, as of the effective date of the plan"
  - 2. Language is found in (a)(7)(A), (a)(7)(B), (a)(9)(B), (a)(9)(C), (a)(15)(A), (a)(15)(B), (b)(2)(A), (b)(2)(B) and (b)(2)(C)

III. VALUE OF DEBT IN THE 11 U.S.C. § 1129 CONTEXT

- B. Factors used to evaluate the value of debt issued in plan payments include
  - 1. Marketability and tradability of debt instrument (liquid v. illiquid instruments);
  - 2. Quality and value of any collateral securing the debt;
  - 3. Reorganized debtor's capital structure and leverage ratios;
  - 4. Debt covenants and ability to accelerate debt; and,
  - 5. Presence or absence of pre-payment premiums.

III. VALUE OF DEBT IN THE 11 U.S.C. § 1129 CONTEXT

- C. Market Rate of Interest – "Momentive" *BOKF NA v. Momentive Performance Materials Inc.* (*In re MPM Silicones LLC*), 874 F.3d 787 (2d Cir. 2017).
  - 1. "[T]he market rate should be applied in Chapter 11 cases where there exists an efficient market. But where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the Till plurality." *In re American HomePatient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005).
  - 2. "In applying this rule, courts have held that markets for financing are 'efficient' where, for example, "they offer a loan with a term, size, and collateral comparable to the forced loan contemplated under the cramdown plan." *In re Texas Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324, 337 (5th Cir. 2013).

IV. VALUE OF DEBT IN THE 11 U.S.C. § 363 CONTEXT

- A. 11 U.S.C. § 363 does not include a requirement that sales of estate assets must be paid in cash
- B. Buyers who pay part of the purchase price with debt do so with
  - 1. Assumption of existing debt;
  - 2. Issuance of new debt via "seller financing"; or,
  - 3. Receipt of debt instrument(s) in exchange for the sale of an asset.

IV. VALUE OF DEBT IN THE 11 U.S.C. § 363 CONTEXT

- C. Issues in valuing the debt instruments received by the estate are similar to those where creditors receive debt instruments in exchange for their claims against the debtor include
  - 1. Marketability and tradability of debt instrument (liquid v. illiquid instruments);
  - 2. Quality and value of collateral securing debt;
  - 3. Obligor's capital structure and leverage ratios;
  - 4. Debt covenants and ability to accelerate debt; and,
  - 5. Presence or absence of pre-payment premiums.

V. VALUE OF DEBT IN THE "ENTERPRISE VALUE" CONTEXT

- A. 11 U.S.C. § 1129 refers obliquely to debt issued to fund a plan
  - 1. References are to using debt to pay specific classes or types of claims
  - 2. Focus in 11 U.S.C. § 1129 is usually on the value of the debt instruments (or stream of payments) to be received by creditors

V. VALUE OF DEBT IN THE "ENTERPRISE VALUE" CONTEXT

- B. BUT, if a reorganized debtor issues stock to either equity securityholders or creditors
  - 1. Valuing the stock to be issued means addressing the company's debts as part of an "enterprise valuation"
  - 2. You must be able to explain how the debt on the reorganized debtor's balance sheet affects the value of the stock to be provided to creditors with junior rights and remedies

V. VALUE OF DEBT IN THE "ENTERPRISE VALUE" CONTEXT

- C. Impact of Debt upon Enterprise Value
  - 1. Debt with "below market" terms and conditions can increase enterprise value above where it would be with "market rate" debt
    - a. "Below market" debt (that is, debt with substantially favorable terms for the debtor) can create value in the capital structure for junior creditors
    - b. Examples – below market interest rates, below market payment rates, presence of guarantees or below market financial covenants create value for their enterprise by freeing value to flow to junior creditors

V. VALUE OF DEBT IN THE "ENTERPRISE VALUE" CONTEXT

- C. Impact of Debt upon Enterprise Value
  - 2. Debt with "above market" terms and conditions can decrease enterprise value below where it would be with "market rate" debt
    - a. "Above market" debt (that is, debt with significant unfavorable terms for the debtor) can remove value in the capital structure from junior creditors
    - b. Examples – interest rates higher than in the same industry and payment terms that are more onerous than those paid by competitors
    - c. Effect is to use that cash flow to pay a senior creditor and thereby make that cash flow unavailable for paying junior creditors

V. VALUE OF DEBT IN THE "ENTERPRISE VALUE" CONTEXT

- C. Impact of Debt upon Enterprise Value
  - 3. "Above market" or "below market" terms and conditions for debt affect whether equity interests are "in the money"

VI. CONCLUSION

- A. All debt is not viewed equally
- B. Terms, conditions and covenants can affect whether the economic effect of debt is greater or less than the accounting treatment
- C. Expert testimony is required to show the value of the debt and its impact upon the reorganization