

Alert

“Redemption Option Value”: Mandatory Distributions to Out-of-the-Money Stakeholders

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On Dec. 8, 2014 the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the “Commission”) issued its 2012-2014 Final Report and Recommendations (the “Report”), proposing numerous changes to Chapter 11 of the Bankruptcy Code (“Code”). This *Alert*, which is one of a [series](#) published by Schulte Roth & Zabel LLP that analyzes the Report, focuses on the Commission’s proposal to compel senior creditors to pay a mandatory “tax,” or so-called “redemption option value” (“ROV”), to junior stakeholders. Simply put, this proposal, if enacted, would force senior creditors to give a portion of the value of their collateral to out-of-the-money stakeholders *even if* the senior creditors are *not* being paid in full. The proposal is a significant departure from fundamental bankruptcy principles, including the “absolute priority rule,” and would in many cases impair the expected recoveries of secured creditors.

What Is the ROV Proposal Generally?

Senior creditors would be required to share a portion of their distributions from the debtor’s estate, whether received under a plan or in connection with a sale of substantially all of the debtor’s assets (referred to as a “Section 363x sale”) with certain junior stakeholders, regardless of whether the senior creditors are paid in full. The amount senior creditors would be required to share would be based on the value of a hypothetical option to acquire the company within a reasonable period of time after the effective date of a Chapter 11 plan or a Section 363x sale order. Report, at 218. The proposal also includes certain elements designed to discourage junior stakeholders from litigating the value of the debtor’s business. See Report, at 209.

How Is ROV Calculated?

ROV is intended to reflect the value of a “hypothetical option” to purchase the debtor’s business at a future date. Report, at 209. As with traditional options, the key components of ROV are the strike price (referred to as the “redemption price”) and the redemption period. *Id.* The redemption price equals the full face amount of the claims of the senior creditors, including any unsecured deficiency claim, interest at the non-default contract rate, and allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of the exercise of the redemption option, as though the senior creditors’ claims remained outstanding on the date of exercise. Report, at 210. The redemption period is the period of time between the plan effective date (in the Chapter 11 plan context) or the date of the order approving the sale (in the Section 363x sale context) and the third anniversary of the petition date. Report, at 208. ROV would be determined through generally accepted market-based valuation models, including the Black-Scholes option pricing model. Report, at 210. In addition to the redemption price and

redemption period, the Black-Scholes valuation would use a volatility rate appropriate for the particular debtor and a risk-free rate (generally based on the U.S. Treasury rate). Report, at 221. According to the Report, in a scenario “where the senior class is entitled to the entire value of the firm and is determined to be receiving 50 percent of the principal amount of their claims ... the [ROV] likely holds no value for the [junior stakeholders] under reasonable assumptions.” If, however, the “percentage recovery of the senior class [is changed] to 90 percent [and all other assumptions remain unchanged] ... the [ROV] is approximately 5 percent of the reorganization value, which would be distributed to the [junior class].” Report, at 221-22.¹

Who Benefits?

ROV is payable to the class of stakeholders immediately junior (the “immediately junior class” or “IJC”) to the senior creditors benefiting from preservation of the debtor’s going-concern value in a Chapter 11 plan or a Section 363x sale. Report, at 207-08. According to the Commission, the IJC “will typically be the class immediately junior to the fulcrum security class” Report, at 210.

Who Pays?

Generally speaking, the senior class(es) of creditors receiving either proceeds of a Section 363x sale or residual interests in the reorganized entity under a plan would, as a practical matter, be paying ROV to the IJC.² In the plan context (if the plan does not contemplate a sale), “the relevant senior stakeholders are the class or classes of senior creditors receiving the residual interests (e.g., equity securities) in the firm” but would not include “a senior class paid in cash or solely in debt securities of the reorganized firm.” Report, at 208 n.762. On the other hand, the relevant senior class in the Section 363x sale context would be the class or classes entitled to receive the sale proceeds. *Id.* The senior class required to surrender value would be entitled to determine the form of consideration in which ROV is to be paid (i.e., cash, debt, stock, warrants or other consideration).³ Report, at 210.

Is ROV Payable in the Chapter 11 Plan Context?

Yes. The proposal to require senior creditors to share a portion of their plan distributions with the IJC would be implemented through amendments to the cram-down provisions of Code Section 1129(b). Report, at 208. Critically, Section 1129(b) would be amended to provide that a plan may be confirmed over the rejection by a senior creditor class that “is not paid in full within the meaning of the absolute priority rule, if the plan’s deviation from the absolute priority rule treatment of the senior class is solely for the distribution to an [IJC] of the [ROV], if any, attributable to such class.” Report, at 208-09.

¹ The “reorganization value” refers to the value of the debtor’s business and is calculated differently in the plan context and the Section 363x sale context. In the plan context, reorganization value equals “the enterprise value attributable to the reorganized business entity, plus the net realizable value of [the reorganized entity’s] assets that are not included in determining the enterprise value and are subject to subsequent disposition as provided in the confirmed plan.” Report, at 207. In the context of a Section 363x sale, however, “reorganization value” equals “the net sale price for the enterprise plus the net realizable value of [the enterprise’s] assets that are not included in [the] sale and are subject to subsequent disposition ... as contemplated at the time of the sale.” *Id.* These valuation methodologies do not appear inconsistent with existing law.

² The Commission states that “the estate ... should be responsible for paying” ROV, but it also recognizes that “[o]f course, any such value paid from the estate will reduce the value available for the senior class.” Report, at 224.

³ Non-cash consideration would be valued on a basis consistent with the manner in which the reorganization value was determined. Report, at 210. Further, as a practical matter, in a sale of all or substantially all of the debtor’s assets (whether in a Section 363x sale or under a plan), ROV would take the form of non-cash consideration only if the sale consideration were itself not cash.

With respect to a rejecting IJC,⁴ a plan would be confirmable so long as the IJC receives not less than the ROV attributable to such class. Report, at 208. If, however, the IJC rejects the plan *and* “challenges the reorganization value used to determine [its] entitlement to [ROV],” a court could still confirm the plan if it finds that the reorganization value was not proposed in bad faith and the plan satisfies the cram-down provisions “other than the requirement that [ROV] be provided to such class.” Report, at 209. In other words, the IJC would be entitled to ROV so long as it does not dispute the reorganization value that the plan proponent used to calculate ROV. *Id.*

Is ROV Payable in the Section 363x Sale Context?

Yes. ROV would be payable to the IJC in connection with a Section 363x sale. Unlike in the plan context, ROV would be payable even when the senior class is paid in cash and receives no “residual interest,” or equity interest in the assets that are sold in the Section 363x sale. Report, at 208 n.762, 209. If, however, the IJC objects to the sale, it will not be entitled to ROV (the “Deathtrap Provision”). Report, at 209.

Is ROV Payable Even if a Senior Class Is Not Paid in Full?

Yes. The Commission proposes that the Code require an allocation of ROV to the IJC regardless of whether the relevant senior class has been paid in full. Report, at 208-09.

The Commission’s Rationale

The Commission found that the absolute priority rule, while an “important creditor protection,” can result in an allocation of value among creditors “in an arguably random manner depending on the timing of the value realization event — i.e., plan confirmation.” Report, at 213. Similarly, in the context of a Section 363x sale, the Report states:

Although the price being offered for a debtor’s assets arguably reflects the current market value of those assets, to the extent the market is dysfunctional at the time of the sale, or economic or industry factors are negatively impacting valuations, the debtor’s estate may be monetized at value far below what the estate could be worth at a later date to the prejudice of stakeholders lower in the pecking order of priorities.

Report, at 214.

According to the Commission, if the assets are valued “during a trough in the debtor’s business cycle or the economy as a whole,” and the proceeds are distributed solely to a senior class, there is an “arguable unfairness” to junior stakeholders who are then foreclosed from participating in any future appreciation of the value of the assets sold or going-concern value of the reorganized entity when the business cycle or economy improves. Report, at 207, 213. The Report therefore concludes that “relying on a valuation [during such a trough] may result in a reallocation of ... future value in favor of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair and inconsistent with the Bankruptcy Code’s principle of providing a breathing spell from business adversity.” Report, at 207.

The proposed allocation of ROV to the IJC in a Section 363x sale or under a plan is intended to address this potential unfairness. That is, ROV recognizes that “the future possibilities of the ongoing firm include the possibility that the IJC might have been in the money or received a greater recovery if the

⁴ To confirm a plan under existing law, a debtor must satisfy the cram-down provisions with respect to any class that does not vote to approve the plan, including any class that is not entitled to receive distributions under the plan.

firm had been valued at a later date.” Report, at 208. The proposed distribution of ROV to the IJC thus reflects the possibility that during the redemption period, the value of the firm might increase and be sufficient not only to pay the senior creditors in full with interest, but also to provide incremental value to the IJC. *Id.*

Potential Impact on Secured Creditors

If enacted, the ROV recommendation would have a significant impact on secured creditors. First, the proposal would likely reduce secured creditor recoveries when compared to recoveries under existing law. By requiring secured creditors to pay ROV to an IJC, the proposal effectively imposes a tax on secured lenders.

The stated rationale for requiring the payment of ROV to the junior class, as discussed above, is to address some “arguable unfairness” to junior stakeholders who are unable to participate in any potential future appreciation if the assets are sold during a down cycle. But the proposal requires the senior class to pay ROV even in circumstances where the senior class is receiving cash proceeds from the sale of its collateral and has no right to share in the potential future appreciation of the assets. Payment of the ROV, especially in this context, is extraordinarily unfair and punitive.

Despite the deterrents built into the recommendation, the proposal seems likely to generate additional litigation over the determination and allocation of ROV (and its constituent parts). For example, in the plan context, the IJC would be foreclosed from receiving ROV if it “challenges the reorganization value used to determine [its] entitlement” to ROV. But reorganization value is only one component of ROV — the IJC could challenge the other aspects of ROV, such as the redemption price, redemption period or the methodology used to calculate ROV, and still preserve its right to payment of ROV. This additional litigation could increase the length of the sale or confirmation process and could also add (potentially significant) costs to the estate.

In addition to any delay caused by ROV-related litigation, the matter of determining the IJC may, in itself, add delay to the Section 363x sale approval process, including the distribution of sale proceeds to the senior class. Under the proposal, a sale approval order must provide “for an allocation of redemption option value to the immediately junior class.” Report, at 209. Yet, in cases where there is uncertainty as to the amount of claims of the senior class at the time of a sale, it may not be possible to ascertain the IJC or the amount of ROV. These open items must, however, be resolved in order to distribute sale proceeds and to determine the IJC for purposes of the Deathtrap Provision.

The Commission acknowledges that there are numerous issues related to the ROV proposal that require “further development to determine whether and how it should be applied in more complex contexts,” including:

- Whether a senior class should be required to pay ROV when it does not have a blanket lien and is entitled to less than all of the firm’s enterprise value;
- Whether an IJC (or member of an IJC) can recover ROV if it is subject to contractual or structural subordination (rather than a lien subordination);
- Who pays ROV when there are multiple classes senior to the IJC and not all are receiving interests in the residual value of the firm;

- Whether ROV is payable when only part of the IJC class objects to a sale or challenges reorganization value under a plan; and
- Whether ROV is payable to the IJC if the IJC receives some distribution but is not paid in full.

Report, at 211.

There are at least three other issues left unresolved in the Report. First, the Report does not include a definitive methodology for calculating ROV. The Commission concludes that a market-based method such as the Black-Scholes model would “*likely* be the best way to consistently and accurately determine” ROV. Report, at 221 (emphasis added). The Report, however, also notes that other formulas, such as the Binomial Options Pricing Model and Monte Carlo options model, could be considered where “Black-Scholes is not effective to value an option on a particular enterprise.” Report, at 221 n.795. The Report thus leaves open the question of what methodology, if any, courts should presumptively accept in determining ROV.⁵

In addition, the Report does not address whether the IJC will forfeit its right to ROV if it (or any member of such class) objects to the sale or plan on grounds other than those related to valuation (e.g., objections based on process, or whether the plan/sale was proposed in good faith, etc.). Further, the Report does not address the impact the ROV proposal may have on reorganized companies’ balance sheets when they emerge from bankruptcy. Because, in the plan context, ROV would be payable only by the class(es) receiving residual interests in the company, senior lenders may be less willing to accept plan distributions in the form of equity interests and instead opt for debt instruments that effectively give them control of the reorganized company. This may, in some cases, cause debtors to emerge with an overleveraged balance sheet and make a second bankruptcy filing more likely in the near term.

Conclusion

The ROV proposal is controversial and represents a sharp departure from existing law. It would, if enacted as proposed, have material adverse impacts on the rights and recoveries of secured creditors.⁶

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⁵ Regardless of which methodology courts apply to determine ROV, the ROV proposal may present new challenges for valuation experts. Under existing valuation practices, experts provide a range of values for a firm at a given point in time. This approach recognizes the inherent difficulty in assigning a precise value to a diverse set of assets. Despite these challenges, the ROV proposal would require experts to pinpoint the value of a firm at a future date. The proposal should thus clarify that, absent other factors, mere valuation errors cannot form the basis of a claim that reorganization value was proposed in bad faith.

⁶ The ROV proposal would not apply to a small or medium-sized enterprise, which is defined in the Report to mean “a business debtor with (i) no publicly traded securities in its capital structure or in the capital structure of any affiliated debtors whose cases are jointly administered with the debtor’s case, and (ii) less than \$10 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates as of the petition date.” Report, at 279.

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