‘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 (the Code). This article 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. 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 and would be determined through generally accepted market-based valuation models, including the Black-Scholes option pricing model. Report, at 210. 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.” Report, at 221-22. 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 222.

Who Benefits?

According to the Commission, ROV would be payable to the class of stakeholders immediately junior (the “immediately junior class” or “IJC”) to the “fulcrum security class ….” Report, at 210. The fulcrum class typically will recover less than its entire claim.

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

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. In the Section 363x sale context, the relevant senior class would be the class(es) 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). Report, at 210. Note, 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.

Is ROV Payable in the Chapter 11 Plan Context?

Yes. The ROV proposal 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 a [IJC] of the [ROV], if any, attributable to such class.” Report, at 208-09.

With respect to a rejecting IJC, 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. 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.

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. Thus, “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 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 with recoveries under existing law. By requiring secured creditors to pay ROV to the IJC, the proposal effectively imposes a tax on secured lenders.

Although intended by the Commission 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, the proposal would require 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. Report, at 209. But reorganization value is only one component of ROV — the IJC could challenge the other aspects of 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, delay distribution of sale proceeds to the senior class. Under the proposal, a Section 363x sale approval order must provide “for an allocation of redemption option value to the [IJC].” 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.” Report, at 211. There are at least three other unresolved issues beyond those identified in the Report. First, the Report leaves open the question of what methodology, if any, courts should presumptively accept in determining 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, notes that other formulas, such as the Binomial Options Pricing Model and Monte Carlo options model, could be applied where “Black-Scholes is not effective to value an option on a particular enterprise.” Report, at 221 n.795.

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.

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