Client Alert

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Redemption Option Value: Broad Implications for Secured Lenders

Second in a Series of In-Depth Discussions of Key Issues on the ABI Commission Final Report on Chapter 11 Reform

As discussed in our first installment, the American Bankruptcy Institute ("ABI") released its Final Report and Recommendations (the "Report") containing proposals to modify the Bankruptcy Code, many of which will have significant and negative implications for secured creditors. One of the most far reaching of the proposals is to require, in connection with a sale of all or substantially all of the debtor's assets (a "363 Sale") or a plan of reorganization, that senior creditors provide certain out-of-the-money junior creditors or equity holders with what the Report terms the "Redemption Option Value." As will be more fully discussed, this value is intended to capture (and transfer to certain junior creditors) the value of a hypothetical option to purchase the entire company and satisfy all of the debtor's senior debt, thereby allowing certain out-of-the-money junior creditors to share in the possibility of future value appreciation of the debtor's assets within a defined time period following consummation of the 363 Sale or confirmation of the plan of reorganization.

For many reasons, this proposal should be troubling to secured lenders. First and most importantly, the proposal represents a significant deviation from the absolute priority rule that has served as a bedrock principle of the Bankruptcy Code and upon which lenders have come to rely when offering and pricing credit. In contravention of the absolute priority rule, in order to exit bankruptcy, the proposal would require an economic transfer of value from impaired senior creditors to out-of-the-money junior creditors or equity holders. Moreover, although the Report contends that the proposal will streamline cases and decrease litigation, it is more likely to have the opposite effect. Given the complexity of the proposal and the numerous factors that will need to be determined in order to calculate the hypothetical value of the debtor's business over a future time period and the corresponding value of the redemption option, there is a strong likelihood that such a proposal would only lead to increased litigation, leading to longer and more expensive bankruptcy proceedings.

The Report also ignores the potentially significant impact such a proposal may have on the broader credit markets. The absolute priority rule and access to an efficient sale process to effect secured creditor remedies have been fundamental factors in establishing the availability and pricing of credit. If this proposal were to be adopted, there very well may be unintended and largely negative consequences to the availability and pricing of credit.

Finally, despite the very real dangers of added complexity and cost to bankruptcy proceedings and the disruption to the credit markets, the Report does not provide any real empirical data justifying the need for these drastic changes. The Report contends (without data) that junior creditors have been hurt by quick 363 Sales and plans of reorganization implemented during a trough in the debtor's business cycle or the economy as a whole. Therefore, junior creditors have not been able to realize any upside that would come from a lengthier chapter 11 plan process. However, as will be discussed, the reality does not support this contention. Rather, empirical evidence shows that 363 Sales routinely generate contested auctions resulting in accurate and fair market value for the debtor's assets.

Calculating "Redemption Option Value"

Under the proposal, even if the fair market value of the debtor's assets (determined in connection with either a 363 Sale or a plan of reorganization) dictates that senior creditors would be entitled to all of the sale proceeds or the debtor's entire enterprise value in accordance with the absolute priority rule, in order for any 363 Sale or plan of reorganization to be approved, in certain circumstances discussed below, the approval order must provide for an allocation of value by holders of the fulcrum security (i.e., the class of debt in the debtor's capital structure at which the firm's enterprise value is exhausted at the time of the enterprise valuation in the case) to the immediately junior class of debt or equity. The Redemption Option Value to be transferred would be the hypothetical value of an option

to purchase the entire company and pay in full or "redeem" all of the outstanding senior debt. The value of this option would be calculated using a market-based model for pricing options, such as the Black-Scholes formula, which would take into account: (i) the strike price of the option, (ii) the term of the option, (iii) the volatility of the option, and (iv) an appropriate risk-free rate.

Under the proposal, the strike price for the option would be equal to the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus all interest, fees and expenses that would accrue through the end of the redemption period. The term or "redemption period" would generally be the period commencing on the effective date of the plan or closing of the sale and ending three years following the commencement of the case (i.e, if the sale is consummated 6 months following the commencement of the bankruptcy case, the redemption period would expire 30 months following the sale). The volatility component of the formula would be determined by looking at the historical volatility of comparable companies, using an agreed upon volatility rate or using a set metric, and the risk-free rate generally would be based on the U.S. Treasury rate. The proposal contemplates that the junior creditors would not receive an actual option, but rather, the price that would be paid for such hypothetical option.

A redemption option value would not, however, be due in every instance. Where secured creditors are impaired and significantly underwater, junior creditors will likely not be entitled to any recovery based on the proposed formula. The closer the senior creditor class comes to being paid in full, however, the more value will be required to be transferred to junior creditors in order to allow the sale to close or plan to be confirmed.

Implications of the Proposal

Modification of Absolute Priority Rule

Obviously, one of the most significant implications of the Redemption Option Value proposal, should it be adopted, is that, in order to approve a 363 Sale or a plan of reorganization, value otherwise allocable to senior creditors would be required to be transferred to junior creditors despite the fact that senior creditors are not getting paid in full – something that is directly contrary to the absolute priority rule.

Increased Litigation and Expense

While the Report states that the proposal would serve to incentivize the major parties to reach a consensual reorganization, resulting in faster reorganizations and less litigation, the reality will likely be very different. If enacted, the proposal is likely to result in increased litigation over the amount of the Redemption Option Value and will likely be focused on the conflicting testimony of the parties' various experts regarding the future value of the company following bankruptcy. Rather than curtailing litigation, this proposal seems only likely to encourage it.

In addition, the Report itself acknowledges that while implementation in a relatively simple capital structure may be easy, the potential complexities of applying the proposed mechanism in more involved corporate and financing structures would be difficult. For instance, the Report leaves open how the proposal would be implemented where: (i) a senior class is entitled to less than all of the firm's enterprise value; (ii) contractual or structural subordination (rather than a lien) results in an immediately junior class; (iii) there are multiple classes senior to the immediately junior class and not all senior classes are receiving distributions in the form of interests in the residual value of the firm; (iv) only part of the immediately junior class objects to a sale or challenges reorganization value under a plan, or (v) some enterprise value is distributable at the current enterprise valuation to an immediately junior class, but the junior class is not being paid in full. Therefore, given the numerous issues left to be resolved, it is very likely that this proposal will only increase litigation and cost rather than decrease it.

The consequences of such additional complexity, litigation and expense are likely to be borne by senior creditors. Taken together with Report's other proposals to extend the minimum time required to effect a 363 Sale, and to make it easier for debtors to secure new DIP financing without requiring the consent of the secured creditors, the proposals will likely result in further erosion of the secured creditors' collateral and recoveries and the shifting of leverage to the more junior out-of-the-money creditors with little to lose from the additional time and expense being financed (voluntarily or involuntarily) by the secured creditors' collateral.

Implications for Broader Credit Market

The Redemption Option Value proposal may also have unintended and negative consequences for the broader credit markets. The current 363 Sale process is widely understood by the credit industry and is generally perceived to result in auctions that are highly competitive and that result in accurate realizations of fair market value. Further, lenders providing credit do so with an understanding of the absolute priority rule and price credit accordingly. Any change to the current distribution system may very well have a substantial and negative effect on credit markets, particularly when so much credit has been given relying upon the accepted and current distribution scheme based upon the absolute priority rule. This has been proven by rating agencies, which have already indicated that the cost of credit would rise if these recommendations were enacted.[1]

Rationale for Proposal is Limited

Perhaps the most puzzling aspect of the Redemption Option Value proposal is that, given its substantial change to the absolute priority rule and the potential negative impact on the broader credit markets, such reform does not even appear to be necessary and the rationale for the proposed change at this time is limited at best. The Report states that reforms are required because sales occur too quickly, which prevents robust auctions, curtails the exploration of other restructuring alternatives and prohibits parties from performing reliable asset valuations. The Report concludes that this is “unfair” and hurts junior creditors’ recoveries as such creditors are not permitted to realize any upside that would come from a chapter 11 plan process or share in the possible future value appreciation of the affected assets.

However, there is no empirical or quantitative evidence that bankruptcy sales fail to generate accurate, fair market value for the assets being sold. In fact, quite the opposite is true. The market for distressed assets is robust and well-developed.[2] There is also no evidence that additional time exploring other restructuring options would lead to increases in value for out-of-the-money constituents. Rather, the only certainty is that longer cases will be more expensive. The proposal also seemingly glosses over the fact that, in many instances, the junior creditors that would obtain the new “protection” under the proposal are sophisticated financial institutions or investment funds that choose to invest in a particular part of the debtor’s capital structure fully aware of the risk (lower recovery) and rewards (increased interest rate) associated with such choice. This proposal could reward those creditors that chose to receive higher interest payments and agreed to take on additional risk while hurting those creditors that chose to receive lower interest rates and invest in a safer portion of the capital structure.

Although the Redemption Option Value is at this point only a proposal, there are potentially significant and negative implications for secured creditors should the proposal be adopted. We will continue to monitor the debate likely to be generated by these recommendations. Moreover, certain other proposals contained in the Report would compound some of the issues discussed in this alert and we will be distributing additional client alerts in the next several weeks discussing those other proposals and their potential impact on secured creditor remedies and recoveries.

1 *See* Fitch Ratings Report, dated December 9, 2014, in which Fitch reported that the proposed reforms “could adversely alter recovery prospects of first lien debt claim holders.”

2 *See, e.g., Mark Jenkins & David C. Smith, Creditor Conflict and the Efficiency of Corporate Reorganization*, (paper presented at April 2014 symposium), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2444700.

For More Information

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