**The Roles and Applications of Valuation in**

**Restructuring and Insolvency Context**

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# **Introduction**

Valuation has been playing an important role nowadays, particular in the restructuring and insolvency space. It is a crucial tool to monetarise a restructuring plan which relevant stakeholders are required to evaluate to determine its fairness and whether it is acceptable. There is a wide range of aspects in the restructuring plan which require valuation. For example, value of the business, claims by the secured or unsecured creditors, assets or collaterals, cross-class cram down, break-even, contingency, etc. Valuation, if used properly, plays a big part to address these issues and assist in the decision-making process.

However, valuation has also been one of the intense arguments in the court given that it requires professional judgement. As many have said, business valuation is both an art and a science. While it requires certain financial and accounting background with calculation, it also requires the selection of the appropriate methodology and assumption, usually within a set of limitations such as information asymmetry or uncertainty on future events. It is further complicated with the different perspectives held by various stakeholders. Therefore, the choice of the justifiable valuation methodology, value, approach, assumptions, timing, has given rise to the disputes among different stakeholders when evaluating a restructuring plan.

The essential elements to be met in order to satisfy the court that a restructuring plan should be sanctioned require the assistance of valuation. The “no worse off” test and the “genuine economic interest” test under Part 26A of the UK Companies Act 2006, [[1]](#footnote-1) and the “best interests of creditors” test and the “absolute priority” test under Chapter 11 of the US Bankruptcy Code[[2]](#footnote-2) are the elements that need to be met for sanction of a restructuring plan in which valuation can assist in answering the questions. Similar concepts were also introduced in the restructuring regime in the Netherlands under the Dutch Wet Homologatie Onderhands Akkoord (WHOA) and in the European Union.[[3]](#footnote-3)

Valuation is not straightforward due to the ever-changing world. It “*can be difficult and give rise to valuation disputes between parties that are both costly and time-consuming, involving expert testimony and protracted litigation*”.[[4]](#footnote-4) The number of stakeholders involved in the restructuring plan of a debtor gives rise to different perceptions on how valuation should be conducted. It often leads to cost issue too which sometimes discriminates small vendors and employees. Therefore, it is important for restructuring professionals to understand the selection and the rationale behind the selection of the proper, but may not necessarily the best, valuation methodology, values, and the pros and cons of each.

# **What is valuation? What is value? Who determines them?**

## *2.1 General definition of fair value and treatment of valuation*

The Organisation for Economic Co-operation and Development (“**OECD**”) defines fair value, which is interchangeably as market value, as *the price at which an asset would change hands between a* ***willing buyer*** *and a* ***willing seller****,* ***neither being under any compulsion*** *to buy or to sell and* ***both having reasonable knowledge of relevant facts***.[[5]](#footnote-5) Traditionally, valuation methods include (i) multiples or comparables (i.e. market-based), (ii) discounted cash flow method (i.e. income-based), and (iii) asset-based method. The choice of which depends on numerous factors including nature of the business, purpose, information available and its reliability, etc., and more importantly, judgement. It is noted that the terms in the definition of fair value given by OECD include “willing buyer”, “willing seller”, and “neither being under any compulsion”. In restructuring and insolvency context, a buyer or a seller may, in certain circumstances, comprise or be compelled to accept a deal that it would not be willing to accept in usual circumstance. This gives rise to the concept of full value and compromised value expressing in the terms such as enterprise value, going concern value, net orderly liquidation value (“**NOLV**”), liquidation value, forced sale value, etc. The different “values” that may be used depends on the circumstances. Combining with various other monetary and non-monetary components, for example forecasts, market multiples, discount rate, timing, quality and location of an asset, economic environment, government policy, forms the central argument of valuation.

## *2.2 Valuation in restructuring & insolvency context*

A few common values are always utilised in the restructuring context and have been discussed in numerous business literatures. Enterprise value (sometimes reorganisation value) is measured using the market values or the observed acquisition prices of comparable companies.[[6]](#footnote-6) Going concern value is the value under the assumption of a continuation of business without halt for the foreseen future.[[7]](#footnote-7) Liquidation value is often performed simply, without reflecting basic economic rules which affect the valuation result, and is distorted significantly.[[8]](#footnote-8)

While valuation is an essential element to quantify a restructuring plan, the restructuring related legislations are silent as to the valuation methodology in most of the jurisdictions. A close description can be found in section 506(a)(1) of the US Bankruptcy Code where it states that the value shall be determined *“in light of the purpose of the valuation and of the proposed disposition or use of such property”*. While this provides guidance on the approach in obtaining a value, it still does not specify the valuation methodology that should be employed. The silence as to the valuation methodology in most of the restructuring legislations echoes the fact that the selection of which requires professional judgement. It also leaves sufficient room for restructuring professionals and the court to determine which valuation methodology and value are the most appropriate taking into account the actual circumstances.

As mentioned above, various components play their own parts in the valuation to determine the most appropriate valuation methodology and value. Simply choosing which value, for example enterprise value versus liquidation value, should be applied is insufficient to answer all issues related to the valuation exercise. All relevant aspects are required to be considered individually and as a whole to make use of valuation to assist in evaluating a restructuring plan.

# **How are valuation methodology and value chosen?**

## *3.1 Sears Holdings Corporation*

General facts

In *Re Sears Holdings Corp., 51 F.4th 53 (2d Cir. 2022)*, the appeal court gave an analysis on whether the value in a best-case-scenario sale (i.e. market price or full retail price), an orderly going-out-of-business sale (i.e. NOLV), or a force liquidation sale would be the best estimate. The appeal application was made by the second-lien holder to challenge the bankruptcy court’s valuation methodology, as well as to its valuation of several specific categories of collateral, including the inventory and the letters of credit. The valuation was relevant to the second-lien holder as it would determine whether the second-lien holder had a super-priority claim pursuant to section 507(b) of the US Bankruptcy Code.

The US Circuit Judge upheld the decision of the bankruptcy court that, among other things, the inventory of Sears Holdings Corporation and its affiliates (“**Sears**”) be valued at the NOLV and the full face value of the undrawn letters of credit be deducted when assessing the best case scenario.

Rulings and comments

The US Circuit Judge pointed out at the beginning of the decision handed down that the core of the case came down to a fundamental concept: *how to value the assets and liabilities of a company*.*[[9]](#footnote-9)* The bankruptcy court decided that it would value the inventory based on the NOLV, a point at the price less than the full retail price but more than the liquidation value.[[10]](#footnote-10) Referencing to section 506(a)(1), the court gave opinion that the value of Sears’ inventory should be calculated “in light of the disposition or use” in fact “proposed”, not the various dispositions or uses that might have been proposed, and that this proposal must guide the valuation exercise.[[11]](#footnote-11)

While at the outset, neither Sears nor the second-lien holder knew how the inventory would be sold, the court recognised that Sears was in financial distress and a company-wide liquidation was possible. Therefore, the court rejected the second-lien holder’s argument that the full retail price should be adopted but settled on the NOLV. The second-lien holder argued that the bankruptcy court should follow *Associates Commercial Corp. v. Rash, 520 U.S. 953 (1997)* whereas inventory was valued at its replacement value. The court disagreed with the argument as in *Rash*, the inventory was retained and used by the debtor, as opposed to Sears’ intention to dispose the inventory. When determining the point price range between the retail price and the liquidation price, the court applied a percentage, representing the realisable value net of selling costs in an orderly liquidation, adjusted with corporate overhead.[[12]](#footnote-12)

The valuation of contingent liability which in this case, the letters of credit, was also considered by the court. One of the arguments of the second-lien holder was that the letters of credits should be valued at the amount that was actually drawn during the bankruptcy proceeding. However, the court ruled that it was necessary to discount contingent liability by the probability that the contingency would occur taking into account the “*resulting need to tap available sources of capital*”,[[13]](#footnote-13) as opposed to the second-lien holder’s after-the-fact valuation methodology as it defeated the purpose of valuation as at the petition date.

In *Sears*, the court took the approach that the NOLV reflected the actual circumstances considering that given the financial distress it would not be able to sell the inventory at its full retail price but could still avoid a forced liquidation sale. This is a reflection of the closet estimate of the most appropriate scenario. However, the application of the percentage would require judgement or individually review of the items which would increase costs. Similarly, determining the probability that the contingent liability would become actual required research and analysis on the applicable percentage.

## *3.2 Smile Telecoms Holdings Ltd*

General facts

In *Re Smile Telecoms Holdings Ltd [2022] EWHC 740 (Ch)*, the selection of the valuation methodology was considered. The court ruled on whether the assets of Smile Telecoms Holdings Limited and its group of operating companies (“**Smile**”) should be valued under desktop valuation, market sale or distressed sale so as to determine if the senior lenders would be “out of the money”. The value was relevant to the senior lenders as that would determine if the senior lenders had a genuine economic interest in Smile.

Smile proposed a restructuring plan to secure additional liquidity to avoid immediate administration and to restructure the debts so as to enable it to dispose the assets on a solvent basis. In the event that the restructuring plan was not sanctioned, Smile would be placed into insolvency process. Smile filed valuation evidence concerning a desktop valuation on the best and worst scenarios of the disposal process with discount applied for distressed sales to reflect the absence of extensive warranties. A sale process was also conducted whereas a non-binding offer received was below the worst scenario value.

Rulings and comments

Making reference to the convening judgement for the order under section 901C(4) of the UK Companies Act 2006 made in *Re Smile Telecoms Holdings Ltd [2022] EWHC 387 (Ch)*, the court held that the senior lenders were clearly out of money in both the best and worst scenarios. [[14]](#footnote-14) It also held that applying discount is a commonplace to reflect the fact that any sale out of an insolvency process would likely to be discounted.[[15]](#footnote-15) Further, the valuation evidence was supported by “*real world evidence*”[[16]](#footnote-16) – the marketing and sale process. The court was convinced that this was the “*best evidence of the actual valuation of the assets*”.[[17]](#footnote-17) On the other hand, the court was unsatisfied with the last-minute challenge by the senior lenders on Smile’s valuation evidence without any assistance to the court. Accordingly, the court ruled that the senior lenders were well out of money and did not have genuine economic interest in Smile.

To work out whether there is genuine economic interest, in *Smile*, the court utilised the desktop valuation as a guidance on the outcome from the disposal process and made reference to the non-binding offer, which was lower than value in the worst scenario from the desktop valuation, obtained from the sale process to determine that the market testing value demonstrated the actual value of the assets. This is a cost-effective and efficient approach should the circumstances allow and justify (in this case, the sale process was conducted simultaneously) as it can avoid the need of lengthy computation and making and justifying assumptions. In contrast, this may add to unnecessary costs and delay the restructuring process if the sale process is conducted simply to obtain a market testing value. [[18]](#footnote-18) It should also be noted that, in *Smile*, the court also criticised the lack of assistance provided by the senior lenders to the court to justify their challenge to Smile’s valuation evidence.

## *3.3 Adler Group SA*

General facts

In *AGPS Bondco Plc [2023] EWHC 916 (Ch)*, conflicting valuation evidence was produced by opposing parties which both attempted to determine the historical gross asset value, and to value the business by forecasting the future sale of residential properties and assessing the value of the development properties. AGPS BondCo PLC (“**AGPS**”), a subsidiary of Adler Group SA (“**Adler**”), applied for order under Part 26A of the UK Companies Act 2006 to sanction a restructuring plan to attempt to orderly wind down and sell the assets, rather than rescue the business as a going concern. Both AGPS and the opposing party, an ad hoc group of holders of the senior unsecured notes (“**AHG**”), agreed that if the restructuring plan was not sanctioned, AGPS (together with Adler and other subsidiaries) would have no choice but to file formal insolvency proceedings and would realise less on the sale of its assets than it would have should the restructuring plan was sanctioned. The valuation was relevant to AHG which argued that, should the restructuring plan be sanctioned, it would be worse off than in liquidation.

Rulings and comments

The court noted that the real differences between the conflicting valuation evidence related to the components in the valuation which in this case – the yields and the inputs into development appraisals.[[19]](#footnote-19) The court was satisfied with AGPS’s valuation evidence on the capitalisation rates adopted in the discounted cash flow valuation which were cross checked against comparable evidence and sales data and adjusted where necessary. The court also satisfied with the residual valuation method adopted, using a specialist piece of software, to value the development properties which was routinely used to value the development portfolio of the Adler’s group by computing the market value and appropriating project costs of each property. Therefore, the court preferred the value computed and submitted by AGPS.

In order to consider liquidation value, AGPS submitted evidence on the appropriate insolvency discount, which was identified by conducting interviews with experts, and gave evidence about the factors which gave rise to an insolvency discount. The court was satisfied that AGPS’s evidence was supported with substance, and the insolvency discount was identified by each expert with reasons, as opposed to the absence of details in AHG’s evidence. Taking into account the valuations and the insolvency discounts, the court was satisfied that AHG would be “no worse off” under the restructuring plan.

While the conflicting valuation evidence both attempted to compute the value using the same valuation methodology, the court made ruling on the components and assumptions adopted to compute the value. The capitalisation rates adopted in the discounted cash flow method required market research which could be time consuming. In addition, it may not be accurate given information asymmetry. In *AGPS*, this rate could be obtained relatively easily as the group has routinely inspect and monitor its development portfolio. Further, the value was cross checked with open data and adjusted to enhance accuracy, though there would be cost concern. The insolvency discount obtained to compute the liquidation value was done through interviews with experts which ensured the reliability of this component. It can also be noted in *AGPS* that, the court adopted different valuation methodology to value different types of assets subject to their characteristics and information available.

# **Conclusion**

The “no worse off” test in Part 26A and the “best interests of creditors” test in Chapter 11 share certain similarities. They both require that the dissenting class of creditors,[[20]](#footnote-20) who would be crammed down in the restructuring plan, would not receive less than what they would have received in the relevant alternative. [[21]](#footnote-21) Part 26A also introduces the concept of “genuine economic interest” in which dissenting creditors who would not receive a payment in the relevant alternative scenario could be excluded from voting. Accordingly, valuation would be the key to differentiate various circumstances (e.g. restructuring versus liquidation, in the money versus out of money) and assist in determining whether a restructuring plan should be sanctioned.

Neither jurisdiction has specified or stuck with one valuation methodology or value that should be adopted in the legislations or by the court as there is no one rule fits all situation. In addition, no one can say one jurisdiction has been addressing the issues in valuation better than others given their judgmental nature. Furthermore, as it has been acknowledged by various judges, valuation is arithmetical,[[22]](#footnote-22) contains inherent uncertainty[[23]](#footnote-23) and significant degree of scepticism,[[24]](#footnote-24) may not necessary be reliable,[[25]](#footnote-25) and future looking.

When conducting valuation exercise, one should consider the circumstances and purpose of the valuation. The NOLV approach applied in *Sears* is not applicable to the market testing approach in *Smile* given the different circumstances, time constraint and availability of information. The asset (or liability) class that is being valued is also an important factor. It would be so wrong to adopt the valuation methodology in valuing the properties in *AGPS* to value the inventory in *Sears*. In addition, the components in the valuation need to be carefully scrutinised which sometimes involve valuation of their own. Furthermore, the timing of the valuation should also be considered in which the valuation should be conducted as at the relevant date (usually the petition date)[[26]](#footnote-26) but not conducting after-the-fact valuation.[[27]](#footnote-27) Lastly, substantive and relevant materials would be required to assist the court in understanding the valuation evidence.

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11 U.S. Code

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Re Virgin Active Holdings Limited [2021] EWHC 1246 (Ch)

The Directive (EU) 2019/1023 of the European Parliament and of the Council

**Appendix A: Author Statement for Short Paper**

The following statement must be appended to the cover of your Short Paper:

# **Author Statement**

Chun Yin Law (Johnny Law)

# Full name

**DECLARATION OF HONOUR**

I declare that the paper, titled “ …T…he…R…ole…s a…nd…A…pp…lic…at…ion…s …of …Va…lua…tio…n…in…Re…st…ruc…tu…rin…g …an…d ……

Insolvency Context

………………………………………………………………………………………………………………..”

is my own work, that it has been prepared independently and that all references to, or quotations from, the work of others are fully and correctly cited.

# **A white letter on a black background  Description automatically generatedSigned**

# **Date:** 9 July 2023

# **Place:** British Virgin Islands

1. *Companies Act 2006 (UK)* s 901G. [↑](#footnote-ref-1)
2. *11 U.S. Code* § 1129. [↑](#footnote-ref-2)
3. The Directive (EU) 2019/1023 of the European Parliament and of the Council and the European Union (Preventive Restructuring) Regulations 2022. [↑](#footnote-ref-3)
4. A N Goldman, G W Shuster Jr., B W Joveland, L R Lifland and A Pierce, *Covid-19: Rethinking Chapter 11 Bankruptcy Valuation Issues in the Crises*, at <<https://www.wilmerhale.com/en/insights/client-alerts/20200421-covid19-rethinking-chapter-11-bankruptcy-valuation-issues-in-the-crisis>>, accessed on 2 July 2023. [↑](#footnote-ref-4)
5. *Private Pensions: OECD Classification and Glossary*, p 43. [↑](#footnote-ref-5)
6. Kenneth M. Ayotte & Edward R. Morrison, *Valuation Disputes in Corporate Bankruptcy*, 166 U. PA. L. REV. 1819 (2018), p 1830. [↑](#footnote-ref-6)
7. J Aronsson and A Granstedt, *A Qualitative Look into Auditor’s Going Concern Assessment* (Jonkoping University International Business School 2021), p 12. [↑](#footnote-ref-7)
8. F Poborsky, ‘Fundamentals of the Liquidation Method of Business Valuation’, *Procedia Economics and Finance 25*, p 393. [↑](#footnote-ref-8)
9. *Re Sears Holdings Corp., 51 F.4th 53 (2d Cir. 2022)*, p 4. [↑](#footnote-ref-9)
10. *Ibid*, p 9. [↑](#footnote-ref-10)
11. *Ibid*, p 28. [↑](#footnote-ref-11)
12. *ESL Invs. v. Sears Holdings Corp. (In re Sears Holdings Corp.), 621 B.R. 563, 569 (S.D.N.Y. 2020)*, Casetext Inc., p 5. [↑](#footnote-ref-12)
13. *Supra* n 11. [↑](#footnote-ref-13)
14. *Re Smile Telecoms Holdings Ltd [2022] EWHC 740 (Ch)*, para 36. [↑](#footnote-ref-14)
15. *Ibid*. [↑](#footnote-ref-15)
16. *Ibid*. [↑](#footnote-ref-16)
17. *Ibid*. [↑](#footnote-ref-17)
18. In the matter Virgin Active, the court ruled that there is no absolute obligation to conduct market testing. Whether or not it was necessary or practicable depends on whether it would be likely to have a result in a materially more reliable valuation. *See Virgin Active Holdings Limited [2021] EWHC 1246 (Ch)*, para 138-141. [↑](#footnote-ref-18)
19. Re *AGPS Bondco Plc [2023] EWHC 916 (Ch)*, para 95. [↑](#footnote-ref-19)
20. Under US Chapter 11, they are referred as impaired class of claims or interests. See above n 2. [↑](#footnote-ref-20)
21. Under UK Part 26A, relevant alternative is described as “the most likely to occur in relation to the company if the compromise or arrangement were not sanctioned”. See above n 1. Under US Chapter 11, relevant alternative is the liquidation procedure under Chapter 7 of the Bankruptcy Code. See above n 2. [↑](#footnote-ref-21)
22. *Supra* n 17, para 256. [↑](#footnote-ref-22)
23. *Ibid*, para 212, 291, 300. Also *supra* n 13, p 5, 19, 27. [↑](#footnote-ref-23)
24. In *ABT Auto Investments Ltd v Aapico Investment Pte Ltd and Others [2022] EWHC 2839 (Comm)*, para 173. [↑](#footnote-ref-24)
25. Ibid. [↑](#footnote-ref-25)
26. *Supra* n 20, para 217(4), (6). [↑](#footnote-ref-26)
27. *Supra* n 13, p 29. [↑](#footnote-ref-27)