**A review and critique of the different approaches to addressing restructuring valuations in the US and UK**

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9. **Introduction**

The US and the UK both have very effective restructuring regimes which are sought after by foreign debtors seeking to restructure and studied by foreign lawmakers seeking to develop their own restructuring laws. However, the approach to the valuation of distressed companies is markedly different in the US and the UK. At its core, valuation in the context of a restructuring, is a question of how best to allocate the value of a distressed debtor to its stakeholders in light of the inherent uncertainty around that value. The US approach primarily relies on valuation appraisals which capture the intrinsic market value for a debtor following its restructuring. Whilst, the UK approach primarily relies on determining value based on the current market price of the debtor absent a restructuring – a so called counterfactual valuation standard. To understand how the valuation standard plays out in a restructuring, it is also important to understand the legal framework within which it is framed.

This paper sets out an overview of: (i) the key valuation methodologies; (ii) the different legal frameworks for implementing a non-consensual restructuring of a large capital structure in the US and the UK; and (iii) the applicable valuation standards in each of the US and the UK. It then concludes with a critique of the differing approaches to valuation in these two jurisdictions.

1. **Overview of Valuation Methodologies**

It is important to understand the strengths and weaknesses of different valuation methodologies in any particular restructuring context. There are a wide variety of valuation methodologies and the question of which methodology is best suited to determine the value of a distressed company will depend on various factors. These include the general state of the economy at the time of the restructuring, as well as, industry specific and debtor specific factors. The most common methodologies in both UK and US restructurings are discussed below.

1. A Market Testing Approach. This approach involves running a sales process. It is often the most effective means of ascertaining value provided there is a functioning market and there is time to implement a robust sales process. However, there are a number of potential limitations to this approach in a restructuring context. The main limitation is that potential bidders will likely provide low offers in light of the distressed company being a forced seller. Other limitations include: (i) the ability to conduct a robust marketing process may be limited by the impact of the marketing exercise on the performance of the business; (ii) the unavailability of credit for potential financial and trade buyers to make a competitive bid; (iii) the chilling effect of the ability of the debtors’ creditors to credit bid causing potential purchasers to conclude that the marketing exercise is to benchmark value for the restructuring rather than a viable acquisition opportunity; and (iv) limited legal protections, for the potential purchaser, in the form of warranties and indemnities in the sale documentation. [[1]](#footnote-1)
2. An “Income Approach”. This approach uses a discounted cash flow methodology to establish a value based on the cash flows that the company can be expected to generate in the future. This approach relies on various assumptions around predicted cash flows under the business plan and the appropriate discount rate to apply to these future cash flows. It is an important valuation methodology; nevertheless, the uncertainties associated with, the factors affecting predictions about future cash flows and determining the appropriate discount rate, leave considerable room for scepticism about the value it ascribes for a business[[2]](#footnote-2). One commentator has described it as nothing more than “a guess compounded by an estimate”[[3]](#footnote-3).
3. A Market Comparables Approach. This approach derives a valuation based on determining the appropriate EBITDA multiple to apply to the distressed company through considering the EBITDA multiple for comparable companies or recent transactions involving comparable companies. This approach relies on the market reflecting accurate information and the valuer identifying appropriate comparables. The credibility of this approach suffers from the fact that “multiples are easy to misuse and manipulate”[[4]](#footnote-4).
4. A Leveraged Buy-Out Approach. This approach uses a debt capacity analysis to determine how a private equity purchaser would fund a deal and the level of debt capacity available at the restructured entity to provide a typical equity rate of return in the current market. This approach is limited by the fact that it reflects: (i) the availability of credit, which will likely be scarce in a downturn; and (ii) the value of the business to one particular class of potential buyer, private equity firms, rather than strategic industry buyers for whom the value of the business is potentially greater through synergies.[[5]](#footnote-5)
5. A Secondary Debt Trading Approach. This approach derives a value based on the value that the company’s debt is trading in the secondary market. This approach is useful as a check but the market perception of value may be distorted as a result of an illiquid market and factors distorting the secondary market. [[6]](#footnote-6)

Each of these valuation methodologies has its inherent strengths and weaknesses. The objective approach of market testing may undervalue the business; however, the more subjective elements of the Income and Comparables Approaches leave significant scope for valuation disputes as different creditor groups advocate for substantially different values. Inherent in the context of any restructuring, is the incentive of the appraisers hired by senior creditors to undervalue the debtor and for the appraisers hired by the junior creditors or equity to overvalue it, so as to preserve a greater amount of the value in the restructured debtor for their respective creditor groups.

1. **US Legal Framework for Implementing a Cross-Class Cram Down**

Chapter 11 of the US Bankruptcy Code (1978) provides for a holistic restructuring regime which is an effective tool to implement operational as well as balance sheet restructurings. It provides for a specialist bankruptcy court. This means that issues that arise within the Chapter 11 case are dealt with by judges that have a restructuring specific expertise. Chapter 11 provides for a range of tools which can support a distressed debtor whilst it negotiates a restructuring solution with its stakeholders during a period of exclusivity to propose a restructuring plan to them. These tools include: (i) an effective moratorium; and (ii) debtor-in-possession financing.

The requirements to implement a restructuring plan under Chapter 11 are set out under section 1129 of the Bankruptcy Code. Section 1129(a) sets out the requirements for a consensual confirmation pursuant to which each class of claim must accept the plan. The key aspects of this section from a valuation perspective are: (i) section 1129(a)(7) which provides that the plan has to meet the “best interest of creditors” test; and (ii) 1129(a)(11) which provides that the confirmation of the plan is not likely to be followed by the liquidation of the debtor or a further restructuring, the so-called “feasibility test”. The “best interests of creditors” test is a baseline measure to protect creditors, this provides that every impaired creditor must receive at least the value that they would receive in a liquidation under Chapter 7 of the Bankruptcy code. The “feasibility test” requires the plan proponent to show that the plan is workable and has a reasonable likelihood of success.

Section 1129(a)(8) provides that each class must either: (i) accept the plan or (ii) must not be impaired by the plan. A class of creditors is deemed to accept the plan if it is supported by more than half the creditors in the class who represent two thirds in value of those present and voting for the plan. In the event that Section 1129(a)(8) is not complied with then the plan can still be confirmed provided it complies with all of the other provisions set out in section 1129(a) as well as complying with section 1129(b).

Section 1129(b) contains the standards for non-consensual confirmation, which is commonly known as “cram down.” This section provides that the plan must be supported by one impaired creditor class and that it must meet the following two criteria, namely that the plan: (i) must not unfairly discriminate and (ii) must be fair and equitable. The second limb of this test is commonly known as the “Absolute Priority Rule”. The Absolute Priority Rule requires that claims senior in priority be paid in full before junior claims receive any value, and that junior claims be paid in full before equity holders receive any value. This rule also encompasses the requirement that a senior class cannot receive more than full compensation for its claims and courts will not confirm a plan if a plan undervalues a debtor and therefore would have resulted in paying senior creditors more than full compensation for their allowed claims.[[7]](#footnote-7) The Absolute Priority Rule is of crucial importance as it provides the backdrop upon which a consensual plan is negotiated; “creditors know that if the negotiations go awry, a plan complying with the rule can always be approved and implemented over their objections”[[8]](#footnote-8).

The Absolute Priority Rule therefore protects senior creditor interests but it also provides scope for disenfranchised junior creditors to litigate for a value that reflects the intrinsic enterprise value of the restructured company.

1. **US Valuation Standard**

The valuation standard for allocating value to the stakeholders of a distressed company that “can continue its day-to- day operations is based on a ‘going concern’ or ‘market price’ valuation”[[9]](#footnote-9). The Bankruptcy Court determines this valuation standard on the basis of valuation appraisals. The “standard” valuation methodologies used in these appraisals are the DCF, comparable companies and comparable transactions methodologies.[[10]](#footnote-10) Often these methodologies will be used in combination, with each methodology providing a check on the other. Judge Sontchi concludes in his much cited article on valuation methodologies:

*“While use of an "alternative" valuation may be appropriate, one should be reluctant to depart from the familiar. The judge will be inherently suspicious of the use of such an alternative valuation. The valuation professional should be prepared to provide a clear reason for not using the DCF, comparable companies and/or comparable transactions methodologies. Otherwise, the judge may suspect that the professional is manipulating the valuation to reach a predetermined result and, thus, will give the valuation little or no weight.”*

Chapter 11 is not prescriptive in providing for the appropriate valuation methodology or methodologies to determine value. There are instances where these standard methodologies may be inappropriate. This was demonstrated in the valuation dispute in the Genco restructuring where Judge Lane found that a valuation based on Net Asset Value was a more reliable indicator of value than a DCF valuation in the dry bulk shipping sector.[[11]](#footnote-11)

The increasing use of third party sales of part or substantially all of a debtors’ business through the mechanics provided for under section 363 of the Bankruptcy Code is also a noteworthy trend[[12]](#footnote-12). According to the commentators Messrs Huebner and Schaible:

“*Historically, US Courts have not been unanimously enthusiastic about using market testing to value a bankrupt company. In re Penn Central Transp. Co. 596 F.2d 1102, 1115-6 (3d Cir. 1979) where the court held that market prices are not an adequate measure of enterprise value in bankruptcy. However, in Bank of America National Trust and Savings Ass’n v 203 North LaSAlle Street P’ship 526 U.S. 434, 456-7 (1999), the U.S. Supreme Court strongly validated the use of market-based approaches to valuation, at least where there is a competitive bidding process with multiple bidders.*”

1. **UK Legal Framework for Implementing a Cross-Class Cram Down**

The UK does not have a holistic restructuring regime that provides for a cross-class cram down. Rather it has two separate tools, the scheme of arrangement and administration, which can be twinned to provide for a de facto cram down. The scheme of arrangement allows a debtor to agree a restructuring plan with its creditors, which provided it is accepted by the requisite majority of each creditor class (more than 50% in number representing 75% in value of those present and voting for each class), then it is binding upon all creditors within the class.

Each class of creditor must vote in favour but the scheme proposal need not be put to a class of creditors that has no economic interest in the company and whose rights are therefore not affected by the scheme.[[13]](#footnote-13) A cross-class cram down can be achieved by appointing an administrator to transfer the assets of the debtor to a newco owned by the senior creditors leaving junior creditors with worthless claims against a shell company. The Court will consider the question of value in the context of the scheme whilst the administrator will consider the question of value in the context of the transfer. The result is akin to a cross-class cram down under section 1129(b); however, it is a less elegant mechanism as it does not allow for the restructuring to be implemented within the existing undertaking of the debtor.

The UK does not have an effective moratorium in which the company can continue to operate nor does it provide for access to debtor-in-possession financing. This difference in the ability to maintain value through a restructuring process between the US and the UK is significant as without the consent of the senior creditors to a contractual moratorium on their enforcement rights the counterfactual valuation described below is a stark reality.

1. **UK valuation standard**

The valuation standard in the UK is, the counterfactual, this provides for a value based on the concept of “market price”, namely, what price could be realised for the distressed company today if the restructuring is not implemented. This is in contradistinction to the US “market value” approach described above which seeks to identify the intrinsic value of the company having stripped out short term factors which are depressing the debtor’s market price. This counterfactual standard has evolved through only a limited number of valuation disputes which have left a degree of uncertainty around the criteria to determine this standard.

In determining this standard, the court will focus on the value ascribed to the debtor by any market testing. Nevertheless, in light of the difficulties that a distressed debtor has in effectively testing its market price, the court will consider the standard valuation methodologies described above in the US context; however, these methodologies are required to address the question of the present day market value rather than the intrinsic value of the debtor.

In My Travel[[14]](#footnote-14) the court found that the appropriate valuation standard was the liquidation value of the debtor. The liquidation counterfactual to the proposed restructuring was undisputed by the junior creditors as My Travel relied upon a license to operate which the Civil Aviation Authority was going to withdraw if the restructuring was not implemented. The junior creditors sought to argue that value should be allocated on basis of the restructured enterprise value of My Travel rather than its counterfactual liquidation value. This submission was considered by Justice Mann, however, he concluded that for the junior creditors to seek to establish that the restructuring efforts of others as proof that “the present company presently has a value which exceeds the amount of the unsubordinated debt is an enormous leap. [He asked] Where is that value to come from? The hopes of the other creditors as to the future prospects for another company (newco) do not generate extra value in the present company”[[15]](#footnote-15).

Justice Mann then presided over the only other significant valuation dispute in relation to the UK scheme of arrangement for IMO Car Wash[[16]](#footnote-16). This judgement provides further support for the counterfactual being the appropriate valuation standard which in the context of this restructuring was a going concern valuation rather than a liquidation valuation. The debtor tested the market through a third party sales process and procured a valuation report prepared on a going concern basis using the Income, Market Comparables and LBO Approaches. The valuation report was for the administrator in waiting who had been commissioned to implement the cram down through a sale of the assets to a newco owned by the senior creditors. The debtor also commissioned a valuation of the company’s real estate from which a further going concern value was extrapolated.

The junior creditors produced a valuation purporting to establish an enterprise value for the restructured company which they claimed showed that the value of the company was significantly greater than the company valuation and broke within their junior debt. Although Justice Mann found in favour of the company valuations he did not completely dismiss the “intrinsic value” standard advanced by the junior creditors, commenting (para 49) that it gave him pause for thought on this point: “Are the purchasers in fact getting too good a deal (too much unfair value) because in the present market sales are unlikely to take place, and when economic conditions change the same group will be perceived to be more valuable, and the purchaser will ultimately reap the benefit of that? This is not quite the way the case is put, but I can see that in some circumstances it might be. It is, I suppose, another analysis of the “intrinsic value” which is said to differ from the current market value.” Nevertheless, Justice Mann found that the particular valuation methodology advocated by the junior creditors, the so called Monte Carlo approach which produce a range of probable values by running a series of discounted cash flow analysis, lacked the necessary subjective analysis necessary for a meaningful valuation and was not good enough for the junior creditors to establish their case.

This judgment therefore leaves open the possibility of a junior creditor seeking to establish that the counterfactual should incorporate an element of potential future value rather than merely a going concern value in the current market. It is worth noting that in this case Jutsice Mann appeared to take comfort that the junior creditors were not being unfairly disenfranchised on the basis of a number of further factors, including: (i) the Income Approach still valued the company at less than the senior debt when the “alpha factor”, which adjusted the valuation downwards to reflect certain current market negative assumptions, was stripped out of the valuation; and (ii) the junior creditors had the option to buy-out the senior debt which provided them a self-help remedy if they considered the senior valuation to be under valuing the company.

As described above, it is the administrator who implements the cram down through effecting the sale of the assets of the debtor to a “newco” owned by the senior creditors. It is the responsibility of the administrator to exercise his judgement on value. The administrator has a duty to take reasonable care to obtain the best price which the circumstances of the case permit[[17]](#footnote-17). In order to fulfil this duty the administrator has to be able to show that he has taken appropriate steps to obtain the best price and fulfilled the requirements of the Statement of Insolvency Practice 16. These requirements provide that the administrator must be able to demonstrate he has taken appropriate steps to market test the value of the debtor and, if not, demonstrate that he has considered appropriate valuation appraisals.

The legal framework in which an administration sale is implemented means that it is a relatively high threshold for a junior creditor to challenge the value ascribed by the administrator implementing the sale. Unless it is possible for a junior creditor to argue that the administrator has the necessary funding and will be preserving value by trading the business for a significant period of time in administration in order to achieve a sale in the future, the focus in challenging an administration sale will be on the market price of the business today rather than the US market value standard which ascribe a future “going concern” or “post-restructuring enterprise” value. [[18]](#footnote-18)

1. **Critique**

The approach to determining valuation in the construct of Chapter 11 has been termed the “bargaining and litigation” approach[[19]](#footnote-19). The US approach provides for an allocation of ownership of the enterprise based on judicial appraisal but allows the parties to avoid this allocation by agreeing to an allocation among themselves and thereby avoid the litigation risk of contesting value. The US approach provides for significant valuation uncertainty as a result of both the actual uncertainty inherent in appraising the value of a business and the judicial valuation uncertainty around how the judge will decide to value the business. This approach incentivises senior creditors to negotiate a settlement with junior creditors, so as to avoid the uncertainty inherent in asking a judge to determine value.[[20]](#footnote-20) However, the cost of this approach is that there are no shortage of examples of protracted valuation litigation in Chapter 11 cases and litigation is costly and often destructive of value[[21]](#footnote-21).

It is noted that in the US there is support for providing a better framework to assist the judge with his central role in determining value. According to Messrs Baird and Bernstein[[22]](#footnote-22) “The available evidence suggests that valuations made by modern bankruptcy judges, though unbiased, are subject to substantial variance. This should not be surprising. In Chapter 11, a single, non-expert judge is expected to value the reorganizing business on the basis of the testimony of experts who, far from being impartial, are advocates for competing points of view.” They go on to conclude that the adversarial approach to determining value magnifies the valuation variance problem and they suggest that the court should rely more heavily on appointing an independent expert to assist it by assessing the expert testimony from the parties.

The UK approach is undoubtedly a blunt instrument; it provides for a significant amount of senior creditor control and there is limited scope for junior parties to litigate or otherwise seek to delay the restructuring. There are a number of reasons for this. Firstly, there is no effective moratorium, this puts senior creditors in a stronger position to exert there contractual rights to enforce and control the restructuring process. Secondly, the UK legal framework provides limited support to allow the debtor to continue to trade making the counterfactual a more stark reality, for example it does not provide for debtor in possession financing, ipso facto clause protection or an effective moratorium. Thirdly, junior creditors are liable to bear other parties costs in the event that they are unsuccessful in any valuation litigation. Lastly, provided an administrator is able to demonstrate that he has taken steps to obtain the best price reasonably obtainable then it is a high threshold to challenge the value ascribed to the debtor by the administrator.

Nevertheless, there are incentives for senior creditors to agree a consensual restructuring and not resort to a cram down of junior creditors. Firstly, there is significant uncertainty around the counterfactual valuation standard and the possibility that the courts will seek to develop the standard in line with the US standard is a risk in any valuation dispute. Secondly, the framework in which junior creditors are crammed down through an administration sale is not an elegant procedure which may have cost implications to the business. Lastly, an administrator is personally liable if he transacts at an undervalue and can be expected to carefully consider value before agreeing to implement the sale.

The limited number of valuation disputes before the English court may suggest that the English approach is effective. The baseline position of market price provides for greater certainty as to, how the administrator will determine value, and the courts will ultimately construe value should there be a dispute. This encourage parties to reach an agreement on value without recourse to the courts. Nevertheless, disputes that have arisen to date have been in structures where junior creditors have been significantly out of the money. It remains to be seen, in circumstances where the valuation evidence is more finely balanced and better formulated by junior creditors, whether the courts may show greater concern for junior creditors being disenfranchised on the basis of market price rather than an intrinsic market value standard.

In the UK, there are important reforms afoot to develop a restructuring regime which provides for a cross-class cram down akin to the US model which can be implemented by the debtor without the requirement for an administration sale. As part of the consultation on these reforms, it has been suggested that in order to minimise the potential for US style litigation disputes it will be necessary to better define the UK valuation standard and that there should be an expanded role for insolvency officeholders to act as a mediator between creditor groups to assist with the process of resolving valuation disputes[[23]](#footnote-23).

In conclusion, there is a trade-off between, the UK approach which provides for greater certainty and minimises the scope for value leakage as a result of costly valuation disputes, and the US approach which better protects the position of junior creditors and equity by allowing them a platform in which to advocate for an allocation of the intrinsic value in the restructured debtor.

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