The Valuation of Distressed Companies
— A Conceptual Framework

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I. Introduction

It is often crucial to ascertain the value of a distressed company.[1] Those interested in the company's undertaking require this information to determine what should be done with the company's business, and how the value in the company's estate should be distributed amongst them. In this article, addressed primarily to the parties to corporate reorganisation proceedings in the UK and their advisers, we provide a conceptual framework within which these questions might be answered.

The first part of the article identifies the bases on which a company's business might be valued. Drawing upon economic theory, empirical evidence, and the sophisticated principles evolved by US courts with long experience of dealing with such issues, it explains the circumstances in which one or other of these bases might appropriately be adopted. The onset of corporate distress creates unique additional problems in attempting business valuations, whether carried out in a court context or out of court. Focusing particularly on the incentives of those interested in the outcome of reorganisation proceedings, the article seeks to distinguish between the 'structural' and the 'strategic' factors giving rise to these problems, and explains how these might impact upon the valuation process. It then draws on the US jurisprudence on business valuation to outline three methods for putting a value on a 'going concern'. It is submitted that the principles developed by US courts will prove helpful and persuasive as UK courts grapple more and more frequently with valuation issues. The second part of the article consists of a detailed analysis of the recent judgment of the English High Court in *In re MyTravel Group Plc*,[2] which is employed as a case study in the application of the conceptual framework laid down in the first part.

II. Bases of Valuation

On what basis might a company's business be valued? This depends on whether the company's business is essentially viable.[3] In some cases, the net present worth of the business as a going concern is less than the total value of its assets, were they to be broken up from the business and sold separately. This means that the business is not viable any more, or as the finance and economics literature puts it, that it has become

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[1] In this article, the term 'value of the company' is treated as being synonymous with 'value of the company's business'.
[2] [2004] EWHC 2741 (Ch); [2005] 1 WLR 2365; see also the Court of Appeal's decision, reported as *Fidelity Investments International Plc v MyTravel Group Plc* [2004] EWCA 1734; [2005] 2 BCLC 123.
[3] This draws on Rizwaan J. Mokal, *Corporate Insolvency Law – Theory and Application* (Oxford: Oxford University Press, 2005), 194-195. For more detail, see ibid, chapters 6 and 7.

economically distressed. The longer the assets constituting that business (e.g. the company's premises, its machinery and its intellectual property, etc.) remain harnessed to their current use, the more money that will be lost by all those with claims against the company. Here, it would be in the interests of the claimants as a group for the company's assets to be realised piecemeal. Ideally, the claimants would wish for that property to be disposed of at *market value*. This happens when assets are individually exposed to the relevant markets through a suitably lengthy and extensive process of advertising, where reasonable efforts are made to identify potential purchasers, and where an appropriate level of negotiations is carried on with the identified parties in order to obtain the best price. When, however, the distressed company's property is disposed of in an insolvent liquidation, the liquidator typically only obtains *liquidation value*, sometimes referred to as a 'fire-sale value'.[4] The paradigm of a 'fire-sale' is the sort of auction of assets usually associated with liquidation. The assets may be exposed to the relevant markets in a perfunctory manner, with minimal advertising, few attempts actively to attract serious potential bidders, and little or no attempt to negotiate for the best price.

So much for economic distress. However, the troubled company might only be in *financial distress*. This is another way of saying that it is cash-flow insolvent, which means simply that it is unable to pay its debts as they arise.[5] A company which is *only* financially distressed is economically viable, and its assets might be in their highest value use. However, these assets are illiquid, and the company's capital structure is such that it faces liabilities it is unable to meet, at least as and when they become due. In this case and given its essential viability, dismantling the business would not be in the interests of all those with claims against the company: To break up the assets constituting the business would then amount to withdrawing them from their highest value use and applying them towards inferior projects.

A business which is merely financially distressed (i.e. one whose assets are more valuable if kept together as a functioning unit than they would be if sold off piecemeal) is said to have a 'going concern surplus'. One way of preserving this surplus is to dispose of the business as a going concern and thus to obtain the *going concern value* (also called 'enterprise value'):

> "Going-concern value may be much greater than market value (and therefore, much, much greater than liquidation value) because a living business – with established customers, knowledgeable employees, and so forth – may well bring a higher price as a unit than would the sale of each asset separately, even in the unlikely event that those separate sales would obtain market value for each asset."[6]

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[4] There is a danger of overgeneralisation. It appears that a proportion of companies which end up in a winding-up are not economically distressed. While the business of a company in winding-up is typically broken up, this outcome is not inevitable. It appears that liquidators manage to sell a distressed company's business wholly or partially as a going concern in approximately 10% of cases; see R3 – Association of Business Recovery Professionals, *Corporate Insolvency in the UK: 12th Survey* (5 July 2004), 30 including Figure 24. The relevant analysis in these cases is in principle that applicable to companies which are merely financially distressed; see the text which follows.

[5] In the context of a liquidation, this is deemed to be the case if the company fails upon demand to repay a debt of at least £750 that has become due; see Insolvency Act 1986, section 123.

[6] Jay Westbrook, 'The Control of Wealth in Bankruptcy' (2004) 82(4) *Texas LR* 795, 811.

So how might enterprise value be realised? Starting with the more obvious method, the business could be sold off as a going concern to new investors, and the proceeds distributed amongst the claimants according to the nature of their claims. However, for a variety of reasons this might not be possible or desirable. Firstly and on the demand side of the market, the company might have become financially distressed because of industry-wide factors.[7] This would corrode the market price of its business, given that its main potential buyers would be other companies operating in the same industry, which might also therefore feel the impact of those industry-wide factors, and which might in any case be in no position to expand by acquiring the extra capacity represented by the business.[8] Secondly and once again if the company is distressed for industry-wide reasons, there might also be an impact on the supply side, with other businesses of similarly distressed competitors also on the market, again leading to a fall in the price for such assets.[9] Thirdly and in any case, the business might be large and expensive and it might be difficult to assemble a new group of investors willing and able to be its residual risk bearers.[10] Finally and importantly, the fact that the business has suffered recent distress and that it might be facing lean years in the near future is thought to send a negative signal to the market, perhaps unduly dampening the expectations potential purchasers place in it.[11] Linked to this is the problem of buyers making lower offers, either on the basis of a sincerely held assumption that businesses with better prospects would have been retained by prior claimants and their finances reorganised,[12] or simply opportunistically.[13] The

[7] See e.g. *Fidelity Investments International Plc v MyTravel Group Plc* [2004] EWCA 1734, [1]: the business in question was said to have become distressed because of "the war in Iraq, the SARS epidemic in the Far East and unusually hot weather in the United Kingdom and Scandinavia", all of which were said to have depressed demand for overseas travel and foreign holidays. These factors could be expected to have had some impact on all those companies in the business of providing overseas travel and foreign holidays.

[8] See e.g. Andrei Shleifer and Robert Vishny, 'Liquidation Values and Debt Capacity: A Market Equilibrium Approach' (1992) 47(4) *Journal of Finance* 1343. This is supported by empirical evidence, which indicates that the greater the degree of the industry-wide downturn and the more industry-specific the assets constituting the business, the worse will be the sale price of the assets concerned; see e.g. Todd Pulvino, 'Do Asset Fire-sales Exist? An Empirical Investigation of Commercial Aircraft Transactions' (1998) 53 *Journal of Finance* 939; David Brown, 'Liquidity and Liquidation: Evidence from Real Estate Investment Trusts" (2000) 55 *Journal of Finance* 469; Per Strömberg, 'Conflicts of Interest and Market Illiquidity in Bankruptcy Auctions: Theory and Tests' (2000) 55 *Journal of Finance* 2641.

[9] For evidence of this 'large-block stock transaction' effect, see e.g. Pulvino, 'Do Asset Fire-sales Exist?' and Pulvino, 'Effects of Bankruptcy Court Protection on Asset Sales' (1999) 52 *Journal of Financial Economics* 151. Reasons suggested for this effect are information asymmetry and liquidity costs; see e.g. Robert Holthausen, Richard Leftwich and David Mayers, 'The Effect of Large Block Transactions on Security Prices' (1987) 19 *Journal of Financial Economics* 237, and from the same authors, 'Large Block Transactions, the Speed of Response, and Temporary and Permanent Stock-price Effects' (1990) 26 *Journal of Financial Economics* 71.

[10] Philippe Aghion, Oliver Hart and John Moore, 'The Economics of Bankruptcy Reform' (1992) 8 *Journal of Law, Economics, and Organization* 523, 528–9.

[11] US jurisprudence has long recognised this possibility; see e.g. *In re Penn Cent. Transport Co.*, 596 F.2d 1102, 1115-1116 (3d Cir. 1979).

[12] This is what the economics literature refers to as an 'adverse selection' problem. An analogous point is made by David Webb, 'An Economic Evaluation of Insolvency Procedures in the United Kingdom: Does the 1986 Insolvency Act Satisfy the Creditors' Bargain?' (1991) 43 *Oxford Economic Papers* 139.

[13] Pulvino, 'Effects of Bankruptcy Court Protection on Asset Sales", 154.

existence of some or all of these factors would result in the market placing on the business a price lower than would be justified by its true value-generating potential.[14]

This suggests that all those with claims against the company would be better off if the company's business were to be sold off, not to new investors, but in effect, to some or all of the company's existing claimants. This would be the optimal way of maximising its value, and would come about if the company's liabilities were to be reorganised.[15] The most common methods of restructuring[16] are:

(i) The postponement of imminent liabilities into the more distant future, e.g. the obligation to make a capital or interest payment due the following month is exchanged for an obligation to make the payment the following year;

(ii) The conversion of fixed liabilities into fluid ones, e.g. a debt-for-equity swap, which replaces the obligation to pay over a specified amount with an obligation to repay whatever, if anything, is available; and

(iii) Debt write-downs, e.g. all creditors of a particular type agree a *pro rata* reduction in the value of their pre-distress claims.

All of these are ways of recognising, both, the essential viability of the company's business (by avoiding the dismantling of its assets and providing it with the opportunity to trade out of its difficulties), and the undesirability of bringing about a market sale of that business (by retaining some or all of its existing investors in place).

A combination of these and other methods might of course be implemented through a voluntary agreement amongst the company and those of its claimants whose claims must be restructured in order for the company to be able to mount an attempt to trade out of distress. The problem with the voluntary approach stems from the fact

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[14] It is important to note what to most readers may be a statement of the obvious, that the *present* value of any asset is a function not only of its present but also of *all future* streams of income generated by it. This is simply another way of saying that what a rational and well-informed buyer would be willing to pay for an asset depends not just on what use can be made of the asset today but also of what uses can be derived from it the next day, the next year, and so on. The *present* value of a 10-year lease of land is higher than that of a 1-year lease of that same piece of land, even though what the lessee can do with the land *today* is identical for most practical purposes in both scenarios, precisely because the 10-year lease continues to generate a stream of 'income' (i.e. use) long past the point in time at which the 1-year lease ceases to do so. This point has also long been recognised in the US jurisprudence. See e.g. *Protective Comm. v. Anderson,* 390 U.S. 414, 442 (1968) (quoting *Consol. Rock Prods. Co. v. Du Bois,* 312 U.S. 510, 526 (1941)): "[T]he commercial value of property consists in the expectation of income from it." The reason for emphasising this truism will become apparent in the discussion below of the first instance decision in *In re MyTravel Group Plc* [2005] 1 WLR 2365.

[15] US law explicitly makes use of the economic/financial distress distinction here. See e.g. *United Airlines, Inc. v HSBC Bank USA, N.A.* 416 F.3d 609 (Jul 26, 2005), 612-613 (opinion written by Judge Frank H. Easterbrook, also a Professor at the University of Chicago and one of the most distinguished Law and Economics scholars in the world.): "Many provisions in the [US Bankruptcy] Code… are designed to distinguish financial from economic distress. A firm that cannot meet its debts as they come due, but has a positive cash flow from current operations, is in financial but not economic distress. It is carrying too much debt, which can be written down in a reorganization. A firm with a negative cash flow, by contrast, is in economic distress and liquidation may be the best option."

[16] Or of reorganisation; these terms are used interchangeably in this article.

that it requires the participation in, and consent to, the agreement of each of these parties. This might be undesirable because of high coordination and motivation costs.[17] The reasons for the existence of these costs are extensively analysed in the literature. *Coordination costs* arise in this context when the necessary parties to a restructuring (e.g. all those creditors or shareholders whose rights must be altered if the restructuring is to be efficacious or otherwise acceptable to the relevant claimants) are widely dispersed and it would be excessively costly for them to be located and brought into the agreement. *Motivation costs* arise because at least some of these necessary parties would have incentives to 'hold out' for a better deal for themselves than is on offer, or alternatively, to 'free-ride' on the sacrifice of other parties by remaining outside of the agreement altogether in the expectation that others would sign up to it, thus leading to an improvement in the company's fortunes from which the free-riders would also of course benefit. In order to overcome these problems, the law provides that in appropriate circumstances, a vote by a sufficiently large majority of a class of claimants would operate to bind the dissentient minority. In England, the two main mechanisms for achieving this result are a Company Voluntary Arrangement pursuant to Part I of the Insolvency Act 1986 (which, to simplify, binds all the claimants if voted for by a majority in number, representing 75% in value of creditors voting in person or by proxy, and by a majority of those of its members voting in person or by proxy) and a Scheme of Arrangement under section 425 of the Companies Act 1985 (where a vote by a majority in number, representing 75% in value of relevant creditors present and voting in person or by proxy binds the entire class).

III. Sources of Valuation Uncertainty

While the valuation of businesses is a difficult task at the best of times, particular complexities arise when the business to be valued is in distress. Uncertainty as to the value of such a business might arise for either or both of two types of reasons, which will be referred to in this article as 'strategic' and 'structural factors'.[18] Let us take these in turn.

The *strategic factors* leading to valuation uncertainty arise because those holding senior claims have an incentive to undervalue the company's business, whereas junior claimants have an incentive to overvalue it.[19] In order to understand this point (and others to be made in the discussion to follow), consider the reorganisation of X Plc, under which its business would be transferred to Y Plc, a new company, and in which debt claims against X would be swapped for equity claims in Y. Suppose that there are two types of debt claims against X: Senior and Junior. Note that if the present value of X's business – call this '*v*' – is found to be higher than X's Senior liability, then both Senior and Junior claimants would have valuable claims against it, which means that both classes would have to be offered shares in Y. By

[17] See Mokal, *Corporate Insolvency Law*, 26. In this context, 'costs' can be understood as being synonymous with 'problems'.

[18] Readers with an economics background will notice that these factors are manifestations in this context of motivation and coordination costs respectively.

[19] For quantitative and qualitative evidence from the US that the parties interested in reorganisation proceedings put forward valuations of the bankrupt company which are self-serving in this way, see Stuart Gilson, Edith Hotchkiss, and Richard Ruback, 'Valuation of Bankrupt Firms' (2000) 13(1) *The Review of Financial Studies* 43, 63-73.

contrast, if *v* is less than X's Senior liability, then Senior claimants would get the entirety of Y's equity, Junior claimants being shut out altogether in recognition of the fact that they have no economic interest in X. It follows that Senior claimants have an incentive to argue that a lower value be attributed to *v*, since this enables them to maximise their share of Y's equity.[20] Similarly, if some of X's managers stand to gain shares in Y as a result of the proposed reorganisation, they too have analogous incentives to underestimate *v*.[21] Correspondingly, Junior claimants have an incentive to place a higher value on *v* since this would enable them to obtain a proportion, and indeed a larger proportion, of Y's equity.[22]

This brings us to the *structural factors* which cause valuation uncertainty. The main source of these has already been identified in the previous section of this article. Exposing the company's business to the market might result in its undervaluation if the market is depressed because potential buyers are not looking to expand, or because there are other similar businesses in the market, or because it is difficult to assemble a sufficiently large and well-resourced group of investors, or because of reputational reasons, etc. Since the market price of the business does not reflect its true value, there would be likely to be uncertainty as to what that true value is. This holds *a fortiori* where it is considered that exposing the business to the market would be futile, again for the reasons mentioned above. Further, it is to be remembered that there are incentives for equity analysts to study the stock of a healthy company in order to come up with more accurate estimates of the value of the company's business. This information can be sold to those wishing to capitalise on it, for example, in order to acquire shares in or control of the company. Once the company becomes distressed, however, (and especially if it goes into a formal insolvency proceeding,) it appears that fewer analysts follow the company's stock.[23] There is now less incentive to do so, given that there would be less outside interest in acquiring the company's shares (for the sorts of reasons mentioned above), and since the onset of distress would often trigger legal or regulatory restrictions on trading in those shares. It follows that the superior estimates of the value of the company's business made by analysts are no longer available,[24] which of course exacerbates uncertainty as to that value.

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[20] Another scenario is described by Stephanie Strom, 'Derailing a Big Bankruptcy Plan', *New York Times*, 29 July 1994, quoted in Gilson *et al*, "Valuation of Bankrupt Firms', 65, n 23: "Frequently, investors who specialize in buying senior debt of bankrupt companies conspire to keep values low so that when a company emerges from bankruptcy proceedings, they get most of its value, including its stock. If the company has been undervalued, the market will send its shares soaring – and they make out like bandits."

[21] For empirical evidence "consistent with managers lowballing the financial projections when they receive stock or stock options to make their compensation appear lower", see Gilson *et al*, 'Valuation of Bankrupt Firms', 68; at 68-70, they also discuss evidence that managers hoping to attract friendly new investors who would keep them in post place a low value on the company's business, while pre-distress managers tend (other things being equal) to place a higher value on the business in order to minimise the apparent extent of the distress and thus to minimise harm to their reputational capital. See also David Yermack, 'Good Timing: CEO Stock Option Awards and Company News Announcements' (1997) 52 *Journal of Finance* 449.

[22] See Gilson *et al*, 'Valuation of Bankrupt Firms', 67.

[23] The evidence comes from the more developed US market; see Gilson *et al*, 'Valuation of Bankrupt Firms', 45 and 61-63. The position in the UK now appears to be changing, in that analysts appear to take a greater interest in the stock and debt of distressed companies.

[24] Gilson *et al*, "Valuation of Bankrupt Firms", 62.

Consider the implications of this in the context of the simple example introduced above. In distressed company X's reorganisation, Senior and Junior claimants must have some idea of the quantum of *v*, the value of X's business, in order to decide how they should allocate shares in the new company Y. They may be able to have *v* determined by a court. Alternatively and preferably, they can attempt to avoid the costs, time and uncertainty of litigation by negotiating with each other as to the value to be attributed to *v*. These negotiations would nevertheless take place 'in the shadow of the law', i.e. with an eye on the value each of them considers the court might place on the business if asked to do so.[25] Either way, it is important to remember that a court faces the same structural difficulties in coming to its determination as do the claimants themselves, and what is more, must proceed on the basis of arguments and evidence proffered by the claimants and their experts, who, as we have seen, have strategic incentives to over- or undervalue X's business. The fact that the various claimants make differing predictions of the value that a court might place on *v* is itself a structural factor contributing to the uncertainty inherent in the valuation process.

Out of an abundance of caution, we should emphasise that there is nothing necessarily improper in the different valuations placed on the distressed business by different classes of claimant. In any potential litigation, a claimant has some incentive to overestimate the expected value of its claim, including its probability of success, and the defendant has the opposite incentive. The essential nature of the disagreement about the value of a distressed business is no different from any situation in which parties disagree about the existence and/or value of their rights and obligations *inter se*. It follows that in the present context, too, negotiations concerning the value of the business (and indeed as to how rights in the restructured entity are to be allocated as amongst various claimant classes) are in essence settlement negotiations, and there is no necessary reason (in economics or at law) for them to be stigmatised over and above any other rational and voluntary settlement process.[26]

IV. Valuation Methods

Three methods for ascertaining the going concern value of a business have become standard in the sophisticated jurisprudence on Chapter 11 of the US Bankruptcy Code.[27] They have been helpfully summarised as follows:[28]

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[25] See the seminal paper on this effect, Robert Mnookin and Lewis Kornhauser, 'Bargaining in the Shadow of the Law: The Case for Divorce' (1979) 88 Yale Law Journal 950.

[26] This point is persuasively explained by Douglas Baird and Donald Bernstein, 'Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain' (2005) *John M. Olin Law & Economics Working Paper No. 259* (2D Series), available at the Social Science Research Network at http://ssrn.com/abstract_id=813085.

[27] These methods are applied in the recent decision of the influential US Bankruptcy Court for the District of Delaware in *In re Exide Technologies*, 303 B.R. 48 (2003), 58-66. See also *In re Coram Healthcare Corp.*, 315 B.R. 321, 94 A.F.T.R.2d 2004-6268 (Bankr.D.Del.) (Oct 05, 2004). For further discussion in a non-bankruptcy context, see *Montgomery Cellular Holding Co., Inc. v. Dobler*, 880 A.2d 206 (Del.Supr.) (Aug 01, 2005) (where the first instance court accepted the approach of the respondents' expert, who used all three methodologies; this was not challenged in the subsequent appeal before the Delaware Supreme Court).

[28] See Kerry O'Rourke, 'Valuation Uncertainty in Chapter 11 Reorganizations', 2005 *Columbia Business LR* 403, 420-421 (emphasis added; some footnotes omitted or abbreviated) and the sources cited therein.

"The *market comparison* [or 'comparable company'] *approach* attempts to derive a debtor's enterprise value from the enterprise value relative to earnings potential that the market has assigned to each of its peers. This valuation proceeds in two steps. First, a financial performance metric for the debtor, e.g., normalized earnings before interest, taxes, depreciations, and amortization ('EBITDA'), must be calculated. Next, the multiple, or average multiple if more than one company is used, of a 'healthy' comparable company's market-assigned enterprise value to its corresponding EBITDA must be determined. These two inputs are then multiplied to generate an enterprise valuation estimate for the debtor. Potential problems with this approach include deciding which debtor performance metric should be chosen, which financial performance period the valuation should be based on given the debtor's current financial condition, and which companies, if any, are truly 'comparable' to the debtor.

The *comparable transaction* [or 'precedent transaction'] *approach* is similar, but seeks to derive the debtor's enterprise valuation from the prices (enterprise valuations) paid by purchasers in recent acquisitions of comparable companies, rather than from market-assigned enterprise values. Complications associated with this approach include determining which transactions involved 'comparable' companies and adjusting for any control premium[29] which a purchaser may have paid. A control premium might not be appropriate if equity interests in the reorganized entity will be dispersed. Generally speaking, this method is 'best utilized to corroborate valuations obtained by other methods,' given the uniqueness of each transaction.[30]

Finally, the [*discounted cash flow* ('DCF') *approach*] aims to calculate enterprise value based on the present value of a debtor's projected cash flows. The DCF analysis includes several steps. The first step requires projection of the debtor's cash flows for the near-term, typically five years. These cash flows are then discounted back to present value using a weighted average cost of capital ('WACC'). The WACC represents the return that a hypothetical investor would demand from an investment in the company, based in part on the company's relative debt to equity ratio. Next, a terminal value, representing the value of the debtor's cash flows beyond the projection period into perpetuity, is calculated by applying an enterprise value multiple or perpetual growth rate to the final year of projected cash flows. Lastly, the terminal value is discounted back to present value using the WACC and this amount is then added to the present value of the projected near-term cash flows to obtain the debtor's enterprise value. Choosing appropriate inputs for the DCF analysis, like the other valuation methods, can be difficult."

Not all of these methods would be equally appropriate in each case, and there might be additional methods suitable on the facts which might be used in combination

[29] "The Control Premium is a measure of the difference in value between a controlling interest in a company and a minority interest and can be found in successful public tender offers where the investor acquired a control position"; *In re American HomePatient, Inc.*, 298 B.R. 152 (Bankr. M.D. Tenn. 2003), 174 n 19.

[30] Quoting from *MFS/Sun Life Trust-High Yield Series v Van Dusen Airport Services Co.*, 910 F. Supp. 913, 942 (S.D.N.Y. 1995).

with some or all of the above.[31] It is important to note that the practice in the US courts is to use several methods in any given case, with each method acting as a check on the others.[32] In particular, the comparable companies and comparable transactions methods rely on data from companies other than the one then in question, and so should be combined together with the DCF method, which yields a valuation derived from the performance of the relevant company itself.[33]

While these methods do not eliminate disagreements about the value of distressed companies,[34] they do show that in determining valuation questions, experienced and well-advised courts have over several decades evolved principles premised on their acceptance that it is both necessary and possible to value businesses as going concerns if that is what they are. It is submitted that these principles will provide useful guidance to UK courts as they come to grips with questions concerning the valuation of distressed enterprises.

V. A Case Study: *MyTravel Group Plc*

The question of the basis on which to value a company subject to a proposed reorganisation has recently come before the English courts. In the light of the foregoing discussion, the way in which the matter was dealt with is an eye-opener. The remainder of this article uses this decision as a case study to demonstrate the nature of the concepts and the operation of the principles elucidated thus far.

1. The facts and judgments

In *In re MyTravel Group Plc*,[35] the company in question ('MyTravel') was the holding company of a number of companies ('the Group') incorporated in the UK, North America and elsewhere. The Group had its own fleet of leased aircraft, operated an airline, owned a portfolio of hotels, and capitalised on these assets to sell holiday and travel services. The UK part of the operation was closely supervised by the Civil Aviation Authority ('CAA') which licensed the operating company and also issued licenses for the aircraft.

[31] For a recent example of both of these phenomena, see *In re Mirant Corp.* (9 December 2005, not yet reported) (Bkrtcy.N.D.Tex.): the company in question being in the energy sector, the parties' experts agreed that in principle, an additional valuation method was available which was based on a calculation per megawatt of capacity. However, neither this nor the comparable transaction method could be applied on the facts because of the absence of relevant data.

[32] In *Lippe v. Bairnco Corp.,* 288 B.R. 678 (S.D.N.Y.2003), 701, for example, the court excluded the testimony of a business valuation expert on the basis that "by failing to use the DCF method and relying solely on the comparable companies method, [the expert] did not have the ability to do a 'check' on his determinations".

[33] See e.g. *In re Med Diversified, Inc.*, 334 B.R. 89 (Bankr.E.D.N.Y., Nov 14, 2005). The following recent cases provide examples of the combined use of the DCF and comparable transactions methods: *In re Bush Indus., Inc.,* 315 B.R. 292, 299-302 (Bankr.W.D.N.Y.2004); *In re Exide Techs.,* 303 B.R. at 65; *In re Cellular Info. Sys., Inc.,* 171 B.R. 926, 930 (Bankr.S.D.N.Y.1994); *In re Pullman Constr. Indus. Inc.,* 107 B .R. 909 (Bankr.N.D.Ill.1989). For recent examples of the comparable companies and DCF combination, see *Andaloro v. PFPC Worldwide, Inc.*, (Aug 19, 2005, unreported) (Del.Ch.); *Taylor v. American Specialty Retailing Group, Inc.* (2003) 29 *Del. J. Corp. L.* 280.

[34] See generally the recent discussion in O'Rourke, 'Valuation Uncertainty', particularly 421-424.

[35] [2005] 1 WLR 2365.

MyTravel's main assets were its equity and debt investments in its subsidiaries.[36] It also had several credit facilities, including:

(i) A £250m multi-currency credit facility;

(ii) A US$100m private placement of unsecured loan notes;

(iii) A £400m bonding facility with a consortium of banks;

(iv) Various facilities worth £168m; and

(v) Other financing arrangements worth £1bn covering aircraft and ships.

Finally, it had issued convertible bond notes worth £216m with a coupon which stood at 7% at the relevant time. The bonds were subordinated in the event of liquidation pursuant to the following provision ('the subordination clause'):

> "If any order of a court of competent jurisdiction is made or any effective resolution is passed for the winding up of the company, the company shall, if and to the extent required to make payment in respect of the original bonds under payment, only to the extent of such amounts as would have been payable if the holders of the outstanding original bonds had, on the day immediately proceeding the date of the commencement of the winding up become holders of shares in the company of a class having a right to receive… in a winding up of the company (in priority to the holders of all other classes of shares in the company issued or to be issued) an amount equal to the redemption moneys and/or unpaid interest expressed to be payable in respect of the original bonds up to but excluding the date upon which the holders thereof are treated as having become holders of shares in the company aforesaid…"

MyTravel's liabilities included those arising under the facilities mentioned above, significant sums owed to subsidiaries, and certain off-balance sheet liabilities.

By 31 March 2004, MyTravel was insolvent with net liabilities said to amount to £877.6m. While steps had been taken to improve the position and it was thought to be close to breaking even as at the end of October 2004, there was still a projected consolidated liability of £867.4m. The CAA, which has power to revoke or suspend licenses if it considers the holder not to be sufficiently financially sound, indicated that it expected MyTravel to restructure its balance sheet, and had in place contingency plans against the possibility that some of MyTravel's licenses might be suspended. A suspension would effectively bring the latter's business to an immediate halt. Even if that did not happen, MyTravel's board took the view that the Group could not continue to take bookings from customers that it knew it might not be able to fulfil, which once again meant that the Group's business would not be able to continue in the absence of a reorganisation.

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[36] At the hearing to determine whether a scheme meeting should be called, the judge dismissed as "at best pure speculation" the suggestion that MyTravel might have valuable claims against its directors, officers, or auditors; [2005] 1 WLR 2365, 2395, [68].

Against this background, MyTravel attempted a voluntary restructuring of its balance sheet, negotiating a debt for equity swap with respect to the first four facilities mentioned above. An offer was also made to the bondholders of 8% of MyTravel's enlarged equity in return for their debt. If at least 75% of the bondholders failed to agree to this offer by a stipulated date, the offer was to be reduced to 4%. An ad hoc committee of some of the bondholders ('the Committee') indicated that the offer was unacceptable.

MyTravel then embarked upon the process of promulgating a scheme of arrangement under section 425 of the Companies Act 1985. The intended effect was to transfer MyTravel's assets and undertaking to a new company ('Newco'), which would also assume some of MyTravel's debts. The remaining debts (held by 'the Converting Creditors') would be exchanged for 94% of the equity in Newco. MyTravel's shareholders would also get 4% of Newco's shares. Crucially, however, the liability under the bonds would not be transferred. Instead, Newco would offer to buy out the bondholders in return for 2% of its shares.

The ensuing litigation focused on two issues. Firstly, the proposed scheme envisaged that the transfer of MyTravel's assets and undertaking would take place pursuant to section 427 of the Companies Act 1985, the relevant portion of which applies where the proposed arrangement is for the purposes of, or in connection with, a scheme of "reconstruction of any company". At the hearing before Mann J to seek the court's approval to summon a section 425 meeting, the Committee[37] argued (among other things) that it was essential to the concept of a "reconstruction" that the shareholders in the new company should be the same, or substantially the same, as the shareholders in the old ('the section 427 issue'). Since the shareholders of MyTravel would only own 4% of Newco's equity, this was clearly not the case. It followed that the scheme fell outside of the ambit of section 427, which in turn meant that there would be no point in the court summoning a meeting under section 425. In his judgment,[38] Mann J accepted this argument.

It is the second issue raised in the litigation which is relevant to our purposes. MyTravel had argued that it did not need to cater for the bondholders in the scheme nor even to consult them about it, on the basis that ('the economic interest issue'):

> "the bondholders had no economic interest in the company; the only alternative to the scheme was a liquidation and in a liquidation their subordinated status and the deficiency of assets meant that they had no prospect at all of recovering any of the sums due under the bonds."[39]

While noting that there was, in view of his decision on the section 427 issue, no need to decide this point,[40] Mann J accepted this argument in lengthy *obiter dicta*. According to the judge, the evidence indicated that in the absence of a reorganisation, MyTravel's optimal course of action would be to go into administration and then into insolvent winding up. Even on the assumptions most favourable to the bondholders, this would produce a shortfall in relation to ordinary "unsubordinated" (i.e. non-

[37] For whom, it should be mentioned, one of the authors of this article was leading counsel.
[38] Prepared with urgency at the parties' request; see [2004] EWCA Civ 1734, [62].
[39] [2005] 1 WLR 2365, 2382, [35].
[40] Ibid, 2381, [33]. For the judge's reasons for doing so nevertheless, see 2386-2387, [44].

bondholder) creditors of £435m. It was therefore clear to Mann J that the bondholders, ranking below these creditors because of the subordination clause, had no economic interest in MyTravel and thus need not be included in the proposed scheme. The judge's reasons for reaching these conclusions are analysed below.

Mann J's judgment was delivered on the morning of 24 November 2004.[41] By that afternoon, MyTravel had decided, instead of challenging the judge's conclusion on the section 427 issue,[42] to alter the scheme to remove any reliance on section 427. Instead, MyTravel's assets and undertaking would be transferred to Newco by agreement in consideration for the latter's assumption of all those of the liabilities of the former which were envisaged under the original scheme to be assumed by Newco (once again excluding liabilities towards the bondholders). That same afternoon, therefore, Mann J gave permission to convene meetings of MyTravel's shareholders and of the creditors included in the proposed scheme.

The Committee appealed to the Court of Appeal against (among other things) Mann J's finding that the bondholders had no economic interest in the company. Chadwick LJ, who gave the only substantive judgment, held that the only question that had to be answered in order to dispose of the matter was whether the proposed scheme classes (of MyTravel's shareholders and of the relevant creditors) were properly constituted. According to Chadwick LJ, this question was easy to decide:

> "it was beyond argument that whatever interest the bondholders do have in the company (absent the scheme) that interest is materially different from that of the general creditors, because of the subordination provisions which would apply in the event of an insolvent liquidation; and in any event, their rights under the proposed arrangements are different."[43]

This meant that the class of general creditors was properly constituted as excluding the bondholders. It followed that:

> "If the meeting of general creditors approves the proposals put before it by the requisite majority and the court… sanctions those proposals, the proposals will be binding as between the company and its general creditors. But they will not bind the subordinated bondholders. The company has decided to proceed on that basis; and on the basis that it will meet any challenge by the bondholders to the transfer of the undertaking if and when that challenge is made."[44]

An appellate court determination of the economic interest issue was accordingly not essential to disposing of the appeal, and the fact that Mann J had decided it "might give rise to problems in the future".[45] On this basis and without expressing any view "on the question whether the judge was correct to make the findings of fact" which

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[41] The following chronology of events is derived from Chadwick LJ's judgment on behalf of a unanimous Court of Appeal; see [2004] EWCA Civ 1734, [22]-[30].
[42] In the Court of Appeal, Chadwick LJ stated that it was unnecessary for him to express any view on the section 427 issue; [2004] EWCA Civ 1734, [30].
[43] [2004] EWCA Civ 1734, [33].
[44] [2004] EWCA Civ 1734, [24].
[45] [2004] EWCA Civ 1734, [32].

had enabled him to determine the economic interest issue, the Court of Appeal set aside so much of Mann J's judgment which bore on that issue.[46]

In the event, in wake of the Court of Appeal's decision, the bondholders:

> "accepted MyTravel's equity offer. This was calculated by modelling a liquidation to determine the relative level of 'pain' suffered by each creditor… For those creditors who were converting to equity, the model's calculation of their dividend in a hypothetical liquidation then formed the basis of the amount of equity into which their debt would convert."[47]

This, taken with the carefully chosen terms of the Court of Appeal's decision, means that while the legal position is far from clear, Mann J's determination of the economic interest issue may retain some persuasive authority.[48] This is troubling since, as we respectfully submit, Mann J's reasoning is difficult to defend.

2. Analysis

We examine Mann J's reasoning on the economic interest issue by breaking it down into its constituent parts and commenting on each in turn:

A. In a scheme of arrangement as a matter of principle it is not necessary to consult any class of creditors (or shareholders) who have no real economic interest in the company, and their votes on the scheme ought to be disregarded.[49]

This long-standing principle, which derives from *In re Tea Corporation Ltd*[50] and *In re Oceanic Steam Navigation Company Ltd*,[51] is merely an application of the absolute priority rule, which requires senior claimants to be paid in full before junior claimants get anything. It may thus be considered uncontroversial. For example, it is the absolute priority rule which dictates that a company's general unsecured creditors (junior claimants) may not be paid at all unless its preferential creditors (senior claimants) have been paid in full.[52] Similarly, when a company becomes insolvent, the same rule supports the alteration of the focus of the duties of its directors from the company's shareholders as a group (a junior class) to its creditors as a group (a senior class).[53]

Therefore, to the extent that it can be established, on the appropriate basis and standard of proof (as to which see below), that a company's assets have insufficient value to pay a senior claimant class in full, a court asked to adjudicate the matter is justified in declaring that members of junior claimant classes no longer have an

[46] [2004] EWCA Civ 1734, [32].
[47] Zubin Randeria, 'Bond bombshell', *The Lawyer*, 23 May 2005.
[48] See e.g. ibid.
[49] [2005] 1 WLR 2365, 2386-2388, [45]-[47].
[50] [1904] 1 Ch 12.
[51] [1939] Ch 41.
[52] See e.g. section 107 of the Insolvency Act 1986 and rule 4.181(1) of the Insolvency Rules 1986.
[53] See e.g. *West Mercia Safetywear Ltd (in liq) v Dodd* [1988] BCLC 250 at 252-253, and section 214 of the Insolvency Act 1986.

interest in the company's assets. It is therefore right that they should no longer have any say in how those assets ought to be utilised.

B. In order to determine whether a class of claimants has a real economic interest in the company, it must be ascertained what would happen in the absence of sanction being given to the proposed scheme.[54]

With respect, this is wrong in principle. The primary question is: what is the current value of the company's assets? If the company in question is promulgating a scheme of arrangement which amounts to a restructuring of its liabilities, it follows, as explained in Section II of this article, that it considers that the value of its business contains a going concern surplus, but that a simple market sale would not capture the entirety of this surplus. The value of the company's assets and undertaking would therefore be maximised by, in effect, 'selling' them to its existing investors in consideration for a restructuring of the company's liabilities to them. This is what the scheme of arrangement is meant to accomplish. It follows that in order to determine which of the company's current investors retain a real economic interest in the company as things currently stand, the value to be determined is the existing going concern value of the company's business, which, after all, is the value the proposed scheme is intended to both preserve and apportion. Assuming that the alternative to the proposed reorganisation would be a liquidation, it is difficult to see the rationale of determining the rights of any of the parties by assuming the very outcome that the scheme of arrangement is intended to avoid, namely, a liquidation of the business and resulting dissipation of the going concern surplus.

Recalling the example introduced above of X Plc's restructuring drives this point home. Suppose that the going concern value of X's business is £1m, which would be lost if the reorganisation does not proceed. The alternative would be a liquidation, in which X's assets would fetch £100,000. Suppose further that Senior claimants are owed a total of £500,000. The question is whether Junior claimants have an existing economic interest in X. We submit that the only sensible basis for answering this question is by reference to X's enterprise value, measured by some combination of the methods described in Section V above. Since X is a going concern, its *current* value is its going concern value. As the US Supreme Court long ago noted, the "commercial value of property consists in the expectation of income from it."[55] To the extent that the assets to be valued function as a living business, it is the income they generate as a living business that determines their value. Once again, therefore, in order to ascertain the value of the rights of Junior claimants, it remains utterly unclear what might justify ignoring this fact, which constitutes the *raison d'être* of the proposed reorganisation, to assume instead, counterfactually, that X is in liquidation.[56]

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[54] [2005] 1 WLR 2365, 2388-2392, [48] and [55]-[58].

[55] *Protective Comm. v. Anderson,* 390 U.S. 414, 442 (1968), quoting *Consol. Rock Prods. Co. v. Du Bois,* 312 U.S. 510, 526 (1941). US jurisprudence suggests that it is an error of law to value a company with a going concern surplus otherwise than on a going concern basis; see e.g. *Dobler v. Montgomery Cellular Holding Co., Inc.*, Not Reported in A.2d, (Del.Ch.) (Sep 30, 2004); this point was not challenged before the Delaware Supreme Court in a subsequent appeal.

[56] For another recent reiteration of this point in the US context, see *In re Bush Indus., Inc.,* 315 B.R. 292, 299-302 (Bankr.W.D.N.Y.2004), [4]. The company here was insolvent. Nevertheless, since it was being reorganised as a going concern, it was its earning capacity as a going concern which was held to form the basis of its valuation: "The criterion of earning capacity is the essential one if the enterprise is

Mann J purported to rely on *Re Telewest Telecommunications Plc*[57] and *In re Hawk Insurance Company Ltd*[58] in this part of his judgment. We submit that this reliance was misplaced. These cases[59] provide principles for determining *the difference that a proposed scheme of arrangement would make to the rights of claimants*, for the purpose of sorting those claimants into voting classes. The approach taken there is to compare the rights of affected claimants under the proposed scheme ('scheme rights') with their rights in the absence of the scheme ('original rights'). (If, but only if, the "realistic" or "real" alternative to the approval and sanctioning of the proposed scheme is a liquidation, then the original rights of the parties are their rights in liquidation.)[60] If either the original or the scheme rights of any two claimants are sufficiently different from each other, then they belong in different classes. Neither these principles nor any other portion of these judgments provide, or even purport to provide, guidance as to the correct basis on which to determine *the current value of the company*. Nothing in these cases helps decide whether the company currently has a going concern surplus. No help can be drawn from them in choosing between the liquidation and the enterprise bases for determining the value in the company's estate. Therefore, these judgments do not provide any guidance as to whether a particular class of claimant has an economic interest in the company's undertaking, which, as explained above, is a function of the value of the company.

C. If the rights of the relevant claimants can only realistically be enforced in a winding up, then the value of those rights must be determined as in a notional winding up.[61]

We submit that this proposition is erroneous as applied to a company undergoing reorganisation proceedings for two independent reasons. Firstly, it gets things exactly the wrong way around. The true value of the rights of a claimant class must be determined *before* it can be decided whether they can only "realistically" enforce these rights in a winding up! Resorting once again to the X Plc example, suppose that it is accepted, as argued above, that the only sensible basis for determining whether Junior claimants have an interest in X is to answer that question by reference to X's

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to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable… Accordingly, the appropriate valuation of Bush Industries is to be grounded upon its earning capacity as a reorganized entity."

[57] [2004] EWHC 924 (Ch).

[58] [2001] 1 BCLC 1409.

[59] And see also *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621; *Re UDL Holdings Limited* [2002] 1 HKC 172, 184; *Sea Assets Limited v Perusahaan Pereroan (Persero) Pt Petrusahaan Peneerbangan Garuda Indonesia* [2001] EWCA Civ 1696, [43]; and of course *Fidelity Investments International Plc v MyTravel Group Plc* [2004] EWCA 1734, [29] and [33].

[60] See the important decision in *Re British Aviation Insurance Co Ltd* [2005] EWHC 1621, [82]-[88]. This makes it relevant to remark that in any case on the facts of *MyTravel*, the realistic or real alternative to the sanctioning and approval of the proposed scheme was *not* an insolvent liquidation but either a voluntary agreement with bondholders or a different scheme, either of which would have provided bondholders with something worth more than the 8% equity that they had previously been offered and which they had rejected. See the discussion in point E below.

[61] [2005] 1 WLR 2365, 2388-2392, [48] and [55]-[58], once again purporting to rely upon *In re Telewest Telecommunications Plc* [2004] EWHC 924 (Ch) and *In re Hawk Insurance Company Ltd* [2001] 1 BCLC 1409. See the comment on these cases in the text above.

enterprise value.[62] In that case, Junior claimants can "enforce their rights" by demanding that they be included in the reorganisation in some appropriate way. X (and Senior claimants) can only proceed with the reorganisation by, at the very least, persuading (*inter alia*) the requisite majority of Junior claimants pursuant to a CVA or scheme of arrangement that the reorganisation terms are in their interest. On the other hand, suppose our suggestion is rejected and the question whether Junior claimants have an interest in X is determined by reference to the latter's liquidation value.[63] *Only then* (and still subject to the terms of the scheme or CVA) does it turn out that the rights of Junior claimants could only be enforced in a liquidation, and that in liquidation, the value of their rights is nil.

It follows that in this part of its judgment in *MyTravel*, the court begged the question: It proceeded by assuming precisely what it had set out to investigate, namely, whether it was proper to value the bondholders' rights by reference to their position in an insolvent winding-up.[64]

The second error in this part of the judgment, we submit, lies in its confusion between the liquidation basis for determining the value of a company's assets on the one hand, and the rules applicable within winding-up for the distribution of that value on the other. This is explained below in the discussion of point F.

<u>D.</u> The question whether a company's assets are sufficiently valuable that a class of claimants has a real economic interest in the company is to be determined on a balance of probabilities.[65] If the evidence that there is sufficient value in the assets is "purely theoretical or merely fanciful, then… the party alleging an insufficiency will have established its case on a balance of probabilities (or even to a higher standard)."[66]

With respect, these propositions are sound. They are also consistent with the position taken in US courts, which have held that in a statutory appraisal proceeding, each side has the burden of proving its respective valuation positions by a preponderance of the evidence.[67] It might also be useful to emphasise the continuing importance of the

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[62] Recall that the enterprise value was assumed to be £1m, and Senior claimants were assumed to be owed £500,000. On this basis, Junior claimants have an economic interest in X because the latter's value exceeds the amount of its Senior liability.

[63] X's liquidation value was assumed to be £100,000. Since this is insufficient to repay Senior claimants in full, Junior claimants do not on this basis have an existing economic interest in the company.

[64] It is easy to confuse this argument with one we are not making. Our argument is *not* that since the bondholders could enforce their rights by demanding to be taken into account in the formulation of the scheme, that they had an economic interest in the company. That would be as question-begging as the position we have criticised. Our argument is that (a) the starting point must be the actual current value of the company, which was its going concern value since the company was a going concern. It is only once that value had been determined that it would become possible (b) to ascertain whether the bondholders had any interest in the company, and only after that could it be said (c) whether they could realistically enforce their rights otherwise than in an insolvent liquidation. Our criticism of the court is that it erroneously reversed this direction of reasoning, purporting to ascertain whether the bondholders had any interest in the company by assuming that their rights were what they would be if the company were in insolvent liquidation.

[65] This point is not made explicitly but can only be implied; see [2005] 1 WLR 2365, 2390, [54].

[66] [2005] 1 WLR 2365, 2390, [54], disagreeing with Vinelott J's dicta in *In re Maxwell Communications Corporation Plc* [1993] 1 WLR 1402, 1405.

[67] See e.g. *M.G. Bancorporation v. LeBeau,* 737 A.2d 513, 520 (Del.1999).

court's role if one side fails to satisfy its burden. US jurisprudence suggests that the court is not then free to accept the competing valuation by default, but must use its own independent judgment to determine fair value.[68]

E. On the facts, the only alternative to the scheme similar to that propounded by MyTravel was insolvency proceedings culminating in an insolvent liquidation. It followed that the question whether the bondholders had any real economic interest in the company was to be determined on the hypothesis that MyTravel had gone into insolvent liquidation.[69]

Two problems with this step in the court's reasoning have already been noted. Firstly, it focuses on MyTravel's position in an hypothetical liquidation in determining the value of the bondholders' rights, when the entire basis of the proposed scheme was that the company enjoyed a going concern surplus which could and ought to be preserved by preventing the company from going into liquidation. Secondly, there is once again the confusion between liquidation as a basis for ascertaining the value of MyTravel's assets and liquidation as a basis for the distribution of that value. Discussion of this is best postponed until we consider the next step in the court's reasoning.

Thirdly, however, and even accepting that the correct method for determining the value of the bondholders' rights was to consider the main alternative to the proposed scheme, it is highly doubtful whether, on the facts, insolvent liquidation was that alternative. Judging by the conviction with which the commercially astute parties best informed about its affairs (its directors, its bank lenders, and the latter's financial advisers PricewaterhouseCoopers) pursued its restructuring,[70] MyTravel clearly had a significant going concern surplus (i.e. there was a large positive difference between the enterprise and liquidation values of its business).

To the extent to which this was true, neither MyTravel's bondholders nor its Converting Creditors would have wished the company to end up in insolvent liquidation, since to do so would have resulted in the loss of the going concern surplus, a loss suffered by all of them as a group. The real dispute, therefore, was about the *distribution* of the surplus (as represented by the equity in Newco) as between the Converting Creditors on the one hand and the bondholders on the other. In the negotiations preceding the promulgation of the original scheme, the former had been willing to offer 8% of that equity to the latter. This was accompanied by an attempt to pressurise the bondholders into acceptance: the offer came with the threat that it would be halved if not accepted by a stipulated date. Keeping these facts in mind, we can see that the most plausible alternative to the proposed scheme was not a liquidation but instead a higher offer of equity (i.e. more than 8%) by the Converting Creditors to the bondholders. Both sets of parties would have had an incentive to come to an agreement in something like these terms.[71]

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[68] See e.g. *Gonsalves v. Straight Arrow Publishers, Inc.,* 701 A.2d 357, 362 (Del.1997).

[69] [2005] 1 WLR 2365, 2391-2392, [57] and [59].

[70] For a brief account by a PricewaterhouseCoopers partner, see Zubin Randeria, "Bond bombshell", *The Lawyer*, 23 May 2005.

[71] The Converting Creditors would have straightforward commercial reasons for agreeing to allocate any proportion of Newco's equity to the bondholders that would still leave them (Converting Creditors) with more value than they would obtain in MyTravel's insolvent liquidation. Correspondingly, the

Instead, by persuading the court that the rights of the parties were to be valued by reference to their position in a non-existent and highly unlikely liquidation which represented the antithesis of the purpose in aid of which the valuation was to be carried out, the Converting Creditors were able to strong-arm the bondholders into accepting their initial offer.

F. Since the only alternative to something like the proposed scheme was an insolvent liquidation, and since the bonds could only have been enforced within a winding-up, the bondholders were to be treated as if the subordination clause were effective to subordinate their claims to those of other creditors.[72]

The criticisms of making any reference to liquidation are of course relevant once again here. We should also however notice a new point whose consideration we have so far deferred. It is one thing to ask whether a company's assets should be sold off piecemeal or as a going concern. This is a question of *drawing* value from those assets, of *realising* the value in the company's estate. It is a wholly separate question how that value should be *distributed*.[73] Note that liquidation has two broad roles. It is a forum within which the value of the company's assets may be realised. Distinctly, the liquidation regime also contains rules (contractual as well as statutory) as to how the value thus raised is to be distributed amongst those with claims against the company. Recall from the discussion in Section II of this article that the various bases for valuing a company's assets are methods for *realising* that value. Assets are valued on a liquidation basis if they are to be split up from the business and sold off piecemeal, most likely, at less than fundamental market value.[74] As mentioned above, this is the method typically associated with the sale of assets by a liquidator.

With the realisation/distribution distinction in place, we can now see that even if the court in *MyTravel* was minded to ascertain the company's value on this liquidation basis, it required an extra argument to justify the distinct and distinctly problematic conclusion that the distribution of that value should also take place as if upon an insolvent liquidation. The court referred to the "hypothesis of an insolvency (for the purposes of testing the economic interest of the bondholders in the company)".[75] However, it showed no explicit recognition that it was possible to interpret this hypothesis in *either* or *both* of the following ways:

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bondholders would have commercial reasons for agreeing to any offer of Newco's equity which brought them greater value than they would receive in a liquidation. This represented the bargaining range of the parties, and an agreement could be expected to be struck within that range, the precise figure being determined by the parties' respective bargaining power. For an illuminating account of the determinants of bargaining power, see Jon Elster, *The Cement of Society* (New York: Cambridge University Press, 1989), 74-94; discussed in Mokal, *Corporate Insolvency Law*, 53-54.

[72] [2005] 1 WLR 2365, 2391-2392, [57] and [59].

[73] This distinction between realisation (or "deployment", as it is referred to in the US bankruptcy literature) and distribution is well recognised; see e.g. the discussion in Mokal, *Corporate Insolvency Law*, 266-269.

[74] Similarly, of course, enterprise valuation also tracks a method for drawing value from the company's assets, namely, disposal of the company's business as a going concern, to either its existing or new investors.

[75] See [2005] 1 WLR 2365, 239, [57]. As explained below, this formulation is misleading even on its own terms, since it is important to distinguish between insolvency and (insolvent) liquidation because of the precise terms of the subordination clause.

(i) *How much value was present* in the company's estate was to be ascertained upon "the hypothesis of an insolvency", which, in the context in which it was used in the judgment, must be taken to mean "as if the company were in insolvent liquidation".[76]

(ii) The basis upon which that value was to be *distributed* was to be ascertained upon "the hypothesis of insolvency", interpreted as above.

The importance of distinguishing between (i) and (ii) can be understood by reference to the subordination clause. Even if the first, though not the second, of these propositions were to be accepted and MyTravel were to be valued on a liquidation basis, the bondholders would have ranked on par with other creditors in terms of their economic interest in the company. (This would continue to hold true unless and until MyTravel in fact went into liquidation.) However, if both (i) and (ii) were to be accepted, as the court went on to do (albeit without recognising the distinction between them), then the bondholders did not have such an interest, the subordination clause having been activated by the assumption that the distribution of the value in MyTravel's estate would be on the basis that it was in liquidation.

Objections to accepting (i) have been discussed in points B, C and E above. Acceptance of (ii) faces all of the same problems, and in addition, also requires the court forcibly (and outside of the majority-voting machinery of section 425) to rewrite the bondholders' contract. Recall the terms of the subordination clause. The bondholders were not to become subordinated simply upon MyTravel becoming factually insolvent. Rather, these commercially sophisticated parties had carefully bargained to accept that the bonds would rank below other debt claims *if but only if* the company went into winding-up (whether solvent or insolvent). Since MyTravel never went into winding-up, the subordination clause never became effective. As explained above, this would remain the case even if the company's assets were to be valued as if in a liquidation.

With respect, therefore, the court's acceptance of (ii) required simply ignoring the actual terms of the subordination clause. This amounted to a judicial rewriting of the parties' contract, which is difficult to justify.

G. The fact that other creditor groups had been willing to offer the bondholders some value in the reorganised entity in the negotiations prior to the promulgation of the scheme did not make it any less appropriate to measure the bondholders' economic interest as in a notional winding up. The "bondholders might be able to extract some value, whether as a matter of bargaining, ransom, conscience or otherwise, but that is a different question. That value does not necessarily reflect an economic interest in the company. This latter question involves assessing what the bondholders would receive if they enforced their bonds against the company."[77]

Several of the problems inherent in this proposition have been elucidated in the foregoing discussion. The last sentence just quoted once again gets things the wrong

[76] See the previous footnote.
[77] [2005] 1 WLR 2365, 2393, [60].

way around: Whether the bondholders could "enforce" their bonds against MyTravel depended on whether they had (and would be recognised as having) an economic interest in the company,[78] and not the other way around. Further and as explained in Section II above, the very reason that MyTravel and several of its lenders proposed a restructuring would have been their recognition of the existence within the company's estate of a going concern surplus. This rendered inappropriate valuation of the company on a liquidation basis. MyTravel and its main lenders wished to preserve and benefit from the going concern surplus. In principle, the offer to the bondholders of up to 8% of the reorganised company's equity simply recognised the fact that the bondholders too were entitled, as claimants against the company, to some proportion of that surplus, and that their cooperation would have to be secured in order to preserve it.

The negotiations between the bondholders and other creditors were no different from any other settlement negotiations where parties differ as to the value of their respective rights, and "bargaining, ransom, conscience" etc. played no different a role here than they do in any other such negotiations. In the absence of the court's intervention, the parties could be expected to have settled, with the bondholders getting something more than 8% (which they were offered and rejected) and perhaps less than 25% (which is what they were initially said to be seeking)[79] of the reorganised company's shares.

<u>H.</u> The fact that other creditors "obviously think that a restructuring is potentially a better way of recovering more of their debt at some point in the future" does not "prove" that "the *present* company *presently* has a value which exceeds the amount of the unsubordinated debt… The hopes of the other creditors as to the future prospects for another company (Newco) do not generate extra value in the present company."[80]

According to the principle Mann J himself appears to have accepted,[81] the onus of showing that MyTravel presently did not have a value exceeding the amount of the "unsubordinated" debt lay not with the bondholders but with the company, which was alleging insufficiency. What MyTravel therefore had to show was that the present value of its assets was insufficient for the bondholders to receive anything.[82] As explained above, the *present* value of the company is a function of (among other things) its *future* streams of income. Since the company's business was to continue as a going concern, its *present* value could only properly be calculated on the basis of the income streams expected to be generated by it precisely as a going concern. MyTravel appears to have placed no evidence before the court to show that its going concern value was insufficient to pay off the "unsubordinated" debt. It should therefore have been held to have failed to discharge its burden of proof. The "hopes" (more

[78] Which, even on the erroneous assumption that the bonds were subordinated to other debt claims, depended on whether the company's *enterprise* value exceeded the amount of its "unsubordinated" liabilities.
[79] See Zubin Randeria, "Bond bombshell", *The Lawyer*, 23 May 2005: "Initially, the bondholders laid claim to approximately 25 per cent of equity on the basis that their debt claim was around a quarter of the aggregate converting debt claim."
[80] [2005] 1 WLR 2365, 2396, [70] (original emphasis).
[81] [2005] 1 WLR 2365, 2390, [54].
[82] This once again makes, for the sake of argument, the erroneous assumption that the bondholders were subordinated to other creditors even though the company was not in winding-up.

accurately, the carefully calculated forecasts of the value to be derived from MyTravel's assets, i.e. mainly its future cash-flows) of the company's institutional lenders had nothing to do with it, other than to demonstrate the conclusion of sophisticated commercial parties, who had reasons of self-interest for getting this right, that the business had a going concern surplus and thus should not be allowed to end up in liquidation.

Finally, it should be noted that it makes no difference whatsoever to this analysis whether the functioning enterprise that was MyTravel's business continued to be owned by MyTravel or was transferred to Newco. Value can only be derived from assets, and Newco's assets would be nothing other than the assets transferred to it by MyTravel. So if the Converting Creditors expected to receive better value from Newco tomorrow than they would by putting MyTravel into liquidation today, that was precisely because they recognised the present income-generating potential of MyTravel's undertaking.

VI. Conclusion

We can now seek to consolidate the results of this analysis. When a question arises whether a particular class of claimants has a current economic interest in the company, the starting point must be to determine the present value of the company's assets. A clue to the basis for the determination of this value would be provided by the company's present state. If it is in insolvent liquidation, then it is most likely to be in economic distress, and the value of its assets is likely to be their liquidation, or somewhat unusually, their market value.[83] Alternatively, if the business is offered to the market as a functioning enterprise, then this is a good signal that the company's decision-makers (i.e. its directors, acting in their own right and/or in consultation with the company's main or its senior lenders) believe it has some going concern surplus. Finally, if the company is undergoing reorganisation proceedings, that reflects its decision-makers' belief not only that it enjoys a going concern surplus but also that attempting a market sale would result in the loss to them of some of that surplus.

In any situation where the proposal is to keep the business together as a functioning enterprise, the value of the company is likely to be its going concern value. This should be determined using some combination of the comparable company, comparable transaction and discounted cash-flow methods. Some other method might also be appropriate on the facts, as long as it is a way of measuring enterprise (not liquidation) value.

The parties should be encouraged, here as in other areas, to avoid litigation by settling upon a common figure for the company's value. If litigation does ensue, it is the company proposing the reorganisation that has the burden of proving on a balance of probabilities the value of its business. Also, if it or any other party alleges that this value is so low as to eliminate the economic interest in the company of a particular claimant class, the burden of proving this to the usual civil standard lies with that party.

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[83] This is subject to the qualification we provided in footnote 4 above. What matters is the company's fundamental value and how it is proposed to realise this value (i.e. whether through a sale or a reorganisation). The proceedings it is undergoing are merely an indication as to the proper basis for ascertaining that value.

Once the present value of the business has been fixed, it becomes possible to answer the question whether a class of claimants has a present economic interest in the company. This in turn reveals what methods are available to the various claimants to enforce their rights, for example, whether they can insist upon their voice being heard in some appropriate way in the reorganisation process. Here as at each other stage of this process, only in the most unusual circumstances (to put it no higher) would it be proper to proceed on a counterfactual assumption as to the company's state (e.g. to assume it to be in liquidation when in fact it is not), whether in ascertaining its value or the precise nature of the rights of those with claims against it.

Finally, it should always be kept in mind that the various parties interested in the reorganisation proceedings face structural hurdles in determining the company's true value, and that they also have a tendency to suffer incentives to provide self-serving estimates of that value. Senior claimants and managers offered equity in the reorganised entity have an incentive to undervalue the business, while junior claimants have an incentive to overvalue it. While these problems cannot be eliminated, being on the look-out for them will enable their effect to be noticed and suitably countered.