VALUATION IN CHAPTER 11 BANKRUPTCY: THE DANGERS OF AN IMPLICIT MARKET TEST

*Diane Lourdes Dick**

Large corporate debtors typically include broad legal disclaimers in their financial disclosures to the bankruptcy court, such that the valuation estimates they offer in support of a proposed plan of reorganization are essentially meaningless. Some bankruptcy courts, however, discourage parties from litigating valuation; instead, they encourage them to negotiate, trusting that to the extent the debtor's estimates are woefully out of sync, the bargaining process will cause the debtor to pursue a restructuring that rests upon a more accurate value estimation. Meanwhile, these same courts interpret a lack of viable challenges to the debtor's valuation estimates as evidence of their accuracy: if the value of the debtor's assets truly exceeded the amount of its liabilities, then large and powerful investors would enter the fray. But this so-called "Implicit Market Test" is deeply flawed. This Article uses a timely case study—the Chapter 11 bankruptcy reorganization of Allied Nevada Gold Corp.—to demonstrate how these realities of modern commercial bankruptcy practice threaten to erode important safeguards in the Bankruptcy Code.

TABLE OF CONTENTS

* Associate Professor of Law, Seattle University School of Law. Special thanks to Matthew Bruckner, Lawrence Cunningham, Judge Karen A. Overstreet, United States Bankruptcy Judge (Ret.), Keith Sharfman, David Skeel, Jay Westbrook, and William Whitford for helpful comments on this and related work.

I. INTRODUCTION

On March 10, 2015, Allied Nevada Gold Corp. ("Allied Nevada") filed for Chapter 11 bankruptcy protection in the U.S. Bankruptcy Court for the District of Delaware.[1] The publicly traded company, a gold and silver producer, controls one of North America's largest precious metal mining operations at the Hycroft Mine in Nevada.[2] In its petition, the debtor referred to its freshly prepared 2014 financial statements, reporting assets of $941 million and debts of $664 million, including nearly $345 million in unsecured bonds.[3] These figures, which were released publicly for the first time in the company's bankruptcy filing, diverged substantially from the debtor's earlier public reports. For instance, the company's 2013 financial statements—which were incorporated by reference in disclosures pertaining to a new public stock issuance made a few months prior to the bankruptcy filing[4]—reported assets of more than $1.5 billion and debts of approximately $736 million.[5] Additionally, a November 2014 project-feasibility study commissioned by the company estimated that the Hycroft Mine would be worth $1.81 billion following a planned expansion (the "Hycroft Expansion").[6]

Although the company struggled with cash-flow problems that threatened commencement of the Hycroft Expansion,[7] in September 2014—just six months prior to the bankruptcy filing—management boasted that the Hycroft Mine was on target to produce 250,000 ounces of gold and nearly two million ounces of silver in 2014.[8] Moreover, by the debtor's own disclosures to the bankruptcy court, "[a]s of December 2014, the Debtors' proven and probable mineral reserves consisted of 10.6 million ounces of gold and 465.3 million ounces of silver."[9] Considering spot-metal prices in 2015, these reserves had a potential market value

---

1. *See, e.g.,* Voluntary Petition, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Mar. 10, 2015). Unless the context indicates otherwise, "Allied Nevada" and the "Debtor" refer to Allied Nevada Gold Corp. and its debtor affiliates together.

2. *Hycroft Mine*, HYCROFT MINING CORP., http://www.alliednevada.com/hycroft-mine/ (last visited May 30, 2017).

3. Voluntary Petition, *supra* note 1, at 4; Allied Nevada Gold Corp., Annual Report (Form 10-K) (Dec. 31, 2014), at 65 (listing $344,800,000 in Senior Notes).

4. Allied Nevada Gold Corp., Registration Statement (Form S-3) (Nov. 19, 2014).

5. Allied Nevada Gold Corp., Annual Report (Form 10-K), at 23 (Dec. 31, 2013).

6. *See* M3, HYCROFT PROJECT: NI 43-101 TECHNICAL REPORT MILL EXPANSION FEASIBILITY STUDY 23 (Nov. 3, 2014), http://www.alliednevada.com/wp-content/uploads/NI-43-101_Hycroft-Feasibility-Study_R0_3-Nov-14_COMPLETE.pdf.

7. *See, e.g.,* Laura J. Keller & Cecile Gutscher, *Swap Gone Bad Said to Push Allied Nevada Gold to Hire Moelis*, BLOOMBERG (Feb. 6, 2015), https://www.bloomberg.com/news/articles/2015-02-06/dollar-swap-gone-wrong-said-to-push-allied-nevada-to-hire-moelis.

8. Denver Gold Conference, *Allied Nevada Gold Corp.: Hycroft Mill Expansion Prefeasibility Update*, 3, ALLIED NEVADA GOLD CORP. (Sept. 14–17, 2014), http://www.alliednevada.com/wp-content/uploads/DGG-2014.pdf

9. Amended Disclosure Statement for the Debtors' Amended Joint Chapter 11 Plan of Reorganization, Exh. D, Liquidation Analysis at 7, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Aug. 27, 2015).

of $20 billion.[10] Yet, notwithstanding such large resource endowments, the company apparently lost more than half a billion dollars of asset value in just one year.

In court filings explaining the decision to file for bankruptcy, management pointed to broader market conditions, such as the drop in gold and silver prices from their historic highs, as well as to increasingly burdensome financial obligations arising under an out-of-the-money currency swap.[11] The debtor also complained that it had been unable to obtain financing for the Hycroft Expansion, a crucial step that would allow the company to extract a greater share of its mineral reserves.[12] Further contributing to the debtor's apparent woes, declining asset values constituted a technical default under its bond-indenture agreement, which required that the company maintain a $437 million tangible net worth.[13] This, in turn, triggered cross-default provisions across the company's other major financing instruments.[14]

On the surface, the story of Allied Nevada appears to reflect the classic narrative of a company in Chapter 11: declining asset values and challenging market conditions that lead to a cascade of defaults, giving powerful lenders so much leverage that the company could not survive without bankruptcy protection. This, however, is not a classic tale. Through what is referred to as a "prepackaged" bankruptcy, the debtor and its creditors negotiated in advance of the filing, agreeing to give the company's bondholders virtually all of the equity in the reorganized company in satisfaction of their claims and in exchange for certain junior convertible/equity-based debtor-in-possession and exit financing.[15] At the same time, the draft offered the company's existing shareholders warrants to purchase up to 10% of the equity in the reorganized debtor; however, pursuant to a so-called "death trap" provision, if they voted against the plan, they would receive nothing.[16]

To be sure, shareholders were at a significant negotiating disadvantage from the outset of the case.[17] Although an unsecured creditors'

10. *See, e.g.*, INVESTMENTMINE, www.infomine.com/investment/metal-prices (last visited May 30, 2017) (showing the market prices for gold and silver in 2015 under the Precious Metals, five-year tab).

11. Declaration of Stephen M. Jones in Support of Chapter 11 Petitions and Various First Day Applications and Motions at 11–14, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Mar. 10, 2015).

12. *Id.* In first-day filings, the debtor estimated the cost of completion to be approximately $1.39 billion. *Id.* at 13. Later in the case, management stipulated that approximately $867 million of financing would be necessary to complete the expansion project. Declaration of Stephen M. Jones in Support of Debtors' Motion for Entry of an Order Disbanding the Official Committee of Equity Security Holders at 5, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Jul. 31, 2015).

13. Annual Report, *supra* note 3, at 65.

14. *Id.*

15. Debtors' Joint Chapter 11 Plan of Reorganization, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Apr. 24, 2015).

16. *Id*. at 19, 22.

17. They face the challenges described in Diane Lourdes Dick, *Grassroots Shareholder Activism in Large Commercial Bankruptcies*, 40 J. CORP. L. 1 (2014).

committee was formed nine days after the bankruptcy filing,[18] it would be a full month before the U.S. Trustee would exercise its discretion to appoint an official equity committee.[19] Even after an equity committee was formed, committee members and other shareholders involved in the case struggled to gain support from large institutional owners who remained conspicuously absent from the proceedings.[20]

In July, following management's controversial decision to suspend operations at the Hycroft Mine,[21] the debtor removed the warrant clause from the draft plan, leaving shareholders without any distribution.[22] When the newly appointed equity committee exercised its right to participate in the case by requesting additional information and objecting to—among other things—the draft plan and the debtor's decision to grant executive bonuses, the debtor resisted the equity committee's discovery requests and then countered with a scathing motion to disband the committee altogether.[23] Referring to the committee's "scorched-earth tactics," the debtor pleaded with the court: "enough is enough."[24] The equity committee ultimately agreed to support a revised plan that gave existing shareholders warrants for up to 17.5% of the equity of the reorganized debtor.[25]

Meanwhile, an *ad hoc* group of individual shareholders—who claimed that they collectively held more shares than the members of the equity committee—sought to continue the fight against the plan. These shareholders argued, among other things, that the debtor grossly undervalued the company to use Chapter 11 to transfer ownership of the company without adequate consideration to shareholders.[26] They argued that the debtor's plan-related disclosures failed to provide any reliable basis

18. Notice of Appointment of Committee of Unsecured Creditors, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Mar. 19, 2015).

19. Notice of Appointment of Committee of Equity Security Holders, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Apr. 10, 2015).

20. In stark contrast to most Chapter 11 cases of this magnitude, equity committee membership was left entirely to individual shareholders with relatively small holdings. In fact, the debtor claimed in one of its motions that the official equity committee members "aggregately own approximately 0.5% of ANV's stock." Debtors' Motion for Entry of an Order Disbanding the Official Committee of Equity Security Holders at 3, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Jul. 31, 2015).

21. Allied Nevada Gold Corp., *Allied Nevada Suspends Mining Operations and Shifts Focus to Process Operations and Mill Demonstration Plant*, MARKET WIRED (July 8, 2015), http://www.marketwired.com/printer_friendly?id=2036640.

22. Amended Disclosure Statement for the Debtors' Amended Joint Chapter 11 Plan of Reorganization at 5, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. July 23, 2015).

23. Debtors' Motion for Entry of an Order Disbanding the Official Committee of Equity Security Holders, *supra* note 20.

24. *Id.* at 4.

25. Notice of Agreements in Principle With Official Committee of Unsecured Creditors and Official Committee of Equity Security Holders, Exh. A at 3, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Aug. 19, 2015).

26. *See, e.g.*, Brian Tuttle, *Allied Nevada Shareholders Question Barrick Gold's Involvement In Bankruptcy*, SEEKING ALPHA (Feb. 22, 2017) (noting that some shareholders, now on appeal to the Third Circuit, are alleging the intentional misrepresentation of the value as part of a scheme to enter into an agreement with Barrick Gold).

for the debtor's estimated valuation of the reorganized company.[27] Yet, notwithstanding the debtor's own admissions that it basically had no idea what its assets were worth, the court confirmed the plan on October 6, 2015.[28] In so doing, the court extinguished basic rights and entitlements of the company's public equity investors, vesting ownership of the company in bondholders.

The Bankruptcy Code is clear: an outcome of this sort is only lawful if the company was actually worth as little as the debtor claimed.[29] The problem is that the bankruptcy courts that regularly hear large Chapter 11 cases[30] increasingly allow commercial debtors to submit financial disclosures that are riddled with disclaimers, and they almost always discourage parties from pursuing expensive valuation battles in court. Instead, they trust that if the debtor's estimates are so out of sync with economic realities, then private negotiations and market mechanisms will produce a plan that ultimately rests upon more accurate value estimations.[31] Not every party in interest, however, is invited to the negotiation table, and not every party to the negotiation has an incentive to dispute the debtor's estimates. And, at least for some stakeholders, this process of "negotiation" is really a process of litigation, with debtors assuming defensive postures to resist information sharing. When courts blind themselves to these realities and assume that the lack of viable challenges to a proposed plan means that the financial markets agree with the debtor's valuation estimates, they readily dismiss stakeholders who attempt to defend their interests, at times even treating them as scourges upon the legal process.

Courts should reject these practices to ensure the proper functioning of important safeguards in the Bankruptcy Code. This Article uses a recent case study to explore the valuation dilemma in Chapter 11. Part II introduces the key elements of Allied Nevada's financial disclosures, including valuation-related disclosures. Part III articulates the importance of disclosures relating to the debtor's enterprise value and also considers the modern judicial tendency to rely on private negotiations and implicit market mechanisms to resolve valuation disputes. It then describes the variety of incentives and disincentives that may lead parties to accept the

27. Objection-Debtors Amended Plan of Reorganization at 18–23, filed by Brian Tuttle, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Sept. 24, 2015).

28. Order Confirming Debtors' Amended Joint Chapter 11 Plan of Reorganization, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Oct. 6, 2015).

29. *See* 11 U.S.C. § 1129(a)(7)(A)(ii) (2012) (setting forth the standards for determining whether a plan satisfies the best interest of creditors test); *id.* § 1129(b) (setting forth the standards for determining whether a plan satisfies the fair and equitable test).

30. In most cases involving publicly traded debtor companies, the bankruptcy case will be filed in the District of Delaware or the Southern District of New York. As Theodore Eisenberg and Lynn LoPucki observed, increased forum shopping has led to a concentration of cases in these two jurisdictions, with Delaware receiving the lion's share of large company filings. Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 CORNELL L. REV. 967, 968 (1999).

31. This tendency to rely on private negotiations and market mechanisms is examined more thoroughly in Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 B.Y.U. L. REV. 759 (2013).

debtor's proposed plan, even if it rests upon incomplete valuation data. Finally, this Article suggests ways to check the debtor's extraordinary power and generate a more equitable commercial bankruptcy process that better preserves the integrity of the financial markets.

II. VALUATION GUESSWORK: THE MODERN COMMERCIAL DEBTOR'S SCANT FINANCIAL DISCLOSURES

A. Allied Nevada: The Debtor's Liquidation and Valuation Analyses Revisited

In *Allied Nevada*, the debtor introduced into evidence several documents intended to demonstrate the company's hopeless insolvency. First, a liquidation analysis prepared by the debtor (the "Liquidation Analysis") estimated total gross asset proceeds of approximately $176 million to $255 million in a hypothetical Chapter 7 liquidation.[32] To the extent the company achieved reorganization, a valuation analysis performed by the company's independent financial advisor estimated the value of the reorganized debtor to be $200 million to $300 million (the "Valuation Analysis").[33] Of course, even at the high end of these ranges, the company's common stock would be worthless, as unsecured creditors would not receive distributions sufficient to satisfy their claims.[34]

On closer inspection, the debtor's financial disclosures are less than convincing. At the outset of the case, the debtor—like most large corporate debtors—disclosed that it did "not have current market valuations for its assets[, arguing it] would be prohibitively expensive, unduly burdensome, and an inefficient use of estate assets for the Debtors to obtain current market valuations."[35] Moreover, in its plan-related disclosures, the debtor conceded that, "except where specifically noted, the financial information contained herein has not been audited by a certified public accountant and has not been prepared in accordance with generally accepted accounting principles."[36]

The debtor's 2014 financial statements were the apparent starting point for many of the debtor's financial disclosures, including the Liquidation Analysis and the Valuation Analysis. In accordance with generally accepted accounting principles, these financial statements reflected virtually all of the company's asset values at "cost" or "net book" value, rather than at fair market value.[37] Moreover, the 2014 balance sheet re-

32. Amended Disclosure Statement for the Debtors' Amended Joint Chapter 11 Plan of Reorganization, Exh. D, Liquidation Analysis, *supra* note 9, at 3.

33. Amended Disclosure Statement for the Debtors' Amended Joint Chapter 11 Plan of Reorganization, Exh. E, Valuation Analysis at 1, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Aug. 27, 2015).

34. *See* 11 U.S.C. § 1129(b)(2)(B)–(C).

35. Statement of Financial Affairs for Allied Nevada Gold Corp. at 4, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Aug. 27, 2015).

36. Amended Disclosure Statement for the Debtors' Amended Joint Chapter 11 Plan of Reorganization at 5, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Aug. 27, 2015).

37. Annual Report, *supra* note 3, at 48.

flected nearly half a billion dollars in asset write-downs, with the largest portion occurring with respect to the debtor's long-lived assets, including plants, facilities, and equipment related to mine development.[38] In notes to the 2014 balance sheet, the company explained that it:

> reviews and evaluates its long-lived assets for recoverability annually and at interim periods if triggering events or changes in circumstances indicate that the related carrying amounts may not be recoverable. Events that may trigger a test for recoverability include significant adverse changes to projected revenues, costs, or future expansion plans.[39]

Acknowledging that impairment tests of this sort are "highly sensitive to . . . assumptions and inputs," the company identified the triggering event as such: "During 2014, the Company was unable to secure the financing required to begin construction of the mill expansion project which significantly decreased the overall near-term probability of completing the mill expansion project and resulted in an impairment write-down of long-lived assets."[40] Accordingly, the company took an impairment write-down of approximately $388 million with respect to the Hycroft Expansion,[41] and a $42 million write-down with respect to stockpiles of ore that had been extracted from the mine and required further processing through a mill.[42]

In determining the amount of these write-downs, the company relied on internal data and assumptions that are considered to be highly susceptible to bias and manipulation. "As of December 31, 2014, following the impairment charge, the mill-related long-lived assets were carried at their estimated net realizable sales value, which the Company determined represented their estimated fair value."[43] Another note explained:

> The fair value of the Company's mill-related long-lived assets at December 31, 2014, which was determined utilizing an estimated net realizable sales value approach, totaled $75.7 million and consisted primarily of tangible crusher components, the mills themselves, and motors and mill drives. Due to the uniqueness of the mill-related components and the fact that there is little to no market activity for identical or similar assets, the estimated fair value of Company's mill-related components are classified within Level 3 of the fair value hierarchy."[44]

The Financial Accounting Standards Board describes Level 3 inputs as the lowest priority inputs, as they are "unobservable" and therefore less precise.[45] "Unobservable inputs" are not based on independent sources

38. *Id.*
39. *Id.* at 56.
40. *Id.* at 61–62.
41. *Id.* at 62, 76.
42. *Id.* at 60.
43. *Id.* at 62.
44. *Id.* at 76.
45. *Id.* at 55.

but on "the reporting entity's own assumptions about the assumptions market participants would use."[46]

The Liquidation Analysis and the Valuation Analysis were similarly riddled with assumptions, qualifications, and disclaimers. Notably, the Liquidation Analysis—which was based on net book values of assets as reported on the company's 2014 balance sheet—assumed an estimated recovery rate of 38% to 58% on property, plant, mine equipment, and ore, based in part upon management's assumptions as to the value of a prospective purchaser's option to complete the Hycroft Expansion.[47] Among other things, "[m]anagement's valuation of the option to develop the Hycroft Expansion . . . reflects . . . the estimated incremental $766.6 million capital cost required to construct the mill."[48] The 2014 write-downs, however, had already taken into account the financing costs of the Hycroft Expansion and the inherent uncertainties surrounding the project. In this way, the Liquidation Analysis seems to have twice discounted the debtor's single largest tangible asset class.[49]

Meanwhile, the Valuation Analysis provided that the "estimated enterprise value . . . does not purport to constitute an appraisal or necessarily reflect the actual market value that might be realized through a sale or liquidation of the Reorganized Debtors, its securities or its assets, which may be significantly higher or lower than the estimated enterprise value range herein."[50] Rather, as is traditionally the case in Chapter 11, enterprise value is based on the reorganized company's earning capacity rather than underlying asset values.[51] The opining firm explained that, in estimating future earning capacity, it relied on the debtor's financial statements and other information provided by the debtor, and

> did not assume any responsibility for independent verification of any of the information supplied to, discussed with, or reviewed by [us] and, with the consent of the Debtors, relied on such information being complete and accurate in all material respects . . . . [A]t the direction of the Debtors, [we] did not make any independent evaluation or appraisal of any of the assets or liabilities . . . of the Reorganized Debtors.[52]

46. FIN. ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS UPDATE: FAIR VALUE MEASUREMENT No. 2011-04, at 50 (2011), https://asc.fasb.org/imageRoot/00/7534500.pdf.

47. Amended Disclosure Statement for the Debtors' Amended Joint Chapter 11 Plan of Reorganization, Exh. D, Liquidation Analysis, *supra* note 9, at 3.

48. *Id.* at 8.

49. Individual shareholders raised these and other arguments. *See generally* Brief of Stoyan Tachev in Support of Objection to the Amended Plan of Reorganization, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Oct. 5, 2015); Objection-Debtors Amended Plan of Reorganization, *supra* note 27.

50. Amended Disclosure Statement for the Debtors' Amended Joint Chapter 11 Plan of Reorganization, Exh. E, Valuation Analysis, *supra* note 33, at 1.

51. Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510, 526 (1941) ("The criterion of earning capacity is the essential one if the enterprise is 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.").

52. Amended Disclosure Statement for the Debtors' Amended Joint Chapter 11 Plan of Reorganization, Exh. E, Valuation Analysis, *supra* note 33, at 2.

Nowhere does the Valuation Analysis disclose, however, whether, and to what extent, the analysis offsets the debtor's earlier asset write-downs. This is important because the 2014 write-downs were based on the debtor's difficulty in obtaining financing for the Hycroft Expansion, but the reorganized debtor would emerge from bankruptcy with a plan in place to secure the needed financing and complete the project.[53]

Because of the numerous assumptions, qualifications, and exclusions, Allied Nevada's valuation estimates were—like those provided by most commercial debtors—essentially meaningless. Pivotal financial disclosures rested upon subjective and untested assumptions. But when the official equity committee attempted to gain access to more information by engaging in discovery, the debtor assumed a defensive litigation posture, resisting requests on the grounds they were "overly broad and unduly burdensome."[54] For instance, when the committee requested, among other things, information and documentation relating to the Valuation Analysis—a pivotal instrument that purported to lend credence to the debtor's plan of reorganization—the debtor objected to producing any materials prepared by the investment banking firm on the grounds that such documents constituted expert reports.[55] Similarly, when individual shareholders attempted to continue the fight by raising these and numerous other criticisms in their objections to the proposed plan,[56] the debtor responded by calling their critiques "baseless" and premised upon "rank speculation."[57]

On deeper inspection, the arguments are frustratingly circular. Although the debtor complained that the equity committee was being "value destructive" in its attempts to engage experts and thoroughly evaluate the debtor's business and financial information,[58] it later accused object-

53. It was also unclear whether the Valuation Analysis took into account the future value of the debtor's substantial net operating loss ("NOL") carryovers, most of which were generated by the debtor's 2014 asset write-downs. Earlier in the case, the debtor estimated its federal income tax NOLs to be approximately $177 million. Debtors' Motion for Interim and Final Orders Establishing Notification and Hearing Procedures for Transfers of Certain Equity Securities at 3, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Mar. 10, 2015). Pursuant to the U.S. Tax Code, NOLs can be used to offset future tax liability to improve liquidity. Assuming a corporate federal income tax rate of 35%, these NOLs could reduce the debtor's future tax liabilities by approximately $62 million. The debtor, however, subsequently explained that the NOLs were deliberately not taken into account due to mandatory reductions in valuable tax attributes in respect of the debtor's anticipated cancellation of indebtedness income. *See* Memorandum of Law in Support of Confirmation and Omnibus Reply to Objections to Confirmation of the Debtors' Amended Joint Chapter 11 Plan of Reorganization at 45, *In re* Allied Nevada Gold Corp., No. 15-10503 (Bankr. D. Del. Oct. 2, 2015). The Liquidation Analysis also declined to take NOLs into account, presumably because most deferred tax assets are nontransferable and thus would not survive liquidation. On the treatment of NOLs in Chapter 11 cases, see Diane Lourdes Dick, *Bankruptcy's Corporate Tax Loophole*, 82 FORDHAM L. REV. 2273 (2014).

54. Debtors' Motion for Entry of an Order Disbanding the Official Committee of Equity Security Holders, *supra* note 20, at Exhs. 5 & 6.

55. Debtor's counsel further drives home this point in a March 23rd letter to the U.S. Trustee. *See id.* Exh. 1.

56. *See* sources cited *supra* note 49.

57. Memorandum of Law in Support of Confirmation and Omnibus Reply to Objections to Confirmation of the Debtors' Amended Joint Chapter 11 Plan of Reorganization, *supra* note 53, at 40.

58. Debtors' Motion for Entry of an Order Disbanding the Official Committee of Equity Security Holders, *supra* note 20, at 3.

ing shareholders of failing to offer any "independent expert testimony or admissible evidence regarding [the company's] enterprise value," stating that "none of the Objecting Shareholders purport to be experts themselves," and stating further that their arguments rested on nothing more than inadmissible lay opinions about technical matters that require expert testimony.[59] In support of the latter claim, the debtor cited two decisions from the U.S. Bankruptcy Court for the Southern District of New York, which both reiterate the importance of expert testimony in light of the "inherently subjective and fact-intensive nature of valuation and projection of profits."[60]

Of course, given that individual shareholders would have had to use their own funds to retain experts—with no guarantee of reimbursement from the debtor's estate—it is unreasonable to expect that they should obtain expert testimony and put forth a successful valuation trial simply to show that the debtor had not satisfied its own burden of proof. Moreover, by this late stage of the proceedings, they faced profound strategic disadvantages. The debtor's financial disclosures had already served as justification for the debtor's decision to file for bankruptcy, bolstering its claims of hopeless insolvency and laying the groundwork for it to accuse the official equity committee and the individually objecting equity holders of interfering with the restructuring and attempting to extract nuisance settlements.

Nonetheless, the *Allied Nevada* court was apparently persuaded by the debtor's arguments, as it ultimately overruled the individual shareholders' objections without demanding more detailed disclosures from the debtor or making an independent investigation of the company's reorganization value.[61] In this way, the case highlights the true dangers of scant financial disclosures in Chapter 11: they give debtors an extraordinary, and potentially unchecked, power to control the restructuring and alienate stakeholders, even after they have gained a seat at the negotiation table. Debtors can use this tremendous discretion to transfer value to preferred stakeholders with hardly any meaningful disclosure. Because of this, the practice of Chapter 11 bankruptcy may, at least in the nation's busiest corporate bankruptcy venues, be moving far away from the statutory protections that the drafters believed necessary for fair and equitable bankruptcy reorganization.

B. A Ready Response: An Implicit Market Test

Those who believe that Chapter 11 bankruptcy serves as a healthy extension of fully functioning financial markets have a ready response.

---

59. Memorandum of Law in Support of Confirmation and Omnibus Reply to Objections to Confirmation of the Debtors' Amended Joint Chapter 11 Plan of Reorganization, *supra* note 53, at 41.

60. *Id.* at 41 n.97.

61. *See In re* Allied Nevada Gold Corp., No. BR 15-10503-MFW, __ F. Supp. 3d __, 2017 WL 587741, at *1, *4 (D. Del. Feb. 10, 2017) *appeal pending* (describing the bankruptcy court's overruling of the motion to stay the confirmation hearing).

They argue that any fairness concerns relating to meaningless disclosures are illusory because all proposed plans of reorganization are subject to vigorous market tests. For instance, an argument of this sort was made by Allied Nevada's counsel, who rebuffed claims that creditors would receive a "windfall deal" on the grounds that "the [Debtor's] unsecured notes are trading at well under par evidencing that sophisticated investors believe they will be significantly impaired under a plan."[62] The Third Circuit acknowledged the same argument in a 2007 case: if a "bondholder thought [a debtor company] was solvent, they wouldn't [sell] their debt [for less than par]."[63]

Allied Nevada's attorneys further explained that "[a]ny stakeholder or third party can offer an alternate proposal, which the Debtors would be required to consider in the exercise of their fiduciary duties."[64] Thus, the argument posits that if there is any material likelihood that a debtor's proposed plan grossly undervalues the company, large and powerful institutional stakeholders would resist the plan; if they decline to do so, distressed investors would acquire debt or equity stakes and intervene to fight on behalf of all residual claimants. Even if they cannot rely on the debtor's estate to finance their intervention, such ostensibly large and sophisticated arbitrageurs would assume the costs themselves. In other words, objectors should be expected to demonstrate an investment-backed belief that the company is worth more than the debtor claims.

The argument is naturally appealing; it frees bankruptcy courts from the uncomfortable task of confirming plans on the basis of admittedly weak disclosures, inviting them to interpret lack of dissent by more sophisticated parties as a signal that the financial markets agree with the debtor's valuation estimates. In the following Part, I take up arguments of this sort, exploring the reasons why this and other "Implicit Market Tests" are not only unreliable, but also pose a major threat to the fairness and efficacy of the bankruptcy process.

III. DISCUSSION

Allied Nevada presents an opportunity to reexamine the theoretical assumptions that underlie Chapter 11's approach to valuation issues that arise in large and complex commercial reorganizations. The cases invite judges, practitioners, scholars, and lawmakers to question the fairness and efficacy of an emerging practice that gives debtors the power to offer vague and subjective valuation estimates to support plans of reorganization, all while disclaiming the very purposes these financial disclosures are intended to serve.

---

62. Debtors' Motion for Entry of an Order Disbanding the Official Committee of Equity Security Holders, *supra* note 20, at Exh. 2.

63. VFB LLC v. Campbell Soup Co., 482 F.3d 624, 632–33 (3d Cir. 2007).

64. Debtors' Motion for Entry of an Order Disbanding the Official Committee of Equity Security Holders, *supra* note 20, at Exh. 1, at 3.

Of course, bankruptcy courts could simply hold debtors to the letter of the law and demand that they provide meaningful disclosures. Debtors have an affirmative duty to provide "adequate information," and whether the debtor's disclosures meet this standard must be determined from the investor's perspective.[65] Although the Bankruptcy Code acknowledges that debtors need not always engage in full and exhaustive disclosure, there is considerable gray area and courts have room to exercise their discretion and demand more thorough disclosure in light of the facts and circumstances of a particular case.[66] Where a debtor resists, the court could then take the more drastic step of appointing a trustee and/or an independent examiner to conduct an appraisal of the debtor's assets.[67]

Yet the courts most likely to hear large corporate bankruptcy cases rarely do anything of the sort. Instead, they rely on other powerful parties—typically secured creditors' and unsecured creditors' committees and, to a far lesser extent, equity holders—to conduct their own investigations and to vigorously oppose plans that rely on wildly off-base valuation estimates. To be sure, in many large and complex Chapter 11 cases, parties spend enormous amounts of time and resources retaining experts and fighting over valuation, such that if and when they eventually reach consensus, the court may rightfully assume that the final proposed plan rests upon a more accurate assessment of the debtor's reorganization value.

But then what about cases like *Allied Nevada*, where creditors have no incentive to put up a fight and large equity holders are inexplicably absent from the proceedings? Here, the court seemed to rely on what I call an "Implicit Market Test," whereupon it interpreted the lack of viable challenges to the debtor's valuation estimates as evidence of their accuracy. By "viable challenges," I mean objections by sophisticated parties with market power in the capital and/or securities markets who have the means to offer alternative valuation data. Because this test takes into account the size of market actors, it naturally impairs smaller stakeholders. For instance, when individual parties—such as retail shareholders—defend their interests by attempting to show that the debtor has failed to meet its burden of proof, they not only have to overcome the opposition

65. *See, e.g.*, Krystal Cadillac-Oldsmobile GMC Truck, Inc. v. Gen. Motors Corp., 337 F.3d 314, 321–22 (3d Cir. 2003).

66. *See, e.g.*, 11 U.S.C. § 1125(a)(1) (2012). Under that section, "adequate information" means "information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan." *Id.* The statute also acknowledges that "adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information." *Id.*

67. On the role of, and ethical issues surrounding, a court-appointed examiner in Chapter 11 cases, see Daniel J. Bussel, *A Third Way: Examiners as Inquisitors*, 90 AM. BANKR. L. J. 59 (2016); Daniel J. Bussel, *Ethics for Examiners*, 84 FORDHAM L. REV. 2073 (2016).

of those who show up in court to challenge them; they also have to prove wrong the countless large investors who declined to join their cause.[68] In this way, the court essentially took judicial notice of the market, which apparently speaks loudly through its silence: if the value of the debtor's assets truly exceeded the amount of its liabilities then large and powerful investors would have entered the fray.

This approach is elegant in its simplicity. It suggests that the value of a company is an inherent virtue, universally recognizable through deductive reasoning. It proposes that, notwithstanding the sparseness or unreliability of the debtor's financial disclosures, market participants can readily deduce the true value of the company and use this knowledge to decide whether and to what extent they should intervene in the bankruptcy case.

But this logic is flawed. For one thing, business valuation involves expensive and time-consuming comparisons and analyses.[69] In a large and complex bankruptcy, the debtor-in-possession is in the best position to subject its assets to a thorough, independent appraisal, and to develop a proposed plan that takes these findings into account. Moreover, while market participants regularly engage in their own valuation analyses with respect to debtor companies, their assessments are intended to advance *investment goals* rather than to achieve a *fair and equitable outcome* in the bankruptcy. Thus, even if they believe that a proposed plan vastly undervalues a company, their return on investment calculations must also weigh the costs of intervening in the case and the likelihood of success. *Allied Nevada*—a fast-tracked, prepackaged bankruptcy with strong support from a sophisticated creditor class—is not an attractive value play for most equity investors. This is not to mention the fact that market participants—including large shareholders—may also hold creditor positions or otherwise be conflicted based upon their other portfolio investments. All of this suggests that whether to take up a fight in bankruptcy court is a calculated decision and a highly imperfect measure of Wall Street's concurrence with the merits of the debtor's claims.

In contrast, the bankruptcy court is tasked with confirming a fair and equitable plan.[70] The bankruptcy process confers a tremendously valuable opportunity for debtors to restructure their finances. Just as the early courts of equity reminded plaintiffs they must bring their claims with "clean hands," so too should bankruptcy courts demand that debtors make full and meaningful disclosures for the benefit of all stakeholders. Precisely because state-law rights can be legally compromised in bankruptcy, the process requires much more disclosure than is generally required in out-of-court restructurings.[71] Earlier in Chapter 11's history, courts recognized the importance of the debtor's obligation to provide

68. *See generally* Dick, *Grassroots Shareholder Activism*, *supra* note 17.
69. *See generally* IAN RATNER ET AL., BUSINESS VALUATION AND BANKRUPTCY (2009).
70. 11 U.S.C. § 1129(b)(1)–(2) (2012).
71. This is the so-called "fish bowl" quality of bankruptcy. *See* Alan S. Trust, *Bankruptcy as a Fish Bowl of Disclosure*, AM. BANKR. INST. J., Mar. 2010, at 48.

meaningful disclosures. For example, in a 1985 decision, the U.S. Bankruptcy Court for the Southern District of New York explained, "it is crucial that a debtor be absolutely truthful [in its] disclosure statement."[72] The Third Circuit noted in 1988 that the obligation to provide thorough information "cannot [be] overemphasize[d]."[73] In the same year, the U.S. Bankruptcy Court for the Southern District of Ohio reminded parties that "[t]he disclosure statement was intended by Congress to be the primary source of information upon which creditors and shareholders could rely in making an informed judgment about a plan of reorganization."[74]

But if *Allied Nevada* is any indication, modern bankruptcy practice—at least as it unfolds in large public company cases—may be slipping away from these core principles. Commercial debtors typically include broad disclaimers in their financial disclosures; then, far from conveying a spirit of openness, they actively resist other parties' attempts to gain access to information. Moreover, although debtors routinely accuse equity committees of performing unnecessary work, they also belittle dissenting shareholders for failing to obtain sophisticated expert reports.[75] Judges are probably sympathetic to these critiques because of earlier concerns that Chapter 11 allows shareholders to leverage their procedural rights into distributions even when they are clearly underwater.[76] But as the bankruptcy process has evolved,[77] and as dominant creditors command far greater influence over restructurings,[78] there is less of a case for restraining equity holders.

Yet debtors continue to raise and exploit our historical misgivings over equity participation in Chapter 11 cases, urging strict adherence to an Implicit Market Test. They ask that courts presumptively exclude shareholders from the negotiation table, and then look incredulously upon any dissenting party who is unwilling to invest his or her own money to attack the proposed plan. By surrendering to these demands, modern courts weaken the Bankruptcy Code's plan-confirmation provisions, which were designed to protect the state-law rights of all claimants and interest holders.[79] This Implicit Market Test not only undercuts the protections put into place for the smallest stakeholders, but it also makes an overall mockery of their attempts to defend their interests by encouraging courts to confirm plans on the basis of perceived Wall Street "whisper" valuation numbers that small investors lack the ability to discern.

72. *In re* Galerie Des Monnaies of Geneva, Ltd., 55 B.R. 253, 259 (Bankr. S.D.N.Y. 1985).

73. Oneida Motor Freight, Inc. v. United Jersey Bank, 848 F.2d 414, 417 (3d Cir. 1988).

74. *See In re* Scioto Valley Mortg. Co., 88 B.R. 168, 170 (Bankr. S.D. Ohio 1988).

75. *Id.* at 170–71.

76. *See generally* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990).

77. *See* Harvey R. Miller, *Bankruptcy and Reorganization Through the Looking Glass of 50 Years (1960-2010)*, 19 BANKR. L. & PRAC. 3 Art. 1 (2010), https://www.americancollegeofbankruptcy.com/file.cfm/68/docs/Harvey%20Miller%20Keynote%20Address%202010.pdf.

78. *See* Michelle M. Harner & Jamie Marincic, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations*, 34 SEATTLE U. L. REV. 1155, 1158 (2011).

79. *See* 11 U.S.C. § 1129(a)(7)(A)(ii), (b) (2012).

For these reasons, courts should limit their reliance on Implicit Market Tests. Tests of this sort are especially inappropriate with respect to the decision whether to initially appoint or subsequently disband an official equity committee. Unless there have been allegations of fraud and a bankruptcy trustee or examiner has been appointed, an equity committee should be formed and retained if the debtor's most recent audited financial statements reflect positive stockholders' equity. And in all cases in which the debtor's disclosures to the bankruptcy court deviate dramatically from its prepetition disclosures, Implicit Market Tests should not be used to support rulings on any motions or objections, including those relating to plan confirmation. In this way, debtors would essentially be forced to stand behind their earlier disclosures to investors. Implicit Market Tests should be used—if at all—only in those cases where the debtor's financial disclosures are consistent with its prepetition disclosures and the court is confident that the debtor has satisfied its obligation to make adequate disclosures. In those cases, tests of this sort may enhance the bankruptcy process by empowering judges to rule on motions or objections in an efficient and expeditious manner.

Moreover, in all Chapter 11 cases—but especially those that involve large, publicly traded companies—judges should carefully examine whether debtors are making sufficient disclosures to support a plan that extinguishes state-law rights and entitlements. Although sophisticated market participants and their attorneys may be familiar with standard contract disclaimers, disclosures can become so riddled with legal disclaimers that they ought to be deemed facially inadequate. In light of the importance of the debtor's disclosures, the line between adequate and inadequate disclosures should be more clearly drawn so that courts know when it is necessary to make independent investigations as to enterprise value.

Of course, judicial valuation is admittedly a costly and imprecise exercise,[80] and, although judges can control costs by limiting the amount of trial time, the number of witnesses, and by streamlining the issues through the motion process, they may also prefer to rely on market mechanisms to provide additional cues as to the debtor's true worth. But they should utilize *explicit* rather than *implicit* devices. For instance, judges may explore Professor Bebchuk's well known options approach to corporate reorganizations.[81] Likewise, they might employ postconfirmation pricing mechanisms, such as the volume-weighted, average-price approach.[82] Under this device, a portion of the equity shares in the reor-

80. Professor Sharfman highlights these and related problems. *See, e.g.*, Keith Sharfman, *Judicial Valuation Behavior: Some Evidence from Bankruptcy*, 32 FLA. ST. UNIV. L. REV. 387 (2005); Keith Sharfman, *Valuation Averaging: A New Procedure for Resolving Valuation Disputes*, 88 MINN. L. REV. 357 (2003).

81. Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 785 (1988) (proposing a corporate reorganization process pursuant to which stakeholders receive options rather than pure shares in the reorganized company).

82. A similar method was used in *In re* Dana Corp., Inc., No. 06-10354 (Bankr. S.D.N.Y. 2007).

ganized company are held in escrow pending a "true up" process that calculates the value of the company based on the post-confirmation market price of the stock over a specified period.[83] These reserved shares are then later distributed to parties, such as shareholders, who are later determined to have been shortchanged in the restructuring.[84] Similarly, courts might subject proposed plans to a mandatory auction period, whereupon any internal or external investor may acquire at face value the claims of creditors who stand to receive equity in the reorganized debtor. Such a process would ensure that creditors receive full satisfaction of their claims, while allowing the market to determine the value of the company's upside potential.

Finally, as a potential middle ground between the disclosure practice reflected in *Allied Nevada* and full-blown judicial valuation, courts can require an auditing of the debtor's financial disclosures and the proposed plan in accordance with generally accepted auditing standards or, at a minimum, review by an outside independent licensed auditor who can attest in a so-called comfort letter[85] to the principal financial inputs and calculations. Devices of this sort would provide more direct assurance to the court, while also alleviating the fairness concerns raised in this Article.

IV. CONCLUSION

Through its growing reliance on what I call "Implicit Market Tests," an emerging bankruptcy practice privileges large stakeholders with market power at the expense of smaller stakeholders. Advocates of these Implicit Market Tests acknowledge that inequitable outcomes may sometimes occur, but nonetheless believe that all market participants benefit from the efficiency gains. Of course, parallel reasoning can be used to support eradication of Implicit Market Tests: although administrative costs will necessarily increase, all participants stand to benefit from fair and equitable restructurings. So why does modern bankruptcy practice continue to err on the side of efficiency rather than fairness? Maybe the real question is, when bankruptcy courts hear commercial restructuring cases, are they acting as courts of law in pursuit of justice, or are they serving as glorified boardrooms where sophisticated parties strike deals with the force of law? Until these questions are addressed, Chapter 11 will continue to generate stories like *Allied Nevada*, which ought to disturb anyone who hopes for a just system.

---

83. *See* Marshall S. Huebner & Damian S. Schaible, *Valuation in Chapter 11: Overview and Tools for Consensual Resolution*, DAVIS POLK & WARDWELL (June 26, 2009), https://www.davispolk.com/sites/default/files/files/Publication/6771a85a-00c8-4d69-b1fb-1b5263b2edec/Preview/PublicationAttachment/3aca3008-f6c0-4c9d-addd-1e5183e0b01a/INS09_Chapter-2_Davis-Polk--Wardwell.pdf (describing this valuation method under section B.i.).

84. *Id.*

85. Comfort letters are thoughtfully explored in Rene Sacasas & Don Wiesner, *Comfort Letters: The Legal and Business Implications*, 104 BANKING L.J. 313, 325 (1987).