Testimony before the ABI Commission to Study the Reform of Chapter 11
Role of Valuations
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My name is Sandi Horwitz. I am a Managing Director and head of Successor Trustee and Default Administration at CSC Trust Company of Delaware, a wholly-owned subsidiary of Corporation Service Company. For the past nine years I have acted as indenture trustee in a fiduciary capacity on behalf of investors in defaulted debt issues. I have been a member of over two dozen official committees of unsecured creditors, notably Mirant, Calpine, Northwest Airlines, AbitibiBowater and NewPage. I have, in some instances, served as chair or co-chair. Immediately prior to my position as an indenture trustee I was a workout banker and previously a senior banking executive.

It is my understanding that the Commission is interested in evaluating the role of valuations in Chapter 11 reorganizations. I am honored to be submitting this testimony and am doing so from my personal experience as an indenture trustee who actively represents the specific interests of unsecured debt holders, and more generally those of the entire unsecured creditor constituency as a member of a statutory committee of unsecured creditors.

I am neither a lawyer nor a valuation expert, so my remarks reflect those of a layperson who relies on the advice of such professionals to arrive at a view on valuations of reorganized debtors. I wish to emphasize that the views I am expressing are my own and do not reflect those of CSC Trust Company of Delaware or its parent.

I am limiting my testimony to valuations prepared in connection with the Chapter 11 plan confirmation process, focusing on why they are important to maximizing recoveries to general unsecured creditors and the challenges creditors' committees confront in developing their valuation analyses for purposes of negotiating confirmable plans of reorganization.

I wish to state at the outset that I do not recommend codifying valuation methodologies, compulsory market testing (except in the limited context of so called "new value plans" involving insiders of the type discussed in the Supreme Court's *LaSalle* decision), or mandated court-appointed masters or experts. I believe the current regime whereby the court has broad discretion to determine the appropriateness of these matters based on the facts and circumstances of each case should be retained. It is my understanding that the Bankruptcy Court is a court of equity, and, as such, the presiding judge should have the flexibility and latitude to determine the basis by which to derive the fair treatment of estate creditors.

I contend that the valuation of a reorganized debtor can be the most significant factor affecting recoveries to unsecured creditors because such creditors' recoveries commonly take the form of equity in the post-emergence enterprise. The value of that equity necessitates valuing the long term prospects of the reorganized enterprise. With the predominance of secured debt, it seems that all too often at the commencement of the case there is a rush to judgment by debtors and secured creditors that general unsecured creditors are out-of-the-money. I do not believe this "rush to judgment" is accidental. The most senior creditors in the capital structure are eager to complete the restructuring quickly to neutralize the junior creditors before the debtor can fix itself, thereby diverting value creation resulting from the fix from unsecured creditors. This belief can pervade the entire restructuring process and impede the creditors' committee efforts to assess value, which, by its nature, is time-intensive.

I will now convey some concerns I have that can indirectly affect the valuation process prior to a creditors' committee even embarking on the formulation of its valuation position.

The first concern I have is that valuation issues should not, to the extent possible, be addressed prematurely in a case. In this context I am referring to the type of provisions I have often seen in DIP financing orders whereby the debtor stipulates that secured creditors (first and perhaps even second lien creditors) are oversecured. I fully understand why such a stipulation is necessary with respect to the court allowing, at the beginning of a case, those secured creditors to receive postpetition interest and have their professionals' fees paid. But that is not the aspect of the stipulation with which I am troubled. My concern is with respect to that portion of the stipulation which provides that the facts so stipulated by the debtor will become binding on the creditors' committee within X days, usually 90 – 120 days. Given that all of the debtor's assets may be encumbered, the value of the collateral is in essence the value of the entire enterprise. In large or complex cases, this is not sufficient time for the committee to formulate a definitive view on valuation and actually litigate the issue. While vigilant committee counsel will strenuously object to that provision, if the court overrules the objection, a premature valuation fight can well ensue.

Another concern I have relates to financial advisor fees (to be more precise, the success fee component) being implicitly or explicitly subject to, or dependent on, a certain valuation outcome. Such arrangements raise bias issues for the financial advisor, particularly when it testifies as an expert on the matter of valuation. For court-approved engagements such as creditors' committee's financial advisors, this compensation structure is rare because some courts have criticized it. However, in my experience, this arrangement has been used for financial advisors to ad hoc committees of first or second lien creditors and raises the specter of economic conflict and credibility. In these instances, I question the appropriateness of estate funds being used to pay for success fees structured in this fashion.

The valuation analysis process can be quite complex, and oftentimes pose an arduous intellectual undertaking for committee members who typically do not possess a homogeneous skill set. Creditors' committees comprised of trade, labor and financial creditor representatives rarely share common restructuring experiences and certainly do not share common motivations. Committees must promptly decide upon their formation what type of advisors to retain with a view towards those who can manage the disparate abilities and interests of the members and possess the best qualifications to assess value as case developments evolve.

Given the foregoing and particularly in the context of unsecured creditors purportedly being out-of-the-money, committees confront numerous hurdles. The first can be committees' desires to engage two financial advisors, one of which being an investment bank to advise on valuation and provide expert testimony. In circumstances where committee counsel advises that valuation will be the key to determining the recoveries to unsecured creditors I am a strong supporter of dual retentions. Debtors' may fiercely resist two retentions, which, in my experience, can result in strained and contentious relationships with the statutory creditors' committees, the only other fiduciary in the case. In my experience, committees are mindful of not wanting to burden estates with undue costs and strenuously negotiate the terms of compensation.

A second hurdle is the timely receipt of thorough information from debtors, including but not limited to projected cashflows, historical and projected financial performance, strategic business plans and executory contracts. I do not know if this reflects debtors wishing to maintain control or because of the influence DIP lenders and/or other secured creditors have over debtors to emerge quickly and give short shrift to the unsecured creditors they deem to be out-of-the-money. Under either scenario, creditors' committees can be stymied and left to conclude that they are being marginalized in the Chapter 11 process. I wonder if a court-appointed valuation master whose compensation is paid by the estate would alleviate this behavior by establishing a protocol for the timely release of information. An indirectly related issue concerns whether court approval of employee incentive programs containing bonuses based on "early exit" milestones only serve to compound the negative effects of protracted information gathering exercises.

Finally, a third challenge confronting creditors' committees is the growing use of quick Section 363 asset sales, a situation that can undermine their efforts to maximize recoveries for general unsecured creditors. While I recognize that a sale can be viewed as the real value of the estate and the only viable option, I would argue that this alternative can benefit the DIP lenders and possibly other secured creditors to the complete detriment of the unsecured credits who may well benefit from a classical operational and financial restructuring from which value can ultimately be realized. Although I wonder if there should be higher threshold standards governing the process to obtain court approval of sales, I fear that codifying such standards may have unintended consequences.

In conclusion, the development of an enterprise valuation can be difficult, complex and expensive if valuation becomes a hotly contested matter. Nonetheless, it can be the critical tool official committees of unsecured creditors have to ensure a value-maximizing outcome for their constituents. I personally believe that the courts should retain the greatest flexibility and discretion to use all available means to evaluate and confirm plans of reorganization.