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Northwest Bankruptcy: Market Test of Plan Not Required

Recently, Northwest Airlines confirmed its plan of reorganization and should soon emerge from bankruptcy, having restructured its operations while in chapter 11. The reorganization plan converts its unsecured debt to equity of the reorganized company. While the plan does provide for a cash equity infusion through a committed rights offering, it provides no return to the equity holders, simply canceling the old equity shares. Certain equity holders believed that Northwest would be more valuable, and they would be able to participate in the reorganized company, if Northwest engaged in a merger or other consolidation transaction as part of its reorganization plan. These objecting equity holders commenced litigation to contest Northwest's plan valuation, asserting that the debtor ought to market test or otherwise explore whether greater value would be available through a third party sale or consolidation transaction, especially considering that the airline industry is dominated by consolidations. While such equity holders made vigorous objections to the plan and Northwest's valuation, and persistent demands for confidential information, their efforts were unsuccessful. Yet, they did cause the appointment of an examiner, Richard Nevins. Following submission of the examiner's report to the bankruptcy court, the equity holders withdrew their objections and the court confirmed the plan, which extinguished their equity interests. The examiner concluded that chapter 11 does not require a market test of reorganization value and that the conduct of Northwest did not trigger any such responsibility. Indeed, the examiner found that the board of Northwest had followed an appropriate and well-informed course of action, reflecting its board of directors' exercise of reasonable business judgment, which should not be second-guessed by the court.

The Examiner's Investigation

Given their lack of litigation success, the equity holders resorted to the examiner provision of the Bankruptcy Code, which, in a chapter 11 case, requires the appointment of an examiner to investigate "allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity" in the management of the debtor.[1] They asserted that Northwest's decision to pursue the proposed "stand alone" plan improperly extinguished equity because (1) greater value was potentially available in a merger/consolidation and (2) it undervalued the post-emergence entity under a stand alone plan of reorganization. The equity holders demanded that the examiner investigate:

(i) whether the debtors have explored all available options to maximize the value of their estates;

(ii) the debtors' and the creditors' committee's merger and acquisition activity, negotiations or discussions with other airlines (or the creditors and shareholders of other airlines); and

(iii) whether the debtors have any plans, agreements, or understandings, tacit or otherwise, to consummate a valuable transaction after confirmation and/or whether the debtors are "parking" third-party interest in their businesses.

In the order directing appointment of an examiner, however, the court limited the scope of the investigation to:

> [d]etermin[ing] whether the debtors, including their professionals, have used customary and appropriate processes and procedures to value their assets and businesses for purposes of section 1129(b) of the Bankruptcy Code, or, on the contrary, have employed improper processes and procedures in order to arrive at a materially reduced valuation of their assets and businesses for purposes of section 1129(b) of the Bankruptcy Code.

Following that mandate, the examiner investigated the process followed by Northwest in determining to pursue a stand alone plan and whether the methodology and assumptions used in Northwest's valuation for its plan were appropriate and should not be disturbed. Ultimately, the examiner approved the process and concluded that the valuation was appropriate and should not be disturbed. The examiner's report emphasizes that a court should not interfere with the well-reasoned and informed decision of a board in proposing a plan, especially where the debtor still has a statutorily-protected exclusive right to file a plan.

'Revlon'-Type Duties[2]

The examiner noted that in addition to retained state law duties of care and loyalty (as extended to the stakeholders) and duties to conserve and protect property of the estate for the benefit of creditors and to refrain from acting in a manner that could damage the estate or hinder a successful reorganization, the board of directors of a chapter 11 debtor also has a duty to consider all viable alternatives to maximize value of the debtor's estate. Critically, however, the examiner determined that a debtor's board of directors does not have a duty to auction or test-run the market before proposing a stand-alone plan of reorganization, noting that requiring a debtor to always be marketed for sale to the highest bidder would render meaningless the debtor's exclusive right to propose a plan for a certain period and the debtor's power to propose a plan supported by its business judgment. The examiner also rejected the argument that chapter 11 provisions governing confirmation of a plan require valuation to be established through an auction-like methodology. The examiner submitted that chapter 11 requires only that a debtor must provide distributions to creditors under its proposed plan that are not less than under a chapter 7 liquidation; it does not mandate a hypothetical auction. Rather, a debtor simply must proceed in good faith and may not conceal or hide facts, including a bona fide offer that may be indicative of value.

Strategic Options Considered

The investigation focused on the board's determination to pursue a stand-alone plan, encompassing its efforts to (i) restructure its business operations in reliance upon the ameliorative provisions of chapter 11, (ii) the development of its business plan, (iii) the development of the reorganization plan, and (iv) Northwest's valuation. The examiner also reviewed the actions taken by the board to understand its fiduciary responsibilities in chapter 11, its actions in retaining financial advisors, the instructions governing their engagement, the work process

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they followed, the involvement of management and the reports of such advisors to the board, and the frequency, breadth, and nature of the board's deliberations.

Restructuring

The examiner's report confirmed that while parties disputed valuation, Northwest was successful in formulating and substantially attaining its restructuring objectives of reducing labor costs, updating its fleet, restructuring its aircraft leases and otherwise achieving a competitive position upon emergence, including having adequate liquidity (largely achieved by arranging for an additional $750 million in equity capital). In the examiner's view, Northwest largely achieved its restructuring and recapitalization objectives.

The Business Plan

The examiner reviewed the evolution of Northwest's business plan, observing that all three iterations of Northwest's business plan were developed in a consistent, disciplined and rigorous process by the company's management, which was aided by Northwest's lead financial advisor. The examiner also noted that the industry experience of the management team was extensive. The prepetition business plan was revised in connection with the prosecution of Northwest's motion to reject its collective bargaining agreements under section 1113 of the Bankruptcy Code, where all parties had an opportunity to review, challenge and contest the business plan and the assumptions it used. That plan was subsequently amended in connection with Northwest's effort to obtain exit financing, and in response to changing fuel prices and market conditions, actual performance during 2006, more favorable market trends, and the savings achieved through the business restructuring. Noting that all business plans are premised on financial forecasts and are therefore uncertain, the examiner reported that while he did not test or substantively review the business plans, they were developed and refined in a disciplined, professionally managed process.

Plan of Reorganization

The examiner reviewed the evolution of the plan from its inception in the spring of 2006, including the establishment of a board committee and its active management of the process wherein Northwest primarily considered three options: (1) emerging as an independent entity through a stand-alone plan distributing equity to stakeholders, (2) emerging as an independent entity with a substantial minority equity holder, or (3) a consolidation/merger transaction within the industry. To explore those options, Northwest retained additional financial advisory firms; one to advise on the synergies and difficulties from possible combinations within the airline industry and another that was a more broadly-based investment banker with restructuring expertise. The examiner observed that industry consolidation was inevitable: "The question is not if consolidation will occur, but when it will occur (and what parties it will involve)." Although large portions of the examiner's report are redacted (presumably relating to the investigation regarding Northwest's evaluation of its strategic options), the report summarizes the activity of the two advisory firms and Northwest in assessing the viability of various combinations, relying upon publicly available information. The examiner reported that Northwest demonstrated that "consolidation in the airline industry is a complex exercise, having numerous risks and issues, notably the need to harmonize and renegotiate labor agreements." If Northwest were to merge with a company with higher labor or retiree costs, Northwest risked giving back the benefits it had gained from labor. Thereafter, the examiner reviewed the "Equity Raise Process," in which Northwest contacted various investors regarding a minority equity transaction, noting that this experience refined Northwest's view of its value as the interest of investors waned as the company's valuation, as implied from market trading, escalated, prompting such investors to conclude the company was overvalued, which would jeopardize their ability to achieve targeted rates of return. Eventually, the rights offering emerged as the most viable option. According to the examiner, Northwest selected its underwriter after a "thorough process," obtaining a commitment for a $637.5 million equity offering and direct equity purchase of $112.5 million.

The examiner reported that Northwest had indeed followed an informed and well-considered process to reach its determination to pursue a stand-alone plan and that although valuations are always subject to debate on assumptions and similar factors, he found no deficiencies in the procedures employed or the methodologies relied upon.

There was little doubt that the examiner was convinced that the board had engaged in a thorough process to review the options available to maximize the value of Northwest's estate.

Valuation

The examiner turned to Northwest's reorganization valuation. His analysis is important because the objecting equity holders claimed, in part, that Northwest undervalued the reorganized enterprise in order to reflect insolvency and extinguish prepetition equity. Northwest relied on its lead financial advisor for the core valuations forming the basis for its reorganization plan. The examiner observed that financial analysts valuing a company as a going concern typically employ one of three valuation methods: (1) comparable public company analysis, (2) discounted cash flow analysis, and (3) comparable precedent transaction analysis. Northwest's advisor used a comparable public company analysis and a discounted cash flow analysis. Comparable private company analysis was unavailable because, according to Northwest, no comparable private company existed. This point was undisputed. Nonetheless, as a result, Northwest did not consider the value of a prospective control premium. Even though the examiner suggested that a control premium might have been analyzed, its absence was not sufficient to question the methodology Northwest used. The examiner, as a "matter of process," concluded that the analysis of market comparables was satisfactory, and a debate over which set of comparables to use or which year to rely upon, in the examiner's view, did not reflect a process deficiency. The examiner also opined that in terms of the discounted cash flow analysis, each of the choices made by Northwest's advisor were defensible, as were the levels of secured debt and capitalized value of its operating leases projected for the reorganized Northwest. Interestingly, the scope of the examiner's valuation investigation extended also to Northwest's claims analysis and its claims advisor, due to a differing claims estimates previously used by the creditors' committee. Again, the examiner found no evidence that the Company engaged in a claims reconciliation process designed to inflate the value of the estimated claims.

Conclusion

The examiner's investigation was limited to process. The examiner, despite the requests of the objecting equity holders, did not evaluate or judge the debtor's choice of a stand-alone plan or conduct its own valuation of Northwest. The examiner reported that Northwest had indeed followed an informed and well-considered process to reach its determination to pursue a stand- alone plan and that although valuations are always subject to debate on assumptions and similar factors, he found no deficiencies in the procedures employed or methodologies relied upon. In fact, he recommended deference to the board of directors' business judgment. In subsequently confirming the plan, as conforming to the requirements of chapter 11, including being proposed and prosecuted in good faith, the bankruptcy court concurred.

1. If the court does not appoint an examiner on its own, a party in interest or the United State Trustee may request such appointment, which request the court shall oblige if either "(1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate; or (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000." 11 O.K. §1104(c). If the $5,000,000 threshold is established, the requested appointment is mandatory. See *In re Loral Comic's, Ltd.*, 313 BAR. 557 (Banker. S.D.N.Y. 2004), rev'd, No. 04 Civ. 8645RPP, 2004 WL 2979785 (S.D.N.Y. 2004).

2. "Revlon" duties generally arise when a board of directors is on the verge of selling, breaking up or transferring control of the corporation. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994). Under those circumstances, directors may not consider the interests of nonshareholders and have a narrow duty to maximize shareholder value. *Revlon Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).