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UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

IN RE:	) CASE NO. 03-44662
	)
WCI STEEL, INC., *et al.*,	) CHAPTER 11
	)
DEBTOR(S)	) JUDGE MARILYN SHEA-STONUM
	)
	)
	) SUPPLEMENT TO THE OPINION RE
	) CONFIRMATION
	)

On December 15, 2004 the Court entered an Opinion re: Confirmation of Proposed Competing Plans of Reorganization (the "Opinion"). The following findings of fact and conclusions of law supplement that Opinion.

I. THE DEBTORS' PLAN

A. The Debtors' Plan Violates § 1129(b) because Renco is Retaining 100% of the Debtors' New Equity While Failing to Contribute New Value that is Worth the Reasonably Equivalent Value of Such Equity.

3.5. Findings of Fact Re: Marketing Efforts

A.28 The Court finds that the factual record in this case does not provide any basis for the Debtors[1] to argue that there has been meaningful and good faith market exposure. In May 2003, several months before this bankruptcy case was filed, the Debtors retained Jefferies & Company, Inc. ("Jefferies") as their financial advisor for the explicit purpose of

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1 Capitalized terms not otherwise defined in this Supplement have the meaning ascribed to them in the Opinion.

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negotiating a reduction in indebtedness owed to the Secured Noteholders. (Amended Jefferies Retention Agreement (as defined below) (Docket No. 75)). The original retention agreement did not refer to a sale of assets or require Jefferies to provide services relating to a sale of assets. Instead, under the original retention agreement, Jefferies would have received a bonus based on the reduction in indebtedness owed to the Noteholders (the "Original Jefferies Retention Agreement"). (Exclusivity Hearing Transcript ("EH Tr.") 147-49.)

After their bankruptcy petitions were filed the Debtors on October 3, 2003 moved to retain Jefferies as their financial advisor pursuant to an amendment to the Original Jefferies Retention Agreement (the "Amended Jefferies Retention Agreement") (Docket No. 75). No objections were filed and the order approving the retention of Jefferies was signed on December 8, 2003 by Judge William Bodoh. The Amended Jefferies Retention Agreement eliminated Jefferies' bonus for achieving a reduction in indebtedness owed to the Secured Noteholders. Contrary to Debtors' counsel assertions at the May 4, 2004 hearing in connection with the Exclusivity Termination Motion (EH Tr. 215-16), the Amended Jefferies Retention Agreement makes no reference to any sale of the Debtors and does not call for Jefferies to provide any services relating to the sale of the Debtors.

Any effort by the Debtors to have Jefferies conduct a marketing process for a sale was pretextual. Jefferies brought no marketing experience in the steel industry as it has never before sold a steel company. Although more than 30 steel companies have filed for bankruptcy over the last three years, Jefferies was not engaged in any of those bankruptcies. (EH Tr. 143-45.)

The minutes of a meeting of the Debtors' board of directors on November 10, 2003, reflect that a "Renco proposal," whereby Renco would retain its equity in the Debtors, was discussed. In addition to Mr. Rennert, Renco's counsel attended the board meeting. (Ex. 58.)

Thomas Gentile, the Debtors' acting CFO since early October 2003, testified that he always understood that Renco desired to retain the equity ownership of WCI (Trial Trans. - Gentile 124.)

Jefferies purported to commence a "marketing process" for the Debtors' assets at the beginning of February 2004. (EH Tr. 133.) The process established by Jefferies proceeded with information that understated cash flow projections and was conducted in an unrealistically short time frame to test market interest. The written materials that Jefferies prepared and disseminated to prospective bidders contained cash flow projections that showed lower cash flow than both (a) Metal Strategies, Inc.'s projections delivered in April 2003 to Debtors' management and Ira Rennert as sole director (EH Tr. 68), and (b) internal projections delivered by Debtors' management to the independent directors on or about April 15, 2004. (EH Tr. 211-12.) In addition, Jefferies asked potential bidders to provide indications of interest within 14 business days after receiving their first phone call (EH Tr. 128).[2]:

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[2] The **planned 2 ½-week** process was as follows:
• Jefferies commenced making phone calls to potential purchasers on or around Tuesday, February 3, 2004 (EH Tr. 133);
• If the recipient of the phone call expressed an interest in the Debtors' assets, Jefferies distributed a short teaser describing the Debtors' assets on or about the same day as the interest was expressed (EH Tr. 234);
• Upon receipt and review of the teaser from Jefferies, a potential purchaser was instructed to contact Jefferies again to seek to enter into a confidentiality agreement (EH Tr. 87, 96, 234);
• Jefferies then distributed the confidentiality agreement to parties, who had to receive it, review it, sign the confidentiality agreement and return it to Jefferies if

Of all the bidders contacted by Jefferies, only two – the Secured Noteholders and D.E. Shaw – have ever visited the "data room" set up by the Debtors. Only Renco and the Secured Noteholders have engaged in substantive negotiations with the USWA.

Jefferies' marketing efforts led to the submission of only two meaningful offers – a bid from Renco and a bid from the Secured Noteholders, the only two parties privy to confidential information that was not included in the IM. (EH Tr. 181-82.)[3]

Steven Strom is a Managing Director and member of the Restructuring Advisory Group at CIBC, the Secured Noteholders' financial advisors. Mr. Strom has significant experience both buying and selling companies, including companies in Chapter 11. (EH Tr.

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they wanted to receive an Information Memorandum ("IM") (EH Tr. 133, 234);
• Upon receipt of the executed confidentiality agreement from the potential purchaser, Jefferies mailed a letter, along with the IM, to such purchaser; the IM included, inter alia, financial projections and analysis, and other financial data. (EH Tr. 133.) In addition to the IM, the Debtors established a "data room" for due diligence by prospective buyers of the Debtors' businesses or assets (EH Tr. 59); and
• The potential purchaser was required to reiterate its interest to Jefferies by no later than February 20, 2004 (EH Tr. 128; 235).

3 On May 6, 2004, two days after exclusivity hearing, Jefferies sent an e-mail to prospective bidders advising that "WCI STEEL HAS HAD SUBSTANTIAL EBITDA IMPROVEMENT OVER THE LAST FOUR (4) MONTHS TURNING FROM NEGATIVE TO POSITIVE RESULTS." (Ex. 52A; Trial Trans. - O'Connor 239-40.) Jefferies also revisited its buyers log and finally did the necessary work to obtain closure on most identified prospects, as Mr. Strom had testified is the appropriate practice. (Ex. 52D, Trial Trans. - O'Connor 245-47.) Mr. O'Connor acknowledged that these steps were taken in response to criticisms of the marketing process. (Trial Trans. - O'Connor 244-45.) However, such steps were clearly a matter of "too little, too late." Given that D.E. Shaw, who had been working to complete its due diligence since February 2004, needed additional time as of July, it is clear that Jefferies' eleventh-hour gestures towards marketing the company after both the Debtors and the Secured Noteholders had already filed competing plans had no legitimate chance of generating serious interest.

28-30.) At the Exclusivity Hearing, Strom testified that in his opinion the IM was designed to discourage and/or depress bidding for the Debtors' assets in the marketplace. (See EH Tr. 67-69.) Among the reasons Strom gave for this opinion are the following:

• The IM's projections of financial results were unrealistically low (EH Tr. 112; Tr. 1065)

• The IM failed to highlight or even properly account for labor savings (EH Tr. 138);

• Jefferies made no attempt to account for the recent dramatic improvement in the steel market, instead using the unrealistically low January 2004 projections (EH Tr. 68-69);

• The time period provided for submitting indications of interest -- less than two weeks -- was unreasonable and inadequate (EH Tr. 60); and

• The "buyers logs" maintained by Jefferies to record interactions with prospective bidders shows that, although Jefferies identified and sent out teasers to many potential strategic buyers and financial sponsors, Jefferies failed to follow up and obtain closure -- i.e., either a bid or an explicit statement of disinterest, preferably with an explanation of why -- on the vast majority of these prospects (EH Tr. 60-65).

The Court finds Mr. Strom's testimony in this regard persuasive.

The Debtors' own steel industry expert, Brett Levy of Jefferies, acknowledged that potential purchasers are well aware of Renco's tax- and pension-related motivations for retaining ownership of WCI and recognized that Ira Rennert would, therefore, be likely to resist any third party efforts to acquire WCI in this bankruptcy case. (Trial Trans. - Levy 538-39, 570-71.) While he was a steel industry analyst at RBC Capital Markets prior to coming to Jefferies in late July 2004, Levy had observed this driving dynamic in the WCI situation in his industry newsletter in a number of reports commenting on the WCI bankruptcy. For example, in a September 23, 2003, report issued on the heels of WCI's bankruptcy filing, Levy wrote that "[a]lthough potential synergies may be meaningful to a strategic acquiror, RBCCM believes Ira Rennert would be loathed [sic: loath] to give up control of WCI Steel." (Ex. 101 at 4).

B. The Debtors' Plan is not Confirmable Because its Distribution of $94 Million in new 9% 10 year notes Does not Comply with the Requirements of § 1129(b)(2)(A).

1. Findings Re: Value of Secured Noteholders' Collateral

B. 3.5 The Debtors' Plan fails to clear the first bar of the confirmation obstacle course because the treatment of the secured portion of the claims of the Secured Noteholders does not offer the current value of the collateral that secures their notes and most holders of the Secured Notes have not consented to that treatment.

With Court approval, the Debtors retained NCC as appraisers. Specifically, the Debtors requested that NCC inspect, evaluate and appraise the Secured Noteholders' collateral in connection with the Debtors' analysis and preparation of a plan of reorganization.

The notes to Debtors' consolidated financial statements for October 31, 2003 (filed on March 12, 2004) state that before retaining NCC to evaluate and appraise the Secured Noteholders' collateral WCI had "compared the estimated undiscounted future cash flows to the carrying value of the [Secured Noteholders' collateral]" as of the Petition Date. (Ex. A at 12.) However, no such written comparison is known to WCI's acting CFO Thomas Gentile (Trial Trans. - Gentile 129), and none has been produced.

An estimate of the future cash flows of the Secured Noteholders' collateral would be materially higher today than as of the Petition Date, given the substantial improvement in WCI's financial performance and the financial outlook since that date.

The Uniform Standards of Professional Appraisal Practice ("USPAP") are a comprehensive set of standards that are promulgated by the Appraisal Standards Board of the Appraisal Foundation and must be adhered to by all certified appraisers (similar to the role of Generally Accepted Accounting Practices for the accounting profession). (Trial Trans. - Connolly 678, 826; Ex. 119.)

Among other things, USPAP requires that a proper plant, property and equipment appraisal report must explain how each of the following three standard approaches to valuation of plant, property and equipment was considered and employed: (1) the "cost approach," which is based upon the assumption that the value of property is equal to the cost of reproducing or replacing the assets, less an allowance for physical deterioration and functional and economic obsolescence; (2) the "income approach," which is based on the economic proposition that the value of income-producing assets is equal to the present value of the income they generate; and (3) the "market approach," which compares the value of the subject property to recent sales of similar items, making various adjustments as appropriate. (USPAP Standard 8(b)(ix); *see generally* American Society of Appraisers *Valuing Machinery and Equipment* at 68-69 (2000) (the "ASA Treatise") (excerpts of which are Ex.118); Ex. 117 Tab C at 10-11 (Connolly PP&E Appraisal, discussion of valuation methods); Ex. 112 at 36-38 (Accuval report, general discussion of valuation methods (with a far more detailed

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discussion on the following pages); Trial Trans. - Connolly 677-78.)[4]

At the confirmation hearing there was extensive testimony concerning the differences between "bottom up" and "top down" appraisal approaches. (*E.g.*, Trial Trans. - Connolly 793-94 and 924-25; Trial Trans. - Schmitt 1318.) The "bottom up" approach, purportedly used by Connolly, values machinery and equipment on a piece-by piece basis, then adds up the totals.

a.) The Debtors' Collateral Valuation

NCC performed its appraisal by separately appraising the fair market value of the real property and the "fair market value in continued use" of the steel mill equipment. The equipment was appraised on an itemized basis, piece by piece, even though WCI is a fully integrated steel mill on which the Secured Noteholders hold a blanket lien and security interest.

NCC prepared four separate appraisal reports with an effective date of September 16, 2003, the Petition Date, including a single appraisal report for WCI's real property that included values on forced liquidation, orderly liquidation and fair market value bases (Ex. 117 Tab B), as well as three reports for WCI's personal property on each of those three bases (Ex. 117 Tab C). Under the Debtors' Plan, the reorganized debtor would use the Secured Noteholders' collateral in its ongoing business that is projected to be highly profitable. Therefore, only the appraisals on a fair market value in continued use basis are relevant here.

(i) The absence of support for Connolly's appraisal

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4 The ASA Treatise is a comprehensive discussion of the appraisal of machinery and equipment that both appraisal experts accept as authoritative. Connolly claims partial authorshipcredit for this work. (Trial Trans. - Connolly 799-800.)

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The narrative portion of NCC's appraisal report addressing the fair market value in continued use for the PP&E consists almost entirely of boilerplate that appears to be the standard language generically used by NCC in reports of this nature. (Ex. 117 Tab C, first document). Contrary to the requirements of USPAP, nothing in this section explains how each of the three approaches were considered, which of the approaches was utilized, and why. (Ex. 117 Tab C, first document, at 10-12). For example, the entire discussion of the income approach reads as follows:

> **INCOME APPROACH** - Capitalization of the net income that the item can produce. This approach, of course, is used in special cases when no sales comparison is available for adjustment to the subject. It would be used only on significant items and detail is not usually made a part of the report.

(Ex. 117 Tab C, first document, at 11.) In this introductory material which should serve as a guide to the report, the reader is not informed that the income approach was *not* used, nor is any further explanation offered as to why that approach was not employed in NCC's assignment.

During his testimony, Connolly noted that, in a section headed "**INFORMATION ANALYZED**," there is a single sentence which states "[t]he income approach, although considered, was not applied." (Ex. 117 Tab C, first document, at 8; Trial Trans. - Connolly 682-83.) This oddly placed disclosure still leaves unanswered *why* the income approach "was not applied." Although he admitted that appraisal reports are supposed to be written for a lay reader, Connolly claimed that no explanation was necessary because "[a]nybody with knowledge in the steel industry" would realize that it is not possible to attribute income to specific pieces of equipment. (Trial Trans. - Connolly 841-44.) When the collateral that is being appraised is a fully integrated steel mill, a failure to apply the income approach must, at a minimum, be clearly explained and fully justified. Apparently Connolly could provide no such justification, so he simply omitted any explanation for his failure to apply this approach.

There is a far greater problem with his appraisal: reasoning and data supporting his valuation are not found *anywhere* in either his reports or his backup files. USPAP is unambiguous about the ethical obligations of an appraiser to document the bases for his or her conclusions:

Record Keeping

> An appraiser must prepare a workfile for each appraisal, appraisal review, or appraisal consulting assignment. The workfile must include:
>
> • the name of the client and the identity, by name or type, or any other intended users;
> • true copies of any written reports, documented on any type of media;
> • summaries of any oral reports or testimony, or a transcript of testimony, including the appraiser's signed and dated certification; and
> • a*ll other data, information, and documentation necessary to support the appraiser's opinions and conclusions* and to show compliance with this Rule and all other applicable Standards, or references to the locations of such other documentation. ....
>
> Comment: A workfile preserves evidence of the appraiser's consideration of all applicable data and statements required by USPAP and other information as may be required to support the appraiser's opinions, conclusions, and recommendations. For example, the content of a workfile for a Complete Appraisal must reflect consideration of all USPAP requirements applicable to the specific Complete Appraisal Assignment.

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(USPAP Ethics Rule (Ex. 119) (emphasis added).[5]

Connolly's violation of this requirement (which is duplicative of the requirement of Fed. R. Civ. P. 26(a)(2)(B)) that an expert must disclose "all opinions to be expressed and the basis and reasons therefor" as well as "the data or other information considered by the witness") renders his opinion useless. His entire workfile is a stack of paper approximately four inches high, three-quarters of which are photo indices and equipment inventories provided by WCI. (Ex. 76.) The remaining inch or so constitutes the entirety of NCC's work papers. (Ex. 76 Tab A; Trial Trans. - Connolly 847.) And, as already noted, nothing in these workfiles shows how Connolly derived a single figure in his appraisal report.

(ii) The "shadow appraisal" revealed in NCC's workfile

To the contrary, NCC's workfiles consist almost entirely of a set of spreadsheets containing dictation notes and handwritten calculations that indicate far higher values for each major equipment grouping than what is reflected in Connolly's report. Taken together, these papers appear to reflect a "shadow appraisal," the results of which Connolly rejected completely without explanation. Much of the work on this shadow appraisal was performed by Les Miles, a qualified and experienced appraiser in his own right who actually devoted far more time to the WCI assignment than Connolly. Miles is an accredited machinery and equipment appraiser and a co-author of the ASA Treatise, and he teaches ASA courses on cost

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5 *See also* Trial Trans. - Connolly 845 (agreeing that "all of the reasoning and data" underlying an appraisal must be contained either in the report or in the workfile); American Society of Appraisers Code of Ethics 4.4 (Ex. 77) ("When a member accepts employment to make an appraisal, or to testify as to value of property before a court of law . . . , the appraiser shall, before testifying, complete an adequate written appraisal report, or have complete documentation, and substantiation available in his files.").

basis valuation. (Trial Trans. - Connolly 823-25). While Connolly spent approximately a day and a half at WCI in connection with the appraisal, Miles spent well over a week. (Trial Trans. - Connolly 823.)

USPAP requires that all appraisal reports must be signed and include a certification that "[n]o one provided significant professional assistance to the person(s) signing this report." (USPAP 8.3 (Ex. 119); Ex. 117 Tab C, first document at 57; Trial Trans. - Connolly 826-27.) Miles did not sign the NCC report, and his involvement was not disclosed. (Trial Trans. - Connolly 827-28.) Connolly attempted to justify this omission by saying that Miles "did not give me significant assistance, professional assistance" because "his scope on this assignment was to list the equipment and verify the list, give me his initial indication what the condition was." (Trial Trans. - Connolly 827.) However, NCC's workpapers show that Miles actually did far more than Connolly described, but that Connolly rejected all of Miles' input and then chose not to disclose that such input was provided. (Ex. 76 Tab A.)

Most of the spreadsheets in NCC's workfile bear initials ("LES") denoting that Miles dictated those transcribed materials. (Trial Trans.- Connolly 860-61; Ex. 76 Tab A.) Connolly admitted on cross-examination that numerous portions of these spreadsheets reflect Miles' effort to quantify the elements necessary to perform a cost-basis valuation of various pieces of equipment. (*E.g.,* Trial Trans. - Connolly 865-68.) Somebody at NCC subsequently took the information from Miles' dictation and performed the appropriate cost-basis calculations. (*Id.*). The results are impossible to reconcile with the figures Connolly decided to place in his report, and nothing in the workfile actually supports Connolly's figures.

For example, Connolly values WCI's blast furnace -- obviously an extremely important and valuable part of the PP&E -- at $7,515,000. (Ex. 117 Tab C, first document at 22 & 52.) He admits that nothing in the appraisal report shows how that figure was derived or what method was used. (Trial Trans. - Connolly 863-64.) As noted above, Connolly maintains that the report informed readers that the income approach was not used, but admits the report does not tell the reader whether either the cost approach or the market data approach were used. (Trial Trans. - Connolly 864.) The spreadsheets in NCC's workfile do, however, include three pages relating to the blast furnace (Ex. 76 Tab A at JCC 00167-69.), including the following dictation notes from Miles:

> NOTE TO MARKET ANALYST -- THERE IS $100.0 MILLION AT COST. . . . THEY DO APPROX. $(sic)1.0 MILLION TONS/YR. FOR PURPOSE OF CALCULATING ON THE PHYSICAL DEPRECIATION. ESTIMATING PHYSICAL DEP. IN APPROX. 55%. 10% FUNCTIONAL WHICH WE WILL NEED TO CHECK. IT IS INDICATED THAT THE FUNCTIONAL OBSOLESCENCE IS NIL AS THEY ARE PRETTY WELL STATE OF THE ART WITH WHAT THEY HAVE DONE & UPGRADED TO.

(*Id.* at JCC000168.) The same page contains handwritten notes[6] that Connolly acknowledges represent a calculation of cost-basis value working from Miles' notes:

> 100 mil [$100 million replacement cost per Miles]
> 55% 45 mil. [Miles' physical depreciation]
> 10% 40.5 mil. [Miles' functional obsolescence] [7]
> 50% 20.250 [an economic obsolescence figure, see below]
> say 20 mil. [rounding]

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[6] Connolly said that he did not know who had written the notes.

[7] Functional obsolescence is the diminution of the utility of a piece of equipment based on physical characteristics of such equipment that render it less desirable than a new replacement(e.g., the equipment does not incorporate state-of-the-art technology). (Trial Trans. - Connolly 867.)

(*Id.*; Trial Trans. - Connolly 867-68.) On the following page, the typed "Category Total" in the column under fair market value is "$55,000,000.00" (Connolly never explained the source of that figure); the same handwriting that appears on the prior page has crossed out that figure, written the $20,000,000 figure derived through Miles' cost approach, and highlighted the figure in orange. (Trial Trans. - Connolly 895.) It thus appears that Les Miles and others at NCC used the cost approach to estimate the value of the blast furnace at $20 million, far higher than the $7,515,000 value Connolly used in his appraisal.

The spreadsheets reveal a similar status with respect to the valuation of virtually every category of PP&E at WCI. The following chart sets the cost approach valuations of some of the major categories as shown in NCC's workfile (all of which had been highlighted with orange marker), compared with the values Connolly used in his report:[8]

Item	**Workfile Value**	**Value Used by Connolly**
Blast furnace	$20 million	$7,515,000
Basic oxygen furnace	$15 million	$5,016,000
Continuous caster	$50 million	$23,032,000
Hot strip mill	$50 million	$20,109,000
Power facility	$19 million	$6,507,000
TOTAL	$154 million	$62,179,000

A review of the spreadsheet in the workfiles shows that similar disparities exist for every category of PP&E. (*Compare* Ex. 76 Tab A *with* Ex. 117 Tab C, first document at 52.)

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8 This chart is similar to the demonstrative exhibit introduced by the Secured Noteholders during the cross-examination of Connolly (Ex. L), differing primarily in that rounding of the figures in Connolly's report has been eliminated.

If all categories were totaled, the results of Miles' "shadow appraisal" would be very close to Accuval's $184 million figure (as well as to the $185,433,000 figure that was carried on WCI's books before Debtors wrote down PP&E based upon Connolly's appraisal (Ex. A at 14)).

(iii) Connolly's "overall depreciation" argument

Each of the cost approach calculations in NCC's workfile includes a sizeable discount -- 50% -- for economic obsolescence. (*E.g.*, Trial Trans. - Connolly 902, 906-07. Economic obsolescence represents factors negatively impacting the value of an asset that are extrinsic to the asset itself, such as reduced demand for the product the asset produces. (Trial Trans. - Connolly 868- 69.) There are numerous methods for estimating economic obsolescence, none of which are explained in Connolly's report or shown in the workfile. Such omission is a plain violation of USPAP. (Trial Trans. - Connolly 878-79).

Connolly testified that he had calculated an implicit "overall depreciation" figure based upon the sale of all of the assets of LTV Steel (the "LTV 2 sale"), as well as certain "other references out there," (only one of which he identified) and applied a figure of 97.8% to all of WCI assets. (Trial Trans. - Connolly 876-79, 885-88.) Connolly acknowledges that nothing in his workfile describes or illustrates this "overall depreciation" approach. (Trial Trans. - Connolly 879.) He admited that none of the data purportedly used in this approach was included in the workfile. (Trial Trans. - Connolly 880).

Connolly's assumption that one could appropriately look to the LTV II transaction as a basis for determining the value of the PP&E ignores (or shows a misunderstanding of) the obvious difference in the disposition of the assets in the two situations. LTV II involved the sale of assets that were no longer operating, so these assets were not sold as a going concern. LTV II was a forced liquidation and bears no resemblance whatsoever to future utilization of the PP&E as contemplated in the Debtors' Plan. (*See* ASA Treatise (Ex. 118) at 144: "Differences in perceived profitability are crucial and often explain the large differences in the selling prices of ostensibly comparable facilities.") The use of the LTV II transaction as the primary point of reference in the NCC report is not the work of a neutral bringing expertise to the court, but a cynical effort to justify the economic terms that the Debtors intended include in their plan.

(iv) Connolly's unsupported valuation update

In any Chapter 11 plan, the Secured Noteholders are entitled to the current value of their collateral as of the effective date of that plan. Connolly's original appraisals valued the PP&E retrospectively as of the Petition Date, September 16, 2003. In an apparent effort to rectify this problem, Debtors asked Connolly to update his valuation to June 1, 2004 which he purported to do through the "Connolly Update." (Ex. 117 Tab D). In light of all of the other deficiencies in the Debtors' evidence on the value of the collateral securing the Secured Notes, the fact that June 1, 2004 was not the effective date contemplated in the Debtors' plan is simply one additional reason for the uselessness of the "Connolly Update." (Trial Trans. - Connolly 784). Connolly has not done any work to appraise WCI property as of any subsequent date. (Trial Trans. - Connolly 930.) Even if a valuation as of June 1, 2004 could be deemed adequate proof of the value of the Secured Noteholders' collateral as of the effective date of the Debtors' Plan, the Court finds that the Connolly Update is entitled to no more weight than his initial appraisal – that is, none.

The Connolly Update consists of a five-page letter accompanied by twelve pages of backup materials, which Connolly identifies as the entirety of his workfile on that assignment. (Trial Trans. - Connolly 930.) This "workfile" consists entirely of documents provided to Connolly by WCI relating to the blast furnace reline. "The subject facility was not revisited for the assignment." (Ex. 117 Tab D at 4.) Of the five pages in the Connolly Update itself, three pages are boilerplate repetition of value concept definitions and two pages are devoted to a discussion of the blast furnace reline project, followed by a conclusory assertion:

> The author has reviewed and analyzed those estimated expenditures [for the reline] and combined with the material analyzed and reviewed for the original appraisal reports . . . conclude the following value ranges for the real estate and personal property (machinery and equipment) as of June 1, 2004: . . . Fair Market Value: $100,000,000 to $110,000,000

(*Id.* at 5.) No further explanation is given as to how these figures were derived, and Connolly offered no explanation at the hearing.

Connolly thus increased his initial $94 million valuation of PP&E by between $6 and $16 million, with this increase apparently representing solely the impact of the $30 million reline project. (Trial Trans. - Connolly 930-31.) He made no attempt to reconsider the rate of economic obsolescence, the positive effect of the reline on productivity, or take into account the dramatic improvement in the Debtors' operating results and the dramatic change of fortunes in the American steel industry generally since the Petition Date (Trial Trans. - Connolly 935), despite his conclusion that the high level of "overall depreciation" he had attributed to the Debtors' assets was due, at least in part, to his perception of the depressed state of the steel industry when the appraisal was initially conducted. (Trial Trans. - Connolly 875.)

On cross-examination, Connolly asserted his decision not to revisit his overall depreciation approach was justified because "[i]f it's a temporary situation, you do not take it into consideration. I did not analyze whether it was temporary or long term." (Trial Trans. - Connolly 935.) This attitude cannot be reconciled with Connolly's purported use of the LTV II transaction -- which occurred during a "temporary" weak steel economy -- as a benchmark for valuing the PP&E under very different circumstances.

The Debtors' Plan does not give the Secured Noteholders credit for the $6 to $16 million increase in valuation reflected in the Connolly Update under the Debtors' Plan, allowing only $94 million in New Notes on the Class 2 Claims. The Debtors apparently maintain that this increase should not be included within the Secured Noteholders' Collateral because it is the purported result of a post-petition capital project. The evidence left open the issue of whether the reline is ordinary scheduled maintenance necessary to preserve the existing blast furnace or is a post-petition capital project which may be surcharged against the Secured Noteholders pursuant to § 506(c). Caine testified that a blast furnace must be relined every seven to ten years in order to preserve its useful life. (Trial Trans. - Caine 82-83.) WCI historically scheduled relines approximately every seven years, and had originally scheduled the reline in question to occur in 2002. (Trial Trans. - Caine 93; *see also* Ex. 117 Tab D, first letter attachment (Capital Appropriation Request for the reline dated 1/25/01).) During 2002, WCI took steps to begin the reline process, including purchasing specially-formed bricks at a cost of $2 to $3 million. (Trial Trans. - Caine 83.) The reline was postponed due to WCI's ensuing financial difficulties. Notwithstanding the unresolved § 506(c) issues and regardless of whether the cost of the reline may properly be surcharged against the Secured Noteholders' collateral, the $2 to $3 million worth of bricks overlooked by NCC during its original appraisal, should have been included in the value of the Secured Noteholders' collateral. (Trial Trans. - Connolly 933-34 ("Didn't pick them up, sir.").)

The Court finds that NCC's appraisal is severely undermined by, *inter alia,* the shadow appraisal that appears in NCC's workfile. However, the Court does not find that the shadow appraisal, is itself, affirmative record evidence of the value of the PP&E.

C. The Debtors' Plan Unfairly Discriminates Against the Secured Noteholders in Violation of § 1129(b)

2. Conclusions of Law

c.) Gerrymandering

Section 1122(a) of the Bankruptcy Code permits a plan proponent to place a claim in a given class "only if such claim or interest is substantially similar to the other claims or interests of such class." 11 U.S.C. § 1122(a). While the terms of the statute expressly bar similar classification of dissimilar claims, the statute has repeatedly been interpreted also to require that "similar claims may not be separately classified solely to engineer an assenting impaired class" for purposes of invoking the cramdown provisions of § 1129(b). *Boston Post Rd. Ltd. P'ship v. F.D.I.C. (In re Boston Post Rd. Ltd. P'ship)*, 21 F.3d 477, 482 (2d Cir. 1994); *accord, e.g., Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1279 (5th Cir. 1991) ("thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan"); *Travelers*

Ins. Co v. Bryson Props. XVIII (In re Bryson Props., XVIII), 961 F.2d 496, 502 (4th Cir. 1992) (separate classification of similar claims allowed only "for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims"); *In re Silberkraus*, 336 F.3d 864, 867 (9th Cir. 2003) (affirming denial of confirmation of plan which "impermissibly gerrymandered [two] unsecured claims into a separate class from the other general unsecured claims").

The Sixth Circuit's decision in *U.S. Truck* is controlling authority on the issue of gerrymandering. As the Sixth Circuit has explained, the policy barring the gerrymandering of claims is straightforward: in its absence, "[t]he potential for abuse would be significant." *In re U.S. Truck Co.*, 800 F.2d 581, 586 (6th Cir. 1986). "Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class." *Id.* For this reason, "[t]o justify a separate classification, the debtor must prove that there is a legitimate business reason supporting the classification" independent of its desire to manipulate creditor voting to arrange an impaired accepting class. *See, e.g., In re Boston Post Rd. Ltd. P'ship*, 21 F.3d at 483.

The Sixth Circuit upheld the classification of the dissenting Teamsters Committee's unsecured claim in a different class than unsecured trade creditors generally, on the ground that the Teamsters had different rights, remedies and interests in connection with the debtor. Here, as found above, there is no difference between the rights, remedies and interests with WCI of the Class 7 versus the other (Class 4 and 5) unsecured creditors.

Further the U.S. Truck plan provided the same treatment for the Teamsters' Claim voting "no" in Class IX as it did for other general unsecured creditors voting "yes" in Class XI. *See* Article II of the Fifth Amended Plan of Reorganization attached as Exhibit A to the District Court's opinion in *In re U.S. Truck*, 47 B.R. 932 (E.D. Mich. 1985). The Sixth Circuit indirectly refers to this important fact. *See In re U.S. Truck*, 800 F.2d 581, 586, n.9:

> We are unaware of any cases that deal with this problem as it arises in this case.[9]
>
> [9] In those cases where the courts have held that, as a general rule, similar claims need not be classified together, the debtor had not created the separate classes for the purpose of assuring acceptance . . . and the allegedly similar claims were treated differently under the plan. . . . In those cases where the courts have held that similar claims must be classified together, they have often faced problems of discriminatory treatment.

Under these standards, the Debtors' Plan impermissibly seeks to gerrymander an impaired accepting class and thus cannot be confirmed. There is no distinction between the interests and rights of the unsecured creditors, but the Debtors' Plan, unlike the plan confirmed in U.S. Truck, treats the Class 7 creditors in a sharply different manner from the other unsecured claim classes of Class 4 (paid 85%) and Class 5 (paid 50%).

U.S. Truck thus does not support the Debtors' classification scheme. The Debtors' scheme lacks any business justification for placing unsecured creditors in separate classes. The sole reason the Debtors offered for separate classification was that enhanced treatment of the Class 5 vendors was required to obtain "beneficial" terms from those vendors post-petition. But, as explained above, the evidence failed in any way to support this explanation. Furthermore, WCI's Plan does what U.S. Truck condemns: it offers favorable treatment to creditors who vote "yes", and unfavorable treatment to the Secured Noteholders voting "no".

It is the Debtors' burden to justify separate classification. In the absence of a legitimate business reason, the explanation for the separate classification of these claims becomes clear. Had the "Continuing Vendors" remained in Class 7 with the other trade and unsecured creditors, their assenting votes could not have carried the class over the contrary votes of the Secured Noteholders' deficiency claim. Thus, the Debtors manufactured a class of trade creditors based on a rationale unsupported by their actual business and then purchased those creditors' votes with an unnecessarily rich distribution. Settled law dictates that such gerrymandering violates § 1122(a) of the Bankruptcy Code. Class 5 therefore cannot constitute an impaired accepting class for purposes of § 1129(a)(10).

M Shea-Stonum
Marilyn Shea-Stonum
United States Bankruptcy Judge