# Valuation Methods in Bankruptcy

# Idearc and Other Valuation Cases of Interest


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# Valuation 101: Critical Component in the Chapter 11 Process

- Valuation is the central aspect of corporate finance.
- Nearly every aspect of capital markets analysis is driven by valuation of companies and their securities.
- Valuation requires the interpretation of information and the application of sound judgment.
- A delicate balance of science and art.
- Valuation is critical to many elements of the restructuring/Chapter 11 process, and the importance of difficult valuation issues have increased in the current financial environment.
  - Assessing adequate protection.
  - Evaluating use of property and cash collateral.
  - Lien priming when obtaining credit.
  - Relief from automatic stay.
  - Plan confirmation and numerous 1129(b) determinations including, inter alia; enterprise valuation; 1129(b)(2)(A) “cram-up” of secured debt; valuation of reorganized securities; “cram-down” under 1129(b)(2)(B)(i).
  - Bankruptcy litigation.
- Faced with a dizzying level of capital structure complexity, bankruptcy judges face the responsibility of assessing increasingly difficult and complex valuation issues.
- Historically, the relative dearth of large commercial bankruptcy cases coupled with the vibrancy of the capital markets have reduced the “tough calls” bankruptcy judges have traditionally been called on to make.
- Recent trends have brought this to an end, as there has been a flood of bankruptcy cases, with a plethora of constituencies disappointed by the market seeking relief before the Bankruptcy Court.
- The smaller business cases, which usually have very limited access to the capital markets, pose particularly difficult issues for a judiciary concerned with reaching equitable results.
- For larger deals with complex and often unseen financial relationships and structures, bankruptcy judges are faced with an unprecedented number of hard, big-money decisions.

# Valuation 101: Fair Market Value May Not Always Be "Fair"

- Let's start with the concept of fair market value.
- Recognize that we only *KNOW* fair market value ("FMV") for one instant in time – when an informed buyer and seller, neither under any "compulsion" to effect a transaction, agree to a deal at some price. This is the generally accepted rubric in the financial world defining FMV.
- This momentary valuation epiphany lasts for only one point in time, as evidenced by deals where buyers walk or want to walk away a short time after an agreement at FMV had been reached.
- The counterintuitive irony is that at the one point in time when we see FMV, there is an agreement on price, but a DISAGREEMENT on value. That is, the buyer thinks it's worth more, the seller thinks it's worth less, and that is why they agree to the deal.
- Moreover, at the initial stages in changing financial times, sometimes there is NO price where "non-compelled" buyers and sellers will willingly transact. Markets have "seized up" – buyers believe things will go lower, and sellers refuse to accept the reality that prices have fallen – sometimes dramatically.
- The experiences in the economic downturn of SIVs (Structured Investment Vehicles) vainly trying to sell components of their sub prime – derived portfolios at "fair prices," and the ill-fated attempt of the major banks and the treasury to create the "Super Conduit" to remedy this market failure provides one example of a market "seizure." In retrospect, the fact that SIVs could not get "fair" prices for even their AAA securities in late 2007 was because the market correctly anticipated that things were much worse than the SIVs wanted them to be.
- So FMV valuation is always an ESTIMATION in the absence of an actual transaction. It is not a guess, but a reasoned application of analysis to the correct facts leading to an informed substantiated opinion.

# Common Valuation Methodologies

- Valuing an operating business is a complex exercise. The ONLY thing we know here is the risk-free rate; everything else is up for grabs (analytically speaking).
- Three methods are commonly utilized in a traditional valuation analysis:

**Comparable Company Method ("Comps")**

A public "marketable" valuation determined on the basis of certain key ratios, or "market multiples" of revenues, net income, EBIT, or EBITDA for comparable public companies

**Comparable Transaction Method ("Deals")**

A control or transaction valuation determined on the basis of multiples of revenues, net income, EBIT, or EBITDA for comparable companies which have recently been acquired

**Discounted Cash Flow Method ("DCF")**

The company's projected future free cash flows discounted to the present date at an appropriate risk-adjusted discount rate (often the weighted average cost of capital or WACC)

**Estimate of Company Value**

# Comparable Company Method: Pros and Cons

- Premise: The value of an investment asset can be estimated by examining the prices that rational investors are currently "paying" for similar assets – stock trading in an active market represents these "purchase" transactions of "marketable minority interests" in companies.
- There are five key steps to the comparable company method, as follows:
  1. Determining representative levels ("rep levels") for the subject company.
  2. Selecting comparable public companies to be used for comparison purposes.
  3. Performing a comparative analysis of the subject and the comparable public companies.
  4. Selecting appropriate market multiples for the subject company.
  5. Determining the subject company's value or equity value.

| Pros | Cons |
|---|---|
| ■ Reflects investor sentiment towards the relevant industry at the time of the observed transaction<br>■ Allows direct measurement of control value<br>■ Based largely on reported/audited results – not highly dependent on assumptions and projections<br>■ Widely recognized by investors and courts | ■ The most unreliable method for periods of dramatic change and high market volatility<br>■ Prices paid may include strategic price premium<br>■ Limited relevance for unprofitable companies<br>■ Information is often limited and incomplete<br>■ Requires adjustment for leverage<br>■ Often requires adjustments for liquidity, control, and idiosyncratic transfers of value |

# Comparable Transaction Method: Pros and Cons

- Premise: The value of an investment asset can be estimated based on the prices that acquirers have recently paid for similarly situated assets in change-of-control transactions. This method yields a control value Enterprise Value.
- There are five key steps to the comparable transaction method, as follows:
  1. Determining representative levels for the subject company.
  2. Selecting comparable transactions to be used for comparison purposes.
  3. Performing a comparative analysis between the subject and the comparable transactions.
  4. Selecting appropriate transaction multiples for the subject company.
  5. Determining the subject company's Enterprise Value.

| Pros | Cons |
|---|---|
| ■ Reflects investor sentiment towards the relevant industry at the time of the observed transaction<br>■ Allows direct measurement of control value<br>■ Based largely on reported/audited results – not highly dependent on assumptions and projections<br>■ Widely recognized by investors and courts | ■ The most unreliable method for periods of dramatic change and high market volatility<br>■ Prices paid may include strategic price premium<br>■ Limited relevance for unprofitable companies<br>■ Information is often limited and incomplete<br>■ Requires adjustment for leverage<br>■ Often requires adjustments for liquidity, control, and idiosyncratic transfers of value |

# The DCF Method:
# Earning Capacity and Cash Flows

- We measure the value of any asset by measuring the present value of the cash flows projected to arise from that asset.
- The present value of all the streams of cash to be generated by the asset in question represents the value of that asset.
- The financial world is in accord with the bankruptcy courts on this issue as first set forth by the Supreme Court in <u>Consolidated Rock Products v. Dubois</u>, 312 U.S. 510, 525(1941), which held that future earning capacity of the enterprise is the appropriate criterion for the determination of solvency in connection with reorganization plans involving productive properties; valuations for other purposes are not relevant to that issue except as they may indirectly bear on earning capacity. This principle has been elaborated upon by scores of subsequent bankruptcy decisions.
- Therefore, to value any asset, building, or company – anything of productive capacity – in this framework, we need to assess:
  - The projected size of the cash flow streams;
  - The projected timing of these streams;
  - The risk premium applicable to the particular cash flows (which we add to the prevailing risk free "cost" of borrowed money for the period co-terminus with the flows). Adding these two values yields the discount rate.
- There are many variations on valuation approaches, but this DCF methodology is often most reflective of FMV, particularly in a Chapter 11 setting given the reorganization "fresh start" process and philosophy. We look to the future, rather than history, to assess value.`

# The DCF Method: Applying the Three Factors

- We will continue to focus on the DCF method and apply our three factors to a reorganizing operating business, where subjective analysis is required for each factor.
- ***Magnitude of Cash Flows*** – this requires a subjective assessment of the company's future prospects, strategies, spending plans, and a broad array of business, financial and competitive factors for even the most established of enterprises. In Chapter 11, the challenge of creating credible and dependable projections is all the greater. An entire session could be devoted to some of the issues faced in vetting a projection particularly in deteriorating market environments.
- ***Timing of Cash Flows*** – same projection issues as above, complicated for situations in which it is unclear when the company will be emerging from Chapter 11 (for example, valuing a company at the beginning of a case in connection with a priming, cash collateral or adequate protection battle). We also face the same issues in determining the terminal value, which is a key driver of overall value.
- ***Risk Free Rate Plus Appropriate Risk Premium*** – This gets a little – no a lot – complicated. There are a host of subjective factors and objective analyses involved in deriving the special discount rate we utilize in this context which we term the WACC (weighted average cost of capital). The method analyzes the distinct components of a "typically" leveraged company of this type and assesses the specific costs of each of those components (debt and equity). It then tax adjusts and "weighs" these components and arrives at a single discount rate.

# The DCF Method: Pros and Cons

| Pros | Cons |
|---|---|
| ■ Theoretically, the most sound valuation method<br>■ Less influenced by market volatility<br>■ Forward-looking<br>■ Based on economic cash flow rather than accounting earnings<br>■ Allows future expected operating strategy to be incorporated into the model<br>■ Separate valuation for tax shield/NOLs | ■ Based on inherently subjective and potentially unreliable projections; must understand the potential biases and motivations of the projectors, and also beware of the Garbage In/Garbage Out phenomena when the underlying facts and assumptions are highly uncertain or unclear<br>■ Sensitivity to a few key assumptions (e.g., projections and discount rate)<br>■ Limited relevance for early stage companies<br>■ Theoretical and highly sensitive to assumptions<br>■ Terminal value often represents a significant portion of total value<br>■ Material distortions if terminal year and/or terminal multiple unreasonable or unwarranted<br>■ WACC has inherent limitations:<br>● Assumes constant capital structure<br>● Does not necessarily reflect projection risk |

# The DCF Method: Information Required

| Required Information | Key Inputs | Typical Sources |
|---|---|---|
| Free Cash Flow Forecasts | ■ Revenue growth<br>■ Profitability margins<br>■ Capex and working capital<br>■ Tax rate | ■ Created by the Debtor’s management and advisors, and typically based upon present and projected industry data, historical financial performance and future operating strategy, a macro outlook for the industry and the economy at large. |
| Terminal Value | ■ Exit multiple or<br>■ Perpetuity growth rate | ■ Comparable companies/transactions<br>■ Industry reports/reasoned judgment |
| Discount Rate – WACC | ■ Beta<br>■ Risk-free rate<br>■ Equity risk premium<br>■ Cost of debt and preferred<br>■ Targeted capital structure | ■ Bloomberg, Capital IQ, Barra<br>■ 20-Year U.S. Treasury Bond yield<br>■ Ibbotson Associates<br>■ Bloomberg, 10-K, current trading price/yield of existing debt<br>■ Existing capital structure, comparable companies |

# Bankruptcy Valuation Generally

- Bankruptcy Code § 506. Determination of secured status

  **(a) (1)** An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. ***Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.***

# Stages of Valuation in Bankruptcy

- Adequate protection against diminution in value.
  - Use/lease of property/cash collateral.
  - DIP financing/priming issues.
  - Automatic stay/delay.
  - Replacement liens, cash, indubitable equivalent, not administrative claim.
- Post-petition interest.
- Plan confirmation.
- Bankruptcy litigation.
  - Automatic stay…equity in the property.
  - Preference actions…insolvency.
  - Fraudulent transfer actions…insolvency…inadequate capital.

# Section 363: Adequate Protection for Use, Sale, or Lease of Property

- During a case, collateral may depreciate as a debtor continues to utilize the property for the benefit of the estate.
- "Adequate protection under § 363  is a function of preserving the value of the creditor's secured claim as of the petition date due to a debtor's continued use of collateral." *In re Nice*, 355 B.R. 554, 563 (Bankr. N.D. W. Va. 2006).
- Creditor is entitled to amount that represents the difference between the date of the filing and the date of the hearing. *See e.g. Oriz Credit Alliance*, *Inc. (In re Delta Resources, Inc.)*, 54 F.3d 722, 729-30 (11th Cir. 1995).
- Property will likely to be valued at fair market value. *See e.g.*, *Salyer v. SK Foods, LP. (In re SK Foods, L.P.)*, 2011 U.S. Dist. LEXIS 76467, 29-30 (E.D. Cal. July 8, 2011).
- The debtor/trustee has the burden of proof under the clear language of this statute. *See* 11 U.S.C. § 363:
  - (p) In any hearing under this section— (1) the trustee has the burden of proof on the issue of adequate protection; and
  - (2) the entity asserting an interest in property has the burden of proof on the issue of the validity, priority, or extent of such interest.

# Section 364(d): Adequate Protection for DIP Financing

- Section 364(d) allows a debtor to obtain post-petition financing pari passu or senior to all other creditors in the case.
- The DIP pari passu lien would be equal to other liens.
- The DIP "priming" lien would be be senior to other liens.
  - Prior liens may be excluded.
- Valuation can be necessary because the debtor must adequately protect the potentially subordinated creditor from damage to their position (i.e. diminution of value) because of the priming lien.
- Value of potentially subordinated secured creditor's interest is determined at the time the chapter 11 petition is filed. *See In re Levitt & Sons, LLC*, 384 B.R. 630, 643-44 (Bankr. S.D. Fla. 2008).
- The value of the interest will most likely be valued at fair market value in a chapter 11 case given that the debtor typically will not be liquidating early in the case.
- Debtor/trustee has burden to prove that potentially subordinated creditors are adequately protected. 11 U.S.C.
  § 364:
  - (d) (1) The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien only if— (A) the trustee is unable to obtain such credit otherwise; and
  - (B) there is adequate protection of the interest of the holder of the lien on the property of the estate on which such senior or equal lien is proposed to be granted.
  - (2) In any hearing under this subsection, the trustee has the burden of proof on the issue of adequate protection.

# Section 362: Adequate Protection for Automatic Stay

- Upon the filing of a bankruptcy case, there is an automatic stay in place which, *inter alia*, precludes/delays creditors from foreclosing their interest in estate property.
- Collateral is valued at or near the time relief is sought. See 3 Collier on Bankruptcy ¶ 362.07[3][b][vi]. pp. 362-91-93 (Alan N. Resnick and Henry J. Sommer eds. Matthew Bender (2004)).
- Fair market value will be used if debtor is reorganizing, liquidation will be used if debtor is liquidating.
- Party moving for relief has burden to prove lack of adequate protection. *See In re Coates*, 180 B.R. 110, 119 (Bankr. D.S.C. 1995). 11 U.S.C. § 362:
  - (g) In any hearing under subsection (d) or (e) of this section concerning relief from the stay of any act under subsection (a) of this section— (1) the party requesting such relief has the burden of proof on the issue of the debtor's equity in property; and
  - (2) the party opposing such relief has the burden of proof on all other issues.

# Section 507: Superpriority Claims for Failure of Adequate Protection

- A creditor may move through 11 U.S.C. § 507(b) to obtain a superpriority expense claim when it has received adequate protection by a court order, but this adequate protection proved insufficient given the value of the property.
  - Often obtained by agreement in the financing order.
- In determining whether a creditor is entitled to claim under § 507(b), collateral must be valued at the time the creditor seeking relief to compare to previous valuation. *Bonapfel v. Nalley Motor Trucks (In re Carpet Ctr. Leasing Co.)*, 4 F.3d 940, 941 (11th Cir. 1993).
- There is a split between courts on valuation methods, with the most recent cases favoring fair market value. *Compare Bank of N.Y. Trust Co. NA v. Pac. Lumber Co. (In re Scopac)*, 624 F.3d 274, 285 (5th Cir. 2010) (fair market value) with *In re Modern Warehouse,* Inc., 74 B.R. 173, 177 (Bankr. W.D. Mo. 1987) (liquidation value) (citing *In re American Mariner Indus.*, 734 F.2d 426, 435 (9th Cir. 1984)).

# Section 506(b): Post-Petition Interest and Fees

- A creditor which is oversecured is entitled to be paid interest and fees provided for in its agreement with the debtor up to the amount of the value of its interest in estate property.
- The period of being oversecured can be temporary, and can occur at a point after the debtor files but before the case is closed. *See In re Geijsel*, 480 B.R. 238, 262-64 (Bankr. N.D. Tex. 2011).
- Valuation date is flexible, depending on what amount of time the movant claims it was oversecured. *TD Bank, N.A. v. Landry*, 479 B.R. 1, 4 (D. Mass. 2012), citing *In re Abdelgadir*, 455 B.R. 896, 902 (B.A.P. 9th Cir. 2011).
- Fair market value will be used if debtor is reorganizing, liquidation will be used if debtor is liquidating. 11 U.S.C. § 506(a).
- Secured creditor has burden on proving that it is oversecured.
  - That is, they must prove that they were oversecured, for how much, and for how long. *Financial Sec. Assur. v. T-H New Orleans Ltd. Pshp. (In re T-H New Orleans Ltd. Pshp.)*, 116 F.3d 790, 798-799 (5th Cir. 1997); *see also*, *In re Heritage Highgate Inc*., 679 F. 3d 132, 140 (3d Cir. 2012).

# Section 1129: Plan Confirmation

- Under § 1129, a debtor may confirm a "cram plan" (whether up (e.g. reinstatement of senior secured debt) or down (modification of the senior secured debt over its objection)), so long as one impaired class has voted to accept the plan of reorganization and the other tests for confirmation are met (e.g. good faith, best interests of creditors, etc.).
- A cram plan must be "fair and equitable." 11 U.S.C. § 1129(b)(2).
- The question of whether a cram plan is "fair and equitable" often involves whether a secured creditor is being provided with the value of its interest in property of the estate.
- Assets are thus valued at time of confirmation. *See e.g.*, *Yaissle v. Unsecured Creditors Comm. (In re Heritage Highgate, Inc.)*, 449 B.R. 451, 456 (D.N.J. 2011).
- Value of debtor will be going concern at fair market value unless the plan is a liquidating plan. *See e.g., In re Cypresswood Land Partners, I*, 409 B.R. 396, 426-427 (Bankr. S.D. Tex. 2009).
- Proponent of plan bears burden of showing that plan pays the value of the creditors' interest in estate property. *See e.g.*, *In re Am. HomePatient, Inc*., 298 B.R. 152, 167 (Bankr. M.D. Tenn. 2003).

# Bankruptcy Litigation Valuation: Section 547 Preferences

- Preferences, under § 547, a trustee can recover the value of transfers that are preferential in that a creditor received more than they would ordinarily have been entitled to under the bankruptcy filing.
- Transfers are eligible to be voided if they were made 90 days before the filing of the bankruptcy while the debtor was insolvent or if made to an insider twelve months before the filing.
- There is a <u>presumption</u> of insolvency if the transfer occurs within 90 days prior to filing the petition.
- Valuation is measured at the date of the transfer but courts often use “retrojection” and “projection” to determine insolvency of debtor. *See In re Bruno Machinery Corp.*, 435 B.R. 819, 838 (Bankr. N.D.N.Y. 2010).
  - **ret·ro·ject;** *verb* \ˈre·trəˌjekt; transitive verb; **:** to project into the past <*retroject* an hallucination into one's childhood>; **ret·ro·jec·tion** *noun* **–s;** source: http://www.merriam-webster.com/dictionary/retroject
- Absent liquidation, generally, fair market value is the valuation basis of the debtor’s assets. *See Briden v. Foley*, 776 F.2d 379, 382 (1st Cir. 1985).
- If debtor is on its “deathbed” at time of transfer, liquidation value should be used rather than going concern or market value. *In re CXM, Inc.*, 336 B.R.757, 761 (Bankr. N.D. Ill. 2006).
- The burden of proof to establish each of the elements of § 547(b) by a preponderance of the evidence rests on the trustee in bankruptcy. *See Cadle Co. v. Mangan* (*In re Flanagan)*, 503 F.3d 171, 180 (2d Cir. 2007).

# Bankruptcy Litigation Valuation: Section 548 Fraudulent Transfers/Strong Arm Powers Section 544

- Section 548 allows the trustee to recover the value of certain qualifying transfers, actual fraud/hinder/delay, and constructive fraud.
- Value is to be determined at the time of the transfer. *See e.g., In re JTS Corp.*, 617 F.3d 1102, 1109 (9th Cir. 2010).
- Courts typically consider the fair market value or what would be the fairly equivalent value of the property, taking into consideration all of the specific circumstances of each case affecting the value of the asset. *In re JTS Corp.*, 617 F.3d 1102, 1109 (9th Cir. 2010).
  - However, if debtor was on its "deathbed" then liquidation value will be used. *See Mishkin v. Ensminger (In re Adler, Coleman Clearing Corp.)*, 247 B.R. 51, 111 (Bankr. S.D.N.Y. 1999).
- Trustee bears burden of proof. *See* e.g., *In re Hannover Corp.*, 310 F.3d 796, 802 (5th Cir. 2002).
- Section 544 strong arm powers and use of state law fraudulent transfer laws present similar issues and process.

# Bankruptcy Litigation Valuation: Section 550 Liability of Transferee for Avoided Transfers

- A trustee, if avoidance is established for a preferential, fraudulent, or otherwise illicit transfer, can recover the value of that transfer from both the initial transferee and any immediate or mediate transferee…subject to a single recovery, and different tests for initial vs. immediate or mediate transferees.
- Value is typically determined at time of transfer. *USAA Fed. Savings Bank v. Thacker (In re Taylor)*, 599 F.3d 880, 890 (9th Cir. 2010). Nonetheless, timing of valuation should "depend[] upon the circumstances of each individual case." *In re Integra Realty Resources, Inc.*, 354 F.3d 1246, 1267 (10th Cir. 2004).
- Value for determining amount that may be recovered under Bankruptcy Code § 550 generally will be based upon fair market price (absent deathbed dynamics). *See, e.g., Active Wear, Inc. v. Parkdale Mills, Inc.*, 331 B.R. 669, 673 (W.D. Va. 2005).

# Market Influence on Valuation

- ***U.S. Bank N.A. v. Verizon Comm. Inc., No.10-01842, (N.D. Tex. Jan. 22, 2013)…Idearc.***
  - Verizon spun off its print and internet yellow pages company into a new publicly traded entity called Idearc, Inc. ("Idearc"). Pursuant to the spin-off, Idearc transferred nearly $2.5 billion in cash, much of it raised from bondholders, to Verizon Financial Services and took on $9 billion in debt in excess of assets.
  - Litigation trustee brought fraudulent transfer claims against Verizon.
  - The court disagreed with the Trustee's expert's rejection of market evidence and position that market participants had over-valued Idearc because of various misrepresentations and omissions made by Verizon. The court held that the market's valuation of Idearc was reliable.
  - The court also rejected the Trustee's expert's heavy reliance on a DCF analysis that yielded a significantly lower valuation than the other methodologies.
- ***In re Mirant Corp.*, 334 B.R. 800 (Bankr. N.D. Tex. 2005)**
  - The court noted that the taint of a bankruptcy may reduce the usefulness of post-petition trading prices of a bankrupt debtor's publicly traded securities as an indication of value.
  - The court also discussed the "inherent subjectivity" in valuation and the potentially "perverse incentive structure" created by parties paying their valuation professionals based on getting the "right" valuation.
- ***In re Exide Techs.*, 303 B.R. 48 (Bankr. D. Del. 2003)**
  - The court held that because markets tend to undervalue entities in bankruptcy, the application of a "market-based" discount is inappropriate for plan confirmation and valuation purposes.
  - Because the court had rejected the debtor's "market-based" discount approach, it adopted the creditors' committee's terminal value exit multiple and discount rate for its DCF.
  - The debtor had also utilized an unorthodox method of determining the discount rate, without using the Capital Asset Pricing Model, which the court dismissed because it had been subjectively modified to yield an advantageous valuation.

# Market Influence on Valuation

- ***In re VFB LLC v. Campbell Soup Co.,*** **482 F.3d 624 (3d Cir. 2007)**
  - Issue was whether the debtor received reasonably equivalent value in exchange for the money it paid to purchase a company's division.
  - The district court found that the debtor had received reasonably equivalent value based on the significantly positive market capitalization of the division immediately post spin-off.
  - The Third Circuit upheld the district court's ruling, validating the district court's use of market data for valuation purposes, and explained that that "[a]bsent some reason to distrust it, the market price is a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses."
- ***In re Iridium Operating LLC,*** **373 B.R. 283 (Bankr. S.D.N.Y. 2007)**
  - The creditors' committee brought a fraudulent transfer action to avoid Iridium's spin-off of assets, arguing that the spin-off rendered Iridium insolvent.
  - Utilizing a market capitalization approach, Motorola persuaded the court that Iridium was solvent immediately post spin-off by using such market factors as: (i) the debtor's ability to obtain financing post spin-off, and (ii) the debtor's positive equity valuation measured by its market capitalization immediately post spin-off.
  - The court explained that "the public trading market constitutes an impartial gauge of investor confidence and remains the best and most unbiased measure of fair market value and, when available to the court, is the preferred standard of valuation."
  - The court held that to justify the disregarding of market values of a company's publicly traded securities in an efficient market, the court would need "a substantial reason to depart from that standard and find that the value implied by an efficient market is not a trustworthy benchmark."
- ***In re TOUSA, Inc.,*** **422 B.R. 783 (Bankr. S.D. Fla. 2009)**
  - TOUSA borrowed $500 million and caused two of its formerly unencumbered subsidiaries to become obligated for the new debt.
  - The creditors' committee brought an action to avoid the liens relating to this new debt as preferential or a fraudulent transfer using a Market Capitalization approach that utilized market values of the publicly traded debtor's debt and equity.
  - The court agreed and explained "The sum of the market values of a company's debt and equity is the textbook definition of enterprise value…[I]t is commonly accepted among valuation professionals…[T]he market price of the equity plus the market price of the debt is what it would cost investors to purchase claims on all of the company's assets."
  - The court rejected the lenders' assertions that the market was inefficient and cited the following as evidence of market efficiency: (i) the SEC allowed TOUSA to file an S-3 short form registration, and (ii) the debt and equity of TOUSA were actively traded.

# Adjusting Management Projections

- ***In re Nellson Neutraceutical, Inc.,* 2007 WL 201134 (Bankr. D. Del. 2007)**
  - The court downwardly adjusted management's cash flow projections when it discovered that the projections were probably manipulated to yield a valuation putting old equity holders in the money.
  - All of the valuation experts had relied on the debtors' long-range business plan to formulate their valuation opinions, but the evidence at trial "overwhelmingly established that the [long-range business plan] was not management's best and most honest thinking about the debtors' financial future but rather was manipulated at the direction of and in cooperation with the debtors' controlling shareholder to bolster the perceived value of the debtors' business solely for purposes of this litigation."
  - After considering the creditors' expert's opinions, the court made an adjustment to the valuation to compensate for the long-range business plan and the debtors' deteriorating business and concluded that the debtors' enterprise value put equity holders out of the money.
- ***In re Chemtura Corp,* 439 B.R. 561 (Bankr. S.D.N.Y. 2010)**
  - The equity committee's expert submitted a DCF only valuation that was subject to aggressive projections under the management created long range plan.
  - The court found the management prepared projections (which assumed that a general macroeconomic recovery to pre-recessionary levels would occur in 2011, which would result in further earnings improvements through 2014) to be overly aggressive. The projections called for unprecedented levels of performance for the business for years after 2011 in the wake of a major financial recession.
  - The court explained that "I can and do find that since the Debtors' Long Range Plan is already aggressive, and since the speed (and in the views of some, the fact) of the economic recovery is uncertain, it is inappropriate to be as confident as the equity committee is as to future growth in the American economy and increasing Chemtura EBITDA growth."
  - The equity committee's model solely relied on the overly aggressive cash flow projections as the basis for determining terminal value.
  - The court held that the final cash flow should have been downwardly adjusted to account for the overly aggressive assumptions and the business's cyclicality.
- ***In re Spansion, Inc.,* 426 B.R. 114 (Bankr. D. Del. 2010)**
  - The court accepted an expert's consideration of a "contingency case" of projected cash flows which downwardly adjusted the management prepared cash flows to account for foreseeable down sides that would affect the debtor's business.
  - Each party relied on a weighted average of the traditional three valuation methods to get a valuation range.
  - The debtors and the senior noteholders prepared two types of financial projections, one base case which represented management's best estimate of the debtors' future performance over the following period, and another contingency case which took into consideration certain foreseeable downsides that could negatively impact the debtor's business.
  - The court agreed that both the base case and contingency case projections should have been considered and found that, in light of the valuation, the plan treated Class 5C (the dissenting convertible noteholders) "fairly and equitably."

# Using Multiple Valuation Methods

- ***ASARCO LLC v. Ams. Mining Corp.,* 396 B.R. 278 (S.D. Tex. 2008)**
  - Plaintiffs alleged that a transfer of a subsidiary's stock in a Peruvian mining company was a fraudulent transfer.
  - The court held that stock price valuation and DCF were more appropriate indicators of fair value than the market multiples approaches.
  - The court noted that, at the time of the transfer, the subsidiary's stock was traded on an extremely reliable exchange and was followed by a number of securities analysts. However, due to the low weekly trading volume and low public float of the stock, the court emphasized that it did not rest its entire reasonably equivalent value analysis on the stock price valuation method.
  - The court held that the Comparable Companies and Precedent Transactions methods were the least reliable methods for this case given valuation ranges, however, the court acknowledged the value of conducting these tests as reasonableness checks.
  - The court denied the plaintiffs' constructive fraudulent transfer claim on the grounds that the amount the debtor received for its subsidiary's stock was not unreasonably less than the stock's fair value.
  - However, the court ruled that the transfer was avoidable because it was done with the intent to hinder and delay creditors.
- ***In re DBSD n. Am. Inc.,* 419 B.R. 179 (Bankr. S.D.N.Y. 2009)**
  - Plan valuation, experts each utilized a weighted average of the three traditional valuation methods, but relied on differing weights and underlying assumptions for each model.
  - The court rejected the DCF model because:
    - The debtor's business involved the development of technology which was not yet in operation.
    - The DCF analysis relied on projected cash flows that required capital expenditures which the court found the debtor would probably be unable to make.
    - A cash flow projection that included a few negative cash flow years could work, but a DCF valuation cannot be based on a stream of entirely negative cash flows.
  - The court held that the Comparable Companies analysis was the most reliable, in large part because it resulted in the smallest discrepancy between the opposing experts.
  - The court also found that the valuation that relied on both market and book values (instead of only the market value) was superior because stock in the comparable companies was trading at a "discount at the time of valuation, and because of the uncertainty in the markets, it was prudent to weight the book and market value equally."
  - The Court found the two Precedent Transactions analyses to be unreliable, one for reasons of not enough comparable companies and the other for too broad of a range of valuations.

# Q&A