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Independence of Valuation Experts Is Crucial in Chapter 11s

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Valuation disputes are frequently at the core of contested Chapter 11 reorganization plans. Under a Chapter 11 plan, senior creditors are entitled to be paid in full before any creditor or equity holder (that is, shareholder of a corporation) with junior rights receives anything. 11 U.S.C. Section 1129(b). The flip side of this rule of absolute priority is that junior creditors and equity holders are entitled to participate under a plan of reorganization on the senior claims or interests being satisfied in full. The senior parties are not entitled to receive more than full recovery at the expense of the junior parties.

Bankruptcy Law

The bankruptcy court in *In re Oneida Ltd.*, 2006 Bankr. LEXIS 1985 (Bankr. S.D.N.Y. 2006), recently addressed the issue of whether a debtor's shareholders were out of the money (and, as a result, would not get anything) in connection with a contested Chapter 11 plan. Oneida is a manufacturer and marketer of tableware and industrial wire products. The company and some of its domestic subsidiaries filed Chapter 11 petitions in March. The debtors filed a plan of reorganization on the same day. In July, they filed a first amended plan.

Under the debtors' plan, a junior tranche of secured debt would be converted into 100 percent of the outstanding common stock of the reorganized company. Unsecured debt (which was minimal) would be paid in full, and shareholders would receive nothing. The shareholders' committee contended that there was value for equity holders and that the proposed plan's failure to give anything to the shareholders violated the absolute priority rule. If no value existed for the debtors' shareholders, the rule would be deemed satisfied. Accordingly, finding the value of the reorganized debtors was key to resolving the contested Chapter 11 plan.

The Supreme Court has held that a reorganized debtor's value should be based on earning capacity (another term for enterprise value). *Consolidated Rock Products Co. v. DuBois*, 61 S.Ct. 675 (1941). Moreover, courts recognize that determining enterprise value is not an exact science. The *Oneida* court explained that the goal is to estimate "based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and conditions of the properties, the past earnings record, and all circumstances which indicate whether or not the record is reliable criterion of future performance."

The *Oneida* court received four valuation reports and heard testimony from four investment bankers on the value of the debtors. The debtors, the secured lenders, the equity holders' committee and the unsecured creditors' committee each had their own valuation expert. The court recognized that each of the valuation experts used the three standard valuation methodologies: a discounted cash flow analysis, a comparable (or selected) company analysis and a precedent transaction (or selected acquisition) analysis.

The midpoint value of the four experts diverged widely. The debtors' valuation expert concluded that it is $210 million. The debtors' secured lender's expert said $207 million. The equity committee's valuation expert said $295 million. The creditors' committee's valuation expert found a midpoint range of $212 million to $241 million.

To confirm the plan, the debtors had to establish that their plan under the absolute priority rule did not deprive the shareholders of any recovery to which they were entitled. The shareholders' committee needed to establish a valuation amount that showed that equity holders were not out of the money after satisfaction of senior debt in order to be entitled to participate in any distributions.

In addressing competing Chapter 11 plans and valuations, in the same context, the court in *In re Coram Healthcare Corp.*, 315 B.R. 321 (Bankr. D. Del. 2004), recognized "each side's incentives to either overvalue or undervalue the Debtors." The court also emphasized that, "[a]lthough valuations are subjective, there are proper and improper methods of performing a valuation."

Some courts have found the adversarial process and the temptation or pressure on expert valuation witnesses to serve as advocates, strategists, consultants and/or advisers, rather than disinterested experts, create an environment where the credibility of valuation is almost automatically put in question. See *In re Exide Technologies*, 303 B.R. 48 (Bankr. D. Del. 2003) (The court considered "the various methods employed by the experts and their resultant valuations, the competing incentives of the parties to either overvalue or undervalue the company, and the extensive divergent evidence offered in support of valuation"). In *In re Med Diversified Inc.*, 2006 Bankr. LEXIS 1677 (Bankr. E.D.N.Y. 2006), a disillusioned bankruptcy court stated that the attorneys had the duty "to ensure that their retained experts prepare valuation reports in as objective and unbiased a manner as can reasonably be achieved under the current state of the appraisal art." The court struck the expert testimony and valuation report from the record, finding "deliberate, manifest, pervasive and systematic bias" on the expert's part in applying the standard methodologies for estimating total enterprise value, rendering the testimony and report unreliable and therefore inadmissible.

In *Oneida*, the court found that a contingent-fee arrangement entered by the valuation expert's firm with the official equity committee (a monthly fee, plus a "success fee" of 1 percent of any recovery by equity holders) seriously undermined the expert's credibility. Similarly, the court in *In re Mirant Corp.*, 334 B.R. 800 (Bankr. N.D. Texas 2005), faced an equity committee valuation expert with an incentive-based fee arrangement to receive an additional $1 million plus 0.4 percent of any recovery by shareholders in excess of $400 million. The court recognized that the presentation materials submitted by the valuation expert to the equity committee at the time the expert was seeking to be engaged could be read as making the expert an advocate for the equity committee, not a disinterested neutral. In *Coram*, the unsecured creditors' committee retained a valuation expert under terms, approved by the court, providing for payment of $700,000 on the effective date of the plan proposed by the debtors. The plan was not approved, and the court ruled that the expert was not entitled to any compensation.

When there is a marketplace for the property being valued, many courts give significant deference to marketplace values. In *Oneida*, the court found that even a contingent, nonconsummated offer from a potential purchaser of the debtors was material and valuable to the court in reaching its valuation conclusion that there was no value for the equity holders of the debtors and, at a minimum, confirmed that the court's conclusion was correct.

Further, the court found that the debtors' exit credit facilities appeared to have been priced by the market and that the interest rate that would be charged on the debtors' actual exit facilities would be a better indicator of the cost of debt of the reorganized debtor than that provided by the equity committee's expert, who relied on problematic comparables.

Not surprisingly, courts generally are more comfortable with real-world market value conclusions than theoretical conclusions lacking connection to any marketplace. After rejecting the analysis of the shareholders' committee's valuation expert, the *Oneida* court confirmed the debtors' plan in August, concluding that there was no value for the debtors' shareholders and that the plan satisfied the absolute priority rule.

In the context of competing experts and plans presenting and based on conflicting enterprise valuation conclusions, an expert must maintain credibility with the court and avoid arrangements, approaches and actions that undermine her or his independence, and counsel must ensure that expert evidence is not tainted with bias.

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