

Valuation Experts, Beware the Gatekeeper!

***Establishing Enterprise
Value in Chapter 11
Reorganization Cases***

Part One of a Two-Part Article

By David S. Kupetz

Valuation issues come into play throughout Chapter 11 business reorganization cases. These issues are frequently at the heart of the reorganization process and involve a wide variety of different matters. Bankruptcy courts determine value on a case-by-case basis and in light of the purpose and circumstances of the valuation. Near the inception of the case, the court may be asked to determine whether equity security holders of the debtor are in the money and, therefore, may be entitled to the appointment of an official equity security holders' committee to be funded from the bankruptcy estate. As the pivotal, central issue in connection with the confirmation of a contested plan of reorganization, the court may be required to determine the enterprise value of the reorganized debtor. This determination dictates how interests in the reorganized debtor must be allocated to satisfy the "absolute priority rule" and, in turn, how consideration is distributed pursuant to the reorganization plan. Since the value of the reorganized enterprise is allocated first to the satisfaction of senior claims and equity interests,

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a lower valuation will require a higher percentage of the reorganized enterprise be reserved for the satisfaction of the claims and equity interests with senior priority rights.

Although valuation experts generally apply essentially the same methodology in determining enterprise or going concern value in connection with a Chapter 11 plan, they frequently reach substantially different conclusions. In some instances, this has led courts to question the use of an adversarial legal process to determine value and/or the credibility of the proposed valuation experts and, in a few cases, to even disqualify the proposed experts from testifying and presenting their valuation reports. In particular, valuation experts may run into trouble where: 1) they may personally profit depending upon their conclusions regarding value; 2) their role appears to expand beyond that of an independent valuation expert and includes that of an advocate, strategist, adviser, and/or consultant with a broader stake in the process; or 3) the proposed expert's independence is otherwise undermined. Of course, a proposed expert must possess the education, experience, expertise, credentials, and other qualifications appropriate and necessary to provide an admissible valuation opinion. If the proposed valuation expert is not qualified or presents a report and/or testimony that is not relevant or reliable, the court should act as a gatekeeper and disqualify the proposed expert and/or prevent the proposed expert evidence from being admitted.

RECOGNIZING THE UNCERTAINTIES UNDERLYING EXPERT VALUATION CONCLUSIONS

The courts recognize that valuation experts generally employ the same or similar financial valuation models, but frequently reach substantially different conclusions. For example, in *In re*

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Coram Healthcare Corp., the court described that both the Chapter 11 trustee's valuation expert and the equity committee's valuation expert had determined the going concern value of the debtors by applying the three standard valuation methodologies: 1) comparable public company analysis; 2) comparable transaction analysis; and 3) discounted cash flow analysis (DCF), and "the end results were far from similar." *In re Coram Healthcare Corp.*, 315 B.R. 321, 337-38 (Bankr. D. Del. 2004). In that case, leading to different conclusions, the experts "included different assets in reaching their valuation conclusions, attached different weights to the three valuation methodologies, and took different positions regarding management's projections." *Id.* Making the same point that valuation experts using the same methodologies frequently reach different conclusions, the court in *Peltz v. Hatten* stated:

[I]t is clear that experts and industry analysts often disagree on the appropriate valuation of corporate properties, even when employing the same analytical tools such as DCF analysis or a comparable sales method. Simply put, when it comes to valuation issues, reasonable minds can and often do disagree. This is because the output of financial valuation models are driven by their inputs, many of which are subjective in nature ... The DCF method involves projections of future cash flows (which are largely dependent on judgments and assumptions about a company's growth rate) and judgments about liquidity and the cost of capital. Similarly, the comparable sales method involves making subjective judgments as to what transactions are "comparable" to the property being valued.

Peltz v. Hatten, 279 B.R. 710, 737-38 (D. Del. 2002) (footnote and citation omitted).

The vast differences in the conclusions reached by valuation experts addressing enterprise value in the Chapter 11 plan of reorganization context can be astounding. For example, in *In re Oneida Ltd.*, 2006 Bankr. LEXIS

1985, 18-21 (Bankr. S.D.N.Y. 2002), the midpoint value range of the experts diverged by as much as \$90 million. In *In re Mirant Corp.*, 334 B.R. 800, 824 (Bankr. N.D. Tex. 2005), the enterprise values opined to in the expert reports submitted in the case ranged from \$7.2 billion to \$13.6 billion.

ENTERPRISE/GOING CONCERN VALUE

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 with rights that are junior in priority receives anything (See 11 U.S.C. § 1129(b)). The flip side of this rule of "absolute priority" is that junior creditors or equity holders are entitled to participate under a plan of reorganization upon the senior claims or interests being satisfied in full and the senior parties are not entitled to receive more than full recovery at the expense of the junior parties. See *In re Exide Technologies*, 303 B.R. 48, 61 (Bankr. D. Del. 2003).

The Supreme Court has held that a reorganized debtor's value should be based upon earning capacity. [See *Consolidated Rock Products Co. v. Du Bois*, 61 S. Ct. 675, 685 (1941) ("The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster, and if the allocation of securities among the various claimants is to be fair and equitable.")] Courts recognize that determining enterprise or going concern value is not an exact science. In the context of a contested plan confirmation hearing, the *Oneida* court described the goal of a valuation as follows:

The goal of any valuation is to make an 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.

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In re Oneida Ltd., 2006 Bankr. LEXIS 1985, 27-28 (quotations and citations omitted).

In the Chapter 11 case of *In re Mirant Corporation*, the court addressed the issue of how to determine the total enterprise value of the entities that made up the *Mirant Group*. The valuation hearing in the *Mirant* case was conducted for 27 days over a span of 11 weeks. Separate valuation experts testified for the debtors, several creditor constituencies, and equity holders (*In re Mirant Corp.*, 334 B.R. at 809). The valuation conclusions of the experts diverged dramatically, with a low enterprise value presented of \$ 7.2 billion and a high value presented of \$ 13.6 billion (*Id.* at 824).

In addressing competing Chapter 11 plans and valuations, the court in *In re Coram Healthcare Corp.*, perhaps cynically (or just realistically), recognized "each side's incentives to either overvalue or undervalue the Debtors." *In re Coram Healthcare Corp.*, 315 B.R. at 339. Further, the *Coram* court emphasized what it viewed as the key point that [a]lthough valuations are subjective, there are proper and improper methods of performing a valuation." *Id.*

CREDIBILITY

In light of conflicting enterprise valuations frequently presented by the parties in connection with contested and/or competing plans of reorganization, it is essential that valuation experts maintain credibility with the court. Some courts have found the adversarial process and the temptation or pressure on expert valuation witnesses to serve as advocates, strategists, consultants and/or advisors, rather than disinterested experts, create an environment where credibility is almost automatically in question. In the *Med Diversified*

case, a bankruptcy court, disillusioned with what it perceived to be the bias and lack of objectivity of the valuation reports presented in connection with litigation involving an alleged constructive fraudulent transfer, stated:

If a court of record cannot rely on its "officers" to ensure it that their retained experts prepare valuation reports in as objective and unbiased manner as can reasonably be achieved under the current state of the appraisal art, then those officers will suffer the adverse consequences from an excess of vigorous advocacy that impairs the truth-seeking duties of the court. The whole point of experts is to assist the court in determining the relevant facts, not in adding to the court's burden in having to redeem unreliable testimony by its own likes.

Chartwell Litigation Trust v. Addus Health Care, Inc. (*In re Med Diversified, Inc.*), 2006 Bankr. LEXIS 1677, 27 (Bankr. E.D.N.Y. 2006).

In *In re Oneida Ltd.*, 2006 Bankr. LEXIS 1985, 31 (Bankr. S.D.N.Y. 2006), the court found that a contingent fee arrangement entered by a valuation expert's firm with the official equity committee (a monthly advisory fee, plus a "success fee" of 1% of any recovery by equity holders) seriously undermined the expert's credibility. In *Coram Healthcare Corp.*, 2006 U.S. Dist. LEXIS 14935, 2-6 (D. Del. 2006), 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 of reorganization proposed by the debtors. However, the debtors were unable to successfully confirm a plan of reorganization, a Chapter 11 trustee was appointed and, ultimately, the bankruptcy court confirmed a

plan of reorganization proposed by the trustee. Query whether this arrangement created a conflict of interest unduly predisposing the expert to reaching a valuation conclusion in support of confirmation of a plan of reorganization presented by the debtors. In any event, presumably just as bad from the expert's point of view, the court determined that the expert was not entitled to any compensation since its engagement agreement (as approved by the court) required payment only upon the effective date of a plan proposed by the debtors and the confirmed reorganization plan in the case was proposed by the trustee (*Id.* at 4-5).

The court in *In re Mirant Corp.* faced an equity committee valuation expert who negotiated an incentive based fee arrangement to receive an additional \$1 million plus 0.4% 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 could be read as identifying the valuation expert as not simply a disinterested neutral, but as an advocate for the equity committee. Nonetheless, in contrast to the approach of the *Oneida* court, the court found it neither startling nor enough reason to disregard their testimony that experts may be anxious to serve the interests of the parties retaining them, may receive additional compensation depending on the results of the case and, in some circumstances, would even have some commitment to a strategy (and its factual underpinnings) that they may have helped devise. *In re Mirant Corp.*, 334 B.R. at 815.

Next month, we discuss admissibility of expert evidence, and disqualification of experts.

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Beware the Gatekeeper

Establishing Enterprise Value In Chapter 11 Reorganization Cases

Part Two of a Two-Part Article

By David S. Kupetz

Last month, we explained that valuation issues come into play throughout Chapter 11 business reorganization cases. We discussed how to recognize the uncertainties underlying expert valuation conclusions; enterprise/going concern value; and the fact that the goal of any valuation is to make an estimate based on an informed judgment that 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 that indicate whether or not the record is reliable criterion of future performance. We conclude this month with a discussion of expert evidence.

ADMISSIBILITY OF EXPERT EVIDENCE AND DISQUALIFICATION OF EXPERTS

The admissibility of expert testimony is a preliminary question of law for the court to determine. [Fed. R. Evid. 104(a); see also *Celebrity Cruises, Inc., v. Essef Corp.*, 434 F. Supp. 2d 169, 175 (S.D.N.Y. 2006), citing *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 592, 113 S. Ct. 2786, 125 L. Ed. 2d 469 (1993)]. The proponent of the testimony bears the burden of demonstrating its admissibility by a preponderance of the evidence. *Id.* In order to be admissible, expert testimony must be relevant and based on a reliable foundation (*Chartwell Litigation Trust v. Addus Healthcare, Inc. (In re Med Diversified, Inc.)*, 2006 Bankr. LEXIS 1677, 10 (Bankr. E.D.N.Y. 2006). Further, an expert must also be qualified as an expert in order for his or her testimony to be admissible as expert testimony. *Id.*) Expert evidence is relevant if it "has any tendency to make the existence of any fact that is

of consequence to the determination of the action more probable or less probable than it would be without the evidence." (Fed. R. Evid. 401). Under Rule 702 of the Federal Rules of Evidence, expert testimony is reliable if: "(1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case." Fed. R. Evid. 702; see also (*In re Med Diversified, Inc.*) 2006 Bankr. LEXIS 1677, 10 (Bankr. E.D.N.Y. 2006).

In *Daubert*, the Supreme Court stated that the trial judge must perform a "gatekeeping" function to ensure that the expert testimony rests on a reliable foundation and is relevant to the matter at issue. This gatekeeping role applies not only to testimony based on scientific knowledge, but also the testimony based on technical and other specialized knowledge. See *Daubert*, 509 U.S. 579, 597, 113 S. Ct. 2786 (1993); see also *Celebrity Cruises*.

While the Court has a duty to admit expert testimony that is reliable and will assist the trier of fact, *Daubert* also charged the Court with a duty to ensure that the courtroom door remains closed to junk science ... Accordingly, the trial court acts as a gatekeeper by ensuring that every step of the expert's analysis is reliable ... Acting in its gatekeeper role, the trial court has a duty to undertake a rigorous examination of the facts on which the expert relies, the method by which the expert draws an opinion from those facts, and how the expert applies the facts and methods to the case at hand. *In re Med Diversified*, 2006 Bankr. LEXIS 1677, 12-13 (Bankr. E.D.N.Y. 2006) (quotations and citations omitted).

In *Daubert*, the Supreme Court provided a non-exclusive list of factors the trial court should apply in assessing whether expert evidence should be admitted. The *Daubert* factors are: 1) has the method been tested; 2) has it been subjected to peer review; 3) what is the rate of error; 4) are there controlling standards (as by a professional organization); and 5)

has the method achieved acceptance? *Daubert* at 593-94.

The *Med Diversified* case resulted in two published opinions disqualifying valuation experts in connection with an adversary proceeding filed in a bankruptcy case to recover an alleged constructive fraudulent transfer of \$7,500,000. First, the plaintiffs in the litigation filed a motion *in limine* to exclude the defendants' valuation expert's expert testimony, contending that he was not qualified as an expert and that his purported expertise did not satisfy the standards of relevance and reliability under *Daubert* and ensuing precedents. More specifically, the motion *in limine* was based on the contention that the proposed expert did not qualify as an expert with regard to the valuation of all the shares of a privately held healthcare services company. "[T]his motion gave rise to the Court's exercise of its gatekeeper functions in excluding expert testimony that is neither relevant nor reliable." *Med Diversified* at 94. The court decided to conduct a *voir dire* of the proposed expert witness and then determine whether the motion *in limine* should be granted at the conclusion of the *voir dire*. The *voir dire* lasted for the majority of three business days and the court actively participated in the process. *Id.*

In determining that he would disqualify the defendants' proposed expert witness, the court in *Med Diversified* applied the *Daubert* factors and made the following findings and conclusions:

- The proposed expert had no peer-granted certification as an expert on business valuations and his expert report is not to be read as a certified business valuation report (in contrast to the certified business valuation report of the plaintiffs' expert witness — interestingly, as discussed below, the court later disqualified the plaintiffs' valuation expert);
- The defendants' proposed expert had no formal education or training in business valuations;
- The defendants' proposed expert admitted repeatedly that he personally does not issue business valuation reports although he

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- relies upon members of his support staff who were certified business valuers for their input;
- The defendants did not call the persons who provided those inputs to testify and be subject to cross examination and, accordingly, the inputs of support staff cannot be relief upon as a basis for finding the proposed expert witness to be qualified as an expert on business valuation;
 - The court was not prepared to admit an expert report submitted by a corporate entity, holding that the person who signs the report has to testify until the admission of his report for all evidentiary purposes has been stipulated to, which did not occur in the subject adversary proceeding;
 - The proposed expert's experience was inadequate to overcome his lack of formal training and certification; and
 - The court refused to accept the argument that the proposed expert's substantive experience of over 20 plus years as an accountant and as a liquidating agent or bankruptcy trustee in bringing avoidance actions in bankruptcy could add up to a satisfactory substitute for formal education and training in business valuations and in peer-recognition, especially in such a unique and highly regulated business of in-home health care services.

The court concluded that the proposed expert not only failed to qualify as a business valuation expert, but that, even if he had qualified, his testimony must be excluded as unreliable because he did not employ the same level of intellectual rigor that characterizes the practice of an expert in the field of business valuation for, among other things, the following reasons:

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- Failing to use a discounted cash flow analysis in his business valuation, even though that method was recognized by leading authorities as the most reliable method for determining the value of a business;
- Basing his analysis on inadequate data; and
- Misapplying certain financial concepts in connection with his valuation analysis. *Med Diversified, Inc.*, at 95-104.

The *Med Diversified* court in the same fraudulent transfer adversary proceeding subsequently addressed the defendants' motion to exclude the testimony of the plaintiffs' expert on business valuation on the ground that his expert report and testimony were unreliable because the methodology he used was flawed (*In re Med Diversified, Inc.*, 2006 Bankr. LEXIS 1677, 9-10). The court set forth a detailed review of and found significant flaws with the analysis of the plaintiffs' proposed expert. Further, the court found that these flaws weren't simply the result of incompetence or negligence, but rather the result of even more serious offenses, stating that the proposed expert was guilty deliberate, manifest, pervasive and systematic bias. As a result, the court struck the experts report and testimony from the record. *In re Med Diversified, Inc.*, 2006 Bankr. LEXIS 1677, 56.

VALUATION CONCLUSIONS AND THE MARKET

When there is a marketplace for the property being valued, many courts give significant deference to marketplace values. For example, in the context of determining reasonably equivalent value in a fraudulent transfer adversary proceeding in connection with the bankruptcy case, a court stated:

When sophisticated parties make reasoned judgments about the value of assets that are supported by then prevailing marketplace values and by the reasonable perceptions about growth, risks, and the market at the time, it is not the place of fraudulent transfer law to reevaluate or question those transactions with the benefit of hindsight. *Peltz v. Hatten*, 279 B.R. at 738.

In *In re Oneida Ltd.*, the court found that even a contingent, non-consummated offer from a potential purchaser of the debtors was material and valuable to the court in reaching its valuation conclusion (*In re Oneida Ltd.*, 2006 Bankr. LEXIS 1985, 34-38). Further, in *Oneida*, 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 which relied on problematic comparables (*In re Oneida Ltd.*, 2006 Bankr. LEXIS 1985, 24-27). Not surprisingly, courts will generally be more comfortable with real world market driven/proven value conclusions than theoretical conclusions lacking connection to any marketplace.

CONCLUSION

Courts recognize that the determination of enterprise value in connection with a contested Chapter 11 plan confirmation hearing is not an exact science. Expert evidence is required in order to reach a value conclusion. Further, competent, qualified valuation experts generally use the same methodologies, but their valuation conclusions frequently diverge dramatically.

The court serves as a gatekeeper charged with precluding unqualified, irrelevant and/or unreliable expert evidence from being considered in the court's determination of enterprise or going concern value. Moreover, this determination is frequently at the heart of a contested Chapter 11 plan of reorganization process and may dictate whether junior creditors and/or shareholders are in the money or, instead, senior creditors will receive all or a higher percentage of the reorganized enterprise in satisfaction of their claims. As a result, in the context of competing experts and plans presenting and based upon conflicting enterprise valuation conclusions, it is imperative that an expert maintains credibility with the court and avoids arrangements, approaches, and actions that undermine her or his independence.

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