

## SQUARING BANKRUPTCY VALUATION PRACTICE WITH *DAUBERT* DEMANDS

STAN BERNSTEIN<sup>\*</sup>, SUSAN H. SEABURY<sup>\*\*</sup> & JACK F. WILLIAMS<sup>\*\*\*</sup>

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<sup>\*</sup> Professor, John Marshall School of Law, Atlanta, Georgia; Former United States Bankruptcy Judge for the Eastern District of New York (Long Island Division). sbernstein@johnmarshall.edu.

<sup>\*\*</sup> Director and Special Counsel, BDO Seidman LLP. sseabury@bdo.com.

<sup>\*\*\*</sup> American Bankruptcy Institute Robert M. Zinman Scholar in Residence; Association of Insolvency and Restructuring Advisors Resident Scholar; Professor, Georgia State University College of Law; Director, BDO Seidman LLP; Certified Insolvency and Restructuring Advisor (CIRA); Certification in Distressed Business Valuation (CDBV); Fellow, American College of Bankruptcy. jwilliams@gsu.edu. The authors would like to thank Gen. Bruce Bingham, Brian Calvert, Grant Newton, Charlie Stryker, and two anonymous peer reviewers for their comments on the manuscript. Any errors are our own.

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## INTRODUCTION

Contested hearings on business valuations occupy a great deal of a bankruptcy court's time. In the past, issues of valuation in a bankruptcy case or adversary proceeding were regularly negotiated, compromised, and stipulated to; rarely did the parties actually litigate the issue of valuation. Times have changed. Issues of valuation are now hotly contested. Increasingly, these hearings are spread over weeks or months. Attorneys, financial advisors, turnaround managers, and experts on the valuation of businesses are becoming more sophisticated in the developing sub-discipline of valuing distressed businesses.<sup>1</sup> Contested hearings on valuation have thrust courts into the maelstrom of assessing the relevance and reliability of the contested testimony of experts as required by the Supreme Court holdings in *Daubert*<sup>2</sup> and *Kumho Tire*.<sup>3</sup>

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<sup>1</sup>For example, organizations like the Association of Insolvency and Restructuring Advisors (AIRA) maintain a certification in distressed business valuation (CDBV) that includes passing a comprehensive series of examinations, extensive business valuation experience, and a satisfactory peer review of samples of valuation work product.

<sup>2</sup> *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 597 (1993) (holding, pursuant to Rule 702, judges must ensure expert testimony is rooted in reliable foundation and is relevant). *See* FED. R. EVID. 702 (stating expert testimony admissible if assists trier of fact in understanding evidence or determining factual issues, and if testimony arises from "reliable principles and methods"); Daniel J. Capra, *The Daubert Puzzle*, 32 GA. L. REV. 699, 747 (1998) (summarizing all expert testimony, subject to *Daubert* "gatekeeping function," must be reliable "or else it is not helpful within the meaning of Rule 702").

<sup>3</sup> *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 138 (1999) (holding *Daubert* "gatekeeping" obligation applicable to all expert testimony as Rule 702 does not differentiate between scientific and other knowledge). *See* Robert J. Goodwin, *The Hidden Significance of Kumho Tire Co. v. Carmichael*, 52

Meanwhile, in bankruptcy, time is money.<sup>4</sup> Valuations often present time-sensitive situations. For example, the confirmations of chapter 11 plans often turn in large part on the value of the reorganized debtor. It is not unusual for most, if not all, constituencies to be represented by their own counsel and to have retained their own experts on valuation. Momentum builds as some parties push to confirmation and others push back. If the debtor was or may be publicly traded, markets watch impatiently in an effort to gauge ownership, control, and the direction of the business. However, at some stage in the chapter 11 case, the push to confirmation has to be checked by due process. Within that process, bankruptcy courts are bound by the Supreme Court's insistence that federal trial courts must act as tough-minded gatekeepers in excluding irrelevant or unreliable expert testimony. *Daubert* and its progeny have prompted bankruptcy courts to become far less willing to admit purported expert testimony over objection. In the past, some bankruptcy courts allowed expert testimony without sufficient concern for its reliability or even its relevance. The rationale for admitting this evidence was that any objections went to the weight and not the admissibility of the evidence. Not so any longer.

This article, the sequel to our earlier published article,<sup>5</sup> examines the approach of the bankruptcy courts to expert testimony on valuation. There, we focused on the procedural underpinnings for admitting the testimony of experts on financial matters in bankruptcy cases and demonstrated how *Daubert* and its progeny have slowly but steadily shifted the bankruptcy court's focus to admissibility of expert testimony. We introduced the dual *Daubert* requirements of reliability and relevance in the context of bankruptcy cases. In that article, we developed both a procedural model and judicial "best practices" in addressing the perplexing issues presented by the testimony of expert witnesses in bankruptcy cases. Given the practices of bankruptcy courts in presiding over contested hearings, we envisioned a vigorous *albeit* limited role for *Daubert* challenges as a realistic matter, recognizing that the financial testimony of experts that was excluded under *Daubert* was and would be the exception and not the rule. We noted, however, that the growing commitment to the standard of *Daubert* signaled a sea-change in how federal courts must address the testimony of expert witnesses. No longer approaching expert testimony from the perspective of deference to the relevant expert community, the

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BAYLOR L. REV. 603, 611–12 (2000) (noting *Daubert* required trial judge to determine if expert's scientific evidence was reliable, but *Kumho Tire* extended reliability requirement to all experts); Andrew I. Gavil, *Defining Reliable Forensic Economics in the Post-Daubert/Kumho Tire Era: Case Studies From Antitrust*, 57 WASH. & LEE L. REV. 831, 846 (2000) (explaining *Kumho Tire* established judge "gatekeeping" obligation applies to both scientific and all other specialized knowledge).

<sup>4</sup> See *Daubert*, 509 U.S. at 597 ("Law . . . must resolve disputes finally and quickly."); *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assoc., Ltd.* (*In re Timbers of Inwood Forest Assoc., Ltd.*), 793 F.2d 1380, 1405 (5th Cir. 1986), *aff'd*, 484 U.S. 365 (1988) (noting Congress enacted Bankruptcy Code provisions to spur quick resolution of reorganization proceedings); *Acequia, Inc. v. Clinton* (*In re Acequia, Inc.*), 34 F.3d 800, 808 (9th Cir. 1994) (pointing to expedited and equitable reorganization as interrelated goals of chapter 11 business reorganization cases).

<sup>5</sup> Stan Bernstein, Susan Seabury, and Jack F. Williams, *The Empowerment of Bankruptcy Courts in Addressing Financial Expert Testimony*, 80 AM. BANKR. L.J. 377 (2006).

courts must now assess whether the qualified expert is providing testimony that (1) will assist the trier of fact, (2) is relevant, and (3) is reliable. We observed that although numerous factors have been generated to aid the courts in this critical task, the overriding thrust of the dual requirements of reliability and relevance in *Daubert* is as clear as it is sensible. First, tests of relevance measure the nature of the fit between the testimony offered by the expert witness and the issues in play against the general threshold of admissibility of the testimony of the expert to answer the question: will the testimony offered assist the trier of fact? Relevance itself requires an understanding of the precise question being asked, for example, is the business debtor insolvent under an adjusted balance sheet approach<sup>6</sup> at the relevant time? Moreover, the requirement of relevance ensures that the fit among the facts, the methodology, and the opinion of the expert is reasonable. Furthermore, the requirement of reliability ensures that the assumptions, exercises in discretion, methodology, process, and results square with the requisite skill, training, or experience that experts in the relevant field possess. We further observed that this multi-prong approach to admissibility responds to the natural inquiry of whether "the expert knows whereof he speaks."<sup>7</sup>

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In Part I of this article, we begin with an abbreviated discussion of the new role envisioned by the Supreme Court for federal courts, addressing the introduction of expert valuation testimony. In Part II, we present in an abbreviated form several valuation tools employed by valuation experts in bankruptcy cases. After introducing the basic tools, we construct a methodology designed to address the relevance and reliability concerns embodied in *Daubert*. In Part II, we also emphasize the importance of a business status determination (what experts refer to as a determination of the appropriate premise of value)<sup>8</sup> early in a case or proceeding in an effort to frame appropriately the true valuation differences among the experts and manage the case efficiently and economically. In Part III, we use valuation cases as narrative to build a better story of how valuation testimony should square with *Daubert* requirements. The narrative is reemerging as an effective teaching and research tool. It is a rich endeavor that puts *Daubert* practices into context. In this article, we focus on expert financial testimony in two recurring contexts: (1) the issue of the insolvency of the debtor in avoidance

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<sup>6</sup>See, e.g., 11 U.S.C. § 101(32) (2006) (insolvency as financial condition exists where "the sum of . . . [the] entity's debts is greater than all of such entity's property at a fair valuation . . .").

<sup>7</sup>See *Daubert*, 509 U.S. at 580 (stressing "knowledge," under Rule 702 reliability requirement that expert testimony "pertain to scientific knowledge," indicates expert knowledge in body of facts and ideas); *Sagamore Park Centre Assoc. Ltd. P'ship v. Sagamore Park Props. (In re Sagamore Park Centre Assoc.)*, 200 B.R. 332, 341 (N.D. Ind. 1996) (stating rule under *Daubert* requires court to determine if expert testimony is reliable); *Bammerlin v. Navistar Int'l Transp. Corp.*, 30 F.3d 898, 901 ("A district court judge should assure himself, before administering expert testimony, that the expert knows whereof he speaks.").

<sup>8</sup>The use of different terms characterizing the same thing is common in parallel or overlapping disciplines. Throughout this article, we will strive to point out such areas where bankruptcy attorneys and courts will use a term that would typically not be used by a valuation expert describing the same situation or state.

actions; and (2) the total enterprise value (or business enterprise value) of the reorganized debtor in contested chapter 11 confirmation hearings.

The story we tell draws from the developing body of law on valuation. Courts have been developing a level of understanding and maturity that is quite impressive. Attorneys and experts have also developed a more sophisticated approach to valuations, often prodded by well-meaning courts intent on "trying to get it right." In this article, although we are critical in our discussion of the decisions of several bankruptcy courts that have addressed the *Daubert* issues in the context of the testimony of one or more experts on valuation, our critiques should not be interpreted as a signal for anything less than our full admiration for those who toil in bankruptcy. Among the authors, one or more of us has served or continues to serve as a bankruptcy judge, restructuring counsel, financial advisor, expert witness, and/or law professor. Our criticisms are intended to instruct all members of the business bankruptcy community. They are launched out of a heartfelt respect for the institutions and practices of this community and those who work in it and an acknowledged duty on our collective part to that institution to seek its improvement. Thus, bankruptcy judges, as fundamental members of the institution whom we hold dear, may seem to get the brunt of our criticisms in this article, but that criticism can surely be shared among the experts who prepare their reports on valuation and the attorneys who prepare them to testify.

## I. *DAUBERT* GATEKEEPER DETERMINATIONS<sup>9</sup>

### A. *Daubert Standard*

In *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,<sup>10</sup> the Supreme Court addressed the question of the admissibility of testimony of experts in federal court. Initially, the Court discussed the application of the Federal Rules of Evidence to the admissibility of this kind of testimony and the role of the district court in reaching that determination.<sup>11</sup> The Court ruled that the standard for admissibility under the Federal Rules of Evidence was a liberal one under which all relevant evidence is admissible, with relevance being determined by Federal Rule of Evidence 401.<sup>12</sup>

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<sup>9</sup> For a thorough treatment of the procedural history and development of the *Daubert* standard, see our article, *The Empowerment of Bankruptcy Courts in Addressing Financial Expert Testimony*. See Bernstein et al., *supra* note 5, at 380–92. Parts of this section have been borrowed from such article. See Bernstein et al., *supra* note 5, at 380–92; see also *Frye v. United States*, 293 F. 1013, 1014 (D.C. Cir. 1923) (defining "general acceptance" standard where issues are not within range of common experience or knowledge, witness testimony skilled with special experience or knowledge is admissible). But see *Daubert*, 509 U.S. at 589 (holding "general acceptance" rule under *Frye* not assimilated into Federal Rules of Evidence and not applicable in federal trials).

<sup>10</sup> 509 U.S. 579 (1993).

<sup>11</sup> *Id.* at 587–88.

<sup>12</sup> *Id.* at 587 (referring to relevance standard defined under Rules 402 and 401 as liberal); FED. R. EVID. 402 ("All relevant evidence is admissible . . ."); FED. R. EVID. 401 (defining relevant evidence as evidence tending to "make the existence of any fact that is of consequence to the determination of the action more

The Court went on to say that the Federal Rules of Evidence contained a specific provision, Federal Rule of Evidence 702, governing the testimony of experts, noting that the rule did not include any reference to, nor did it incorporate the "general acceptance" standard, which would be adverse to the liberal thrust of the main themes of the Federal Rules of Evidence<sup>13</sup>

In *Daubert*, after determining that the Federal Rules of Evidence governed the admissibility of the testimony of experts, the Court stated that the trial court must ensure that scientific testimony is both *relevant and reliable*.<sup>14</sup> For evidence to be relevant, it must relate to an issue in the case and assist the trier of fact in understanding evidence of a fact.<sup>15</sup> Thus, the question of relevance is one of "fit," that is, does the evidence offered fit into the scope of the questions presented by the case?<sup>16</sup> If the evidence is relevant so as to assist the trier of fact, the trial court must next determine whether the proffered evidence is reliable.<sup>17</sup> Among the factors to be considered when determining the reliability of a scientific theory or technique are: whether it can be or has been tested; whether the theory or technique has been subject to peer review or publication; the known or potential error rate; and the general level of acceptance of the theory or technique.<sup>18</sup>

In summary, the Supreme Court in *Daubert* embraced a more direct, confrontational approach to the issue of admissibility of expert testimony. Although going a long way in determining the appropriate standards for the testimony of experts on scientific matters, the Supreme Court limited its decisions to such matters, leaving "technical or other specialized knowledge" for another day.<sup>19</sup> Thus, in footnote 8 to *Daubert*, the Supreme Court stated "Rule 702 also applies to 'technical, or other specialized knowledge.' Our discussion is limited to the scientific context because that is the nature of the expertise offered here."<sup>20</sup> That

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probable or less probable than it would be without the evidence").

<sup>13</sup> *Daubert*, 509 U.S. at 588 (rejecting inclusion of "general acceptance" standard into Federal Rules of Evidence, especially since Rules do not mention "general acceptance"). See FED. R. EVID. 702 (stating testimony from expert witness having specialized knowledge is admissible if "(1) testimony is based upon sufficient facts or data, (2) the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case"); see also *Beech Aircraft Corp. v. Rainey*, 488 U.S. 153, 169 (1988) (explaining expert opinion testimony not limited to specific issues, and refusing to interpret Rules in manner "contrary to [its] liberal thrust").

<sup>14</sup> *Daubert*, 509 U.S. at 589–90. (establishing Rules require judge to ensure any evidence, including scientific testimony, is relevant and reliable).

<sup>15</sup> *Id.* at 591 (referring to Rule 702 in explaining requirement that expert testimony assist understanding of evidence goes to issue of relevance). See FED. R. EVID. 702 ("If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto . . ."); see also *United States v. Downing*, 753 F.2d 1224, 1242 (3d Cir. 1985) (reading relevancy requirement stated in Rule 702 includes considering whether expert testimony is sufficiently connected to facts so as to aid jury in determining factual disputes).

<sup>16</sup> *Daubert*, 509 U.S. at 591.

<sup>17</sup> *Id.* at 593–94 (discussing considerations of reliability including testing, peer-review, potential for error and general acceptance of theory or technique).

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at 590 n.8.

<sup>20</sup> *Id.*

mischievous footnote led some to argue that the holding in *Daubert* was limited to the testimony of an expert in some field of science.<sup>21</sup> Whether the *Daubert* requirements should be extended to include all forms of expert testimony was left to another day.

That day came quickly. In *Kumho Tire Company, LTD. v. Carmichael*,<sup>22</sup> the Supreme Court addressed the applicability of the *Daubert* holding to "technical or other specialized knowledge."<sup>23</sup> In that case, the Court held that all expert testimony provided under Federal Rules of Evidence 702 was subject to the same kind of analysis by the "gatekeeper" required under *Daubert*.<sup>24</sup> The Court further noted that the purpose of the gatekeeper function as required by *Daubert* is to "ensure the reliability and relevancy of the expert testimony."<sup>25</sup> Thus, the test must be a flexible one, allowing the judge discretion in reaching a conclusion about the testimony in question. "That is to say, a trial court should consider the specific factors identified in *Daubert* where they are reasonable measures of expert testimony."<sup>26</sup> With this holding, the Court determined that for all expert testimony, the burden of determining relevance and reliability had completely shifted from the alleged professional standards of the "relevant community" to the sound discretion of the trial judge as imbued by *Daubert*.

### B. Court's Role

The *Daubert* challenge is multi-faceted. Initially, a court must determine whether an expert is **qualified** to offer an opinion. After a court has determined that the expert is otherwise qualified, the court must determine whether the testimony offered by the expert is both **relevant and reliable**. These related inquiries nonetheless should be addressed separately by the court. The purpose of qualifying an expert is to ensure that the trier of fact is assisted in its duty by a competent and qualified expert with the relevant knowledge, experience, education, certification, or other credentials where scientific, technical, or otherwise specialized testimony may be necessary. A wholly distinct purpose of a *Daubert* hearing is to determine whether the proffered expert testimony is relevant to the issues as framed by the parties and rests on a reliable foundation. The party seeking to call an expert has the burden of establishing by a preponderance of the evidence, both the qualification of the expert and the relevance and reliability of the expert's testimony.

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<sup>21</sup> See generally *Ullman-Briggs, Inc. v. Salton/Maxim Housewares, Inc.*, No. 92 C 680, 1996 U.S. Dist. LEXIS 13621, at \*8-9 (N.D. Ill. Sept. 16, 1996) (setting forth the argument that the "valuation of a business is not a matter of scientific knowledge," and thus not subject to *Daubert*).

<sup>22</sup> 526 U.S. 137 (1999) (affirming district court's decision granting summary judgment in favor of defendant tire manufacturer and distributor in products liability suit and finding trial court did not abuse its discretion in excluding expert testimony on manufacturing defect).

<sup>23</sup> *Id.* at 141.

<sup>24</sup> *Id.* at 147.

<sup>25</sup> *Id.* at 152.

<sup>26</sup> *Id.*

*C. Relevance and Reliability*

Initially, a trial court must determine whether the testimony offered by the expert is "**relevant**" to the task at hand."<sup>27</sup> Thus, a court must concern itself with whether an expert's reasoning or methodology can be properly applied to the facts before the court. In this context, relevance is a measure of how well the methodology "fits" the facts of the case. In other words, does the expert testimony seek to address the precise question of interest to the trier of fact?

Once relevance has been established by the party offering the testimony of the expert, the court then turns to the question of **reliability**.<sup>28</sup> In assessing the reliability of a proffered expert's testimony, a court's inquiry under *Daubert* must focus, not on the substance of the expert's conclusions, but on whether those conclusions are generated by a reliable methodology. In *Daubert*, the Supreme Court set out a list of non-exclusive factors the trial court may consider in determining whether an expert's reasoning or methodology is reliable.<sup>29</sup> The Supreme Court never insisted that these factors were intended to be either exhaustive or applicable in all situations. Rather, the purpose behind the articulation of the factors was to serve as a touchstone when a court confronts the testimony of an expert. A review of the cases reveals that courts have appropriately added to the *Daubert* list.<sup>30</sup>

These factors guide discretion; they do not replace it. Thus, a court enjoys the same "broad latitude" in deciding the "reasonable measures of reliability in a particular case" as it does in reaching its ultimate determination of reliability.<sup>31</sup> In short, the test of reliability is a flexible and functional one. The Supreme Court has been adamant that the factors set forth in *Daubert* do not constitute a "definitive checklist or test."<sup>32</sup> No single factor is necessarily dispositive of the reliability of a particular expert's testimony. Moreover, we agree that "[a] review of the case law after *Daubert* shows that the rejection of expert testimony is the exception rather than the rule."<sup>33</sup> In embracing its role as gatekeeper in the context of expert financial testimony, courts have identified two areas of particular concern worth further investigation: (1) the sources of facts and data employed by an expert; and (2) any systematic bias in forming the opinion.

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<sup>27</sup> *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579, 597 (1993).

<sup>28</sup> See *supra* notes 14–18 and accompanying text.

<sup>29</sup> *Daubert*, 509 U.S. at 593–94.

<sup>30</sup> For a thorough discussion of the factors courts may consider on the question of reliability, see Bernstein et al., *supra* note 5, at 403–11.

<sup>31</sup> *Kumho Tire*, 526 U.S. at 142, 153.

<sup>32</sup> *Id.* at 150 (quoting *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579, 593 (1993)).

<sup>33</sup> FED. R. EVID. 702 advisory committee's note (2000).



## 1. Sources of Facts and Data

Some courts have stated that an opinion offered by an expert based solely on the expert's client's data is not reliable.<sup>34</sup> Other courts have found such opinions reliable because they considered the source of data to go to the weight rather than the admissibility of the evidence.<sup>35</sup> In the context of a financial expert, the source documents are generally available (or can be reasonably reconstructed) and little debate turns on the underlying data.<sup>36</sup> Data of interest for purposes of valuation may include weekly projections of cash flow from the date of the filing of the bankruptcy petition to the date of the valuation; actual cash flows compared to budget through valuation date along with explanations for any variances; consolidated and consolidating budgets for the relevant period, including projected balance sheets; consolidated and consolidating projected cash flows; projected changes in financial position and projected income; assumptions used for preparing the projections, cash flows, balance sheets and income statements; complete sets of relevant financials, including the balance sheets, income statements, and cash flows (consolidated and consolidating); historical financial information on an entity by entity basis; projections and cash flows prepared on an entity by entity basis; amount and description of projected intercompany transactions by debtor and non-debtor entities; description of the cash management system and the controls over intercompany transactions; monthly financial packages provided to senior management and the board for the relevant period; breakdown and description of historical and projected capital expenditures (CAPX) for the relevant period plus projected CAPX in the projections; copies of any presentations to the board of directors during the relevant period; any information concerning any bona fide offers or indications of interest to purchase any business unit, or the target company, portions of the target company's business or subsidiaries since the current owners purchased the target company; any comparables (companies and

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<sup>34</sup> See *Pestel v. Vermeer Mfg. Co.*, 64 F.3d 382, 384 (8th Cir. 1995) (refusing to allow expert to rely on testing done by manufacturer because expert had not developed, participated in, nor supervised testing); see also *Clay v. Ford Motor Co.*, 215 F.3d 663, 676 (6th Cir. 2000) (Ryan, C.J., dissenting) ("While there is a certain logical appeal to the notion that [a plaintiff's expert's] opinion must be reliable if it rests upon data produced by the defendant, the notion does not withstand close consideration."). See generally Douglas R. Richmond, *Regulating Expert Testimony*, 62 MO. L. REV. 485, 510–19 (1997) (discussing appropriate bases for expert testimony).

<sup>35</sup> See *Boucher v. U.S. Suzuki Motor Corp.*, 73 F.3d 18, 21 (2d Cir. 1996) ("Although expert testimony should be excluded if it is speculative or conjectural, or if it is based on assumptions that are 'so unrealistic and contradictory as to suggest bad faith' . . . other contentions that the assumptions are unfounded 'go to the weight, not the admissibility, of the testimony.'") (citations omitted); *Viterbo v. Dow Chemical Co.*, 826 F.2d 420, 422 (5th Cir. 1987) ("As a general rule, questions relating to the bases and sources of an expert's opinion affect the weight to be assigned that opinion rather than its admissibility . . ."); *In re Commercial Fin. Servs., Inc.*, 350 B.R. 520, 529 (Bankr. N.D. Okla. 2005) (discussing how flaws in facts assumed by expert in formulating opinion do not necessarily render it unreliable because such flaws often go to weight of evidence).

<sup>36</sup> An exception to this rule occurs in instances where the issues turn on reconstructing the books of a company engaged in fraud.

transactions), comparable selection criteria, and considered but rejected comparables; relevant economic and investment data, including data on interest rates and required rates of return on various securities relative to their risk; relevant industry data; information relevant for use in quantifying any valuation discounts or premiums to the valuation; adjustments to earnings before interest, taxes, depreciation, and amortization ("EBITDA") or other metrics; and any appraisals of significant assets or income streams generated from severable intangible assets like intellectual property licenses.<sup>37</sup>

The better view would consider the reliability of the source, whether the source documents were available, a history of fraud regarding financial statements or other documents generated by the company rendering typical sources of financial data suspect, the availability of third-party sources for debtor financial information where debtor information is suspect, and the cost to obtain access to financial information. Aside from a threshold inquiry whether this is the type of data relied on by financial experts, any other challenge to the source(s) of the data may be relegated to the weight and not admissibility of the testimony of the expert witness.

## 2. Addressing Systematic Bias

As traditionally understood, bias is generally a topic reserved for cross-examination. But what can and should judges do if they perceive that a purported expert's work is infected by the answer the retaining client needs for its case? Courts may exclude expert testimony where the expert's analysis is poisoned by systematic bias in applying the standard methodologies. Systematic bias may be so considerable that it renders any application of even a standard methodology unreliable such that it fails the requirements of *Daubert*. In particular, an expert must tread cautiously not to deviate from standard practices, but if the expert does deviate from those practices, the expert must be prepared, as discussed below, to justify that deviation. For example, in a contested hearing on the confirmation of a plan of reorganization in which the issue of the debtor's total enterprise value is contested, courts expect to hear valuations based on an analysis of three approaches—the (1) income approach (e.g., discounted cash flow model); (2) market approach (e.g., guideline company or similar transaction models); and (3) asset valuation approach. In some instances, the use of all three approaches may not be justified. It is incumbent, however, on the expert to explain carefully such deviations through an objective discussion of the reasons for the divergence from standard practices. Another fertile ground for systematic bias arises when the expert is compensated, in whole or in part, on the basis of a contingency fee. In

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<sup>37</sup> See generally Bernstein et al., *supra* note 5, at 429 (discussing typical financial information to which financial expert will testify); Susan Jensen-Conklin, *Financial Reporting By Chapter 11 Debtors: An Introduction to Statement of Position 90-7*, 66 AM. BANKR. L.J. 1, 20 (1992) (listing financial information often found in disclosure statements during bankruptcy proceedings); Thomas J. Millon, Jr. & Shannon P. Pratt, *Valuation of Companies Within Workout and Turnaround Situations*, WORKOUTS AND TURNAROUNDS II: GLOBAL RESTRUCTURING STRATEGIES FOR THE NEXT CENTURY 225, 227 (Dominic DiNapoli, ed. 1999).

those cases, an expert's compensation is driven directly by a favorable outcome of the matter at hand. Contingency fee arrangements have quickly become fatal; courts now routinely reject expert testimony where an expert has been retained under a contingency fee arrangement, a judicial practice we strongly endorse.<sup>38</sup>

## II. VALUATION—AN OVERVIEW

Valuation is a process of determining the value of an asset, both tangible and intangible, including the value of a business.<sup>39</sup> A valuation reflects value at a particular point in time and may change based on the premise and standard of value employed.<sup>40</sup> Valuation is both an objective and subjective process with many areas ripe for the exercise of the discretion of an expert.<sup>41</sup> Fundamentally, value is based on growth, risk, and cash flows.<sup>42</sup> Although the fundamental concepts of business valuation hold true when valuing distressed businesses, particular facts and circumstances may require certain adjustments and additional considerations. For example, although traditional valuation tools and methodologies may be applicable, factors such as the impact of cancellation of indebtedness<sup>43</sup> on net operating losses and carryforwards (and carrybacks),<sup>44</sup> additional working capital and capital expenditure needs, volatility and vulnerability of earnings, and the like must be considered so as to minimize the likelihood of an erroneous valuation.

In theory, an expert should be able to explain to the court the methodology and factors necessary to perform a valuation in a bankruptcy context—an aspect necessary in any case where insolvency is at issue<sup>45</sup> or where a total enterprise value of the reorganized debtor is a relevant question,<sup>46</sup> for example, when assessing a proposed cram-down plan.<sup>47</sup> In this section, we introduce in an abbreviated form various accepted approaches and techniques in rendering a valuation of a distressed company to aid in understanding our discussion of the best practices under *Daubert*, which we derived from the cases analyzed below.

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<sup>38</sup> See, e.g., *In re Oneida Ltd.*, 351 B.R. 79 (Bankr. S.D.N.Y. 2006) (court critical of expert witness retained through contingency fee arrangement).

<sup>39</sup> See Association of Insolvency and Restructuring Advisors, Certification in Distressed Business Valuation Part 3: Application of Business Valuation Concepts to Bankruptcy and Other Distressed Situations 1:1 (2008) (materials available with third author, Jack F. Williams, and with [aira@airacira.org](mailto:aira@airacira.org)) [hereinafter AIRA].

<sup>40</sup> *Accord* 11 U.S.C. § 506(a) (2006) (stating value depends on circumstances).

<sup>41</sup> See AIRA, *supra* note 39, at 1:1.

<sup>42</sup> See *id.*

<sup>43</sup> 26 U.S.C. § 108 (2006).

<sup>44</sup> 26 U.S.C. § 382 (2006).

<sup>45</sup> Both an avoidable preference action under section 547(b) and a constructively fraudulent transfer action under section 548(a) require proof of insolvency or, in the case of fraudulent transfer actions, other possible conditions of financial distress in addition to or instead of insolvency. See 11 U.S.C. §§ 547(b) & 548(a).

<sup>46</sup> Reorganizational value of the debtor is used in several situations, including identifying the appropriate capital structure of the debtor upon emergence, negotiating with stakeholders toward a consensual confirmable plan, determining the size of the "pie" to be distributed to various constituencies, and complying with fresh start accounting requirements. See AIRA, *supra* note 39, at 1:2.

<sup>47</sup> 11 U.S.C. § 1129(b) (explaining cram down provision).

### A. Introduction

Valuation requires the implementation of a generally accepted methodology or protocol.<sup>48</sup> Although methodologies are varied, those passing muster under *Daubert* tend to follow a fairly predictable path. Although a more detailed discussion of methodology is reserved for treatment in the next section, we educe several important threshold points here.

In isolation, "value" is an unhelpful word. Granted, the fundamental premise on which all investment decisions are based is that value to a potential investor is equal to the present value of future benefits. Various methods may be employed to quantify the future returns to the investor the company may be reasonably expected to generate and to determine its present value by considering the uncertainty associated with realizing these returns. Nonetheless, value begs context. Context comes from the purpose for the valuation and the ultimate standard and premise of value employed. Thus, to determine the value of a debtor at any given point in time, an expert should first determine the appropriate standard and premise of value,<sup>49</sup> for example the fair market value of the debtor as a going concern.

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<sup>48</sup> See David S. Kupetz, *Valuation Experts, Beware the Gatekeeper! Establishing Enterprise Value In Chapter 11 Reorganization Cases*, BANKRUPTCY STRATEGIST (Dec. 2006) ("[V]aluation experts generally apply essentially the same methodology in determining enterprise or going concern value in connection with a Chapter 11 plan . . ."); Millon & Pratt, *supra* note 37, at 225–26; Israel Shaked & Allen Michel, *Valuing the Financially Distressed Firm*, 18 AM. BANKR. INST. J. 34, 34–35 (Apr. 1999) (discussing common valuation methodology including liquidation and going concern).

<sup>49</sup> The standard or definition of value is driven by the need for the valuation in the first instance. In fact, 11 U.S.C. § 506(a) suggests that value is determined in light of the purpose for which it serves. Valuation standards include, among others, *fair market value* (value at which the subject asset would trade hands between a willing buyer and a willing seller when both have reasonable knowledge of relevant facts and neither is under any compulsion to act, without consideration of unforeseeable subsequent events); *fair value* (statutory standard of value used by courts usually involving shareholder's appraisal rights or oppressive transactions, without consideration of any post-transaction effect); *going concern value* (not a value standard but more appropriately viewed as an assessment of business status and a premise of value that assumes a business continues as a viable operating enterprise); *investor value* (value to a particular buyer/investor considering his specific circumstances, knowledge of the transaction, and potential synergy); *total enterprise value*, *business enterprise value*, or *total capital value* (value of fair market value of 100% of the equity plus the market value of the funded debt); *liquidation value* (value from a piecemeal sale of assets, either orderly or forced); *book value* (an accounting term for the value of total net assets minus total liabilities on the balance sheet); *minority value* (value reflecting an ownership position of less than 50%, frequently expressed as a discount or multiple discounts); *control value* (additional value inherent in a legally controlling interest, reflecting the power of control, frequently expressed as a premium); *fair valuation* (the legal standard identified in section 101(32) of the Bankruptcy Code that appears to be more process as opposed to results based, without consideration of unforeseeable subsequent events); *intrinsic value* (perceived actual value inherent in the investment based on the fundamental characteristics of the investment, generally not market driven); and *illiquidity value* (decreased value because of limitations in the marketability of an equity, usually expressed as a discount). See AIRA, *supra* note 39, at 1:7–1:9; BLACK'S LAW DICTIONARY (8th ed. 2004). See generally J. Douglas Bacon & Christopher J. Peters, *Sounding the Floating Lien Creditor's Safe Harbor: "Value" and "Prejudice" Under Section 547(C)(5) of the Bankruptcy Code (Part I)*, 5 J. BANKR. L. & PRAC. 29, 42–44 (1995) (discussing definitions and standards of "value" which affect valuation); Robert F. Reilly, *Ten Elements of the Bankruptcy Business Valuation Assignment*, 26 AM. BANKR. INST. J. 48, 48 (Mar. 2007) (analyzing how definition of "value" can alter valuation process).

Generally, the expert would consider and employ three accepted valuation techniques: (1) the income approach, usually in the form of a discounted cash flow method,<sup>50</sup> (2) the market approach, usually in the form of the similar transaction method<sup>51</sup> and the guideline or comparable company method;<sup>52</sup> and (3) the asset valuation method, usually requiring a comparison of assets (including both severable and nonseverable intangible assets, if appropriate) and liabilities.<sup>53</sup> Typically, an income approach analysis is based on financial projections of the debtor. Thus, the value of the subject company can be estimated by forecasting the future financial performance of the business and identifying the cash flow that the business generates. The similar transaction method analysis is generally based on an expert's analysis of observed transaction multiples prevalent in transactions involving all or most of the various comparable companies' shares before the transaction date. The guideline company method analysis is generally based on observed valuation multiples prevalent in share prices involving minority stakes in

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<sup>50</sup> The income approach analysis usually takes the form of a discounted cash flow analysis, although, in the appropriate circumstances, an expert may employ a direct capitalization method or other methods. *See generally* John Collen, *Real Estate Valuation Techniques*, 8 J. BANKR. L. & PRAC. 135, 145-47 (1999) (discussing income capitalization approach, including comparing and contrasting direct capitalization with discounted cash flow analysis); Francis G. Conrad, *Dot.coms in Bankruptcy Valuations Under Title 11 or www.Snipehunt in the Dark.noreorg/noassets.com*, 9 AM. BANKR. INST. L. REV. 417, 420-21 (2001) (stating income approach to be among most common valuation methodologies); Robert F. Reilly, *Business/Stock Valuation Discount Related to the Built-In Gains (Big) Tax Liability*, 22 AM. BANKR. INST. J. 42, 42 (Mar. 2003) (asserting most common income valuation approaches to be direct capitalization and discounted cash flow analysis).

<sup>51</sup> The transaction method is sometimes referred to as the "mergers and acquisition method." *See generally* Bernstein et al., *supra* note 5, at 408 (stating "comparable transaction method" to be generally accepted valuation technique); Conrad, *supra* note 50 (stating market approach to be among most common valuation methodologies); Reilly, *supra* note 50 (citing market approach as one of common three approaches to valuation); Shaked & Michel, *supra* note 48.

<sup>52</sup> The guideline company method is sometimes referred to as the "comparable company method." The transaction and guideline company methods are both versions of the market approach. *See generally* Bernstein et al., *supra* note 5, at 408 (stating "comparable company method" to be generally accepted valuation technique); Harold S. Novikoff et al., *Valuation Issues in Chapter 11 Cases*, ALI-ABA 395, 409 (Jun. 2005) (stating there are three principle methods for determining value including "comparable company analysis"); Reilly, *supra* note 50 (discussing both "mergers and acquisition" and "guideline company" methods under the same "market" approach); Shaked & Michel, *supra* note 48.

<sup>53</sup> Joshua R. Williams, *Belk of Spartanburg, S.C. v. Thompson: An Overview and Analysis of the Techniques Employed to Value Minority Interests in Closely Held Corporations In Dissenters' Rights Cases*, 52 S.C. L. REV. 391, 397 (2000-01) ("The net asset value method is the easiest, most inexpensive, and least subjective of the three valuation techniques. However, in its purest form, this method is a poor indicator of the closely held corporation's current fair market value."); Peter D. Santori, *Virginia Bankshares v. Sandberg: The Supreme Court Federalism Into the Implied Private Right of Action For Breach of Securities and Exchange Commission Rule 14A-9. A Taste of Things to Come?*, 17 DEL. J. CORP L. 1007, 1021 ("The net asset valuation method calculates share value by allocating to a particular share its pro-rata portion of the total assets of the concern."); Donald J. Brown & M. Daniel Waters, *Dissenters' Rights and Fundamental Changes Under the New Iowa Business Corporation Act*, 40 DRAKE L. REV. 733, 751 n.151 ("Net asset value means the fractional portion, which dissenter's stock represents, of the value of the net assets of the corporation as a going concern. The net asset valuation method requires an appraisal of all the corporate assets.")

publicly traded companies on U.S. stock exchanges. Finally, the asset value method generally focuses on the value of a company's underlying assets.

In determining value, the expert must also determine whether the debtor was (or is) a going concern on the relevant date(s). This determination will affect, among other things, the appropriate premise of value to be employed by the expert (going concern or liquidation value, for example) and the value attributable to any non-severable goodwill (that is, the income earning potential of the assets in excess of total tangible asset and severable intangible asset value), the range of various multiples used in the valuation, and the relative weight assigned among the three usual valuation approaches. Generally, the expert must determine the value of the debtor's assets and amount of liabilities using a going concern measure unless it is more likely than not that the business is a failed concern, and, thus, a liquidation measure may be more appropriate.<sup>54</sup> For many of these assets and liabilities, the debtor's books and records are an important first source, however the generally accepted accounting principles ("GAAP") upon which they are most likely based do not govern the valuation for the purposes of valuation. This review should be followed by consultation with the debtor's management, often an important source of relevant information;<sup>55</sup> however, a significant portion of the debtor's value may arise from a consideration of intangible assets not recorded on the debtor's balance sheet, an asset greatly discounted or simply removed in its entirety where a liquidation measure is employed. Moreover, the amount of liabilities reflected on the balance sheet may increase or additional liabilities not recorded on the financial statements may be included. Intangible assets are those that, although often not appearing on a debtor's balance sheet, nevertheless contribute to the business' earning power. Because balance sheets typically represent historical costs rather than economic values, intangible assets are often not entirely accounted for on the balance sheet. When a debtor's adjusted equity value is greater than its book value, the difference generally reflects the presence of unrecognized intangible assets and a "step-up" to market value of tangible assets that have appreciated since purchase. Specifically identifiable intangible assets can include trademarks, patents, proprietary technology, customer relationships, supplier contracts, copyrights, and computer software that may all lead to competitive advantage and higher value. Any additional value over and above that of tangible assets and specifically identifiable intangibles is attributed to goodwill.

### *B. Methodology*

How an expert reaches an opinion, that is, the methodology employed, is a key determinant of reliability. Although the techniques employed in valuing distressed businesses are generally understood, their actual applications are as much an art,

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<sup>54</sup> American Institute of Certified Public Accountants, *Business Valuation in Bankruptcy* 5 (2002).

<sup>55</sup> Although an important source of relevant information, consultation with a debtor's management should not be tantamount to abdication by an expert of that expert's duties of independence and objectivity.

drawn from experience, reasoned judgment, and discretion, as a science. These quantitative tools for valuation are steeped in a qualitative space. Thus, identifying and applying an explicit methodology permits the trier of fact to consider the reasonableness of assumptions and procedures in an expert's opinion on value and indirectly tests for reliability.

In its collective body of knowledge, the Association of Insolvency and Restructuring Advisors ("AIRA") has developed a standard methodology for valuing distressed businesses.<sup>56</sup> That body of knowledge requires an expert on business valuation generally to employ the following methodology:

1. *Define the legal interest valued.* Generally, in the distressed business context, the legal interest being valued is the company, usually referred to as the total or business enterprise value. Often, the equity interest is "out of the money" and ascribed a zero value, although more cases are litigating that very point as a precondition to plan confirmation.

2. *Identify the characteristics of the ownership interest.* This step involves the identification of the ownership characteristics of marketability and control. Marketability is a characteristic that attempts to measure the speed at which an interest can be converted to cash at minimal cost, that is, an asset's liquidity. Generally, readily marketable assets are perceived to be worth more than less marketable assets, all things being equal. Control is also perceived to affect value. Thus, a lack of control is generally perceived to reduce the value of an asset *vis-a-vis* its proportionate share, all things being equal.

3. *Select a date of valuation.* The selection of a valuation date affects the universe of data and information available for determining the value of a business. The relevant facts and circumstances considered by an expert in distressed business valuations include that information that is known or reasonably foreseeable as of the valuation date. Obviously, the frame of facts and circumstances may change over time. Generally, the date of valuation will depend on the purpose of the valuation.

4. *Identify the purpose of the valuation.* No single valuation method is universally applicable to all valuation purposes. Context is critical. An expert should document the purpose of the valuation; it is that purpose that generally determines the standard and premise of valuation.

5. *Identify the standard of valuation.* The appropriate standard of value depends on the facts and circumstances of each valuation. As previously discussed in greater detail, standards of value include, but are not limited to, fair market value,

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<sup>56</sup> See AIRA, *supra* note 39, at 1:6–1:14. The methodology identified in this article generally tracks the methodology developed by the AIRA and followed by many bankruptcy courts. In June 2007, the American Institute of Certified Public Accountants ("AICPA") issued guidelines to AICPA members who provide valuation services. AICPA Consulting Services Executive Committee Statement on Standards for Valuation Services No. 1, "Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset." That Statement generally tracks the methodology discussed in the text. See generally Robert F. Reilly, *New AICPA Professional Guidance on Valuation Standards Sets Best Practices*, 27 AM. BANKR. INST. J. 1, 42 (March 2008).

investment value, intrinsic value, fair value, or fair *valuation*. Often, the standard of value is prescribed or influenced by statute, administrative ruling, or case law.

6. *Identify the premise of value.* The appropriate premise of value, like the appropriate valuation standard, depends on the facts and circumstances of the valuation. Premises of value include going concern value,<sup>57</sup> value as a mass assemblage of assets,<sup>58</sup> orderly liquidation value,<sup>59</sup> and forced liquidation value.<sup>60</sup> Factors foreseeable as of the date of valuation considered in determining the appropriate premise of value include business status, a recent history of losses, operations (business as usual), unusual delays in paying debts, "COD" basis with trade creditors, content of communications to trade creditors, loss of key employees, economic and industry-specific financial indicators, market changes, offers to sell the company, retention of turnaround professionals, and press coverage.

7. *Identify valuation approaches.* As with the standard and premise of value, the actual valuation approach will depend on the facts and circumstances reasonably foreseeable as of the valuation date. Three generally accepted valuation approaches are the income approach, the market approach, and the asset approach. An expert using the income approach generally employs a discounted cash flow method, although that expert may seek to cross-validate the results using the adjusted present value ("APV") method. Presently, the APV method has not been widely accepted by courts in the valuation of a business. An expert using the market approach generally employs the comparable or guideline company method or the similar transaction method. An expert using the asset approach generally adjusts both tangible and intangible assets to some pre-designated standard and premise of value, depending on the relevant facts and circumstances.

8. *Statement of the expert's opinion on valuation.* The expert should clearly state his opinion on value, and if more than one valuation approach is used, the weights accorded to each valuation approach. The expert may also consider identifying any tests utilized for cross-validation of the opinion. Each basis for the opinion should be clearly stated.

9. *Disclose the sources of information used.* All information relied on by the expert should be disclosed.

The recent opinion in *American Classic Voyages Co. v. JP Morgan Chase Bank (In re American Classic Voyages Co.)* ("ACV")<sup>61</sup> focused on the methodologies for valuation. There, Bankruptcy Judge Kevin J. Carey from the District of Delaware offered a thoughtful approach to valuation. The debtors sought to avoid alleged preferential transfers made to several banks.<sup>62</sup> Of course, one of the elements of the

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<sup>57</sup> The business is assumed to continue as a viable operation with value based on the tangible and intangible asset's income-generating characteristics.

<sup>58</sup> Assets are not presently producing income as part of an existing business, but, sold in the aggregate, are capable of producing income.

<sup>59</sup> Asset are sold piecemeal with a reasonable time of market exposure.

<sup>60</sup> Assets are sold piecemeal with less than normal market exposure, usually as quickly as possible.

<sup>61</sup> 367 B.R. 500 (Bankr. D. Del. 2007).

<sup>62</sup> *Id.* at 502.



*prima facie* preference case is that the transfer was made at a time the debtor was insolvent.<sup>63</sup> Section 547(f) eases a plaintiff's burden by providing a presumption of insolvency within the ninety-day preference period.<sup>64</sup>

What makes *ACV* an interesting teaching case is that Judge Carey skillfully provided both a thoughtful methodology and a sound analysis on the types of questions that opposing counsel may ask of expert witnesses in a preference action. Let us look at what Judge Carey offers us as judges, attorneys, experts, and other bankruptcy professionals.

Initially, Judge Carey reminded us that insolvency in a preference action is gauged as of the transfer date.<sup>65</sup> "Transfer" is defined in section 101(54) and refined in section 547(e) to include every mode of disposition of an interest in property and, unsurprisingly, includes a payment.<sup>66</sup> The important point here is that an expert assesses, and a court determines, insolvency based on the facts and circumstances known or reasonably discoverable as of the transfer date; hindsight has no place. Of course, the well-reasoned expert opinion generally should expand the testing period prior to the transfer date to develop a more robust financial picture of the debtor/transferor.

Second, Judge Carey placed the focus of insolvency on the actual transferor of the transfer scrutinized under preference law.<sup>67</sup> Although, the Judge found this point not an issue in *ACV* because both possible transferors were solvent, this issue can cause some disturbance in an otherwise persuasive expert opinion. An expert must

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<sup>63</sup> See 11 U.S.C. § 547(b)(3) (2006) (requiring debtor to be insolvent in order for preferential payment to be avoidable); 11 U.S.C. § 101(32) (defining insolvency). Although a transfer that "renders" a debtor insolvent may be an element of a constructively fraudulent transfer, no such indulgence is offered in a preference action under section 547(b)(3). See 11 U.S.C. § 547(b)(3).

<sup>64</sup> 11 U.S.C. § 547(f) ("For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.").

<sup>65</sup> See *In re Am. Classic Voyages Co.*, 367 B.R. at 502 (declaring issue to be "whether some or all of the Debtors were solvent on the dates of the transfers at issue in the adversary proceedings and, to the extent necessary, whether the Debtors were solvent on the petition dates"). To meet the elements of Bankruptcy Code section 547(b), the solvency of the debtor must be determined as of the date of the transfer. See *id.* at n.3.

<sup>66</sup> 11 U.S.C. § 101(54) (defining "transfer" as—(A) creation of lien; (B) retention of title as security interest; (C) foreclosure of debtor's equity of redemption; or (D) each mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with—(i) property; or (ii) an interest in property). See 11 U.S.C. § 547(e) (redefining when transaction constitutes transfer).

<sup>67</sup> See *In re Am. Classic Voyages Co.*, 367 B.R. at 502–03 ("For the reasons set forth below, I conclude that the Plaintiffs have not proven, by a preponderance of the evidence, that the Debtors were insolvent on the date of the transfer.").

The court would normally be required to first identify who the transferor is, since it is that entity's solvency which is relevant to the preference analysis. Both experts, however, opined at trial on the solvency of AMCV and DQSC separately. Because I conclude that the Plaintiffs failed to prove the insolvency at the relevant time of either AMCV or DQSC, I need not make the determination of which entity was the transferor in the matter before me.

*Id.* at n.5.

remain cognizant that, particularly in affiliated group cases, the question of insolvency is tied to a particular transferor. Absent evidence in support of disregarding the separate-entity status provided by applicable law, a determination that the affiliated group was insolvent or that nontransferor members of the group were insolvent is beside the point,

Third, Judge Carey addressed the perplexing issue of what it actually means under section 547(f) that there exists a presumption of insolvency within the ninety days preceding the petition date.<sup>68</sup> The Judge correctly read section 547(f) with Federal Rule of Evidence 301, made applicable to preference actions by Federal Rule of Bankruptcy Procedure 9017.<sup>69</sup> That rule provides that "a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of non-persuasion, which remains throughout the trial upon the party on whom it was originally cast."<sup>70</sup> The Judge observed: "A creditor may rebut the Bankruptcy Code § 547(f) presumption 'by introducing *some evidence* that the debtor was not in fact insolvent at the time of the transfer. If the creditor introduces such evidence, the trustee must prove insolvency by a preponderance of the evidence.'"<sup>71</sup> As an expert witness, one must take the law as she finds it even when Congress has placed a thumb on the scale of insolvency. Our take on the meaning of this statement by the Judge, and other cases on the topic, is threefold: (1) the presumption initially shifts the burden of production to a transferee; (2) the transferee must introduce some evidence that directly rebuts the presumption, usually in the form of expert testimony; and (3) once rebutted, the presumption does not "burst," but rather stays in the insolvency calculus as one factor that Congress has particularly identified as relevant, that is, that insolvency seldom occurs overnight and is commonly found on or about a bankruptcy filing.

Fourth, Judge Carey correctly insisted that an insolvency analysis must begin with a determination of whether the debtor was a going concern or failed concern as of the relevant transfer date(s).<sup>72</sup> Although we do not particularly care for the use of the phrase "death bed"<sup>73</sup> in reference to the situation of critical financial status as of

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<sup>68</sup> See *id.* at 507-08

Pursuant to Bankruptcy Code Section § 547(f), 'the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition . . . . A presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption but does not shift to such party the burden of proof in the sense of the risk of non-persuasion, which remains throughout the trial upon the party to whom it was originally case.

<sup>69</sup> *Id.*

<sup>70</sup> See Fed. R. Evid. 301.

<sup>71</sup> *In re Am. Classics Voyages Co.*, 367 B.R. at 508 (quoting *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, 78 F.3d 30, 34 (2d Cir.1996)) (emphasis added).

<sup>72</sup> See *id.* ("[A]n initial decision to be made is whether to value the assets on a going concern basis or a liquidation basis.").

<sup>73</sup> Although colorful, the term "death bed" has no analytical meaning. It is a "word picture" that limits

the transfer date, the determination of going concern versus failing concern is critical. Section 101(32) requires the insolvency determination to be made by a "fair valuation" and, not necessarily, at a fair value. Contrary to conventional wisdom, a fair valuation is *process sensitive* and not *result sensitive*. Thus, a fair valuation initially requires a determination of what range of values would be acceptable, given the status of the debtor. Thus, if the debtor is a going concern, then one would expect a range of values congregating around fair market value; whereas, if the debtor is a failing concern, then one would expect a range of values from an orderly liquidation to a forced liquidation. The Judge properly notes that the threshold for a going concern analysis is a low one; a business need not be thriving to constitute a going concern. For most business debtor cases, the determination of business status, *i.e.*, going or failed concern, drives the valuation opinion, or, more particularly, the value assigned to assets, including nonseverable goodwill, that is, the future income earning potential of the business in excess of total tangible asset value plus severable intangible asset value. Technically, a going concern should exhibit positive goodwill in excess of total tangible and severable intangible asset value; whereas, a failed concern should exhibit nominal or negative goodwill.<sup>74</sup> In many cases, even under an adjusted balance sheet approach as envisioned in section 101(32), a going concern determination will require an expert to value the business using some income model (typically, some form of discounted cash flow) and/or market approach (guideline or comparables company method and/or similar transaction method) and blend that approach with an asset or "fair valuation adjusted balance sheet" approach in order to value properly the nonseverable goodwill of the debtor.<sup>75</sup> The nonseverable goodwill value is then

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rather than liberates thought. Our analysis of the cases and the literature on valuation would suggest that a company is certainly a failed concern where it has used up all of its cash and has no availability to borrow funds. Beyond that accurate but limited observation, the determination of the appropriate premise of value turns fact—and industry—specific. Generally, we would suggest that if a court finds it more probable than not that at the time of the transfer, the debtor would continue as a going concern for at least a year, an insolvency valuation should be made on a going concern basis. In contrast, if a court finds that it is more probable than not that at the time of the transfer, the debtor would cease substantially all legitimate operations within a year, then a liquidation analysis may be more appropriate. However, we temper this suggested approach with the observation that certain industries, like manufacturing and high-tech, may use a longer or shorter measuring interval. Furthermore, we generally find it inappropriate for legal counsel to insist that an expert follow a specific premise of value. Because the determination of the appropriate premise of value as applied to the valuation analysis is intertwined with the valuation opinion, counsel's insistence that an expert employ a specific premise of value is an inappropriate intrusion on the expert's discretion and judgment. Rather, an expert must undertake an appropriate investigation and analysis of the facts and circumstances in order to reach an independent opinion on the premise of value to be applied.

<sup>74</sup> See generally Israel Shaked, Paul D'Arezzo, and David Plastino, *Company Valuation: How Good Is Goodwill?*, 27 AM. BANKR. INST. J. 40 (April 2008).

<sup>75</sup> See 11 U.S.C. § 101(32) (2006); see also Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403, 418 (2001) ("[S]o long as the firm remains a going concern, the present value of the wealth it creates, destroys, or redistributes to various corporate participants may be far greater, or far less, than the income statements and balance sheets show."). Our bankruptcy accounting colleagues will see the hand of Statement of Position 90-7 in the shadows of the adjusted balance sheet approach under section 101(32); a result that, we may add, is not by coincidence.

added to the other debtor "property" items included in the adjusted balance sheet model contemplated by section 101(32).

Fifth, Judge Carey offered experts volumes of insight on how a court (and, therefore, an expert) should assess cash flow projections prepared by a debtor on, or about, a transfer date and subsequently relied upon by an expert in preparing a discounted cash flow valuation of the company.<sup>76</sup> In *ACV*, the defendants' expert employed the future cash flows constructed by the debtors on or around the transfer dates.<sup>77</sup> Although the cash flows were, based on historical performance, "optimistic," the Judge found that the expert exercised his independent and reasoned judgment in finding that the projections were viable and consistent with management's views at the relevant times.<sup>78</sup> The Judge further found that the expert had reasonably determined that the projections were reliable "because they were very detailed (i.e., growth, capacity and other figures were prepared separately for each ship), were consistent with the companies' plans for expansion and strategy that focused on the Hawaiian market, and were consistent with the cruise industry's positive outlook at that time."<sup>79</sup> The Judge further observed that the reasonableness of such projections "must be tested by an objective standard anchored in the company's actual performance."<sup>80</sup> "[A] court must consider the reasonableness of the company's projections, not with hindsight, but with respect to whether they were *prudent when made*."<sup>81</sup> Thus, the effects of the terrorist attacks on September 11, 2001, on the tourism industry, occurring *after the relevant transfer dates*, were off-limits in a consideration of insolvency *as of the transfer dates*. Moreover, as the judge correctly noted, the plaintiff's expert witness's attempt to employ a failing concern liquidation analysis of the debtors did not square with the low threshold of a going concern valuation as mandated by applicable law and did not square with the severe warning not to use hindsight in analyzing and formulating a business valuation for purposes of insolvency.<sup>82</sup>

Finally, we have one minor criticism of the Judge's approach regarding the plaintiff's expert. As mentioned, plaintiff's expert essentially served in two capacities—(1) rebutting the income approach employed by the defendants' expert and (2) offering his own opinion based on a liquidation basis, that is, that the business was a failing concern. However, once the court determined that the

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<sup>76</sup> See *In re Am. Classic Voyages Co.*, 367 B.R. at 509–10 ("[Defendant's expert] also prepared a cash flow calculation, showing the 'free cash flow,' i.e., the cash flows that would be available to debt and equity holders during the projections period.").

<sup>77</sup> *Id.*

<sup>78</sup> *Id.* at 513 ("[A]s of the Transfer Date, [the Debtor] had reason to be optimistic about the future. The unforeseen events of September 11, 2001, dealt a fatal blow to their business. The evidence presented in this case supports the conclusion that the projections were reasonable when prepared.").

<sup>79</sup> *Id.* at 512.

<sup>80</sup> *Id.* (quoting *Moody v. Sec. Pacific Bus. Credit, Inc.*, 971 F.2d 1056, 1073 (3d Cir. 1992)).

<sup>81</sup> *Id.* at 512 (quoting *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995)).

<sup>82</sup> See *In re Am. Classic Voyages Co.*, 367 B.R. at 514–16 (concluding expert witness' valuation method was not consistent with evidence of case).

debtors were a going concern as of the transfer date, then the plaintiff's expert's affirmative testimony on insolvency was no longer relevant and failed to assist the trier of fact, and thus, should have been excluded entirely under *Daubert*.<sup>83</sup> In other words, the plaintiff's expert sought to answer the wrong question, that is, the value of the debtors as a failed business when, in fact, the question was the value of the debtors as a going concern since the court found the debtor to be a going concern. An interesting follow-up is whether the failing concern business status was determined by the expert or posed as a hypothetical by the plaintiff's counsel, although it appears that the expert did make an independent determination to employ liquidation values. Of course, the expert's rebuttal testimony directed at the discounted cash flow model constructed by the defendants' expert would remain. We think it worthy of consideration in hotly contested insolvency cases where a key issue is business status and the appropriate premise of value for a court to set that issue before a full blown insolvency analysis is undertaken. This approach would reduce unnecessary costs often borne by the estate, would move the parties toward settlement, and would allow a court to manage effectively its docket.

### *C. Business Determination and Premise of Value*

Often the threshold issue in the valuation of a business is the question whether the subject business is a going concern. Experts tend to assume a going concern or not, providing very little insight or analysis in their expert reports or testimony in resolving this issue. Courts are no more helpful when they often conclude that a business is or is not a going concern without much analysis beyond embracing the colorful but misdirected metaphor that a business is a going concern "unless it is on its deathbed." Really, what exactly does that phrase mean? As a test, the deathbed metaphor is undisciplined, awkward, and unhelpful. To paraphrase Justice Benjamin Cardozo, nothing fetters thought like a rhythmic refrain.

The determination of whether the target business is or is not a going concern will influence assumptions, tools, and techniques employed throughout the valuation of the business. For example, if the target business is determined to be a going concern for the purpose of calculating insolvency as of the transfer date,<sup>84</sup> then the appropriate process for measuring fair valuation would generally require an expert to employ techniques of valuation that produce resulting values somewhere on a continuum running from fair market value on one end to orderly liquidation value on the other end. The value itself will depend on the relevant facts and circumstance as known or reasonably foreseeable at the time of the transfer under scrutiny. Moreover, a going concern may have substantial value in both severable goodwill (for example, intellectual property licensing rights owned by the subject

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<sup>83</sup> 509 U.S. 579, 597 (1993) (recognizing Federal Rules of Evidence, in particular Rule 702, "assign[s] to the trial judge the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task").

<sup>84</sup> See, e.g., 11 U.S.C. § 547(b) & (f) (2006).

business) and non-severable goodwill (for example, the future earning potential of the assets in excess of the value of the total tangible asset and the intangible severable asset value, generally discounted to present value). If the subject business is determined not to be a going concern, then the appropriate process for measuring the fair valuation of the business should require an asset and liability value somewhere on continuum running between an orderly liquidation and straight liquidation value. In these circumstances, although severable goodwill like the right to license a tradename may have value, nonseverable goodwill value may be severely impaired or even nonexistent.

As suggested above, much in an analysis of valuation turns on the resolution of the threshold issue of going concern status and the application of the appropriate premise of value; however, little guidance can be gleaned from authorities. In fact, in our examination of the case law addressing the issue of going concern has uncovered several myths that we seek to dispel.

The concept of going concern is not technically a measure or standard of valuation at all. It is an expression of the current status of a business and a premise of valuation. For example, Certified Public Accountants (C.P.A.) express their opinion on a business's financial statements based on a going concern standard. A going concern is a business that will continue in operation for an indefinite period of time. In contrast, the longevity of a business may be in question if it has a negative net worth, problems of liquidity or leverage, or of performance or profitability.

The determination that a business is a going concern influences the assumptions an expert will make and the tools and models employed. Once a business is determined to be a going concern, the expert will generally employ robust income and market approaches with the assumption of a continuing business embedded in the models. This determination generally requires an expert determine the total enterprise value of a business, using recognized valuation tools like an income approach, market approach, or asset approach. It does not mean that it is inappropriate to use an adjusted balance sheet approach if the Bankruptcy Code requires it, for example, in the context of a preference action under section 547(b). Borrowing from the well-reasoned commentary to Statement of Position ("SOP") 90-7,<sup>85</sup> an expert would determine the value of the company using the income and/or market approaches, compare that value to total tangible assets adjusted through a fair valuation and intangible severable goodwill adjusted through a fair valuation (collectively, "total asset value"). If the value of the business is greater than the total asset value as adjusted, then the company has positive non-severable goodwill that would be include as an additional asset on the fair valuation adjusted balance sheet.

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<sup>85</sup> Statement of Position 90-7, promulgated by the AICPA, requires certain accounting treatment when a business debtor is operating in chapter 11 and, if it qualifies for fresh start accounting, when it emerges from bankruptcy.

The bankruptcy institution generally approaches the determination of going concern as raising the question: is the business a going concern or is it not? Yet, experts have recognized in related fields that there are actually more than two outcomes to the determination of the status of a business. In the bankruptcy field, the status of a business is best understood as falling along a continuum of conditions ranging from going concern to failed concern, the labels we attach to both termini. Technically, status may be understood as a vector of business conditions from going concern (growing) to going concern (static) to going concern (declining) to failing concern to failed concern. Our cases tend to truncate the determination, then, by concluding that either one or the other extreme is applicable. To be sure, the truncating (or rounding off) the business status is not unreasonable and has practical support; however, that approach does not use all the relevant facts available in a case and paints an inaccurate picture of the business condition. Therefore, a valuation of the business driven by a better understanding of what the status of the business actually measures helps us account for the reality that not all going concerns are equal. For example, a court may confront a business that was a going concern as of the valuation date, but based on facts and circumstances reasonably foreseeable at the time of the transfer, the firm was sliding toward financial distress. In contrast, a court may confront a business that was a going concern at the relevant time and continued to operate as a going concern at a steady or increasing rate. Treating both situations comparably does not square with common sense or the realities of business.

Our experience also suggests that as valuations become more commonplace and courts develop greater sophistication as they confront this and related issues, we will begin to experience more courts embracing a bifurcated approach to valuations where valuation issues, such as insolvency in an avoidance action, will be tried in two phases: (1) the phase in determining whether the business is a going concern; and (2) the phase in determining the value of the business.

It should not surprise us that determinations of going concern often masquerade as determinations of value. What we mean by this is that many expert disputes on valuation are actually disputes over the status of the business and the premise of value to be employed. For example, the plaintiff's expert in a fraudulent transfer action under section 548 has opined that the debtor was insolvent as of the transfer date, employing a liquidation analysis, an analysis that assumes a failed or failing business. In contrast, the defendant's expert has opined that the debtor was solvent as of the transfer date, employing an assessment of the enterprise value of the debtor's business, an analysis that assumes a going concern. In reality, we would probably see that both experts would be close to agreement (or at least there will be no material differences) on the underlying valuation if given a business condition and concomitant premise of value; that is, the experts would find their opinions relatively close if they both employed an assumption of a failed business or the assumption of a going concern. Our present trial models fail to appreciate the economies of bifurcating the process of valuation. The bifurcation model is even

more compelling in a contested hearing on confirmation where the estate will pay the tab of competing experts retained by the debtor, the creditor's committee, and possibly an equity committee. Why put the estate to the expense of full-blown opinions on valuation, expert reports, depositions, and trial testimony by several experts before a court renders its finding on the status of the business and the premise of value, the appropriate range of acceptable projected free cash flows, etc.?

As mentioned, several valuation cases appear to have a preoccupation with the phrase "deathbed" in referring to when a going concern analysis is not appropriate for a distressed business. Although the term is quite colorful, it has little practical analytical significance. The deathbed metaphor suggests that business death must be immediately imminent. This approach collapses the determination of the status of the business into two phases—going concern and tantamount to dead. So, under this approach, what would we do with a business that will not make it through the week? Month? Next business cycle? Year? Two Years?

Some courts have struggled with the concept of the debtor's lying on its deathbed. Thus, cases embrace temporal standards to assess the appropriate business status, like "liquidation value is appropriate, however, if at the time in question the business is so close to shutting its doors that a going concern standard is unrealistic,"<sup>86</sup> or like "liquidation was clearly imminent."<sup>87</sup> A review of the better-reasoned cases suggests that the proper analytical frame of reference is to assess whether *it is more likely than not that the business will fail within the reasonably foreseeable future*.<sup>88</sup> We would suggest that the appropriate temporal reference would be within a year, thus, including, in most circumstances, at least one business cycle. We could then borrow from an analogous situation, that is, the types of evidence we find persuasive in the context of a feasibility finding for confirmation of a chapter 11 plan under section 1129(a).

We have been unsuccessful in determining the source of the next myth, that is, that if a business is a going concern, it must follow that it is solvent. We suspect this is an outgrowth of the metaphor of the deathbed. The thought process goes like

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<sup>86</sup> *In re Vadenais Lumber Supply, Inc.*, 100 B.R. 127, 131 (Bankr. D. Mass. 1989). See *Mitchell v. Inv. Sec. Corp.*, 67 F.2d 669, 671 (5th Cir. 1933) (recognizing it is actual, rather than theoretical condition of debtor which determines insolvency); *In re Windor Inc.*, 459 F. Supp. 270, 275 (Bankr. N.D. Tex. 1978) ("The fact that a company is nominally in existence is not persuasive in valuing the company at 'going concern' valuation.").

<sup>87</sup> *In re DAK Indus., Inc.*, 195 B.R. 117, 125 (Bankr. C.D. Cal. 1996), *aff'd*, 170 F.3d 1197 (9th Cir. 1999). See *In re Intercontinental Polymers, Inc.*, 359 B.R. 868, 873 (Bankr. E.D. Tenn. 2005) (recognizing most courts define fair valuation to require debtor's assets to be valued based on going concern value, unless debtor is on deathbed, "in which case liquidation value is used"); *In re Miller & Rhoads, Inc.*, 146 B.R. 950, 955 (Bankr. E.D. Va. 1992) ("Where a business is in a precarious financial condition or on its deathbed, the assets should be valued on a liquidation rather than a going concern basis.").

<sup>88</sup> See *Miller & Rhoads*, 146 B.R. at 955–56 (defining deathbed debtor as in "precarious financial condition"); *In re Art Shirt Ltd., Inc.*, 93 B.R. 333, 341 (Bankr. E.D. Pa. 1988) (noting if company is on its deathbed, application of going concern value is not appropriate); Frank R. Kennedy, Vern Countryman & Jack F. Williams, *PARTNERSHIPS, LIMITED LIABILITY ENTITIES & S CORPORATIONS IN BANKRUPTCY* Chs. 6 and 13 (Gaithersburg ed., Aspen Publishers 2000).



this: the business is not dead today, is not dying tomorrow, and should survive the week; therefore, the business is a going concern and because it is a going concern, it must be solvent. Granted, we exaggerate, but only to prove our point. In practice, once an expert determines that the business is a going concern, we then employ the appropriate tools and models to determine whether a business is insolvent. Under this myth, we would add the statements we have heard in courts that because businesses are sold in bankruptcy all the time at some positive value, businesses are generally solvent. Not so! Business assets are sold in bankruptcy all the time for positive value *stripped of the debt that once encumbered them!* In bankruptcy, an insolvency analysis always requires a comparison of assets and liabilities.<sup>89</sup> A positive value of the debtor's assets presents one side of the equation; however, an appropriate model must allow the trier of fact to compare assets and liabilities.

The final myth happens to be one of our favorites in that it uncovers the very human nature of judges and practitioners. Authorities are unanimous in that one must determine value as of a given date. That date is usually tied to some event, for example, the transfer date, the date an obligation was incurred, the filing date of the bankruptcy petition, the confirmation date, the effective date of the confirmed plan, etc. Thus, courts warn us that hindsight is irrelevant and, in fact, confuses the issue. Yet experts and courts alike use hindsight all the time. For example, experts have testified and courts have observed that if a business continues to operate after the relevant date, then it must have been a going concern as of that relevant date. That is hindsight, plain and simple.

The following are two examples where hindsight would lead to the wrong conclusion. In the first case, assume a business is in a precarious financial condition in January 20XX. The business plan is failing and customer contracts are drying up. The business may be able to operate a month or two at most and would then have to liquidate. A transfer is made in February 20XX. Later that month, the business is awarded a new, unexpected contract by one of its competitor's customers because of a fire suffered by its competitor. The contract is large enough that it keeps the business operating for another 18 months. In 20X1, the business files a bankruptcy petition. The creditors committee brings an action to attack the transfer as fraudulent and seeks to show the business was insolvent in February 20XX.

Based on the facts and circumstances as known or as reasonably foreseeable, as of the transfer date, it appears that the business was not a going concern and that liquidation would be necessary within a month or two. But an unforeseeable subsequent event occurred. The fact that a competitor suffered a fire, thus forcing its customers to seek cover from other sources like the debtor business, was not foreseeable (a valuation expert may use the phrase "known or knowable" and mean

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<sup>89</sup> See 11 U.S.C. § 101(32)(A) (2000) (defining "insolvent" as "financial condition such that the sum of such entity's debts is greater than all of such entity's property at a fair valuation"); *In re PWS Holding Corp.* 228 F.3d 224, 233 (3d Cir. 2000) (testing solvency by whether company's assets exceeded its liabilities); *In re Labrum & Doak, LLP*, 227 B.R. 383, 387 (Bankr. E.D. Pa. 1998) (mentioning Bankruptcy Code uses "balance sheet test for insolvency, comparing assets to debts").

the same thing) at the time of the transfer, as of the relevant date. To be sure, the buildings in which businesses are located may catch fire, but that fact does not make the subsequent fire reasonably foreseeable. Subsequent events, like the new contract or continued operations, should be ignored.

In the second case, assume a business is financially stable with modest but sustained growth. A transfer is made in February 20XX. Later that year, a terrorist attack occurs that has a negative impact on the relevant segment of the market, causing all businesses to begin to lose money at an alarming rate. In 20X1, the business files a bankruptcy petition. The creditors committee brings an action to attack the transfer as fraudulent and seeks to show the business was insolvent in February 20XX.

Based on the facts and circumstances as known or reasonably foreseeable as of the transfer date, the business appears to be a going concern. Again, an unforeseeable subsequent event occurred. The fact that a terrorist attack harmed the relevant segment of the market was not reasonably foreseeable at the time of the transfer. The subsequent terrorist event and the failure of the business should be ignored.

In summary, in both instances, subsequent events not known or reasonably foreseeable (knowable), based on the facts and circumstances at the time of the relevant transfer, should be ignored. Often one of those subsequent events that should be ignored in developing an opinion (as opposed to testing a preliminary opinion) is the actual continuation or failure of a business after the relevant valuation date.

#### *D. Generally Accepted Valuation Techniques*

##### **1. Income Approach**

The income approach is a method of determining the value of a company by estimating the present value of the projected future cash flows to be generated by the business and available (although not necessarily paid) to the capital providers of the company. The income approach is based on the fundamental assumption that value can be estimated upon expected cash flows and risk.<sup>90</sup> Many valuation experts state that the income approach, for example, the discounted cash flow method, is the most economically rigorous of the methodologies used to estimate business value because it considers all of the factors that determine value: cash flow, timing, and risk, etc. Thus, the income approach seeks to determine a debtor's indicated value by first analyzing applicable financial projections to calculate the projected free cash flow for each year for which projections are available.<sup>91</sup> The approach is

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<sup>90</sup> AIRA, *supra* note 39, at 3:1.

<sup>91</sup> This is referred to as the "projection period." See Bernhard Grossfeld, *Global Financial Statements/Local Enterprise Valuation*, 29 J. CORP. L. 327, 348 (2004) (defining income approach as corporation's ability to generate earnings and cash flow); Robert F. Reilly, *Valuation of Goodwill and Other*

appropriate in many situations for determining the debtor's going concern value, when the value of any asset, including a company, can be reasonably estimated to be the present discounted value of the future cash flows that are generated by that asset. That the enterprise is a going concern is a fundamental premise to the income approach because the value is determined by future cash flows generated by continued operations of the company.

One of the most common and well-accepted forms of the income approach used to value businesses is the discounted cash flow approach. There are three fundamental components of the discounted cash flow approach. These components are: (1) projected discrete period cash flows; (2) terminal value; and (3) discount rate.<sup>92</sup> The general formula for estimating the value of a company is:

$$\text{Value of Firm}^{93} = \sum_{t=1}^{t=n} \text{CFF}_t / (1 + \text{WACC})^t$$

Where:

t	=	time period
n	=	life of firm
CFF <sub>t</sub>	=	expected cash flow to firm in period t
WACC	=	weighted average cost of capital

The calculation for cash flows to the firm may be depicted by the following formula:

$$\begin{aligned} \text{CFF} = & \text{earnings before interest and taxes ("EBIT")} (1 - \text{tax rate}) \\ & + \text{depreciation}^{94} \\ & - \text{capital expenditures ("CAPX")} \\ & - \text{incremental changes in debt free net working capital} \\ & \text{("DFNWC")}. \end{aligned}$$

Under a discounted cash flow approach, the first step is to identify an appropriate set of projections (generally created by management or other investors (read broadly) in the firm as independently considered and analyzed by the expert) or create the projections from which to calculate each period's projected free cash

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*Intangible Assets*, 21 AM. BANKR. INST. L.J. 30, 31 (2002) (basing income approach on economic principle of anticipation where "the value of the discrete intangible asset is the present value of the expected economic income to be earned from the ownership of that intangible"); Robert F. Reilly, *Analysis of Intangible Cont. Rights*, 16 AM. BANKR. INST. L.J. 31 (1997) (recognizing that within projection period longer remaining useful life would indicate higher value, and shorter remaining useful life would indicate lower value).

<sup>92</sup> See AIRA, *supra* note 39, at 3:1.

<sup>93</sup> It may be appropriate to add in excess cash and non-operating assets. Moreover, deductions for certain liabilities, such as underfunded pension funds, may be appropriate. See AIRA, *supra* note 39, at 3:4.

<sup>94</sup> It is appropriate to add back other non-cash charges such as amortization and goodwill write-offs. See AIRA, *supra* note 39, at 3:4.

flow.<sup>95</sup> Theoretically, the figures used in a discounted cash flow analysis accurately represent the true cash flow to the firm generated by a company.<sup>96</sup> The approach incorporates cash investments in working capital and fixed assets, while also recognizing the non-cash expenses contained in earnings figures. The cash flows are typically projected over a discrete time period. For example, adequate cash flow projections may contain information on gross revenues, returns and allowances, net sales, gross profit, depreciation and amortization, environmental expense, capital expenditures, projected income taxes, and projected working capital changes. In a distressed situation, careful attention must be dedicated to the construction of expected cash flows. Necessary attention must be given to potential changes in working capital needs, capital expenditures, or taxes.<sup>97</sup> Moreover, an expert should consider whether the estimate of cash flows is consistent with any proposed plan of reorganization and includes restart costs if certain operations have been shut down but will be restarted, additional advertising allowances to re-attract customers, underfunded pension plan costs, the cost structure effect of assumed or rejected executory contracts and leases, and the normalization of operational costs.<sup>98</sup>

Once an expert calculates this projected free cash flow, the second step requires the expert to calculate the terminal value of the company.<sup>99</sup> As noted above, because

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<sup>95</sup> Free cash flow may be defined in a number of ways, including EBIT; "EBIT after environmental expense" minus taxes plus depreciation and amortization minus capital expenditures minus increases in working capital; EBITDA; EBITDAR; etc. Moreover, a metric like EBITDA may be calculated top-down or bottom-up. The expert's testimony should clearly identify what metric for free cash flow she is using, why that metric is chosen, and how it is calculated. *See Andalaro v. PFPC Worldwide*, No. 20336, 2005 Del. Ch. LEXIS 125, at \*64 (Aug. 19, 2005) (discussing different methods that can be used to value company's equity such as: "finding comparable, publicly-traded companies that have reviewable financial information . . . [and] calculating the ratio between the trading price of the stocks of each of those companies and some recognized measure reflecting their income such as revenue, EBIT or EBITDA . . ."); Robert Reilly, *Analyst Ethics Considerations in Bankruptcy Business/Stock Valuations* 26 AM. BANKR. INST. L.J. 56, 59 (2007) (including analytical review procedures and due diligence investigations of projection variables as appropriate procedures to test reasonableness of income approach); Robert F. Reilly, *Valuation of Goodwill and Other Intangible Assets*, 21 AM. BANKR. INST. L.J. 30, 34 (2002) (suggesting remaining useful life analysis "should be performed to estimate the projection period for economic income subject to either yield capitalization or direct capitalization").

<sup>96</sup> Technically, the cash flow stream used in a valuation depends on the business interest being valued. When valuing the total or business enterprise, an expert should use cash flows to the firm (often also referred to as cash flows to invested capital). *See AIRA, supra* note 39, at 3:3. If an expert is valuing equity, he should generally use either cash flows to equity or indirectly values equity by estimating the value of the firm and subtracting interest bearing debt. *See AIRA, supra* note 39, at 3:3.

<sup>97</sup> *See AIRA, supra* note 39, at 3:1.

<sup>98</sup> *See AIRA, supra* note 39, at 3:7.

<sup>99</sup> A debtor's terminal value is the value of the debtor as of the end of the given projection period. *See Gold v. Ziff Commc'ns. Co.*, 748 N.E.2d 198, 207 (Ill. App. Ct. 2001) (calculating terminal value by taking projected earnings and dividing them by capitalization rate); *In re Nellson Nutraceutical, Inc.*, 356 B.R. 364, 367 (Bankr. D. Del. 2006) ("To calculate a 'terminal value' an expert determines an appropriate metric of value and applies a multiple to that metric."); George R. Mesires, *The Valuation Trial of Nellson Nutraceutical: Emerging Trends and Courtroom Basics*, 26 AM. BANKR. INST. J. 60, 60 (2007) (reporting that metric of value used to determine debtor's terminal value is "typically used as a credit statistic"). The terminal value may be constant, where no continued growth is anticipated past the projection period, or increasing (or, theoretically, decreasing). *See ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 923 (Del. Ch. 1999) (stating that "constant growth valuation model is the best method . . . to determine terminal value for a

the projected cash flows occur over a finite period of time, it is necessary to compute a terminal value at the end of the projected period. The terminal value is essentially an estimate of the value of the business at that future point in time, and it incorporates the assumption of perpetual operations and some mark of implicit growth or stabilization found in the market capitalization approach. Common models used to calculate terminal values include, but are not limited to, the Exit Multiple Approach and the Gordon Growth Model.

The third step an expert must take is to identify and apply the appropriate discount rate. The discount rate is the rate of return that would be required by providers of capital (both debt and equity) to the company to compensate the investors for the time value of money and the systematic risk inherent in the particular investment. The discount rate is the counterpart to the market multiple described below in the use of market approaches to value and is intended to reflect all systematic risks of ownership and the associated risks of realizing the stream of projected future cash flows. Unlike the market multiple described below, the discount rate employed in a discounted cash flow analysis contains no implicit expectations of growth for the future cash flows. Instead, the projected cash flows themselves reveal growth expectations, while allowing for a great deal more flexibility and accuracy in projecting such growth rates.

After identifying the discount rate, the final step an expert must take is to then discounts each year's free cash flow and the terminal value back to the relevant valuation date to determine present value. Finally, the expert considers the value of assets not needed for the debtor's operations and excess cash and adds these values to determine the indicated value of the business under a going concern premise of value as of the date of valuation.

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discounted cash flow analysis"); Del. Open MRI Radiology Assocs., P.A. v. Kessler, 898 A.2d 290, 337 (Del. Ch. 2006) (using constant rate of growth). *But see* Montgomery Cellular Holding Co. v. Dobler, 880 A.2d 206, 215 (Del. 2005) (explaining why constant growth rate is not always proper). An expert should explain how terminal value is calculated, what metrics were used, and why. One should also be cautious if a substantial portion of the discounted value of a business is attributable to the terminal value component when dealing with distressed businesses in bankruptcy. *See In re Mid-State Raceway, Inc.*, 343 B.R. 21, 23 (Bankr. N.D.N.Y. 2006) (discussing how companies turn around distressed businesses); *Ass'n of Flight Attendants-CWA, v. Mesaba Aviation, Inc.*, 350 B.R. 435, 449 (D. Minn. 2006) (discussing long term rehabilitation of distressed businesses). *See generally* Bell v. Commissioner, 200 F.3d 545 (8th Cir. 2000). Recall that if a typical projection period is about 5 years, a terminal value would pick up in Year 6 and on. Projections that far out may start to present issues of reliability. While tolerance for uncertainty is expected and reasonable—after all, valuation opinions are in fact probabilistic endeavors, courts should be mindful of the percentage of total enterprise value attributable to the terminal value of the enterprise *See In re Nellson Nutraceutical, Inc.*, 356 B.R. 364, 367 (Bankr. D. Del. 2006) ("To calculate a terminal value an expert determines an appropriate metric value and applies a multiple to that metric"); *see also In re Intelligroup Secs. Litig.*, 468 F. Supp. 2d 670, 687 (D.N.J. 2006) (describing various ways to calculate terminal value). By this caution, we are not suggesting that a discounted terminal value that accounts for a substantial portion of the total enterprise value is always suspect; what we are suggesting, however, is that an expert explain why a substantial component of the total enterprise value of a business is attributable to discounted terminal value. For example, a business emerging from chapter 11 may require initial substantial CAPX that may decrease cash flows early in the life of the emerging entity, which may not be reaped for several years out and may not be reflected in the cash flows until late in the projection period or in the terminal value of the company.

Often the key determinant and cause of variance among experts in their valuation opinions is the selection of the appropriate discount rate. In order to derive the appropriate discount rate, the standard sub-methodology is to compute the "weighted average cost of capital or WACC" which, in turn, requires separate sub-analyses of (a) the cost of capital for the equity component of the debtor's balance sheet and (b) the cost of capital for the debt component of the debtor's balance sheet, together with a proper weighting of the percentages of debt versus equity components.<sup>100</sup> An expert's selection of a discount rate should be consistent with the overall valuation approach and with the particular cash flow being discounted. If the projected cash flows, for example, contain no deduction for interest expense, the assumption regarding the capital structure of the firm must be incorporated into the discount rate. As such, the discounted cash flow approach would use the WACC, which is an average value required by all sources of capital (debt, preferred equity, common equity, etc.) for the subject company weighed by its respective percentage share in the capital structures. The elegance of the following formula succinctly captures the components of the WACC:

$$\text{WACC} = K_d (1-t)(D/\text{BEV}) + K_p(P/\text{BEV}) + K_c(E/\text{BEV})$$

Where WACC	=	Weighted average cost of capital
$K_d$	=	Cost of debt capital (pre-tax)
$K_p$	=	Cost of preferred equity capital
$K_c$	=	Cost of common equity capital
D	=	Debt capital (market value)
P	=	Preferred equity (market value)
E	=	Common equity (market value)
BEV	=	Business enterprise value (market value)
T	=	Marginal corporate tax rate

The costs of capital (debt and equity) used in the WACC are estimates of appropriate expected returns for the various providers of capital to the company. These variables can be estimated by examining similar investment opportunities in the public market and by attempting to determine the market consensus expected returns for these investments. These figures can then be used as a basis for selecting appropriate expected returns for the company.<sup>101</sup>

The cost of debt capital is typically defined as the yield to maturity on comparable debt instruments traded in the public market, as adjusted for specific

<sup>100</sup> See *In re Mirant Corp.*, 334 B.R. 800, 817 (Bankr. N.D. Tex. 2005) (detailing WACC calculation); *In re Oneida Ltd.*, 351 B.R. 79, 88 (Bankr. S.D.N.Y. 2006) (identifying WACC as "projected costs of debt and equity and the split between the two"); *In re Med Diversified, Inc.*, 346 B.R. 621, 635 n.27 (Bankr. E.D.N.Y. 2006) (providing equation for WACC:  $(K_c * W_c) + (K_d[1-t] * W_d)$ ).

<sup>101</sup> Calculating the WACC for a distressed company is especially challenging because of a potential changing capital structure. A practice emerging in the distressed business context is to employ an iterative process or the adjusted present value method. See AIRA, *supra* note 39, at 2:31.

risk factors related to the relevant company. Similarly, the cost of preferred equity capital can be defined as the risk-adjusted yield to maturity on comparable, publicly traded, nonconvertible preferred stocks. In general, the yield to maturity represents the market consensus on the percentage return that is appropriate for the particular security. It is an estimate of the expected return as of a particular point in time and is relatively easy to compute given the amount and timing of future payments.

The cost of equity capital is widely defined by the use of an estimate of the cost of equity known as the capital asset pricing model or CAPM.<sup>102</sup> The CAPM attempts to relate the systematic risk inherent in an investment with the returns

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<sup>102</sup> Recently, Delaware courts have suggested that the academic financial community may have begun to drift from the Capital Asset Pricing Model or CAPM, which is a one-factor equity return model, toward multi-factor equity models. Competing models, which are variants of the traditional CAPM, discussed by academics and increasingly used along side or instead of CAPM are the modified Capital Asset Pricing Model or MCAPM and, particularly in some Delaware state courts, the Fama-French model. See R. Scott Widen, *Delaware Law and Weighted Average Cost of Capital Calculations*, O'Melveny and Meyers Newsletter (March 12, 2007), available at <http://www.omm.com/newsroom/publication.aspx?pub=535>; see also Del. Open MRI Radiology Assocs., P.A. v. Kessler, 898 A.2d 290, 338 n.129 (Del. Ch. 2006) (professing that Fama-French model is preferred over other models because of its focus on small stocks); Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PA. L. REV. 523, 543 (2003) (explaining Fama's reasoning for rejecting CAPM model lies behind its useless estimates of market capitalization rate for individual companies). But see Union Ill. 1995 Inv. L.P. v. Union Fin. Group, Ltd., 847 A.2d 340, 363 (Del. Ch. 2003) (asserting that Fama-French model is not universally accepted). The MCAPM, suggested as an additional tool in the distressed business context in the AIRA's valuation body of knowledge, is simply the traditional CAPM with an additional adjustment for size and unsystematic or company-specific risk, called *alpha*. See AIRA, *supra* note 39, at 2:3–2:5. The Fama-French model adds two additional factors: size and book-value-to-market-value ratios. See Del. Open MRI Radiology Assocs., 898 A.2d at 338 (noting Fama-French's emphasis on small cap stocks). The use of the ratio theoretically "increases the expected equity return, and thus, the expected risk, for stocks with high book-value-to-market-value ratios relative to stocks with low book-value-to-market-value ratios." R. Scott Widen, *Delaware Law and Weighted Average Cost of Capital Calculations*, O'MELVENY AND MEYERS NEWSLETTER (March 12, 2007), available at <http://www.omm.com/newsroom/publication.aspx?pub=535>. See Union Ill. 1995 Inv. L.P., 847 A.2d at 363 n.64 (stating that "Fama-French calculus takes the relationship of market price to book value into account"). The Fama-French equity model is presently lagging in use by distressed business valuation experts behind the CAPM and the MCAPM.

The Fama-French model provides a different approach to calculating the cost of equity. It is not possible to say whether the numbers provided by the Fama-French model are better or more reliable than the cost of equity estimates provided by the CAPM. Both models fail to produce logical results for a large number of entities. The Fama-French model should be viewed as an additional tool available to analysts in determining the cost of equity.

STOCKS, BONDS, BILLS AND INFLATION (SBBI) VALUATION EDITION YEARBOOK (Morningstar Inc. 2007). "Ultimately, the survival of the capital asset pricing model as a default model for risk in real-world applications is testament to both its intuitive appeal and the failure of more complex models to deliver significant improvement in terms of estimating expected returns." ASWATH DAMODARAN, DAMODARAN ON VALUATION: SECURITY ANALYSIS FOR INVESTMENT AND CORPORATE FINANCE 35 (2d ed. 2006). The modification of CAPM to capture size, unsystematic risk, or other factors is controversial. At this point in the development of the discipline of valuations in the context of distressed businesses, the use of modifications of the CAPM should be made cautiously and may be best reserved at this time as a tool for cross-validation. However, as we write this, ongoing empirical research in the finance field is exploring the modification of CAPM based on size, unsystematic risk, and other adjustments.

expected by investors. In short, the price paid for an asset must yield an expected return sufficient to compensate the investor for the risk that the expected future value is not realized. Expected return estimates generated by the CAPM will not, however, compensate the investor for elements of risk that can be easily reduced through diversification. In fact, one of the critical assumptions underlying the CAPM is that investors prefer to hold well-diversified portfolios.<sup>103</sup> Diversification eliminates the unsystematic risk attached to a particular company's stock. Thus, the CAPM is based on quantifying systematic risk because it assumes that rational investors will hold well-diversified portfolios, thereby eliminating unsystematic risk.<sup>104</sup>

The following formula depicts the components of the CAPM used to estimate the company's cost of equity:

$$K_c = R_f + (\beta * R_p)$$

Where $K_c$	=	Cost of common equity capital
$R_f$	=	Risk-free rate of return (as of the valuation date)
$\beta$	=	Beta, systematic risk of a firm relative to the market
$R_p$	=	Equity risk premium

From the formula, one may see that the CAPM rests on the theory that the expected rate of return on a common stock investment may be explained by three factors: (1) risk-free rate of return; (2) equity risk premium; and (3) *beta*. The risk-free rate of return ( $R_f$ ) depicts the market consensus expected return on a value of security with no risk of default. Thus, the factor theoretically compensated an investor for the time value of money. Experts use the yield on newly issued long-term (10-year) U.S. Treasury bonds as a proxy for this hypothetical rate of return. The Equity Risk Premium ( $R_p$ ) is designed to capture the additional return required by investors to compensate them for the inherent risks of common stock investments. Adding the equity risk premium to the risk-free rate of return (as depicted in the formula above) results in the total expected return on common stock investments. Experts define the equity risk premium as the historical average premium of common stock total returns over long-term Treasury bond yields.

However, because the risk level of common stock investments varies considerably, expected returns will also vary. Thus, it is necessary to adjust the magnitude of the risk premium to the risk profile of the subject company. Experts capture this adjustment through the variable labeled *beta* ( $\beta$ ). *Beta* is generally calculated using historical performance over some articulated time frame.<sup>105</sup> *Beta* is

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<sup>103</sup> See AIRA, *supra* note 39, at 2:2.

<sup>104</sup> See *id.*

<sup>105</sup> See AIRA, *supra* note 39, at 2:4–2:5. For a discussion of the potential problems associated with the use of historical betas where a company has experienced financial distress, see *id.* at 2:4–2:7.



the standardized measure of nondiversifiable risk. Technically, *beta* is defined as the covariance of the returns on the particular asset with the returns on the market portfolio divided by the variance of the returns on the market portfolio. The *beta* for the market portfolio, or the average common stock investment, is 1.0.<sup>106</sup> The higher the perceived risk of a particular common stock investment, relative to an average common stock investment, the higher the *beta*. Recall that *beta* is a measure of the systematic nondiversifiable risk of the levered company. Comparable companies, however, usually employ leverage amounts different than the subject company. To adjust for this difference, an expert typically unlevers comparable company *betas* and then relevers using the expected capital structure of the subject company.<sup>107</sup>

## 2. Market Approach

The second of three approaches used in the valuation of a debtor company is the market approach, which incorporates the "comparable or guideline company" method and "similar transaction" method as indicators of the value of a business.<sup>108</sup> The market approach contains the fundamental assumption that a prudent investor will pay no more for the assets than it would cost to acquire a substitute property of the same utility.<sup>109</sup> The market approach attempts to capture the valuation of an

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<sup>106</sup> See *id.* at 2:3.

<sup>107</sup> See *id.* at 2:7–2:10. There are several open issues on the calculation and use of *beta* by valuation experts, some of which are starting to be explored by, among other forums, Delaware state courts. A synthesis of several cases on the use of *beta* suggests the following developing issue: First, although acknowledging that the longer a time period in support of a *beta* calculation the better, Delaware state courts have not insisted that a valuation expert calculate a five-year as opposed to two-year *beta*. According to these courts, neither approach is presumptively correct. Thus, it is important for the expert to clearly state what support he has in using one type of *beta* testing period as opposed to another. Second, Delaware courts have recognized the problems in relying on adjusted historical *betas* as a way by which an expert may capture unsystematic risk. See *supra* note 102. This is a controversial issue in the discipline of distressed business valuation. Even a single percentage point adjustment to the discount rate generally has a more significant impact on business value than, for example, a 5% increase or decrease in cash flows. Thus, assigning a company-specific risk premium, for example, to a discount rate used in a business valuation may dramatically impact value and may be problematic in light of weak empirical proof and the reliability of measure. These courts express a deep suspicion of arbitrary *beta* and discount rate adjustments. See *Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 338 (Del. Ch. 2006) (rejecting the concept of implementing artificially discounted values). Finally, at this time, the Delaware courts have been silent on the form of capital structure that an expert may use in re-levering a discounted cash flow analysis. Although the target capital structure approach, as opposed to an existing capital structure approach, is consistent with the academic literature, any choice must be based on a well articulated foundation disclosed in the expert report and on the evidentiary record. See *New England Tel. & Tel. Co. v. Public Utilities Comm.*, 448 A.2d 272, 307 (Me. 1982) ("Textbook economics suggests that an enterprise is likely to establish a target capital structure and make individual financing decisions that are consistent with the maintenance of the target."). For an excellent short discussion of these issues, see R. Scott Widen, *Delaware Law and Weighted Average Cost of Capital Calculations*, O'Melveny and Meyers Newsletter (March 12, 2007), available at <http://www.omm.com/newsroom/publication.aspx?pub=535>.

<sup>108</sup> In certain circumstances, an expert may also employ the "historical internal transactions" method that considers internal transactions of the subject company. See *AIRA*, *supra* note 39, at 4:1.

<sup>109</sup> See *id.* at 4:1.

enterprise based upon values determined by the markets as a multiple of various metrics, including, but not limited to, revenues or sales, cash flows, or net income. There are two basic "markets" relied on. The first is the market for publicly traded securities, e.g., equity in particular comparable public companies (that is, trading comparables). The second is the market for entire companies which are sold or acquired (that is, comparable transactions). By applying valuation multiples, as determined by these markets to the debtor's metrics, an expert may arrive at an estimate of value based on a sample of trading comparables and/or of comparable market-based transactions.

The comparable or guideline company approach determines the value of a company generally by analyzing similar public (and sometimes private) companies and applying market multiples derived from the comparative companies to the subject company. The market multiple is used as a proxy for what investors believe to be a reasonable rate of return for the particular security. The market multiple assumes that the company will generate some level of earnings in perpetuity. In the comparable or guideline company approach, companies having their stock traded in the public markets are selected for comparison and used as a basis for choosing reasonable multiples for the subject company. Under this method, the expert seeks to determine the subject company's indicated value by analyzing the prices of comparable publicly traded companies and, more specifically, the valuation multiples inherent in these prices vis-à-vis those companies' historical financial performance. After analyzing these valuation multiples, the expert must analyze the company with respect to the selected guideline companies to determine comparative strengths, weaknesses, and overall differences. Based on these observations, the next step is to select the most appropriate multiples to apply (the "applied multiples") to the debtor's own historical data on its financial performance. These multiples follow two general types: (1) invested capital multiples and (2) equity multiples.<sup>110</sup> Invested capital multiples include total invested capital multiples ("TIC" multiples) or market value of invested capital multiples ("MVIC" multiples). The numerator of an invested capital multiple represents the market value of both debt and equity.<sup>111</sup> The corresponding denominator is a parameter that includes cash flows to both debt and equity holders, such as EBITDA.<sup>112</sup> The numerator of an equity multiple is the market value of the equity.<sup>113</sup> The corresponding denominator is a parameter that includes cash flows available only to equity, such as net income.<sup>114</sup>

In distressed situations, the use by an expert of MVIC multiples may be more appropriate for several reasons. First, MVIC multiples are capital structure neutral and may provide a superior basis of comparison among companies with widely

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<sup>110</sup> See *id.* at 4:2.

<sup>111</sup> See *id.*

<sup>112</sup> See *id.*

<sup>113</sup> See *id.*

<sup>114</sup> See AIRA, *supra* note 39, at 4:2.

different capital structures.<sup>115</sup> Second, a distressed business may have little or no cash flows, after interest expense, that may distort implied equity values and render the use of any equity multiples meaningless.<sup>116</sup> Third, the total enterprise value of a distressed company may not exceed the value of its total debt, indicating impairment to debt holders and no value to equity.<sup>117</sup>

The final step in employing the comparable or guideline company approach is to apply appropriate weightings to all of the resulting indicated values and to reconcile these indicated values into one indicated value in accordance with the guideline method. Again, the selection of comparable companies must be a sensitive, deliberate, and objective process. The criteria, protocol, and results should be carefully detailed in the expert's report. In addition, an expert may also consider focusing on several separate time frames: (1) a five-year average; (2) a three-year average; (3) the most recent fiscal year; and/or (4) the latest twelve months. In gauging the comparable companies, an expert may consider a number of different metrics, such as size, margins, return on equity, historical growth, short-term liquidity, and leverage. Lastly, care must be given to any differences between the subject company and any guideline companies related to the benefits associated with the use of tax attributes, such as net operating losses, carryforwards, and carrybacks (collectively, "NOLs"). For any applied multiple that is built from data above the tax line (for example, EBIT, EBITDA, etc.), where a significant unutilized NOL exists, the NOL must be valued separately and added to the implied value.<sup>118</sup>

Under the similar transaction approach, the expert analyzes the transaction multiples that various acquirers paid in acquiring majority stakes in similar target companies. This approach uses multiples derived from observing the prices paid in actual transactions, such as mergers and acquisitions of similar companies. Common multiples include MVIC/Sales, MVIC/EBITDA, and MVIC/EBIT.<sup>119</sup> These multiples are then applied to the subject company to derive an indication of value. The selection of similar transactions is a sensitive, deliberative, and careful process. Although a certain minimum level of transactions may be necessary to derive any confidence from any inferences that may be applicable to the present task of valuation, the quality of the selected transactions and not their quantity is of paramount importance. These similar transactions should be identified in the report on valuation and the criteria for their selection should be carefully detailed. Moreover, a protocol established before one begins the study may help demonstrate an objectivity that should be employed in this analysis. This protocol should

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<sup>115</sup> See *id.* at 4:6.

<sup>116</sup> See *id.*

<sup>117</sup> See *id.*

<sup>118</sup> See *id.* at 4:14.

<sup>119</sup> See *id.* at 4:15. In addition to MVIC multiples, an expert may decide to focus on several valuation multiples, including, but not limited to: (1) Total Invested Capital ("TIC") to revenues; (2) TIC to Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"); and (3) TIC to Earnings Before Interest and Taxes ("EBIT"). See *id.* at 4:11–4:14.

include the efforts undertaken to identify similar transactions, beyond what one may find in press reports. For example, factors that should be considered include: (1) the form of consideration, including cash, stock, noncompete agreements, seller notes, or any combination thereof; (2) the health of the acquired entity and any need for capital infusion to sustain it as a going concern; (3) assumption of liabilities by the purchaser; or (4) whether the buyer is strategic or financial.<sup>120</sup>

Under any market approach, be it the guideline company method or the similar transaction method, of paramount importance is that the expert delineate the procedures, process, assumptions, and variables employed and the results achieved in a clear, jargon-free, and objective manner. The expert should eschew any methodology that approximates the following:

Market data → "then a miracle occurs" → business enterprise value.<sup>121</sup>

Although widely used as estimates of value, the use of comparable or guideline companies and similar transactions may be problematic. First, it is extremely difficult to find a truly comparable company or similar transaction. Adjustments to harmonize differences among comparables are often arbitrary and may lead to erroneous conclusions. Second, it is difficult to estimate how a multiple should change as a result of a change in a company's strategy, which makes them practically useless in evaluating companies that are undergoing volatile strategic and operational changes. Third, the analysis of the multiples for comparable companies averages away the very distinctions that are most important in estimating value. Fourth, the analysis of multiples for comparable companies typically uses public company data to calculate value. However, incorporating the multiples derived from comparable publicly-held companies into a valuation of a privately-held debtor company introduces a wide array of potential distortions, which may only be partially alleviated by adjusting the valuation both positively and negatively by additional factors, including, for example, the minority discount and the control premium.<sup>122</sup> By the time all of these adjustments are made, the integrity of the valuation may have been seriously compromised. Fifth, some experts employ market multiples derived from private companies collected in proprietary databases that are typically not fully disclosed to opposing parties, their counsel, and experts. The secrecy surrounding the proprietary nature of the data relied on by an expert to render an opinion on valuation does not square with the disclosure requirements under Rule 26 of the Federal Rules of Civil Procedures, as applied to bankruptcy cases and proceedings under the Bankruptcy Rules. If an expert employs proprietary data, then that expert must disclose that data, must defend the integrity

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<sup>120</sup> See AIRA, *supra* note 39, at 4:15–4:16.

<sup>121</sup> One may be surprised how often the "equation" above captures the essence of an expert report.

<sup>122</sup> See SHANNON P. PRATT, BUSINESS VALUATION DISCOUNTS AND PREMIUMS (John Wiley & Sons, Inc. 2001).

of the data collection, and must attest to the reliability of the collection process. Opposing counsel and experts then should have the opportunity to consider, evaluate, and employ that data to test the expert's use of private company data to ascertain an indication of the subject company's value, subject to the issuance of any protective order, if necessary. Finally, the application of the market approach may need to be modified slightly as additional factors (both qualitative and quantitative) should be considered because of the nature of distressed business valuations.<sup>123</sup> These factors include excessive leverage; significant changes in business strategies; quality of new management, including the skills of a chief restructuring officer or other advisor; constraints on liquidity; and potential operational hurdles in the restructuring.<sup>124</sup>

### 3. Asset Valuation Approach

Under the asset valuation approach, the expert focuses on the current value of the company's underlying assets. The theoretical link is that the value of the assets of a company may be a prime determinant of value, which is based on the operations of an enterprise. This approach is particularly appropriate for holding companies, companies in underperforming industries, companies with significant tangible assets and/or real estate, some investment companies, and failed businesses that seek some form of liquidation.<sup>125</sup> This approach to valuing assets is particularly important to consider as opposed to the other approaches because it may discern value not revealed by the income or market approaches due to limited returns which are generated by operations, large values embedded in the debtor's interest in leases, whether for personal property or real property, etc. In other words, the approach of building a valuation based upon assets can reveal when a company has more value when broken up and sold than as a going concern.

## III. EXPERT TESTIMONY IN RECURRING SUBSTANTIVE DISPUTES IN BANKRUPTCY LITIGATION

We designed the previous section to provide a backdrop to the pressing need for frank discussions of the requirements of *Daubert/Kumho* in the context of bankruptcy cases and the application of that line of precedents to testimony on valuations. In order to develop the robust character of the best practices under

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<sup>123</sup> See AIRA, *supra* note 39, at 4:1.

<sup>124</sup> See *id.* One should be mindful that the value conclusions derived from the guideline company method is not the same as the similar transaction method. The guideline company method derives a marketable minority value while the similar transaction method derives a controlling interest value. Any distressed business valuation must consider adjustments to the guideline company method (for example, a consideration of applying a control premium to the subject company's equity value) to make the level of value comparable. See *id.* at 4:16.

<sup>125</sup> See generally Israel Shaked, Stephen Kempainen, & Allen Michel, *Understanding FMV in Bankruptcy*, 25 AM. BANKR. INST. J. 42 (May 2006).

*Daubert* by parties, experts, and courts, we shall now consider the typical *Daubert* issues in the context of various substantive disputes. What follows is a discussion of cases written as a self-conscious narrative in order to educe the best practices as they are being developed by courts in real situations.

*A. The Search and Select Method*

Before addressing a variety of valuation cases, we first want to address an undisciplined practice we refer to as the "search and select" method courts occasionally utilize in reaching a decision on valuation. In our judgment, the bankruptcy court should either accept or reject the report and testimony of the plaintiff's expert witness, and should not engage in an independent exercise in creating an adjusted balance sheet or total enterprise value for the debtor on its own. If the plaintiff's report and testimony are rejected, then the court should award judgment to the defendant because the plaintiff failed to prove its case. In many thorny valuation contests, the evidence is such that the party assigned the burden of proof cannot meet it, and loses at trial. That is simply the nature of our adversary system. This is no less true where the evidence may be present, but the expert has simply not aided the trier of fact or that the testimony is not reliable. Notwithstanding the seduction, a court, however, must generally refrain from migrating from gatekeeper to meta-expert.

Of particular concern is the practice (both real and perceived) of courts "splitting the difference" between expert opinions, for example, on total enterprise valuations of the reorganized debtor or on insolvency analyses. The conventional wisdom is that courts do not ham-handedly split the difference between expert opinions (for example, by adding the expert valuations and dividing by the number of experts), but that they rather engage in the practice of "search and select," that is, culling and winnowing reports to arrive at a meta-report that sustains a value within the range of values provided by the experts, but not clearly supported by any one expert's opinion.<sup>126</sup>

The problems with the "search and select" approach are several-fold. First, it encourages greater divergence in opposing expert opinions. If counsel and experts believe, justifiably or not, that a court may "split the difference," then the one party's expert may be convinced that a higher value point within the range of justifiable values may be appropriate while the opposing party's expert may be equally convinced that a lower value point should be proposed. Notice, the expert is formulating and rendering a reasonable valuation in his judgment, but is influenced by the fact that a court may split the difference. Although experts

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<sup>126</sup> For an interesting empirical study on how bankruptcy courts decide valuation issues, see Keith Sharfman, *Judicial Valuation Behavior: Some Evidence From Bankruptcy*, 32 FLA. ST. U. L. REV. 387 (2005). Professor Sharfman analyzed 24 valuation disputes in bankruptcy tried and determined by the bankruptcy court. His study found that, on average, bankruptcy courts allocated 65.2% of the value in controversy to debtors and 34.8% to secured creditors. *Id.* at 397 (positing that plausible explanation for data is that bankruptcy judges implicitly value debtor losses more highly than creditor gains).

generally struggle to be as objective as possible, they are human beings who may be influenced, whether consciously or not, by the perception that the range created by the opposing experts' valuations will impact the court's final decision.

Second, the "search and select" method may result in a judicial valuation, for example, that no qualified expert would accept let alone render. In such situations, the court has inappropriately inserted itself as an expert rather than a gatekeeper. While the judicial roles of determining valuation and acting as an evidentiary gatekeeper may overlap, they are two very distinct trial functions. Although the court should be active in the latter role, it should abstain from essentially ignoring experts in the former. If further expert analysis is necessary after the parties' experts have testified, then the court should consider appointing its own expert or technical advisor or sending the experts back to the "drawing board."<sup>127</sup>

Finally, expert financial testimony, such as that testimony offered in the insolvency, reasonable value, and total enterprise valuation contexts, is a holistic endeavor that should not be cleaved by a "search and select" judicial approach. Let us consider the testimony offered at confirmation on the total enterprise value of the reorganized debtor. The expert will often testify as to total enterprise value based on the application of several valuation techniques, each requiring assumptions and adjustments to be made. Cash flow adjustments and projections, appropriate discount values, cash flow metrics, terminal values, similar transactions multiples, or comparable or guideline company multiples are not isolated and independent factors that may be selected off the shelves of competing expert testimony. Many variables in the valuation process are driven, in part, by an expert's observations and analysis of other variables and metrics. Thus, when a court employs a "search and select" approach, it fails to appreciate the interdependence of numerous assumptions and variables in a valuation methodology and possibly violates the internal integrity, reliability, and coherence of the valuation itself.

#### *B. Solvency: Avoidance of Preferential Transfers*

In preference litigation,<sup>128</sup> financial testimony and expert reports have characteristically addressed whether the defendant can rebut the presumption under subsections 547(b)(4)(A) and (f) of the debtor's insolvency within the ninety-day period before the petition date or, if rebutted, whether the trustee (or debtor in possession where no chapter 11 trustee has been appointed) can prove the prima

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<sup>127</sup> See, e.g., *In re Mirant*, 334 B.R. 800 (Bankr. N.D. Tex. 2005) (expert sent back to consider court questions and concerns); *In re Oneida Ltd.*, 351 B.R. 79 (Bankr. S.D.N.Y. 2006) (one expert served role as *de facto* technical advisor).

<sup>128</sup> See Robert J. Stearn, Jr., *Proving Solvency: Defending Preference and Fraudulent Transfer Litigation*, 62 BUS. LAW. 359 (2007); *In re WRT Energy Corp.*, 282 B.R. 343, 368 (Bankr. D. La. 2001) (explaining that in avoidance litigation, valuation/solvency date is date of transfer at issue); *In re Commercial Fin. Servs.*, 350 B.R. 520, 541 (Bankr. D. Okla. 2005) (qualifying that "[f]or the purpose of a solvency analysis, . . . assets and liabilities must be valued based upon information *known or knowable* as of the date of the challenged transfer") (emphasis in original).

facie case of insolvency. Under section 547(b)(3), among other things, a debtor must be insolvent to have made a preferential transfer. Insolvent is defined in section 101(32) to mean:

- (A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—
  - (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
  - (ii) property that may be exempted from property of the estate under section 522 of this title . . . .

As to the issue of insolvency, the defendant's rebuttal (or trustee's prima facie case once the presumption is rebutted) requires adjustments to the balance sheet of the debtor as of the date of the preferential transfer(s), which usually had been prepared according to GAAP accounting principles and practices, in order to effectuate a balance sheet based on a fair valuation of the debtor's property and debts, including, in the appropriate circumstances, non-severable goodwill and the present value of any additional contingent assets, less the actual liabilities of the debtor, including a risk-adjusted assessment of the debtor's contingent liabilities.<sup>129</sup> This standard requires training and experience in "adjusted balance sheet" accounting in the bankruptcy context. Further, this standard requires that the expert independently verify the debtor's assets at a fair valuation, although an expert may consult with the debtor's management on such facts and circumstances. If the expert does not meet these requirements, the expert's report and testimony should generally be excluded as unreliable under *Daubert/Kumho*. There is no legitimate point to "weighing the probative value" of the expert's report and testimony; the report and testimony should never be placed upon the scales. The emerging case law is moving decisively in that direction.

The cases under this substantive umbrella of insolvency demonstrate the trend toward a more sophisticated performance of the court's gatekeeping role in excluding "irrelevant and/or unreliable" expert reports and testimony. Part of the more sophisticated performance by the judges is evidenced by their increasing degree of critical mastery of adjusted balance sheet accounting principles and practices and their self-evident higher degree of confidence in their own judgments in rooting out irrelevant and unreliable financial expertise. Note, however, this judicial awareness of its gatekeeping function has produced the collateral

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<sup>129</sup> We note that an expert may also use the income approach or the market approach to determine insolvency under section 547(b)(3). Although section 101(32) requires a comparison of the debtor's debts and property at a fair valuation, in a going concern situation, it may be appropriate for an expert to employ an income and market approach to determine the enterprise value of a company. Once the enterprise value of a company is determined, an expert may generally add back current liabilities to determine the asset value of the company. Cf. Statement of Position 90-7, *supra* note 85 and accompanying text.



consequence of increased costs by both parties not only in the proper preparation of the expert reports, but also in preparing for and defending *Daubert/Kumho* cross-motions for disqualification of offered expert testimony.

Occasionally, courts must address the question of whether the presumption of insolvency found in preference cases involving transfers within ninety days of the petition date under section 547(f) has been rebutted. The prima facie case for an avoidable preference under section 547(b) requires, among others, that a transfer is made while a debtor was insolvent. Insolvency is a term of art; section 101(32) requires that a debtor's debts be compared to its property at a fair valuation. Although referred to as the "balance-sheet" approach, adjusting the balance sheet is simply the beginning of the process. Balance sheet entries must be adjusted through a fair valuation and both assets and liabilities must be supplemented or amended. A professional with expertise in bankruptcy matters may be called upon to make the adjustments to the fair valuation to a "beginning" GAAP balance sheet and may also engage in a valuation of the business to value non-severable goodwill and as a "check" to the adjustment of the values of the assets to a fair valuation. Some experts have ignored this process, relying exclusively on book values for assets and liabilities, while others have made adjustments without reasonable explanation.

### 1. *In re Lids Corp.*

It was the practices of making the required adjustments to a GAAP balance sheet that the bankruptcy court thoughtfully addressed in a preference action filed by the debtor in *In re Lids Corp.*<sup>130</sup> There, the court conducted a two-day trial on the admissibility of the testimony of the defendant's expert who was affiliated with an investment banking firm. The plaintiff also retained an expert witness who was a forensic accountant. The defendant's expert gave the opinion that the debtor was solvent at the time of the relevant transfer under the adjusted balance sheet approach.<sup>131</sup> After careful consideration, the court rejected the expert's opinion on fair valuation for several persuasive reasons.<sup>132</sup> First, the court rejected defendant's expert's analysis under the "adjusted balance sheet" method because the report strictly adopted the "values" in the debtor's financial statements, which were prepared according to GAAP principles and practices.<sup>133</sup> While a common practice, this is usually a fatal error. Unless the entries to a balance sheet have been "marked to market," which is the case in only a few well-defined asset categories, reliance on book values as proxies is inherently unreliable and irrelevant to whether the debtor was insolvent as defined in section 101(32). Moreover, reliance on a balance sheet prepared on a GAAP basis may ignore certain intangible assets or unrecorded

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<sup>130</sup> 281 B.R. 535 (Bankr. D. Del. 2002).

<sup>131</sup> *Id.* at 540.

<sup>132</sup> *Id.* at 546 ("We conclude that the Houlihan Report does not rebut the presumption of insolvency imposed under section 547(f) because Houlihan's valuations are flawed and because EYCF's report raises serious doubts about the validity of Houlihan's assumptions.").

<sup>133</sup> *See id.* at 542-43.

liabilities. The defendant's expert made no adjustments for fair valuation of the tangible assets, which was primarily the debtor's inventory of hats with sport team logos, and made only an unexplained minor adjustment in the debtor's accounting entry for the intangible of "goodwill."<sup>134</sup> The court was entirely correct in rejecting any expert testimony on insolvency based on an irrelevant and unreliable methodology.

The defendant's expert also gave the opinion that the debtor was solvent at the time of the transfer under a total enterprise valuation approach using both the guideline company method and the similar transaction method. Essentially, the total enterprise value approach allows an expert to "back into" a determination of insolvency through the manipulation of the fundamental accounting equation—assets equal liabilities plus ownership equity. Thus, an expert first determines the enterprise value of the business through one or a fusion of the three methods described above<sup>135</sup> and then adds current liabilities. That sum (enterprise value plus current liabilities) must be equal to the reorganizational value of the assets. If the reorganizational value of the assets is less than the enterprise value of the business plus non-interest bearing current liabilities, then the business is insolvent.

As noted, the defendant's expert employed, among others, the guideline or comparable company method in finding that the debtor was solvent. Again, the court rejected the defendant's expert's opinion based on several deficiencies. First, although the court found that the companies selected by defendant's expert were publicly-held corporations engaged in retailing specialty products, none of these companies were comparable because none of them shared key attributes with the debtor: these companies were profitable—the debtor was not; these companies had proven business plans—the debtor did not; and these companies met their projections—the debtor did not.<sup>136</sup> Moreover, the court found that the defendant's expert did not consider the multiple ranges for net revenue and EBITDA for the comparable companies selected and failed to explain why those ranges were not considered.<sup>137</sup> Again, according to the plaintiff's expert in rebuttal, the multiples were "inaccurate because the EBITDA multiples used were greater than the mean and median multiples used for the other, more profitable and stable, companies."<sup>138</sup> Third, according to the court, of equal or greater importance was the unreliability of the EBITDA metric that the expert for the defendant used in calculating the product: EBITDA times the comparable companies multiples. The court found that

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<sup>134</sup> See *id.* at 542.

<sup>135</sup> The income approach, the market approach and the asset-valuation approach are the three typical approaches. See, e.g., *Hull v. Spartanburg County Assessor*, 641 S.E.2d 909, 910 (S.C. Ct. App. 2007) (using income approach); *Estate of Jelke v. Comm'r.*, 507 F.3d 1317, 1322, 1334 (11th Cir. 2007) (using market approach and professing that net asset-valuation approach is best approach "to use in valuing corporations that are essentially holding companies"). The expert would make the appropriate calculations under two or all three approaches and then, exercising sound and reasoned discretion, formulates an opinion either as a point estimate or, more commonly, an interval estimate.

<sup>136</sup> See *Lids Corp.*, 281 B.R. at 544.

<sup>137</sup> See *id.*

<sup>138</sup> *Id.*

the defendant's expert's projections for calculating EBITDA were "unconvincing," and so that method failed to rebut the debtor's insolvency as of the date of transfer.<sup>139</sup>

The court also rejected the defense expert's opinion on solvency based on the similar transactions method.<sup>140</sup> In supporting its opinion that the debtor was solvent, the defense expert used nineteen acquisitions, as publicly reported, from 1995 to 2001. The use of these comparable transactions, however, was problematic. Accepting the plaintiff's expert's opinion, the court found that the condition of the market in acquisitions had materially deteriorated by 2000, and, therefore, the earlier transactions had to be eliminated from the data set as "outdated" and no longer reliable.<sup>141</sup> The court also accepted the plaintiff's expert's criticism that the defense expert's use of net revenues for the multiples did not accurately "reflect value because it fail[ed] to account for losses or profitability and skew[ed] values upward."<sup>142</sup>

The court then turned its attention to the approach that the defense expert embraced in assessing the debtor's liabilities and found that approach lacking. At bottom, the court found that the defense expert had improperly excluded close to a million and a half dollars in "other non-current liabilities" and had completely ignored the debtor's contingent liabilities in comparables. The plaintiff's expert's analysis of these very liabilities, which included contingent liabilities from damages from anticipated lease rejections and severance of employees, substantially increased the debtor's liabilities.<sup>143</sup>

## 2. *In re Payless Cashways, Inc.*

In another take on valuation issues in the context of an insolvency determination in a preference action, the court in *In re Payless Cashways, Inc.*<sup>144</sup> limited the scope of its decision in these procedurally consolidated preference actions to the mixed issue of fact and law of whether the publicly held debtor

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<sup>139</sup> See *id.* at 544–55 (agreeing with Lids' assertions that particular choice of multiples does not give accurate reflection of company's value and that reliance on Lids' projections to calculate value was unjustified in light of past projections being inaccurate).

<sup>140</sup> See *id.* at 545 (rejecting analysis because it ignored fact that Lids was never profitable, yet analysis compared it to profitable companies).

<sup>141</sup> See *id.* ("We also find that the sales considered by [defendant's expert] are outdated. Most of the transactions considered in the [defendant's expert report] occurred several years ago, long before market conditions changed, for the worse.").

<sup>142</sup> *Lids Corp.*, 281 B.R. at 545. The debtor's expert went even further to contend that it could find no public acquisitions by companies that were comparable to the debtor's size, nature of the business, and profitability. *Id.* ("[Plaintiff's expert] stated that it found no companies comparable to Lids based on the size, nature of the business, and profitability of the purposes of a comparable transaction analysis. Therefore, [plaintiff's expert] stated it could not conduct this type of analysis.").

<sup>143</sup> See *id.* at 546 ("[Defendant's expert] failed to account for additional contingent liabilities which [plaintiff's expert] added to Lids' balance sheet (\$10,285,000 to \$89,317,000) consisting of lease rejection and severance obligations.").

<sup>144</sup> 290 B.R. 689 (Bankr. W.D. Mo. 2003).

corporation was insolvent on each day of the ninety-day period before the petition date of June 8, 2001.<sup>145</sup> In an unusual ruling, the court held that the debtor, the fourth largest retail supplier of building materials in the nation, was solvent on March 6, 2001, the ninetieth day before the petition date, and this financial condition continued until May 13, 2001, when the debtor's inventory lenders, Congress Financial Corp. and Hilco Capital, L.P., refused to continue lending outside of a chapter 11 case.<sup>146</sup> Moreover, the inventory lenders demanded that the debtor grant them junior liens against the substantial equity value of its real estate holdings as further security for the inventory financing. After the petition date, it took six weeks for the debtor to negotiate the terms of the financing order with its inventory lenders, but by that time the debtor had lost 20–30% of its customers because of the depleted stock of building materials. Within six weeks of the entry of the financing order, the lenders then refused to continue the financing of the debtor in possession and successfully moved for the appointment of a chapter 11 liquidating trustee.

In a very sophisticated analysis, the court defined the mixed issue of fact and law of solvency during the ninety-day look-back period as turning on whether or not the debtor was a going concern.<sup>147</sup> If it were a going concern, then an adjusted balance sheet analysis, relying upon the fair valuation of its assets would be appropriate; however, if the debtor were on its deathbed or were at the "point of peril,"<sup>148</sup> then a forced sale or liquidation analysis would be appropriate. The court found the testimony of the preference defendants' expert witness more convincing and careful with the relevant facts than the liquidating trustee's expert witness.

Interestingly, the court made no mention of the *Daubert/Kumho Tire* standards for the admissibility of the reports and testimony of purported expert witnesses. Nevertheless, the substance of the opinion showed a familiarity with the standard methodologies for determining whether a debtor corporation was insolvent. Although the court referred to the use by the experts of the comparable or guideline company method (a market approach) to the question of insolvency, the bulk of the opinion focused on an adjusted balance sheet method in reaching its conclusion on the issue of insolvency.

### 3. *In re Wallace's Bookstores, Inc.*

In *In re Wallace's Bookstores, Inc.*,<sup>149</sup> the court excluded testimony from the defendants' three designated expert witnesses in granting the plaintiff's motion *in*

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<sup>145</sup> See *id.* at 691–92 (stating issue as: "Was Payless on its deathbed at any time during the 90 days prior to filing its bankruptcy petition?").

<sup>146</sup> See *id.* at 705 ("I, therefore, find that Payless was a going concern, and solvent, until May 13, 2001.").

<sup>147</sup> See *id.* at 697–705 ("The real issue, however, is whether Payless was a going concern or on its deathbed during the preference period.").

<sup>148</sup> *Id.* at 703 (quoting definition of "point of peril" as "the time when a company's ability to continue as a going concern is in doubt because its expected revenues are less than the expected costs").

<sup>149</sup> 316 B.R. 254 (Bankr. E.D. Ky. 2004).

*limine* heard in connection with the trustee's motion for summary judgment in a preference action. The defendant raised the affirmative defense of payments in the ordinary course of business.<sup>150</sup> At the concurrent hearing, the court also considered the defendants' cross-motion *in limine* to exclude the plaintiff's expert witness and held that it had become moot.

As the court pointed out, it is the burden of the defendants to present sufficient evidence (i) to rebut the presumption of insolvency during the ninety-day look-back period<sup>151</sup> and (ii) to support the ordinary course of business defense as an affirmative defense.<sup>152</sup> The payments, subject to recovery, totaled \$5,650,000 which repaid short-term, high-yield borrowings.

In reaching its decision on both the plaintiff's motion *in limine* and its motion for summary judgment, the court presented a rigorous and comprehensive rationale for granting the trustee's two motions. In reaching its determination, the court reviewed the deposition transcripts of each of the defendants' designated witnesses. The first witness was a licensed C.P.A., but the court found that this witness had no training and experience in analyzing insolvency as defined under section 101(32) of the Bankruptcy Code. In this respect, the C.P.A. failed to measure the "fair valuation" of the debtor's assets and the present discounted amounts of the debtor's contingent liabilities, including a corporate guaranty of millions of dollars. Moreover, the C.P.A. did not appear to appreciate that accepting the book entries on their face for "goodwill" of \$7,700,000, a "shareholder receivable" of \$60,000,000, and "going concern" values for inventory was not a reliable method under the principles and practices of insolvency accounting. More to the point, the witness failed to make any diligent and independent inquiry concerning the transaction basis for the shareholder receivable or its collectability. As to goodwill, the C.P.A. made no investigation concerning the debtor's ability to pay its current obligations in the period immediately proceeding the ninety-day look-back period, that is, whether the debtor had any going concern value. This witness was easily dispatched, with an implied warning to any other C.P.A. held out as an expert in avoidance litigation that any claim to expertise on the fact issue of insolvency has to be supported by evidence of proper training and experience in the principles and practices of

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<sup>150</sup> See 11 U.S.C. § 547(c)(2) (2006).

<sup>151</sup> See *Wallace's Bookstores*, 316 B.R. at 259; see also 11 U.S.C. § 547(f) ("[D]ebtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."); 11 U.S.C. § 547(b) ("[T]rustee may avoid any transfer of an interest of the debtor in property . . . (3) made while the debtor was insolvent.").

<sup>152</sup> See *Wallace's Bookstores*, 316 B.R. at 263; see also 11 U.S.C. § 547(c)

The trustee may not avoid under this section a transfer . . . (2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—  
(A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (b) made according to ordinary business terms.

11 U.S.C. § 547(g) (showing that defendant has burden of proving all three elements of this exception to preference avoidance).

insolvency accounting. Moreover, the expert cannot simply rely upon management's representations or its unaudited financial statements; the expert has to undertake a reasonable and independent investigation of the factual basis of each of the major categories of assets and liabilities, including contingent assets and liabilities.

The court then turned to the second designated witness, another C.P.A. who held, in addition, a Ph.D. according to the court, his expert report was even more "conclusory" than the first witness's report—the kiss of death in a *Daubert* hearing. The court's critique merits quotation in full as an outstanding example of how the gatekeeper role is properly performed:

[Dr. Y], likewise has no education or experience in insolvency or bankruptcy accounting. His report is even more conclusory and contains even less explanation than [X's] report, and his deposition testimony is even more damning. For example, [Dr. Y] testified that he is aware of no difference in the treatment of contingent liabilities under the Bankruptcy Code *vis-à-vis* under generally accepted accounting principles. He also accepted WBI's valuation of an account receivable owed by a related party, without investigating to determine the collectability of the receivable (or even determining the identity of the related party to evaluate whether the receivable should be included in a consolidated balance sheet at all).

In addition, [Dr. Y] did not investigate [the shareholder's] solvency but based his conclusions regarding the values of the [shareholder] receivable and of the liability represented by WBI's guaranty of indebtedness owed by [the shareholder] solely on information indicating that he had historically paid his debts; [Dr. Y] also acknowledged having no information regarding the source of the funds used to pay debts to WBI, so he could not confirm that the debts were paid rather than refinanced. Also, in deciding that there was a zero probability that WBI would be called upon to honor its guaranties of [the shareholder's] debts, [Dr. Y] gave no consideration to whether the debts were in fact called around the times of the transfers.

Thus, the court likewise concludes that the Defendant has not provided sufficient evidence of the reliability of [Dr. Y's] testimony to pass the *Daubert/Kumho* "gatekeeper" test. Accordingly, [Dr. Y's] report must be excluded and does not, therefore, rebut the presumption of insolvency in this case.<sup>153</sup>

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<sup>153</sup> *Wallace's Bookstores*, 316 B.R. at 262–63.

The testimony and the report of the third witness was also excluded as unreliable. The defendant's third witness was an investment advisor. The witness was prepared to testify as an expert about the market in short-term high-yield loans, averring that the loans to this debtor were incurred and paid in the ordinary course of the commercial debtor's business and in conformity with industry practices. The court commented that:

[The investment advisor's] report concludes that the terms of the loans were not unusual for "high yield, short term debt." This conclusion if, of course, circular: by definition, those incurring "high yield, short term debt" agree to short terms and high interest rates. The report includes no information indicating that it was the ordinary course of [the debtor's] business to incur "high yield, short term debt" (even if was ordinary for the Defendant to make loans on that basis.) [The witness'] report must be excluded in this regard.<sup>154</sup>

The defendant's fourth witness barely survived disqualification. This witness, a venture capitalist, was also offered to testify on the ordinary course of business defense. While partially supported by the witness' investigation of 350 short-term high yield loans his company had made, the court found that this kind of investigation carried no probative weight in proving that loans of this character were part of the *debtor's* ordinary course of business, and, therefore, was irrelevant, or if marginally relevant, entitled to little probative weight.

Upon dispatching each of the defendant's witnesses and finding that the plaintiff sustained his burden, the court granted summary judgment on the preference count of the trustee's complaint. In light of this determination, the defendant's cross-motion *in limine* to exclude the plaintiff's expert became moot.

#### 4. *In re Heilig-Meyers Co.*

*In re Heilig-Meyers Co.*<sup>155</sup> also addresses valuation in the context of *Daubert*. There, the Creditors' Committee filed an avoidance action, alleging the pre-petition debt restructuring with the debtor's bank group led by Wachovia Bank, N.A. (collectively, "Bank Group" or "Wachovia") was avoidable as either a fraudulent transfer or as a preferential transfer. The bankruptcy court limited the scope of its decision to the issue of the debtor's insolvency. The court found that the debtor was solvent as of the date of the transfers, rendering moot the secondary issues of

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<sup>154</sup> *Id.* at 265.

<sup>155</sup> 319 B.R. 447 (Bankr. E.D. Va. 2004).

whether the transfers were avoidable as fraudulent transfers or as preferential transfers.<sup>156</sup>

Heilig-Meyers and its domestic affiliates manufactured and distributed home furnishings sold through its network of over a 1,200 local retail stores, located in small towns and rural markets in thirty states.<sup>157</sup> Its local store managers made the decisions to extend credit to its retail customers. The portfolios of retail installment sales contracts were then bundled and securitized to public investors through bond offerings. On May 25, 2000, the debtor entered into a major debt restructuring with its Bank Group.<sup>158</sup> The debtors then filed their petitions for relief on August 16, 2000, one week before the expiration of the ninety-day look back period for the Bank Group restructuring.<sup>159</sup>

The Bank Group's expert witness submitted a report and testified that as of the date of transfer, the debtor had a net worth of \$218 million at "fair valuation."<sup>160</sup> This valuation was consistent with an analysis based upon deriving a multiple of 6.0 to 7.0 from comparable companies in the retail furniture business, which included adding a 40% premium for control, and applying that multiple to the EBIDTA of the debtor.<sup>161</sup> On the other hand, the Committee's expert witness asserted that a fair valuation of the assets was less than half of the Bank Group's adjusted amount, but agreed that the liabilities were very close to the Bank Group's number. The Committee's expert asserted that a fair valuation produced a negative net worth of

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<sup>156</sup> See *id.* at 474; see also 11 U.S.C. § 548(a)(1) (stating trustee may avoid any transfer of interest or obligation of debtor that was made or incurred within two years of bankruptcy filing if debtor, "(B) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation"); 11 U.S.C. § 101(32)(A) (stating insolvency at time of alleged preferential transfers determined by whether dollar sum of debtors' debts greater than dollar sum of debtors' assets at "fair valuation").

<sup>157</sup> See *Heilig-Meyers Co.*, 319 B.R. at 452.

<sup>158</sup> See *id.* at 454–55 (finding by court that these liens and related cash payments granted or made to lenders by debtors are focus of this litigation).

<sup>159</sup> See *id.* at 450 (stating debtors filed their chapter 11 petitions on August 16, 2000); see also 11 U.S.C. § 547(f) (stating "for purposes of section 547, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition"); 11 U.S.C. § 547(b) ("[T]rustee may avoid any transfer of an interest of the debtor in property . . . (4) made— (A) on or within 90 days before the date of the filing of the petition; or (B) between ninety days and one year before the date of the filing of the petition.").

<sup>160</sup> See *Heilig-Meyers Co.*, 319 B.R. at 460, 464; see also 11 U.S.C. § 101(32)(A) (finding "insolvent" with reference to entity's financial condition "such that the sum of such entity's debts is greater than all of such entity's property at a fair valuation"); 11 U.S.C. § 547 (b)(3) ("[T]rustee may avoid any transfer of an interest of the debtor in property . . . (3) made while the debtor was insolvent.").

<sup>161</sup> See *Heilig-Meyers Co.*, 319 B.R. at 460, 464 (following *Daubert* and progeny holding that court serves as "gatekeeper" and expert valuation witnesses may serve as qualified appraisers); see also *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579, 594 (1993) (holding that court may allow expert valuations to testify, but must be mindful that such testimony should be admissible and relevant in light of applicable rules of evidence); FED. R. EVID. 403 (allowing for exclusion of relevant evidence if "its probative value is substantially outweighed by the danger of unfair prejudice, confusion of the issues, or misleading the jury, or by considerations of undue delay, waste of time, or needless presentation of cumulative evidence").



slightly over \$330 million.<sup>162</sup> The difference between the two experts' valuations was, thus, approximately \$500 million.

The court acknowledged its duty under the *Daubert/Kumho* standards, but it found that the opposing experts were both qualified and that their testimony was both relevant and reliable despite the sizeable difference in their opinions. Further, the court noted that the differential left it in an uncomfortable position stating "the irony that judges, few of whom would qualify as expert witnesses in any trial of asset valuation, regularly determine the worth of assets, sometimes forced to choose between the conflicting reports of undisputed experts."<sup>163</sup>

Despite its reservations, the bankruptcy court sought to accomplish its meta-valuation through an *ad hoc* method of (i) adopting the values of some entries from the debtor's audited financial statements for the year ending December 31, 2001, (ii) adopting the values for other entries from the Bank Group's expert's report, (iii) adopting the values for a third set of entries from the Committee's expert, and (iv) modifying the values for a fourth set of entries according to his own lights.<sup>164</sup> The court's bottom line was that the debtor had a net worth of at least \$41 million as of the date of transfer, but that the debtor fell into insolvency by the petition date.<sup>165</sup>

A critical review of the underlying rationale for key items on the adjusted balance sheet reveals areas of possible weakness in the court's methodology. For example, the court adopted the value of the debtor's "retained interest" of \$138,503,000 stated on the audited financial statements, for which the Committee's expert assigned no value whatsoever.<sup>166</sup> The court repeatedly stressed the fact that each component in its analysis presupposed a going concern for the value of the debtor, but that in determining the fair value of the debtor's assets in an adjusted balance sheet analysis, value had to be based upon what those assets would command in a nondistressed market sale.<sup>167</sup> As the Committee's expert testified, the debtor had been securitizing its eligible receivables at 80% of their principal balance, that it was unable to obtain any further securitization of its remaining receivables, and that the securitized value equaled what any third-party purchaser would pay for those receivables, especially given the small size of each receivable, the localized character of the consumer credit decisions, and the wide distribution of the receivables.<sup>168</sup>

The court also adopted the value of the debtor's prepaid expenses of \$26,562,000 for which again the Committee's expert assigned no value.<sup>169</sup> The court reasoned that because the tangible assets were insured, any purchaser of the assets

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<sup>162</sup> See *Heilig-Meyers Co.*, 319 B.R. at 459, 464.

<sup>163</sup> *Id.* at 447, 461 (Bankr. E.D. Va. 2004) (quoting *Domestic Loan and Inv. Bank v. Mann (In re Mann)*, 249 B.R. 831, 839 (1st Cir. 2000)).

<sup>164</sup> See *id.* at 456–57.

<sup>165</sup> See *id.* at 467, 472.

<sup>166</sup> See *id.* at 464.

<sup>167</sup> See *id.* at 456.

<sup>168</sup> See *Heilig-Meyers Co.*, 319 B.R. at 453.

<sup>169</sup> See *id.* at 465.

would factor that into arriving at the purchase price for the inventory. We are unaware of any cases in which the prepaid insurance contracts are assumed by the debtor and assigned in a sale of tangible assets to a third party. Thus, the standard practice in adjusted balance sheet analysis is to strike any value for the prepaid expenses unless a debtor can demonstrate that any portion of the prepaid expenses are partially recoverable by the cancellation of the contracts.

The court also adopted the value of the debtor's inventory on its audited statements of \$363,382,000, which the Committee's expert reduced by close to \$140,000,000.<sup>170</sup> In dismissing the value presented by the Committee's expert, the Court noted that the Committee's expert improperly relied upon post-petition sales of inventory. While this may be true, it is also true that inventory of goods such as furniture is rarely worth its stated book value because of shrinkage, obsolescence, discontinuation, and the like. Thus, some discount was likely necessary and appropriate. Further, unless a purchaser purchased all of the inventories of the debtor *in situ*, the furniture on the floor of these many small stores would have to be repackaged and transported to other locations unless those items were either excluded from the sale and sold by the debtor in a going-out-of-business sale, or were purchased at a substantial discount. Moreover, as a retail business begins losing substantial monies, which the court acknowledged occurred in this case, the debtor's inventory would usually be quite imbalanced with slow-selling or outdated merchandise, and the value of the inventory as a whole may be of much lower value than its book value because the faster selling items would not have been replaced with new inventory.

The court proceeded through the balance sheet items selecting or modifying items to reach its conclusion. The chart below combines the two charts included in the opinion and displays the audited amounts, the experts' amounts, and the amounts the court chose:

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<sup>170</sup> See *id.* at 465.

	<b>Audited Values</b>	<b>Plaintiff's Expert</b>	<b>Defendant's Court Expert</b>	<b>Value</b>
<b>Assets</b>				
Cash	\$ 6,451	\$ 6,451	\$ 6,451	\$ 6,451
Accounts Receivable	\$ 136,530	\$81,918	\$119,131	\$119,131
Retained Interest	\$ 138,503	-	\$138,503	\$138,503
Inventories	\$ 363,382	215,909	\$363,382	\$363,382
Other Receivables	\$ 82,999	26,790	79,559	\$28,105
Prepaid Expenses	\$ 26,562	-	\$ 26,562	\$ 26,562
Net Assets Held for Sale	\$ 13,782	5,800	-	\$ 13,782
Property and Equipment	\$ 285,515	\$49,417	179,220	\$64,417
Other Assets	\$ 159,586	\$73,263	99,192	\$73,263
Goodwill	\$ 141,400	-	-	-
<b>Total Assets</b>	<b>\$1,354,710</b>	<b>\$459,458</b>	<b>\$1,012,040</b>	<b>\$833,596</b>
<b>Liabilities</b>				
Current Long-Term Debt	\$ 681	\$ 681	\$ 681	\$ 681
Accounts Payable	\$ 118,026	\$ 118,026	\$ 118,026	\$ 118,026
Accrued Expenses	\$ 131,090	\$129,017	\$ 131,090	\$129,017
Deferred Revenue	\$ 28,506	(\$26,873)	\$ 28,506	\$ 28,506
Long-Term Debt	\$ 515,737	\$ 515,737	\$ 515,737	\$ 515,737
Deferred Income Taxes	\$ 42,258	-	-	-
Other Liabilities	-	\$53,141	-	-
<b>Total Liabilities</b>	<b>\$ 836,298</b>	<b>\$789,729</b>	<b>\$ 794,040</b>	<b>\$791,967</b>
<b>Total Stockholders' Equity</b>	<b>\$ 518,412</b>	<b>(\$330,181)</b>	<b>\$ 218,000</b>	<b>\$ 41,629</b>

A quick review of the chart above shows that a write down of as little as 5% on inventory accompanied by the write off of the prepaid expenses, steps we feel appropriate in this matter, would completely eliminate the net worth of the debtor. This reveals the sensitivity of this type of analysis and the concern of the court adopting a "search and select" approach.

### 5. *In re American Classic Voyages Co.*

We earlier discussed the critical approach to the methodologies that the court took with respect to determining the issue of insolvency of the debtor in connection with an alleged preferential transfer in *In re American Classic Voyages Co.* ("ACV").<sup>171</sup> At this point in our discussion, we now turn to a detailed discussion of the substantive issues of fact and law in this important case. In ACV, a publicly-held mini-conglomerate cruise line had been operating three steamboats on the Mississippi River and cruise ships around the Hawaiian Islands when it suddenly lost almost all of its existing and projected bookings after the horrific tragedy of September 11, 2001. The parent company, American Classic Voyages Co. ("ACV"), filed for chapter 11 relief on October 19, 2001, in the District of Delaware, and nineteen of its subsidiaries also filed for chapter 11 relief as related cases three days later.<sup>172</sup> The cases were procedurally consolidated on that later date. Within a few months after the petition dates, each of the ships were abandoned to their secured creditors, other secured creditors made credit bids at foreclosure sales, or were sold to third parties.

The Plan Administrator under a liquidating trust established under confirmed liquidating plans of reorganization brought a preference action in 2005 to recover close to \$30 million paid to a bank group, led by JP Morgan Chase on August 14, 2001, within ninety days prior to the petition date.<sup>173</sup> The issues at trial were bifurcated, with the threshold issue of insolvency to be tried first. The expert for each side testified on the separate valuations of the parent company, ACV, and one of its principal subsidiaries, Delta Queen Steamboat Company ("DQSC").

As we discussed in the section on methodology above, the court framed the dispositive issue of law for purposes of the trial, insolvency under the prevailing case law, be measured by a "going concern value" unless the debtor was "on its deathbed,"<sup>174</sup> "wholly inoperative, defunct, or dead on its feet,"<sup>175</sup> or liquidation was "clearly imminent."<sup>176</sup> Because each of the debtors was operating fully as of the date of the transfer, with management committed to reducing operating losses and building revenues, especially for its overnight cruise ships in Hawaii, the court

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<sup>171</sup> 367 B.R. 500 (Bankr. D. Del. 2007).

<sup>172</sup> See *id.* at 502 n.2.

<sup>173</sup> See *id.* at 505.

<sup>174</sup> *Heilig-Meyers Co.*, 319 B.R. at 457. See *In re Taxman Clothing Co.*, 905 F.2d 166, 170 (7th. Cir. 1990) (finding company not on its deathbed even though it was on road to financial ruin); *Fryman v. Century Factors, Factor for New Wave (In re Art Shirt Ltd., Inc.)*, 93 B.R. 333, 341 (E.D. Pa. 1988) (recognizing that to hold company that is on its deathbed as going concern would be "misleading" and would "fictionalize the company's true financial condition").

<sup>175</sup> *In re Bellanca Aircraft Corp.*, 56 B.R. 339, 387 (Bankr. D. Minn. 1985) ("Only where a business is wholly inoperative, defunct, or dead on its feet, will going concern valuation be abandoned in favor of an item by item fair market valuation."). See *Langham, Langston & Burnett v. Blanchard*, 246 F.2d 529, 532 (5th. Cir. 1957) (finding no going concern where bankrupt corporation was "financially dead or mortally wounded").

<sup>176</sup> *Travellers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.)*, 134 F.3d 188, 193 (3d Cir.1998).

found that insolvency was to be measured as a function of going concern value, as testified to by the banks' expert whom the court found to be very credible,<sup>177</sup> and not as a function of liquidation value, as testified to by the plan administrator's expert whom the court found not to be credible.<sup>178</sup>

The banks' expert relied principally upon the discounted cash flow method for calculating the total enterprise value separately for the parent ACV and for the subsidiary DQSC. In preparing this analysis, after his own independent assessment of the facts and circumstances reasonably foreseeable at the date of the transfer, he choose to rely primarily on management's financial statements as of June 30, 2001, and cash flow projects for the five-year period from July 1, 2001, through June 30, 2006, apparently without making any adjustments. He acknowledged that the earnings before interest, depreciation, taxes, and amortization (EBIDTA) were negative, but he accepted management's statements that it was addressing the operating losses, that it was substantially increasing revenues, especially in its operations in the Hawaiian market, and that it was settling a major dispute with a shipbuilder, which would fix the construction costs and would result in the delivery of several ships then under construction that would further increase its revenues. Based upon the discounted cash flow analysis, the banks' expert testified that the assets for the parent ACV exceed its liabilities by \$228 to \$247 million, and that the assets for the subsidiary DQSC exceeded its liabilities by \$151 to \$196 million; in light of this financial condition, neither debtor were remotely insolvent.

The plan administrator's expert testified that he relied principally upon the adjusted balance sheet method for valuing the parent and the subsidiary companies.<sup>179</sup> His valuation for each company was based upon liquidation values, which he derived from the actual proceeds of sales of each vessel to third parties or by the amount of the credit bid for each vessel made by the secured creditor.<sup>180</sup> To reach the liquidation value of the assets for each company, he resorted to a bottom-up analysis that simply totaled the amounts of the sales or credit bids.<sup>181</sup> He justified using a liquidation value approach on the ground that the subject companies were suffering negative EBITDA of \$22.2 for the six months ending June 30, 2001, and that the companies were overleveraged with substantial indebtedness, which had

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<sup>177</sup> The court emphasized that the banks' expert had twenty years of experience in valuing businesses and in that connection, he had performed over 200 valuations. *See Am. Classic Voyages Co. v. JP Morgan Chase Bank (In re Am. Classic Voyages Co.)*, 367 B.R. 500, 514 (Bankr. D. Del. 2007).

<sup>178</sup> In marked contrast, the plaintiff's expert was a C.P.A., with much more limited experience. The court notes that this expert was not even aware of management's cash flow projections when he prepared his insolvency analysis. *Id.* One wonders whether the plaintiff's counsel took the deposition of the banks' expert to discover the scope and nature of the documents and financial records upon which he prepared his valuation report and why that information was not then turned over to the plaintiff's expert for use in preparing his own report. It is also surprising that in light of developments in the much discussed case law, the plaintiff's expert would not have prepared his own discounted cash flow analysis as an approach to the issue of insolvency rather than taking what the court obviously perceived as pot shots at some of the variables in the banks' expert's report.

<sup>179</sup> *See id.* at 514.

<sup>180</sup> *See id.* at 506.

<sup>181</sup> *See id.* at 515.

increased from \$84.6 million as of December 31, 1999, to over \$577 as of June 30, 2001; moreover, the parent company was engaged in a major dispute with one of its shipbuilders, with the outcome of that dispute uncertain.<sup>182</sup> He calculated that on an adjusted balance sheet basis, the liabilities for the parent ACV exceeded its assets by \$398 million, and that the liabilities for the subsidiary DSQC exceeded its assets by \$90 million; therefore, each of the companies had a negative net worth and, thus, were insolvent.<sup>183</sup> The plan administrator's expert also objected to several of the premises and calculations built into the banks' expert witness's report on valuation, but the court overruled each of these objections.<sup>184</sup>

What is surprising about the plan administrator's expert's testimony is that apparently he did not emphasize the fact that the banks pressured the debtors to reduce their outstanding credit facilities from \$70 million to \$30 million on September 14, 2000, and then to \$0 on August 14, 2001. It seems incredulous that a commercial bank group would have operated on the well-informed business assumption that the companies enjoyed the immediate promise of reversing a momentary drop in earnings through aggressive management policies to reduce overhead and to promote sales. It is far more realistic that the bank group readily perceived that these companies were not bankable, and that beginning a little more than one year before the filing, the banks were intent on "exiting" this credit.<sup>185</sup> Although the banks' aggressive approach was not probative evidence of the insolvency of the debtors, it might have called for considerable skepticism in reviewing management's five year cash flow projections which were relied upon by the banks' expert and accepted by the court as wholly credible. However, it appears that the Plan Administrator's expert failed to develop this line of analysis in his expert report.

The court concluded that the banks had introduced sufficient evidence, particularly its expert's report on valuation, to overcome the statutory presumption of insolvency within the ninety days before the petition date; the burden of going forward then shifted to the plaintiff, and the plaintiff failed to satisfy its burden of proof by a preponderance of the evidence.<sup>186</sup> This then led to the dismissal of the complaint against the bank group.<sup>187</sup>

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<sup>182</sup> See *id.* at 511.

<sup>183</sup> See *In re Am. Classic Voyages Co.*, 367 B.R. at 516.

<sup>184</sup> See *id.*

<sup>185</sup> The bank group entered into a further amended loan and security agreement for \$10 million, which the debtors did not draw down in the three weeks before September 11th, but one has to wonder whether the criteria for any advances could be satisfied given the poor financial condition of the debtors. See *id.* at 505.

<sup>186</sup> See *id.* at 516.

<sup>187</sup> See *id.*

*C. Solvency: Avoidance of Constructive Fraudulent Transfers.*

In litigation over constructive fraudulent transfers, whether under section 548 of the Bankruptcy Code or more likely under applicable state law, borrowed under section 544(b) of the Bankruptcy Code, the parties will call expert witnesses to testify primarily on the following issues: (1) some form or statutorily proscribed financial distress such as: (a) the debtor's insolvency or the fact that a transfer rendered the debtor insolvent, on the basis of a fair valuation of property and the amount of the debtor's debts, including the determination of goodwill and the estimation of contingent liabilities and legacy liabilities; (b) the transfer leaving the debtor with the inability to pay debts as they become due; or (c) the transfer leaving the debtors with unreasonably small capital (or assets); and (2) the lack of reasonably equivalent value to the debtor in exchange for the property transferred or obligation incurred.

*1. In re Joy Recovery Technology Corp.*

*In re Joy Recovery Technology Corp.*<sup>188</sup> presents an excellent teaching case, introducing in a sophisticated manner the proper approach in addressing financial expert testimony. There, the trustee of the liquidating trust, established under the debtor's confirmed liquidating plan of reorganization, filed a complaint to avoid and recover a \$2.1 million constructive fraudulent transfer and for other relief under applicable Illinois state law against the privately held debtor corporations' selling 50% shareholders.<sup>189</sup> The bankruptcy court found that upon collapsing the form of the transaction to its substance, this was a classic case of a leveraged buyout, which was avoidable as a constructive fraudulent transfer under applicable Illinois state law.<sup>190</sup> The primary issues of fact to be determined by the bankruptcy court were: (1) whether the debtor was insolvent or was rendered insolvent on an adjusted balance sheet basis by the transaction; (2) whether the debtor, as a result of the secured indebtedness it incurred to fund the transaction, was left with unreasonably small capital; and (3) whether the value of the selling shareholders' shares of the debtor corporation was reasonably equivalent to the \$2.1 million paid to acquire them.<sup>191</sup> Each party retained an expert witness to testify regarding these contested issues of fact.

The court conducted a sharply contested gatekeeper hearing on opposing motions *in limine* to disqualify the other party's proposed expert. Several detailed objections were raised to the qualification of the plaintiff's witness and/or to the

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<sup>188</sup> 286 B.R. 54 (Bankr. N.D. Ill. 2002).

<sup>189</sup> See *id.* at 61. The trustee sought relief for constructive fraudulent conveyance under section 544 of the Bankruptcy Code and under the Illinois fraudulent transfer statute—740 ILCS § 160/5(a)(2) & 6(a)—as well as for common law breach of fiduciary duty and misappropriation of corporate assets under Illinois state statute (805 ILCS § 5/8.60). See 740 ILCS § 160/5(a)(2) & 6(a); 805 ILCS § 5/8.60.

<sup>190</sup> *Joy Recovery*, 286 B.R. at 73–79.

<sup>191</sup> See *id.*

admissibility of his report. Although the court found the opposing experts to be qualified, it drew a sharp analytical distinction between, on the one hand, the qualification of the expert witness and, on the other hand, the weight to be given to the expert's testimony.<sup>192</sup> Because the court found so many errors in the plaintiff's expert's analysis, it appears to us that, in hindsight, the court should have rejected that witness testimony and report as unreliable at the outset. When a court must take such great pains to reconstruct an expert witness's testimony, the process effectively defeats the cardinal rule for admitting the testimony in the first place—namely, that the testimony will assist the court as the finder of fact. A more rigorous screening of the proposed expert under the *Daubert/Kumho* criteria might avoid this extra work.

It is an instructive lesson for future gatekeeper hearings to examine the objections to each expert's methodology in this case in some detail. For the ultimate decision itself is a sound one; therefore, it should prove to be an instructive and reliable guide for developing a more rigorous gatekeeper approach by a bankruptcy court. Just as importantly, this critical examination may also serve as a guide for bankruptcy litigators when working with their experts in anticipation of trial. If the witness is properly prepared, he may avoid an otherwise foreseeable embarrassment or, worse still, disqualification after substantial fees have been incurred.

Initially, the *Joy* court succinctly recited the fundamental criteria that serve as the foundation of a gatekeeping hearing: namely, that the testimony must aid the court as the finder of fact, and that in order for the testimony to aid the court, it must be both relevant to the issues of fact at hand and must also be reliable. As the court noted, the proposed testimony could easily be relevant, but the methodology used by the proposed expert could be so unreliable that the testimony should be excluded on that second ground alone.<sup>193</sup>

The court noted that the trustee's expert was "a CPA with over twenty-years of experience." "He ha[d] testified as an expert witness in more than a half-dozen bankruptcy cases and ha[d] published numerous articles relating to bankruptcy accounting."<sup>194</sup> However, there was no discussion of whether the expert's testimony was probative. Further, the court did not discuss in what types of publications the experts articles could be found nor whether he was a member of any organization with professional standards or whether he was certified by any national body.<sup>195</sup>

The *Joy* court next turned to the question of bias on the part of the expert. Although bias is more often a question of credibility and a fertile ground for impeachment, at some point bias becomes so systemic and pervasive that it renders any opinion unreliable. In *Joy*, the defendant alleged that the trustee's expert was biased by his contingent interest in the outcome of the case—because of the

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<sup>192</sup> See *id.* at 67.

<sup>193</sup> See *id.*

<sup>194</sup> *Id.*

<sup>195</sup> By no means are we suggesting that the expert was not qualified; we note that a more thorough and pointed discussion of qualifications and their fit to the issues at hand would be appropriate.



administrative insolvency of the bankruptcy case itself, the witness could only be compensated if his client prevailed in the pending fraudulent transfer action, which, in turn, depended upon the testimony he was to offer.<sup>196</sup> The court properly overruled that objection, because if it were sustained, very few creditors' representatives in liquidating chapter 7 or 11 cases would ever be in a position to assure payment of the proposed expert witness' fees. Thus, there is a practical need to recognize a contingency in fact in actual payment (not in the obligation itself), allow the expert to testify, and raise the contingency in payment (as opposed to obligation to pay) during cross-examination. This situation differs from those in which the expert receives a contingency fee as a matter of agreement where the obligation is in fact contingent. The bias in such matters is so great, without implicating the practical policy of necessity, that a court should carefully scrutinize the very strong likelihood of unreliability of the testimony.

Finally, the *Joy* court addressed the issue of whether the experts embraced relevant and reliable methodologies in formulating their opinions. Specifically, objections were made to the trustee's expert's failure to follow the recognized methodologies directly relevant to the scope of his testimony and expert report.<sup>197</sup> One of the major challenges for any financial expert is whether an essential metric, the debtor's EBITDA for example, needs to be "normalized," that is, whether necessary adjustments have to be made to the debtor's pre-tax "bottom line" for non-recurring expenses, those one-time charge-offs that by definition will not continue into the next financial period. Thus, if there were substantive adjustments to the bottom line in the one-year under review, these adjustments will have a tendency to reduce the EBITDA for that year; in projecting the bottom line for the following one-year period, the EBITDA will presumably be greater because no deduction would have to be made. Whether the charge-offs are non-recurring or will recur is an important judgment call, presumably made after discussing the nature of the write-off with key management personnel in detail and then making a critical assessment of this matter in the proper exercise of independent and often skeptical judgment. In this case, the trustee's expert did exactly that; and thus did not add back \$167,000 in nonrecurring expenses to the bottom line because these expenses might well be recurring in the next financial period and that it would be necessary to establish a reserve for the expenses.<sup>198</sup> The key is that the trustee's expert had a reasonable explanation for his position. The court commented correctly that "[A]ccounting is not an exact science. Accountants are therefore required to make judgments about how to communicate financial information."<sup>199</sup> The court went further stating: "A *Daubert* hearing is not the time to fully test the validity of those assumptions."<sup>200</sup>

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<sup>196</sup> See *Joy Recovery*, 286 B.R. at 69.

<sup>197</sup> See *id.* at 69–70.

<sup>198</sup> See *id.* at 70.

<sup>199</sup> *Id.*

<sup>200</sup> *Id.* at 70. However, there are all too common situations where even a cursory but skeptical review of the assumptions employed would lead a court to conclude that the testimony is simply unreliable. For example,

The court went on to state that the errors of the trustee's expert in regard to the adjusted EBITDA were "certainly not so inappropriate as to render his testimony speculative."<sup>201</sup> The *Daubert* inquiry is not one to ascertain whether the testimony is "speculative;" rather, the question is one of "reliability," a qualitative measure less forgiving of the expert than mere speculation. If the expert's justification for material adjustments is not fully reasoned on the essential metrics, especially, the computation of the sensitive metric of EBIDTA, then the expert's testimony and report should be excluded.

The defendants also objected to the trustee's proposed expert alleging he applied an improper standard for determining the issue of insolvency on an adjusted balance sheet basis.<sup>202</sup> Instead of using fair market value as the standard, the trustee's expert used a liquidation standard.<sup>203</sup> The court overruled that objection, in part, by holding that the decision concerning the selection of the standard of value was the kind of decision "routinely made by professional accountants,"<sup>204</sup> and, in part, by holding that the viability of the debtor was a contested fact to be adduced at trial.<sup>205</sup>

## 2. *In re KZK Livestock, Inc.*

In *In re KZK Livestock, Inc.*,<sup>206</sup> the trustee sought to avoid loan repayments made by the debtor on behalf of its sole shareholder as a constructively fraudulent transfer. The insolvency of the debtor at the time of the transfer presented the sole issue at trial, an issue on which the court noted the trustee held the burden of proof by a preponderance of the evidence.<sup>207</sup> Prior to trial, the trustee submitted a motion for summary judgment, supported by affidavits from a retired special agent from the FBI, and a financial analyst with excellent credentials and extensive experience in appraisal and business valuation. The analysis of the special agent was based on the debtor's bank accounts and was not in dispute.<sup>208</sup> The defendants objected to both the form and substance of the financial analyst's report, asserting that the report was unreliable.<sup>209</sup> Specifically, the defendants objected to the fact that the analyst's

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if the proposed expert made significant errors of judgment in normalizing expenses, as adjustments to EBIDTA, given the fact that EBIDTA may be the only metric on which the "multiple" is calculated, then the expert's testimony could well be of little probative value in assisting the court as the trier of fact in determining the dispositive issue of insolvency of the debtor as the fraudulent transferor.

<sup>201</sup> *Id.*

<sup>202</sup> *See Joy Recovery*, 286 B.R. at 70–71.

<sup>203</sup> *See id.* at 71. Recall that the actual statutory standard is not fair market value or liquidation value per se; rather, the standard is a fair valuation under the Bankruptcy Code and the Uniform Fraudulent Transfer Act or fair saleable value under the Uniform Fraudulent Conveyance Act.

<sup>204</sup> *Id.*

<sup>205</sup> *See id.* at 71.

<sup>206</sup> *Barber v. Prod. Credit Servs. of W. Cent. Ill., FLCA (In re KZK Livestock, Inc.)*, 290 B.R. 622 (Bankr. C.D. Ill. 2002).

<sup>207</sup> *See id.* at 625.

<sup>208</sup> *See id.* at 626.

<sup>209</sup> *See id.* at 627.

report did "not describe the principles and methods relied upon in conducting the valuations nor the professional organizations which may establish standards for that methodology."<sup>210</sup> After reviewing the report, the court defined the issue as "the competency of the foundation of this analysis."<sup>211</sup> The source of this problem was not the diligence or efforts of the expert, rather the lack of records maintained by the debtor, and the commingling of the assets of the debtor and its sole shareholder.<sup>212</sup> The court found that these shortcomings rendered the report unreliable and speculative.<sup>213</sup> Because of the uncertainty caused by the lack of records, the court found that the trustee had failed to meet his burden in proving insolvency.<sup>214</sup> However, in this case, there appears to have been little attempt to reconstruct the records of the debtor through third-party sources, such as bank statements, tax returns, vendor records, property records, loan and collateral documents, relevant statistical data on financial metrics for a given industry sector and given-sized company, etc., techniques that are well accepted in the discipline of forensic accounting. These tools are often used by forensic accountants to reconstruct records that have been destroyed, lost, or tainted by fraud. Recall, to be reliable, expert testimony must be based on *sufficient* facts or data. Of course, if there records are not present, and cannot be reasonably reconstructed, then the party who shoulders the burden of proof will lose; that is the nature of our adversarial system.

### 3. *Lippe v. Bairnco Corp.*

One of the more illustrative cases on the roles of experts and the court can be found in three of eight district court opinions issued in the case of *Lippe v. Bairnco Corporation*.<sup>215</sup> The anchor litigation was brought by the creditor's trust trustee arising from the bankruptcy case of asbestos manufacturer, Keene Corporation, against its corporate affiliates, officers, and directors alleging fraudulent transfers, breach of fiduciary duty, and conspiracy to defraud.<sup>216</sup> As in many cases involving fraudulent transfers, the issue of the value of the transferred assets was hotly contested. In *Lippe 6*,<sup>217</sup> the defendants filed a motion to strike the testimony of a

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<sup>210</sup> *Id.*

<sup>211</sup> *Id.* at 628.

<sup>212</sup> See *In re KZK Livestock, Inc.*, 290 B.R. at 628.

<sup>213</sup> See *id.*

<sup>214</sup> See *id.* at 631.

<sup>215</sup> For a complete view of the *Lippe* case history, see *Lippe v. Bairnco Corp.*, 249 F. Supp. 2d 357 (S.D.N.Y. Mar. 14, 2003) ("*Lippe 8*"); *Lippe v. Bairnco Corp.*, 288 B.R. 678 (S.D.N.Y. Jan. 28, 2003) ("*Lippe 7*"); *Lippe v. Bairnco Corp.*, 230 B.R. 906 (S.D.N.Y. Jan. 06, 1999) ("*Lippe 5*"); *Lippe v. Bairnco Corp.*, 229 B.R. 598 (S.D.N.Y., Jan. 05, 1999) ("*Lippe 4*"); *Lippe v. Bairnco Corp.*, No. 96 Civ 7600 (DC), 1998 U.S. Dist. LEXIS 20589 (S.D.N.Y. Dec. 28, 1998) ("*Lippe 3*"); *Lippe v. Bairnco Corp.*, 225 B.R. 846 (S.D.N.Y. Oct. 13, 1998) ("*Lippe 2*"); *Lippe v. Bairnco Corp.*, 218 B.R. 294 (S.D.N.Y. Feb. 06, 1998) ("*Lippe 1*").

<sup>216</sup> *Lippe 2* at 850–51.

<sup>217</sup> No. 96 Civ. 7600(DC), 2002 U.S. Dist. LEXIS 109 (S.D.N.Y. Jan. 4, 2002).

law professor retained by the plaintiff to evaluate the transactions in question. The defendants objected to the law professor's report and testimony on the grounds that he "improperly invades the province of the jury by opining as to the veracity of witnesses and the 'subjective fraudulent intent of the parties'"<sup>218</sup> and that he "'argues the result that should be reached on an ultimate issue in the case.'"<sup>219</sup> The court agreed that determining the credibility of the witnesses in the case was the province of the jury and "not the proper subject for expert testimony."<sup>220</sup> The court concluded that the report should not be stricken nor should the law professor's testimony be excluded in total, because *it may assist the trier of fact*, the threshold inquiry on the introduction of all expert testimony. However, the court ruled that the professor's testimony should be limited and that he would not be allowed to give testimony reaching ultimate legal conclusions or give personal assessments of the veracity of other persons involved in the case.<sup>221</sup>

The opinion in *Lippe 7*<sup>222</sup> arose from the *Daubert* hearing on defendants' motion to exclude the expert testimony of the previously discussed law professor and the plaintiff's other two expert witnesses: an investment banker and a finance professor.<sup>223</sup> There, the court began with a general discussion of the relevance and reliability requirements in the *Daubert* analysis of expert testimony. The court noted that "to be reliable, expert testimony must be based on sufficient facts or data, and it must be the product of reliable principles and methods properly applied."<sup>224</sup> The court then listed some of the factors that a trial court may consider when evaluating reliability, but noted that in the end, the test is a flexible one.<sup>225</sup> Further, the court discussed the role of the expert witness: "An expert's role is to assist the trier of fact by providing information and explanations; the expert's role is not to be an advocate."<sup>226</sup>

The court first addressed the issues surrounding the law professor from *Lippe 6* and his dual role in the case. The professor acted not only as an expert to evaluate the transaction in question, but also as counsel for the plaintiffs.<sup>227</sup> The court stated that "[i]t would be most inappropriate to permit him now to testify as an expert witness about the very matters he helped develop as a lawyer-advocate."<sup>228</sup> The court then said that although many experts have some level of bias, and that some bias does not serve to exclude the expert's testimony, the conflict between the role

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<sup>218</sup> *Id.* at \*5 (internal citations omitted).

<sup>219</sup> *Id.* at \*6 (citations omitted).

<sup>220</sup> *Id.* at \*5–6.

<sup>221</sup> *See id.* at \*8.

<sup>222</sup> 288 B.R. 678 (S.D.N.Y. 2003).

<sup>223</sup> *See id.* at 681.

<sup>224</sup> *Id.* at 686.

<sup>225</sup> *See id.* at 686–87.

<sup>226</sup> *Id.* at 687.

<sup>227</sup> *See id.* at 688.

<sup>228</sup> *Lippe 7*, 288 B.R. at 688.

of counsel and expert witness is not one that can be overcome.<sup>229</sup> Thus, the testimony of the law professor was excluded.<sup>230</sup>

Next, the court addressed the problems with the proposed testimony of the plaintiff's investment banker, stating that the testimony should be excluded because his "opinions are based largely on his experience, but include no effort to explain how the conclusions were reached, why the conclusions have a factual basis, or how his experience is reliably applied."<sup>231</sup> The court found several reasons for finding the investment banker's testimony unreliable. First, the court addressed the investment banker's unexplained divergences from industry standards in reaching his conclusion.<sup>232</sup> These divergences came in the form of the failure to perform a discounted cash flow analysis, which, aside from being a significant component of the industry standard for valuation, would have provided a cross-validation to the guideline or comparable company method of valuation chosen by the investment banker;<sup>233</sup> and the statement of value as a single number rather than a range as is typical in valuation cases.<sup>234</sup> Second, the court found the testimony unreliable because it failed to take several variables into account, and ignored available information.<sup>235</sup> Third, the investment banker admitted in his deposition that there was no reliable way to test his methodology or his assumptions.<sup>236</sup> Fourth, the court addressed the expert's inability to explain adequately the decisions he made and the facts he depended on in reaching his conclusions.<sup>237</sup> Particularly, the court noted the investment banker's inability to explain how he arrived at the proper "control premium"—the added value a purchaser would pay for control of the company—suggested unreliability.<sup>238</sup> Finally, the court found that several major errors in his analyses were indicative of unreliability.<sup>239</sup> After finding the investment banker's testimony failed to reach an acceptable level with regard to many of the *Daubert* factors for reliability, the court ruled that the investment banker's testimony should be excluded.<sup>240</sup>

Finally, the court addressed the proposed testimony of a finance professor retained by the plaintiff to testify regarding the insolvency of Keene at the time of the transactions. To support plaintiff's claims, the expert needed to find higher values for the sold businesses, and a lower value for Keene itself. The expert met this goal by adding "control premiums" in her analysis of the transferred entities but including no such premium in her valuation of Keene, citing lack of necessary

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<sup>229</sup> See *id.* at 688–89.

<sup>230</sup> See *id.* at 689.

<sup>231</sup> *Id.*

<sup>232</sup> *Id.* at 689–94.

<sup>233</sup> See *id.* at 689–90.

<sup>234</sup> See *Lippe* 7, 288 B.R. at 689–90.

<sup>235</sup> See *id.* at 690–93.

<sup>236</sup> See *id.* at 690.

<sup>237</sup> See *id.* at 690–94.

<sup>238</sup> See *id.* at 691–93.

<sup>239</sup> See *id.* at 694, 670.

<sup>240</sup> See *Lippe* 7, 288 B.R. at 701.

information.<sup>241</sup> Because she had the same information for each of the business units, the court found this unexplainable internal inconsistency troubling.<sup>242</sup> Having noted several internal inconsistencies and outright errors in the finance professor's report, the court found that the testimony should also be excluded because it was unreliable and would not assist the trier of fact.<sup>243</sup> The court summarized its basis for the exclusion of the testimony:

I conclude that [the investment banker] and [the finance professor] are unlikely to "assist the trier of fact" because their opinions are speculative and conjectural, their opinions are not based on sufficient facts or data but instead are based largely on their own say-so or on unfair and one-sided interpretations of the available data, they do not apply reliable principles and methods in a fair and reliable way, and they make no effort to account for major variables that one would expect to have an impact on their conclusions.<sup>244</sup>

#### 4. *In re USN Communications, Inc.*

In *In re USN Communications, Inc.*,<sup>245</sup> the trustee of the liquidating trust under the confirmed plan of liquidation filed a complaint to avoid a constructive fraudulent transfer of \$68,000,000 to the selling shareholders of a reseller of cellular telephone and other bundled services to the debtor corporation.<sup>246</sup> The closing of the sale occurred one year before (less two business days) of the date the purchaser filed its chapter 11 petition.<sup>247</sup> On a withdrawal of the reference from the bankruptcy court by the defendants, the parties tried the adversary proceeding to the district court bench.<sup>248</sup> The court found the purchase price reasonably equivalent to the value of the shares transferred.<sup>249</sup> The court reached this conclusion primarily based upon the testimony of the defendants' expert that four fairly recent comparable acquisitions by other corporations<sup>250</sup> were priced and sold at a per

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<sup>241</sup> See *id.* at 694.

<sup>242</sup> See *id.* at 695. Also troubling was the expert's inability to explain how a \$520 million company could lose \$425 million of its value in seven months without an uninsured catastrophic event; how Keene could be worth \$95.7 million in 1987 when it owned, among other assets, Versitron, Micro Chassis, and Arlon, but Versitron and Micro Chassis were worth \$120.8 million and \$29.2 million respectively when they were sold in 1988 and Arlon was worth between \$101.9 and \$198 million when it was transferred in June of 1989. *Id.*

<sup>243</sup> See *id.* at 701.

<sup>244</sup> See *id.*

<sup>245</sup> Peltz v. Hatten (*In re USN Comm'ns, Inc.*), 279 B.R. 710 (D. Del. 2002).

<sup>246</sup> See *id.* at 712 (describing avoidance cause of action).

<sup>247</sup> See *id.* at 711.

<sup>248</sup> See *id.* at 712.

<sup>249</sup> See *id.* at 747 ("[T]he Liquidating Trustee has not met his burden in proving that USN's payment of \$68 million for CT Tel was not reasonably equivalent value . . .").

<sup>250</sup> See *id.* at 723–24, 738–39 (D. Del. 2002). In a firm and correct commitment not to interpret future disastrous events from hindsight, the district court gave credence to the prices paid on a per subscriber basis by WorldCom of other cellular resellers, Choice Cellular, Inc., in 1996 and Comtech Wireless, Inc. in 1997.

subscriber cost of between \$900 to \$1,000.<sup>251</sup> The acquisition by the debtor corporation was at the \$1,000 number.<sup>252</sup> The court surprisingly gave very little weight to the trustee's expert witness's valuation of the acquired company at \$43,400,000 because that valuation was based on the discounted cash flow method. The court commented that as a method of valuation, the discounted cash flow method depended upon too many subjective adjustments and, therefore, was far less reliable than the similar transactions method.<sup>253</sup> Moreover, the court faulted unwillingness of the trustee's main witness and rebuttal witness to attribute additional value for the synergies that the senior management and its investment bankers attributed to the combination of the acquired and the acquiring companies.<sup>254</sup>

The court then addressed (in dicta) the second prong of the complaint, namely, whether on an adjusted balance sheet basis the acquiring corporation was insolvent or became insolvent upon the closing of the \$68,000,000 sale transaction.<sup>255</sup> The court found that the acquisition had been funded by a \$125,000,000 initial public offering,<sup>256</sup> and after paying for the acquisition, the debtor corporation was left with a positive net worth of \$67,800,000 as of February 28, 1998.<sup>257</sup> The court gave little weight to the trustee's evidence that: (1) the debtor corporation had a negative EBIDTA, that its EBIDTA was projected not to turn positive for two years after the acquisition; (2) poor billing practices required writing off 50% of the accounts receivable; (3) the burn rate for cash was approximately of \$12,000,000 a month; and (4) working capital needs could only be funded by selling junk bonds within that one year following the closing of the IPO and the purchase transaction.

The court accepted the testimony that a negative EBITDA was quite characteristic of an aggressive growth company. The court further found that senior management of the debtor corporation and their financial advisors were very confident at the time of the closing of the sale in late February 1998 that the

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These transactions were two of the four comparable transactions used to justify the \$68,000,000 acquisition price. *Id.* at 738–39. Although this adversary proceeding was tried during the winter of 2002, the district court wisely ignored the intervening implosion of the entire cellular communications industry, including WorldCom and Adelphi Communications. Paying \$1,000 per subscriber turned out in hindsight, of course, to be much too high a price to pay.

<sup>251</sup> *In re USN Comm'ns, Inc.*, 279 B.R. at 719–20.

<sup>252</sup> *Id.* at 722.

<sup>253</sup> *Id.* at 737–38 (discussing subjective nature of discounted cash flow inputs).

<sup>254</sup> *Id.* at 740.

<sup>255</sup> *See id.* at 742. Once the trustee failed in his proof on the issue of [un]reasonably equivalent value, the defendants were entitled to a judgment of dismissal because it no longer mattered whether the debtor was insolvent or became insolvent, but judges still tend to complete the analysis of the second prong. *See, e.g., VFB LLC v. Campbell Soup Co.*, 482 F.3d 624, 633–34 (3d Cir. 2007) (considering, without deciding insolvency issue, if upholding lower court's judgment of reasonably equivalent value); *see* 11 U.S.C. § 548(a)(1) (2006). *But see, e.g., BFP v. Imperial Savings & Loan Ass'n (In re BFP)*, 974 F.2d 1144, 1149 (9th Cir. 1992) (ending analysis after finding reasonably equivalent value). Perhaps it is based upon an apprehension if years later its judgment is reversed, it might be difficult for the plaintiff to try the case a second time on both prongs.

<sup>256</sup> *In re USN Comm'ns*, 279 B.R. at 727.

<sup>257</sup> *Id.*

company would continue to have ready access to the junk bond market, perhaps at a level of funding as high as \$250,000,000. The unfortunate collapse of the junk bond market, occasioned allegedly by adverse market conditions in Russia, could not be foreseen by senior management and its financial advisors at that time. Had senior management recognized the risk of a failure of the junk bond market, it could have curtailed its plans for growth and reduced the high commissions paid to its marketing force. On this issue, the court also found that the liquidating trustee's calculation of the debtor's adjusted balance sheet built in his expert's valuation of the acquired company at \$43,400,000; once that adjustment was reversed from the acquisition cost, the balance sheet turned positive, even if one were to accept a write-off of 50% of the receivables as a function of a very poor billing system.

The court then turned to the issue of insolvency as a function of unreasonably small capital, and found that the liquidating trustee again failed to sustain his burden of proof. With \$149,000,000 in cash and liquid securities at the time of the closing of the acquisition, the debtor corporation could hardly be found to be short on working capital. As further support, the court repeated its findings with respect to the reasonable projection at the time of closing of ready access to the junk bond market. Finally, the court speculated that if the junk bond market were not accessible, the debtor corporation could resort to commercial banking facilities. To buttress, the court confidently concluded that the acquisition had nothing to do with the collapse of the debtor corporation.

##### 5. *In re Med Diversified Inc. II.*

Courts may also exclude expert testimony where the expert's analysis is poisoned by systematic bias in applying the standard methodologies. As mentioned in the previous cases, bias is most often left for cross-examination and possible impeachment at trial. However, systemic bias may rise to a level that renders any application of even a standard methodology unreliable to the point that it fails the *Daubert* requirements. That is precisely the situation the bankruptcy court faced in *In re Med Diversified Inc. II.*<sup>258</sup>

That case demonstrates the type of systematic bias that warrants exclusion of the expert's testimony and report as unreliable. There, the court concluded that a series of negative adjustments made during a discounted cash flow analysis manifested bias.<sup>259</sup> In particular, the court pointed to three areas where this bias was most evident: (1) computation of the discount rate;<sup>260</sup> (2) the discount taken for lack of marketability;<sup>261</sup> and (3) calculation of the control premium.<sup>262</sup> These adjustments

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<sup>258</sup> 346 B.R. 621 (Bankr. E.D.N.Y. 2006). Because the first author issued this opinion, we have omitted the detailed analysis in support of these findings and respectfully refer the reader's attention to the full text of this opinion.

<sup>259</sup> See *id.* at 625–26.

<sup>260</sup> See *id.* at 635–37.

<sup>261</sup> See *id.* at 638–40 (discussing application of 30% discount taken for lack of marketability that was both counterintuitive and likely meant to "further depress the value of 'Addus'").



were made with little to no reasonable justification offered, no suggestion that other adjustments were considered and discarded and for what reason, and no indication that the expert's approach was objective. Based on these flagrant and systematic biases in applying the standard methodology, the court excluded the expert report and testimony.<sup>263</sup>

The court in the *Med Diversified* cases<sup>264</sup> took the better part of ten days to preside over the voir dire of three experts in which it actively participated. At the "end of the day," the court determined that (i) the plaintiff's expert witness on valuation was so biased in his application of the standard methodologies that his testimony had to be stricken as fatally unreliable;<sup>265</sup> (ii) the defendants' expert witness on valuation was disqualified for lack of specialized training and experience, and because his testimony was wholly unreliable on the ground that he completely failed, among many other deficiencies, to apply one of the critical methodologies—the discounted cash flow method;<sup>266</sup> and, (iii) the plaintiff had no standing to bring common law fraudulent misrepresentation claims as the assignee of the estate's claims, which meant that the report and testimony of its very qualified forensic accountant had to be struck through a post-trial ruling as irrelevant.<sup>267</sup> With each of the expert opinions rejected, plaintiff's counsel was reduced to arguing that the court should rely upon its common sense intuition and enter judgment for the plaintiff.<sup>268</sup> Pushing this insight to its natural limits, there would be no necessity for trials based upon the testimony of expert witnesses. Fortunately, the majority of bankruptcy judges act upon the assumption that argument is no substitute for competent evidence in bankruptcy litigation.

#### 6. *In re Fidelity Mortgage and Bond Corp.*

In *In re Fidelity Mortgage and Bond Corp.*,<sup>269</sup> the debtor, Fidelity Bond and Mortgage Co., brought a constructive fraudulent transfer action under applicable Pennsylvania state law against the selling shareholders of a privately held mortgage

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<sup>262</sup> See *id.* at 637–38 (contrasting findings of two studies that weighted mean control premium paid in healthcare transactions is between 34.9% and 31.1% with 10% control premium applied by expert who "failed to adequately explain how such a low premium was justified").

<sup>263</sup> See *id.* at 642.

<sup>264</sup> *Chartwell Litig. Trust v. Addus Healthcare, Inc. (In re Med Diversified, Inc.)*, 334 B.R. 89 (Bankr. E.D.N.Y. 2005) ("*Med Diversified I*"); *Chartwell Litig. Trust v. Addus Healthcare, Inc. (In re Med Diversified, Inc.)*, 346 B.R. 621 (Bankr. E.D.N.Y. 2006) ("*Med Diversified II*"). The first listed author of this article, Stan Bernstein, is the bankruptcy judge that presided over the *Med Diversified* chapter 11 cases, and the affiliated *Tender Loving Care* chapter 11 cases. The third listed author, Jack F. Williams, testified in support of his firm's application for interim compensation in connection with preparing an expert report on the insolvency of the affiliated corporation, referred to as the *Tender Loving Care* cases.

<sup>265</sup> See *Med. Diversified II* at 626–28.

<sup>266</sup> See *id.* at 629–30.

<sup>267</sup> See *id.* at 634–35.

<sup>268</sup> See *id.* at 642.

<sup>269</sup> 340 B.R. 266 (Bank. E.D. Pa. 2006) (Carey, J.), *aff'd*, 371 B.R. 708 (E.D. Pa. 2007).

servicing company who divested as part of a leveraged buy-out.<sup>270</sup> As part of its evidence, the debtor submitted an expert witness's report showing that, on an adjusted balance sheet basis, the debtor did not receive reasonably equivalent value for the payments to the selling shareholders and that those payments rendered the debtor insolvent.<sup>271</sup> The selling shareholders and the other defendants filed their expert's report that reached contrary conclusions on each of these allegations.<sup>272</sup>

The court made no reference to the *Daubert* standard for admitting the reports of expert witnesses, nor does it appear that an evidentiary hearing was held on any motion *in limine* to exclude the report of either witness. The debtor's expert report assigned a negative net worth of over \$2,001,000 while the defendant's expert report assigned a positive net worth of \$1,732,000, for a variance of \$3,833,000.<sup>273</sup> While striking neither report as unreliable, the court commented that it disagreed with various adjustments made by the debtor's expert, and found that the debtor was solvent in a range between \$793,200 and \$1,732,000—the defendants' net worth number.<sup>274</sup> In reaching this finding, the court discussed several entries in the opposing expert witnesses' reports.<sup>275</sup> On the liability side of the adjusted balance sheet, the court noted that under the entry for subordinated debt, the debtor's expert listed \$2,467,497, which if accepted would have alone been sufficient to prove insolvency, ignoring all other adjustments to the audited financial statements.<sup>276</sup> The defendants' expert listed the liability at \$956,000, the amount on the audited financial statements, for a variance of over \$1,510,000.<sup>277</sup> The court rejected the debtor's expert's number for the subordinated debt because under the transaction documents, the selling shareholders were obligated to repay \$1,715,000 if the surviving debtor did not have a net worth within a range of \$2.5 million to \$4.5 million.<sup>278</sup> In reaching that conclusion, the court relied upon the report of the defendants' expert that the company had a value of at least \$3.0 million and that there was no basis for unwinding the transaction.<sup>279</sup>

### 7. *In re Fruehauf Trailer Corp.*

In *In re Fruehauf Trailer Corp.*,<sup>280</sup> the court found that three weeks before Fruehauf Trailer Corp. filed its chapter 11 petition in the District of Delaware, the board of directors held an emergency meeting to authorize the filing, to improve the

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<sup>270</sup> *Id.* at 271–85.

<sup>271</sup> *Id.* at 293.

<sup>272</sup> *See id.* at 291–92.

<sup>273</sup> *Id.* at 290.

<sup>274</sup> *See id.*

<sup>275</sup> *See Fidelity Mortgage and Bond Corp.*, 340 B.R. at 290–91.

<sup>276</sup> *See id.*

<sup>277</sup> *Id.* at 290.

<sup>278</sup> *Id.*

<sup>279</sup> *See id.* at 290–91.

<sup>280</sup> *Pension Transfer Corp. v. Beneficiaries Under the Third Amendment to Fruehauf Trailer Corp. Ret. Plan No. 003*, 319 B.R. 76 (D. Del. 2005).

provisions of its key employee retention program ("KERP"), and to amend its employees pension plan in order to increase the benefits for 400 of its executives and managers.<sup>281</sup> The additional pension benefits imposed a projected cost to the debtor of \$2.4 million to be funded from the surplus in the pension plan for the union employees.<sup>282</sup> The debtor in possession then filed a complaint against the plan beneficiaries under section 548(a)(1)(B) on the theory that the funding of the increased benefits under the amended pension plan constituted a constructive fraudulent transfer.<sup>283</sup> Pursuant to a confirmed liquidating plan, the right to pursue the action was assigned to the trustee of the Pension Transfer Trust established under the plan.<sup>284</sup>

Before trial, the parties stipulated that the debtor was insolvent as of the date of transfer and that the transfer occurred within one year of the petition date.<sup>285</sup> This left the issue of fact and law of whether the transfer was for reasonably equivalent value for trial. Two of the defendants testified that the amendment to the pension plan was part of the financial inducement to senior management to remain with the debtor pending a contemplated sale of substantial assets for \$55,000,000.<sup>286</sup> Without the modification to the KERP and the amendment of the pension plan, the defendants argued that the proposed purchaser would not have entered into the purchase agreement and substantial value would have been lost to the estate.<sup>287</sup> The plaintiff called three witnesses to testify: one of the two independent directors who testified about the very suspect circumstances surrounding the board's emergency approval of the amendment of the pension plan;<sup>288</sup> the actuary for the plan who testified about the value to the beneficiaries under the amended pension plan and the cost to the estate; and an expert witness called to testify on the mixed issue of law and fact of whether or not the transfer was for reasonably equivalent value.<sup>289</sup> The expert, the head of the Compensation Advisory Services Group for KPMG, had expertise in the field of employment compensation and KERPS.<sup>290</sup> This expert witness convincingly testified that in his extensive experience, amendments to

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<sup>281</sup> *See id.* at 80–84.

<sup>282</sup> *See id.*

<sup>283</sup> *See id.* 86–87.

<sup>284</sup> *See id.* at 84.

<sup>285</sup> *See id.* at 85.

<sup>286</sup> *See Pension*, 319 B.R. at 86.

<sup>287</sup> *Id.*

<sup>288</sup> The first witness testified that the board approved, over the objections of its two independent directors, a modification to the KERP that immediate cash payments to 12 of the company's executives, and an amendment to the pension plan benefiting 400 executives and managers that included a 5% cash contribution to the pension plan, plus 8% interest on the contributions, and the level of benefits, which had been frozen for five years at the 1991 salary schedules. *See id.* at 81. The independent director testified that the amendment was presented as a mere administrative change, with no impact on the debtor's cash position, and without any adequate explanation for the change. The immediate impact of these emergency measures was to increase the benefits to the top executives by 200 to 470%. *See id.* at 82. Based upon this testimony, the district court found that the total lack of good faith was part of the operational criteria for determining a constructive fraudulent transfer under the leading cases in the Third Circuit. *See id.* at 87–88.

<sup>289</sup> *See id.* at 85–86.

<sup>290</sup> *See id.* at 81.

pension plans were not part of key employee retain programs, that the norm in the industry was to allocate no more than one-half of one percent of a company's annual revenues to fund a KERP provided that the period of service was to run between one year and eighteen months, and that in this case between the KERP and the improved pension benefits, the cost to the debtor was *double the industry norm* at .88 percent of its annual revenues, and the retention period was only for eight months.<sup>291</sup>

Further, the court did not find credible the defendants' testimony that the \$55,000,000 sale for a major portion of the debtor's assets would not have gone forward without the continued employment of the executives and managers.<sup>292</sup> Although there may have been some unascertainable value in inducing senior management to remain with the company, the court found that the value was far from reasonably equivalent to the \$2,400,000 in enhanced pension benefits.<sup>293</sup> The Court of Appeals for the Third Circuit affirmed the rulings of the lower courts.<sup>294</sup>

#### 8. *VFB LLC v. Campbell Soup Co.*

In a cluster of cases, courts struggled with the appropriate valuation approach for a public company as of the transfer date. In *VFB LLC v. Campbell Soup Co.*,<sup>295</sup> the Third Circuit affirmed the district court's dismissal of a constructive fraudulent transfer complaint filed against the Campbell Soup Company to avoid a leveraged buy-out of its specialty food division.<sup>296</sup> The plaintiff was the entity formed under a liquidating plan of reorganization for Vlastic Foods International, Inc. (VFI) to which the unsecured claims as well as of the avoidance actions of the estate were assigned.<sup>297</sup> The Campbell Soup Company ("Campbell's") spun off its poorly performing "specialty foods division" ("Division") on March 30, 1998, to a management group in a half-billion dollar "leveraged spin" transaction.<sup>298</sup> The principal components of the Division were Vlastic Foods, pickles, and Swanson Foods, TV dinners.<sup>299</sup> Campbell's management substantially manipulated the sales and earnings of the Division during fiscal years 1996, 1997, and part of 1998 to increase its projected value.<sup>300</sup> Under the terms of the leveraged transaction, Campbell's borrowed half of a billion dollars from a syndicated bank group, and then caused the Division to assume the debt and to grant a security interest in all of

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<sup>291</sup> See *id.* at 83.

<sup>292</sup> See *Pension*, 319 B.R. at 86.

<sup>293</sup> See *id.* at 86–88.

<sup>294</sup> *Pension Transfer Corp. v. Beneficiaries Under the Third Amendment to Fruehauf Trailer Corp. Ret. Plan No. 003*, 444 F.3d 203, 217 (3d Cir. 2006).

<sup>295</sup> 482 F.3d 624 (3d Cir. 2007).

<sup>296</sup> See *id.* at 636–37.

<sup>297</sup> *Id.* at 627.

<sup>298</sup> *Id.*

<sup>299</sup> See *id.* at 626.

<sup>300</sup> See *id.* at 627–28.

its assets to secure the repayment of the debt.<sup>301</sup> The bank group made no independent investigation of the actual financial condition of the Division; it merely accepted the cash flow projections submitted by Campbell's.<sup>302</sup> Campbell's retained the loan proceeds as consideration for the sale of the Division and issued shares of the Division as an "in-kind" dividend to Campbell's shareholders.<sup>303</sup>

The publicly-traded Division collapsed in less than two years.<sup>304</sup> This collapse led to the filing of a liquidating chapter 11 case by VFI in January of 2000.<sup>305</sup> Although some of the component businesses were sold prior to the petition date, the amount realized for all of the assets and businesses of the Division was \$385,000,000–\$115,000,000 less the amount paid to Campbell's. The complaint was tried in a bench trial before the federal district court in Delaware.<sup>306</sup>

The district court rejected the plaintiff's expert testimony out of hand, finding that it suffered from a "hindsight bias."<sup>307</sup> The Court of Appeals for the Third Circuit characterized the testimony as a "side-show."<sup>308</sup> In its discussion, the Court of Appeals discounted the validity of the discounted cash flow method for valuing publicly-held companies:

To the extent that the experts purport to measure actual post-spin performance, as by, for example, discounted cash flow analysis, they are measuring the wrong thing. To the extent they purport to reconstruct a reasonable valuation of the company in light of uncertain future performance, they are using inapt tools.<sup>309</sup>

The district court, as affirmed by the Third Circuit, found instead that the only reliable basis for valuing the Division as a publicly-held company was its market capitalization, which according to Campbell's expert witness was \$1.5 to 1.8 billion dollars as of the closing date.<sup>310</sup> Even after the market had to make substantial adjustments in the value of shares for Campbell's artificial manipulation of the Division's sales volume and earnings before the leveraged spin-off, the adverse effects of which were only realized in 1988 and in 1989, the market capitalization was still \$1.1 billion dollars nine months after the date of sale, January 1, 1999.<sup>311</sup> Under these facts and circumstances, the plaintiff failed to sustain its burden of

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<sup>301</sup> See *Campbell*, 482 F.3d at 628.

<sup>302</sup> See *id.* at 632.

<sup>303</sup> See *id.* at 626–27.

<sup>304</sup> See *id.* at 628.

<sup>305</sup> See *id.*

<sup>306</sup> *VFB LLC v. Campbell Soup Co.*, 336 B.R. 81 (D. Del. 2005).

<sup>307</sup> See *Campbell*, 482 F. 3d at 629.

<sup>308</sup> See *id.*

<sup>309</sup> *Id.* at 633.

<sup>310</sup> See *id.* at 629.

<sup>311</sup> *Id.* at 631.

proof that the leveraged spin-off satisfied the statutory criteria of a constructive fraudulent transfer.<sup>312</sup>

This opinion teaches that if the plaintiff wants to improve the probability of prevailing in its avoidance action, it needs to have experts, well-versed in the academic literature of finance theory and capable of refuting the defendant's expert's testimony on the value of the debtor's market capitalization and any failure of the market to discover the debtor's true operating results. It appears increasingly clear that the federal trial courts and the appellate courts are not disposed to giving much credibility to the plaintiff's experts attacked as engaging in "hindsight" valuations, prepared in support of the plaintiff's litigation objectives. The standard approaches to valuation such as discounted cash flows, comparable or guideline companies, and similar transactions, which require considerable sophistication and critical scrutiny of extensive financial data, are now being subordinated to expert testimony on market capitalization of publicly traded debtor corporations, at least in the context of what constitutes a "fair valuation" of the debtor's property and amount of debts.<sup>313</sup>

#### 9. *In re Iridium Operating LLC*

*In re Iridium Operating LLC*<sup>314</sup> contains an excellent application of the capital markets approach to the question of insolvency authored by Bankruptcy Judge Peck. There, in mid-August 1999, creditors filed an involuntary petition against the publicly-held Iridium in the Bankruptcy Court for the Southern District of New York; other affiliates filed their own petitions the same day with the Bankruptcy Court for the District of Delaware.<sup>315</sup> The Delaware cases were then transferred to the Southern District of New York with the cases then procedurally consolidated.<sup>316</sup> In 2001, the official committee of unsecured creditors filed a multi-count complaint for \$3.7 billion in damages against Motorola.<sup>317</sup> After four years of discovery and motion practice, the parties agreed "in consultation with the court" to try separately the issue of insolvency raised in counts for the avoidance of alleged fraudulent and preferential transfers.<sup>318</sup> The trial of this issue took fifty long days—between

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<sup>312</sup> See *id.* at 632.

<sup>313</sup> Recall that in *Campell* the court was not seeking to determine the total enterprise value of a debtor, but whether the debtor was insolvent as defined by section 101(32), an inquiry that requires a comparison of the amount of debts and the value of property at a fair valuation. Essentially, the court found that the market where the value of the subject shares was fairly established in open and informed trading provided a mechanism of "fair valuation," a result consistent with our suggested approach that "fair valuation" under section 101(32) is a process-sensitive and not result-oriented approach. See generally Stuart Larsen, *Court Obeyes the Market: Third Circuit Deems Campbell's Subsidiary Spin-Off Not to Be a Fraudulent Transfer*, 26 AM. BANKR. INST. J. 26 (September 2007).

<sup>314</sup> 373 B.R. 283 (Bankr. S.D.N.Y. 2007).

<sup>315</sup> See *id.* at 304 (recounting procedural posture).

<sup>316</sup> See *id.*

<sup>317</sup> See *id.* at 290.

<sup>318</sup> *Id.* at 290.

opening arguments on October 23 and closing arguments on June 5, 2007, then followed by post-trial submissions.<sup>319</sup> The court found that the plaintiff failed to sustain its burden of proof that the Iridium companies were insolvent or had unreasonably small working capital with which to continue to operate their businesses during the relevant look-back periods.<sup>320</sup> In fact, the court emphasized that the committee's experts failed to put on any particularized proof with respect to the much shorter look-back periods of alleged insolvency under its preference count. Instead, the committee concentrated exclusively on trying to prove that the debtors were insolvent or had unreasonably small capital with which to operate throughout the entire four-years prior to the petition date relevant to its claim of fraudulent transfers.<sup>321</sup>

In its introduction,<sup>322</sup> the court stated that the appropriate standard for determining the issue of insolvency was convincingly set forth by the decision of the Court of Appeals in the *VFB LLC (Campbell)* case.<sup>323</sup> As the Iridium court read that opinion, the Third Circuit stressed the importance of giving full probative weight to the pre-petition trading of the corporate debtor's shares in a recognized and open public market when determining the issue of the debtor's alleged insolvency in avoidance actions.<sup>324</sup>

Indeed, the *Iridium* court found the committee's primary witness not only lacking in credibility and rather arrogant and non-responsive to questions directed to him during his cross-examination, but also in failing to refute the defendant's expert witnesses' testimony.<sup>325</sup> The latter experts testified in detail about the due diligence by the debtors and its consultants in preparing cash flow projections and their business plans for the five year period from 2001 through 2006; the vetting of these projections and plans by the agent banks' financial consultants, the investment bankers, and private investors; and extent of the information about the Iridium system and its technical limitations available to the public markets. As the court readily acknowledged, the Iridium companies failed spectacularly within nine

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<sup>319</sup> *Id.*

<sup>320</sup> *Iridium*, 373 B.R. at 342 ("[T]he Committee has the burden of proof to show by a preponderance of the evidence that Iridium was either insolvent or inadequately capitalized at the time of any transfer made during the four-year period from August 13, 1995 through August 13, 1999.").

<sup>321</sup> *See id.* at 292. The court seemed to suggest that had the committee not been committed to going for broke by trying to prove too much, namely, that the Iridium companies were insolvent as far back as four years before the petition date, it might have been able to prove that the companies were insolvent at least ninety days before the petition date to avoid any preferential transfers or perhaps six months before the petition date when the commercial activation program was failing to meet projected sales and distribution. It would have been prudent in hindsight for the committee to have developed a fall-back position by preparing a series of insolvency analyses to cover different cut-off dates. *See id.*; *see also* 11 U.S.C. § 547 (2006) (providing rule for when debtor is insolvent); *Lawson v. Ford Motor Co. (In re Roblin Indus., Inc.)*, 78 F.3d 30 (2d Cir. 1995) (explaining how debtor is presumed insolvent according to section 547 of Bankruptcy Code).

<sup>322</sup> *See Iridium*, 373 B.R. at 305.

<sup>323</sup> *See VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007).

<sup>324</sup> *See Iridium*, 373 B.R. at 291.

<sup>325</sup> *See id.* at 293.

months of the roll-out of their hand-held phones linked to 66 globe-circling satellites in November 1998.<sup>326</sup> The court further acknowledged that the market for Iridium shares dropped from \$14.85 per share in November 1998, when the phones were released to the public, down to \$14.00 six months later as the anticipated volume of sales failed to materialize, and finally, two months later, to \$3.06 as of the petition date.<sup>327</sup> This meant the internally generated cash flow projections and the market's valuation, based upon anticipated sales volume and commensurate revenues, seriously misjudged the intended target audience's willingness to buy the hand-held phones. Technical problems causing the phones to malfunction where they could not get a "line-of-sight" to the satellite—such as between buildings in cities—and the fact that the phones did not work in cars unless equipped with antennas to pick up the signs from the Iridium system's global satellites contributed to these issues.

Nevertheless, the court continued to draw sharp analytical distinctions between the validity of the cash flow projects and the business plans, which were vetted internally and externally when prepared, and the serious misjudgments about projected and future business use of the phones.<sup>328</sup> This distinction was drawn in the face of what appears at first blush to be a logical inconsistency: cash flow projections and share prices in public markets are, in large measure, supposed to be reflective of the future use of a product that has yet to be released to the consuming public. As a result, it seems that the committee's expert was faced with an impossible evidentiary burden—every explanatory factor tendered by the committee's expert for the ultimate failure of the business upon its launch date as well as the unreliability of the debtors' business plans and cash flow projections was rejected by the court as based upon "hindsight."<sup>329</sup>

This very comprehensive and superbly well-written opinion teaches the lesson, advanced in much more abbreviated form in *VFB LLC (Campbell)* with regard to public company chapter 11 cases, that the drafts and revisions of cash flow projections and business plans must be examined in considerable critical detail during pretrial discovery. In the favorite phrase of the law and economists, the plaintiff's expert on valuation has to show that it carefully reviewed all of the *ex ante* materials and can point to each of the errors in the underlying assumptions to the business plans and cash flow projections, and not to toss these *ex ante* analyses as with any broad based brush. Similar attention must be paid to the solicitation materials for the private placements and the business press and stock traders' publications who promoted the shares when they were publicly traded. As for the criticism that the plaintiffs' expert witnesses were hired guns, professionals who prepare their reports to further their clients' litigation objections, there is no *a priori* ground for refuting that criticism. The only available, *albeit* indirect, response is to

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<sup>326</sup> See *id.* at 290.

<sup>327</sup> See *id.* at 302.

<sup>328</sup> See *id.* at 300.

<sup>329</sup> See *id.*, 373 B.R. at 345.



be prepared to testify with humility, measured responsiveness to questions posed during cross-examination, and fair deference to the court if it asks any questions. Further, one must be prepared to testify exactly how one proceeded at every step along the way to prepare any valuation report, with a presentation of the methodology used in that process and the general acceptance of that methodology.

The court found that the committee's experts did not adequately explain the main reasons for this horrendous business failure. In effect, the court held that the committee relied upon a *post hoc ergo propter hoc* argument: because Iridium met with such an extraordinary and immediate rejection by its projected universe of purchasers, either the public market had to be seriously misinformed about the operational defects in the Iridium System or it suffered from a reckless exuberance of the same type that characterized other similar market failure during the same general period in the telecommunications industry as a whole. Rather than thoroughly dissect the cash flow projections and business plans of the Iridium companies and the trading activity of the public market during the period before the release of the product to the world-wide traveling business persons who were the targeted buyers, the court found that the committee's experts rejected all of that data out of hand, and reconstructed instead its own cash flow projections for purposes of performing a discounted cash flow analysis of its own independent valuation of the Iridium companies. In this respect, the court especially faulted the committee's experts for not coming to grips with the actual data of the public markets of the companies' shares. In sum, the court found that the plaintiff's expert witnesses were fatefully biased by consistently approaching their charge with an insolvency valuation based upon hindsight, an approach adopted solely to advance the litigation objective of the committee. Although the court seemed to concede that the defendant Motorola itself had the opposing litigation objective, any bias on its part was controlled by its reliance upon financial data that had been prepared over the years of the development of the Iridium System, which had been reviewed by nationally recognized outside experts at the time, and not years after the fact to advance a litigation objective. The court repeatedly expressed how impressed it was with the defendant's principal expert witnesses, especially a Stanford business professor who had studied and published extensively on the reliability of the public markets for valuing public companies as opposed to the other conventional approaches to total enterprise valuations such as discounted cash flows, comparable or guideline companies, and similar transactions.

We agree with the general thrust of *Iridium* and *VFB LLC (Campbell)*. In avoidance actions, the question of insolvency requires a determination of the amount of the debtor's debts and its property at a fair valuation as of the transfer date. We have already suggested that the standard of "fair valuation" points to a process-sensitive approach to value. Reliance on a share price set by open and informed trading of securities in one of the most efficient capital markets in the world is a very good indicator of the fair valuation of a debtor company. Although we would not call the share price established in such a manner a "gavel down"

moment on the issue of insolvency in avoidance actions, it is a pretty good indicator of the fair valuation of a debtor company's assets and amount of liabilities.

#### 10. *In re Longview Aluminum LLC*

In *In re Longview Aluminum LLC*,<sup>330</sup> the Bankruptcy Court for the Northern District of Illinois, granted a judgment after a two day trial for the defendants in three consolidated constructive fraudulent transfer actions filed by the operating chapter trustee. The court found that the trustee failed to carry his burden of proof regarding insolvency or unreasonably small capital for operations as of the closing date by a preponderance of the evidence.<sup>331</sup> The plaintiff produced an expert witness to testify on the issue of insolvency.<sup>332</sup> Interestingly, the defendant called no rebuttal expert witness to the stand and relied instead on cross-examination of the trustee's expert witness.<sup>333</sup>

By way of background, the court explained that what was to become the parent company of the debtor, Michigan Avenue Partners, a limited liability company (MAP), sought to acquire a virtually integrated business for producing aluminum.<sup>334</sup> One of the key business units was an aluminum smelting plant which MAP arranged to purchase from Reynolds Metals Co. through its specially formed subsidiary, Longview Aluminum Co.<sup>335</sup> Under the terms of the purchase agreement, Longview agreed not to operate the plant for a "curtailment" period running from the date of acquisition, February 28, 2001, through June 30, 2002.<sup>336</sup> During the curtailment period, Longview was still required to pay wages and benefits to its furloughed union employees.<sup>337</sup> In consideration of Longview's curtailment of operations, it was to be paid \$226 million dollars from its principal source of electric power, the Bonneville Power Administration, which was a federal marketing and distribution agency.<sup>338</sup> During the curtailment period, MAP agreed to plan to build another plant for the production of electricity at another location for Longview.<sup>339</sup> MAP began negotiations with Enron toward that end, but those negotiations abruptly ended in 2001—presumably when Enron filed for chapter 11 relief in the Southern District of New York.<sup>340</sup>

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<sup>330</sup> 2005 Bankr. LEXIS 1312, 2005 WL 3021173 (Bankr. N.D. Ill. July 14, 2005) (Wedoff, B.J.), *aff'd, sub nom.*, Baldi v. Samuel, Son & Co. (*In re McCook Metals, L.L.C.*), 2007 U.S. Dist. LEXIS 89412 (N.D. Ill. Dec. 4, 2007).

<sup>331</sup> *Id.* at \*38 ("The trustee provided no additional evidence that Longview LLC was engaged in business with unreasonable small capital at the time of the challenged transfers and has thus again failed to satisfy its burden of proof.").

<sup>332</sup> *Id.* at \*11.

<sup>333</sup> *Id.* at \*12.

<sup>334</sup> *In re Longview Aluminum L.L.C.*, 2005 Bankr. LEXIS 1312 at \*4.

<sup>335</sup> *Id.* at \*4.

<sup>336</sup> *Id.* at \*5.

<sup>337</sup> *Id.* at \*6.

<sup>338</sup> *Id.* at \*5.

<sup>339</sup> *Id.* at \*6.

<sup>340</sup> *In re Longview Aluminum*, 2005 Bankr. LEXIS 1312 at \*9–10.

Notwithstanding the principals' plan to reopen and to operate the Longview smelter, the falling price of aluminum in the Pacific Northwest and the increasing energy cost to produce it dissuaded the principals from doing so.<sup>341</sup> Instead the principals first filed chapter 11 petitions in August 2001 for McCook and Scottsboro, two of the sister companies to Longview.<sup>342</sup> Without ever renewing operations at the Longview smelter plant, MAP caused Longview to file for chapter 11 relief on March 4, 2003.<sup>343</sup> On August 5, 2003, five months after the petition date, the court appointed the chapter 11 trustee to sell the remaining assets of the debtor and to administer the estate.<sup>344</sup>

The trustee's expert testified that the debtor was insolvent on a balance sheet basis as of the date of the alleged constructive fraudulent transfer, February 28, 2001, and until the petition date, two years later.<sup>345</sup> With respect to the debtor's reconstructed or adjusted balance sheet, the expert testified that debtor's liabilities were \$367.2 million and the assets were \$248.1 million for a negative net worth in excess of \$121 million as of the date of transfer.<sup>346</sup>

As part of its findings, the court went through each entry on the liability side of the debtor's balance as of the date of the alleged constructive fraudulent transfer, deleting a total of \$163 million in liabilities, leaving only \$207.4 million in liabilities, all but one of which were current liabilities.<sup>347</sup> The court effectively eliminated long term liabilities save the one, some of which were admittedly contingent liabilities.<sup>348</sup> With respect to \$42.7 million in pension liabilities, the court found that although the debtor, as a member of the corporate controlled group, was contingently liable with the other members of the group, the expert had failed to deduct the \$3,845,000 in pension plan assets that the affiliated McCook entity had; moreover, as of the date of the alleged constructive fraudulent transfer, McCook was not in default on its pension obligations—that default did not occur until six months later.<sup>349</sup> For this reason, the court found that the \$42.7 million could not be included on the debtor's balance sheet as a contingent liability.<sup>350</sup> Surprisingly the court did not consider whether any lesser amount should have been included as a contingent liability on that same balance sheet. Because the court focused solely on the reconstructed balance sheet as of the date of the transfer, it could ignore the fact that the controlled group pension liability was triggered by the chapter 11 filing by McCook in August 2001, more than six months before Longview filed its chapter 11 petition.

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<sup>341</sup> *Id.* at \*10.

<sup>342</sup> *Id.*

<sup>343</sup> *Id.*

<sup>344</sup> *Id.*

<sup>345</sup> *Id.* at \*11–12.

<sup>346</sup> *In re Longview Aluminum*, 2005 Bankr. LEXIS 1312 at \*20, 28.

<sup>347</sup> *Id.* at \*28 n.11.

<sup>348</sup> *Id.* at \*28.

<sup>349</sup> *Id.* at \*31.

<sup>350</sup> *Id.*

The court also deleted another \$111.1 million in contingent liabilities that the expert included on the premise that as of the date of the transfer, the debtor would not be operating its aluminum smelter business, thus each of these contingent liabilities should be included on the debtor's balance sheet.<sup>351</sup> Although the court conceded the fact that the debtor never reopened its smelter business, that was not what its senior management had envisioned on the date of the transfer.<sup>352</sup> The court found:

A powerful indication of contemporary, informed opinion as to value comes from the principals of MAP who formed Longview LLC. With their finances and time at stake, and with access to substantial professional expertise, these individuals concluded at the time of the acquisition that the business was indeed one that could be operated profitably. A January 2001 'Presentation to Financing Sources' reflects this conclusion (citing to an exhibit). The company 'fully intended and expected to restart' operations at the Longview smelter (citing to a deposition) and it developed and implemented a comprehensive business plan to do so.<sup>353</sup>

After giving great probative weight to this assumption—the reopening of the smelter by May 1, 2002, the court severely faulted the plaintiff and his expert for using "hindsight" upon which to reconstruct the debtor's balance sheet.<sup>354</sup> Had the plaintiff not grounded its analysis on the failure of the debtor to resume operations, most of those contingent liabilities would have been excluded. These excludable liabilities covered another \$50 million in post-retirement benefit obligations, \$4.5 million in severance benefits, and \$6.0 million as a current liability for the supply of alumina.<sup>355</sup> With respect to a liability of the \$36 million obligation for a power supply facility, the court found that the plaintiff's expert had failed to appreciate that this was a liability solely of the debtor's parent company.<sup>356</sup> Finally, the court found that in calculating a \$20.6 million "take-or-pay liability," the plaintiff's expert used a faulty assumption in projecting annual straight-line increases in cost and that he had presented no corroborative facts to justify these increases; moreover, the expert ignored a critical provision in the agreement with the Bonneville Power Administration that might offset the increases in electric power.<sup>357</sup>

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<sup>351</sup> *Id.* at \*33–35.

<sup>352</sup> *In re Longview Aluminum*, 2005 Bankr. LEXIS 1312 at \*36.

<sup>353</sup> *Id.* at \*21.

<sup>354</sup> *Id.* at \*21.

<sup>355</sup> *Id.* at \*28.

<sup>356</sup> *Id.* at \*32–33.

<sup>357</sup> *In re Longview Aluminum*, 2005 Bankr. LEXIS 1312 at \*34.

11. *EBBC I, Inc.*

On March 7, 2001, *EBC I, Inc.*,<sup>358</sup> filed a liquidating chapter 11 with the Bankruptcy Court for the District of Delaware. After the assets were liquidated, the plan representative filed a constructive fraudulent transfer complaint against AOL, Inc., seeking to avoid and recover approximately \$6 million in prepaid services for advertising under a 1999 Interactive Marketing Service Agreement (Agreement) and under an Amendment to the Agreement on November 15, 2000 (Amendment)(jointly, the "Amended Agreement") with the defendant.

As background, the debtor paid \$7.5 million under the Agreement and another \$750,000 under the Amendment on November 15. Within two short weeks of the payment under the Amendment, the sales during the Thanksgiving Holiday season did not meet projections; the Christmas sales were even more disappointing. After a short period of unsuccessfully trying to sell the company as a going concern with the assistance of investment bankers, eToys issued a public release on February 26, 2001, that it would be shutting down its website, laying off all its employees, and filing for bankruptcy relief. In light of that public announcement, AOL declared a default two days later under the Amended Agreement, based upon the debtor own admission of insolvency, thereby terminating its marketing the toys of the debtor.

The plaintiff alleged two avoidable transfers: the first, the payment of \$750,000 on November 15, 2000, and the second, a "transfer" of property of the debtor as a result of the termination of the Amended Agreement on February 28, 2001. Since these two transfers occurred within one year of the date of the chapter 11 petition, the plaintiff relied upon 11 U.S.C. § 548(a)(1) as the statutory ground for proving that the debtor was insolvent on the respective dates of the two transfers. Oddly the plaintiff did not introduce any expert testimony of its own, although it had the burden of proof on the issue of insolvency. It relied instead on its right to cross-examine the defendant's expert, a questionable litigation gambit.

The defendant's expert prepared a report on the debtor's insolvency as of November 15, 2000. He testified at trial that on an adjusted balance sheet basis, the debtor was unquestionably solvent as of that date. At an earlier hearing, on cross-motions for partial summary judgment, the court determined that the debtor was insolvent on February 28, 2001, the date of the termination of the Agreement, as amended.<sup>359</sup> The expert did not make any adjustments to the debtor's liabilities,<sup>360</sup> but he did make several material adjustments to the debtor's assets. These adjustments to the assets included writing up the book value of the debtor's inventory by 21% on the premise that the book value listed only the wholesale or acquisition cost, not the retail value that could be derived from its retail sales. The expert, however, made a series of material negative adjustments to intangible assets

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<sup>358</sup> *In re EBC I, Inc.*, 356 B.R. 631 (Bankr. D. Del. 2006).

<sup>359</sup> *See id.* at 636.

<sup>360</sup> *See id.* It is surprising that in view of the court's discussion of contingent assets that the expert was not challenged as to why he did not include any contingent liabilities on his adjusted balance sheet.

by completely writing off \$124 million in goodwill, reducing the book value of property and equipment (including software) by 33% and miscellaneous assets (excluding cash and cash equivalents). The one adjustment the expert refused to make to the debtor's liabilities was to include, as the debtor argued, \$37 million in preferred stock. The expert's position was that since the debtor had the discretion not to pay any preferred dividends, the \$37 million was part of equity and should be excluded from the liabilities.

In sum, the defendant's expert testified that as of November 15, 2000, the value of the debtor ranged from a low of \$302 million (excluding the intangible assets) to a high of \$545 million (including the intangible assets).<sup>361</sup> With liabilities of \$287 million, the debtor was solvent by \$15 million under the \$302 million valuation, and was solvent by \$258 million under the \$545 million valuation. The court overruled every objection lodged by the plaintiff, and found the expert's valuation, based upon the adjusted balance sheet, to be credible on the issue of insolvency.

The defendant's expert also testified in support of the proposition that as of November 15, 2000, under either 11 U.S.C. §§ 548(a)(1)(B)(ii)(III) and (B)(ii)(II) respectively, the debtor suffered no inability to pay its debts as they became due,<sup>362</sup> nor did the debtor suffer from unreasonably small working capital, given its ready access to the capital markets.<sup>363</sup> Overruling the objections of the plaintiff, the court found that there were no liquidity, cash problems, or capital inadequacy and on these alternate grounds, and that the debtor was not insolvent or rendered on November 15, 2000.

The court then proceeded to discuss whether the transfers were for reasonably equivalent value on November 15, 2000, and on February 28, 2001. A close discussion is beyond the scope of this article, but suffice it to say that with a company that had closed down before it filed its liquidating chapter 11 liquidating petition, the court found that with no ability to use the marketing services of AOL, the debtor could not claim that it could recover the value \$6.25 million in prospective services under the Amended Agreement, and largely for the same reason that the termination of the Amended Agreement did not result in an avoidable transfer of value or property to the defendant. The court also found that

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<sup>361</sup> See *EBC I, Inc.*, 380 B.R. at 359 (Bankr. D. Del. 2008). It is not easy to understand what the book entries and the adjusted entries on the debtor's balance sheet looked like because the GAAP version and the adjusted version are not set forth in the court's opinion. See *id.* at 358. It is also not easy to understand how \$258 million in equity could be completely lost in six weeks of operations, namely, from November 15 through December 31, 2000. See *id.* at 356.

<sup>362</sup> See *id.* at 359. For an excellent discussion on the issue of a debtor's inability to pay its debts as they become due under section 548, see J.B. Heaton, *Solvency Test*, 62 BUS. LAW. 983, 985–1003 (2007); see also Robert J. Stearn, Jr., *Proving Solvency: Defending Preference and Fraudulent Transfer Litigation*, 62 BUS. LAW. 359, 391 (2007) (discussing application of section 548 of Bankruptcy Code); Scott F. Norberg, Note, *Avoidability of Intercompany Guarantees Under Sections 548(A)(2) and 544(B) of the Bankruptcy Code*, 64 N.C. L. REV. 1099, 1121 (1986) (discussing section 548 as it applies to debts as they mature).

<sup>363</sup> See *EBC I, Inc.*, 380 B.R. at 359–60. For an excellent discussion on the issue of whether a debtor was left with unreasonably small capital and the interplay among the various tests for financial distress under section 548, see Heaton, *supra* note 362, at 985–1003.

there could be no value derived from any assumption and assignment of the debtor's rights under the Agreement, as amended, because as a matter of underlying Virginia law, the Agreement was not assignable given the importance of the identity of the debtor as a party to the contract. Based up these findings, the court drew the conclusion of law that the plaintiff had failed to sustain its burden of proof and that judgment should be entered for the defendant.

*D. Total Enterprise Value of the Reorganized Debtor*

The 1990s saw the beginning of the continuing trend of bankruptcy courts holding evidentiary hearings in contested confirmation hearings to determine the total enterprise value of the reorganized debtor. These hearings were utilized to determine whether the total enterprise value was properly allocated among numerous levels of creditors, senior management, and new and old equity. The common objection in these hearings is that under the proposed plan, the claims of the senior creditors, often purchased at a discount by junior capital, second lienholders, venture capitalists or hedge funds, will receive more of the value of the reorganized debtor, and, as such, the proposed plan violates the standard of fairness and equal treatment embedded in sections 1129(b)(1)(2)(B) or (C) of the Bankruptcy Code. There are also some faint but favorable omens that some bankruptcy courts will begin holding evidentiary hearings on the fact-intensive issue of total enterprise value before proceeding to a contested confirmation hearing, and in these pre-confirmation hearings on valuation, more attention will be paid to motions *in limine* as potentially effective procedural devices for excluding unreliable reports and testimony of some experts well before all stakeholders and the court are put to unnecessary time and expense.

Valuations, in the best of circumstances, are fraught with uncertainty. The income approach turns on a gaggle of assumptions, often with one assumption building on another. The market approach turns on either comparable companies or comparable transactions, where comparability is often in the eye of the expert and where inferences are to be drawn from public companies to support valuations of private companies. The asset approach turns on projected market value or liquidation values, with its own set of estimates. But, as any good statistician will say, there is a world of difference between uncertainty and unreliability. The former state is an inherent part of reasoned discretion and good judgment, indicia of any well-reasoned expert opinion; the latter state is fatal under *Daubert*. In the following section, we address several cases where courts have confronted the issue of the relevance and reliability of expert testimony on total enterprise valuation in contested confirmation hearings. Our task is not an exhaustive critique of every case during the past ten years on the confounding issue; rather, we again seek to educe best practices in an effort to aid court, counsel, and expert.

1. *In re Zenith Electronics Corp.*

In *In re Zenith Electronics Corp.*,<sup>364</sup> a publicly-held corporation negotiated a complex restructuring with its bondholders and its largest creditor, LG, Inc., which held over \$340,000,000 in loans and credit support and also held 57.7% of Zenith's shares.<sup>365</sup> After securing the approval of the S.E.C. for its disclosure statement, and obtaining the acceptance of over 97% of the bonders in number and amount, the company filed its chapter 11 petition with the Bankruptcy Court for the District of Delaware on August 24, 1999.<sup>366</sup> The court held a two-day combined hearing to approve the disclosure statement and to confirm the prepackaged plan within thirty days of the petition date.<sup>367</sup> At bottom, if confirmed, the plan would cancel the interests of the minority shareholders, and pay \$50,000,000 to the bondholders; LG, Inc. would then convert part of its claims and loan \$40,000,000 in working capital in exchange for 100% of the new shares in the reorganized debtor with full management and control.<sup>368</sup> The Official Committee of Equity Security Holders (Equity Committee), representing the minority shareholders, objected to the disclosure statement and plan on the ground that the value of the debtor before reorganization exceeded the total claims and that, therefore, in cancelling the interests of the minority shareholders, the plan violated the fair and equitable standard under section 1129(b)(1) and (2).<sup>369</sup> The court overruled the objections of the Equity Committee in every single particular and confirmed the prepackaged plan.<sup>370</sup>

In its comprehensive opinion, the court acknowledged that the main dispute at the hearing was value of the debtor in possession.<sup>371</sup> Testifying as the expert witness for the debtor on valuation was a principal of Peter J. Solomon Company (PJSC), an investment banking firm.<sup>372</sup> The Equity Committee objected, among other things, to any testimony on this issue on the part of PJSC on the ground that the investment banking firm was biased in several respects.<sup>373</sup> To begin with, PJSC had once given advice to LG, Inc., the principal beneficiary of the prepackaged plan, in connection with a proposed formal engagement and then had quickly switched sides, presumably for the advantage of a much larger fee, and agreed to be retained by the debtor.<sup>374</sup> For the next two years, PJSC actively participated in searching for a strategic buyer for the debtor and, then, in a major financial and corporate

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<sup>364</sup> 241 B.R. 92 (Bankr. D. Del. 1999).

<sup>365</sup> *Id.* at 96.

<sup>366</sup> *Id.* at 97.

<sup>367</sup> *Id.* at 97-98.

<sup>368</sup> *Id.* at 110.

<sup>369</sup> *Id.* at 105.

<sup>370</sup> *In re Zenith Elec.*, 241 B.R. at 111.

<sup>371</sup> *Id.* at 103.

<sup>372</sup> *Id.* at 97.

<sup>373</sup> *Id.* at 100.

<sup>374</sup> *Id.*



restructuring of the debtor.<sup>375</sup> The key players in the negotiations over the restructuring were a turn-around manager as CEO, an informal committee of bondholders, and LG, Inc., as the majority shareholder and the largest creditor.<sup>376</sup> One of the terms of PJSC's pre-petition engagement agreement with the debtor was the contingent payment of a substantial success fee.<sup>377</sup> When the debtor in possession filed a motion to retain PJSC as its investment banker, the Equity Committee objected, averring a lack of disinterestedness.<sup>378</sup> In fact, the court sustained the objection on the ground that PJSC had an actual conflict of interest based upon its prior investment banking advice for LG, Inc.<sup>379</sup> Nevertheless, the court overruled the Equity Committee's objection to PJSC's testifying as an expert witness on valuation.<sup>380</sup> This turned on a subtle distinction between the lack of disinterestedness and bias.<sup>381</sup> A finding that PJSC lacked disinterestedness, based upon limited services for LG, Inc., two years before its advisory services for the debtor, which did create an actual conflict of interest, was not, however, tantamount to bias. The fact that PJSC was a principal architect in a plan cancelling the minority shares of the debtor and that it was entitled to a success fee did not, according to the court, count against the firm's objectivity as an expert witness.<sup>382</sup> The court held that PJSC used the same standard methodologies as the Committee's expert—without discussing what those methodologies were and how they were applied, and, that, therefore, it could not be deemed biased.<sup>383</sup> The court also held that the success fee the debtor had contracted to pay to PJSC before the petition date was not narrowly tied to its testimony in support of the plan and the outcome of the fast-tracked hearing on confirmation.<sup>384</sup> There were other services that PJSC had agreed to provide as conditions to the payment of a success fee.<sup>385</sup> Further, the court observed that the pre-petition contingent agreement could perhaps be rejected as an executory contract.<sup>386</sup>

The court then proceeded to address the value of the debtor in possession. The valuations were absurdly disparate.<sup>387</sup> The "fair market value" for the debtor's assets as determined by PJSC was \$310,000,000 with over \$545,000,000 of non-current indebtedness; thus, the debtor had a negative net worth of \$235,000,000.<sup>388</sup> In stunning contrast, the fair market value of the debtor in possession, as testified to by

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<sup>375</sup> *Id.*

<sup>376</sup> *In re Zenith Elec.*, 241 B.R. at 102.

<sup>377</sup> *Id.*

<sup>378</sup> *Id.*

<sup>379</sup> *Id.*

<sup>380</sup> *Id.* at 103.

<sup>381</sup> *Id.* at 102.

<sup>382</sup> *In re Zenith Elec.*, 241 B.R. at 103.

<sup>383</sup> *Id.*

<sup>384</sup> *Id.* at 102.

<sup>385</sup> *Id.*

<sup>386</sup> *Id.* n.13.

<sup>387</sup> *Id.*

<sup>388</sup> *In re Zenith Elec.*, 241 B.R. at 103.

Ernst & Young, the Equity Committee's expert, was \$1,055,000,000.<sup>389</sup> After deducting the claims, the debtor would have a positive net worth of \$510,000,000. In other words, the variance or delta between these two enterprise valuations by the two equally qualified expert witnesses was \$745,000,000. Although the court referred to both *Daubert* and *Kumho Tire* in passing,<sup>390</sup> its truncated discussion of the application of those authorities to the issues in this case never addressed the incredibly large delta and the reasonable inference that such a large delta may suggest unreliability, and, thus, inadmissibility and not mere weight.

The court found that there were three basic parts of the business: (1) an untested and unmarketed VSB technology division, (2) the consumer electronics division, and (3) the tuner division.<sup>391</sup> The plan proponent's expert valued the VSB technology division at \$155,000,000 in marked contrast to the Equity Committee's expert witness's value of \$833,000,000.<sup>392</sup> The delta for this division alone was \$678,000,000. The court adopted the plan proponent's value for the VSB technology division without adjustment.<sup>393</sup> However, what is problematic is that the technology was truly untested and unmarketed, the only sound inference a finder of fact could reasonably draw is that the value was entirely speculative, thus, neither expert had any basis in fact for estimating its value.<sup>394</sup> It is of some concern that this issue may not have been fully developed due to the time constraints the "fast track" nature of the case placed on the court.

## 2. *In re Bush Industries*

In *In re Bush Industries*,<sup>395</sup> the bankruptcy court held a contested four-day evidentiary hearing on the confirmation of the debtor's Second Amended Plan ("Plan").<sup>396</sup> At the time it filed its chapter 11 petition, the debtor was the only publicly held corporation in the business of manufacturing ready-to-assemble furniture in the United States.<sup>397</sup> The Plan provided for the seven banks to restructure their aggregate of \$158 million in secured claims: \$65 million would be evidenced by two secured notes and the balance of their debt would be converted to a new issue of common shares in the reorganized debtor.<sup>398</sup> The Plan further provided for the payment in full of the allowed general unsecured claims and administrative expenses, but cancelled the shares of pre-petition shareholders ("Equity").<sup>399</sup>

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<sup>389</sup> *Id.*

<sup>390</sup> *Id.*

<sup>391</sup> *Id.*

<sup>392</sup> *Id.*

<sup>393</sup> *In re Zenith Elec.*, 241 B.R. at 104.

<sup>394</sup> *Id.*

<sup>395</sup> 315 B.R. 292 (Bankr. W.D.N.Y. 2004).

<sup>396</sup> *Id.* at 295.

<sup>397</sup> *Id.*

<sup>398</sup> *Id.* at 296.

<sup>399</sup> *Id.* at 298.

The Official Committee of Equity Holders ("Equity Committee") objected to confirmation of the Plan on the ground, among others, that there was sufficient value in the reorganized debtor to justify paying a substantial distribution to Equity.<sup>400</sup> Thus, by purporting to cancel their shares, the plan violated the fair and equitable standard under subsections 1129(b)(1) and 1129(b)(2)(C) of the Bankruptcy Code.<sup>401</sup> The court found that the "equity hurdle rate" was \$168,333,000.00.<sup>402</sup> The debtor's two expert witnesses filed reports that pegged the enterprise value between \$95 million and \$130 million.<sup>403</sup> The Equity Committee's expert witness valued the reorganized debtor at \$200 million.<sup>404</sup> With a variance running between the appraised values of the opposing experts from 35% to 50.45%,<sup>405</sup> it is not surprising that a bankruptcy court might suspect that one or more of the opposing experts is "gaming" the enterprise valuation in order to confer a litigation advantage on the party who solicited and paid for the appraisal.

Rather than holding a *Daubert* hearing before the scheduled contested confirmation hearing, the court limited itself to weighing the testimony of the debtor's two expert witnesses and Equity Committee's expert witness. The court noted that each shared a consensus concerning the three methodologies for determining the value of the debtor: (1) the comparable or guideline company method,<sup>406</sup> (2) the similar transactions method,<sup>407</sup> and (3) the discounted cash flow method.<sup>408</sup> The court accounted for the difference in the respective experts' valuations as largely driven by their divergent choices of the multiple for calculating the terminal value of the reorganized debtor under the discounted cash flow method, drawn from their comparable company analysis.<sup>409</sup> In deriving the terminal value, the Equity Committee's expert used a multiple of 9.0, taken directly

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<sup>400</sup> *Id.* at 295–96.

<sup>401</sup> *Bush Indus.*, 315 B.R. at 298. 11 U.S.C. section 1129(a)(3) requires that a plan of reorganization be propounded in good faith and not in violation of any provision of the Bankruptcy Code. *See* 11 U.S.C. § 1129(a)(3) (2006). 11 U.S.C. section 1129(b)(2)(C) provides, in relevant part: "the court, on request of the proponent of the plan, shall confirm the plan . . . if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(2)(C).

<sup>402</sup> *Bush Indus.*, 315 B.R. at 298.

<sup>403</sup> *Id.* at 300.

<sup>404</sup> *Id.*

<sup>405</sup> *Id.* The arithmetic calculation of the variance is:  $[\$200 - \$130] / 200 = 35\%$ ;  $[200 - 95] / 200 = 50.45\%$ .

<sup>406</sup> *Id.* at 299.

<sup>407</sup> *Id.*

<sup>408</sup> *Bush Indus.*, 315 B.R. at 299. The asset valuation method was not contemplated by any of the experts. *See* Rutheford B. Campbell, Jr., *The Impact of Modern Finance Theory in Acquisition Cases*, 53 SYRACUSE L. REV. 1, 14 (2003) ("In [the asset] valuation method, . . . the evaluator calculated the fair market value that the assets of the company would bring in the event of liquidation and subtracts from that figure the liabilities of the company."); *see also* James R. Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C. L. REV. 121, 139 (1988) ("If the business is expected to be discontinued or divided up and sold, then asset valuation is the more useful method for valuing the business."); Ronald B. Lee, Note, *The Measure of Damages Under Section 10(b) and Rule 10b-5*, 46 MD. L. REV. 1266, 1271 (1987) ("An additional difficulty with the asset valuation method arises if there is an inability to appraise the assets accurately.").

<sup>409</sup> *See Bush Indus.*, 315 B.R. at 300.

from its unadjusted analysis.<sup>410</sup> This generated an enterprise valuation that exceeded the equity hurdle rate and kept Equity "in the money."<sup>411</sup> The debtor's experts, however, reduced the multiple from 9.0 to 6.5, resulting in an enterprise valuation that was less than the equity hurdle and left Equity "out of the money."<sup>412</sup> The court held that the downward adjustment by the debtor's experts was not "subjective," but was soundly justified because the comparable companies were publicly-held corporations in the high end of the furniture industry in contrast to the low-end ready-to-assemble furniture business of the debtor.<sup>413</sup> Here, much to its credit, the court failed to take the bait. It recognized that in valuations, many key assumptions, including upward or downward adjustments, are based on the exercise of sound discretion and judgment, drawn from experience or research or a combination of the two.<sup>414</sup> In fact, the question is not whether the opinion is "subjective," the question is whether the opinion is "conclusory." If valuation were truly objective, then a court need only find the facts and plug the numbers into a pre-determined algorithm negating the need for an expert. Obviously, valuation is not that simple. However, the fact remains that any adjustment that is conclusory does not assist the trier of fact and is unreliable.<sup>415</sup>

In *Bush*, we find that the court appeared to struggle with a situation that the comparable companies relied on by the experts were simply not comparable; these guideline companies operated in a very different market from the debtor. If that were so, the soundness of the comparable company analysis would be suspect; thus, it appears problematic that poor comparables may be resurrected by making material downward adjustments. Under those circumstances where no comparables are available, another professionally recognized methodology, such as the discounted cash flow method, would have to be used. If an appropriate methodology cannot be reliably applied, given the limited data, then no expert

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<sup>410</sup> See *id.* at 300–01.

<sup>411</sup> See *id.* at 300.

<sup>412</sup> *Id.* at 298, 300–01.

<sup>413</sup> *Id.* at 301–02.

<sup>414</sup> See *In re Mirant Corp.*, 334 B.R. 800, 820 (Bankr. N.D. Tex. 2005) (observing valuation was subject to inherent methodological weaknesses and evidence was at best "soft"); see also *In re Coram Healthcare Corp.*, 315 B.R. 321, 337–38 (Bankr. D. Del. 2004) (noting despite use of same valuation methodologies, opposing experts reached very different results); *In re Cellular Info. Sys., Inc.*, 171 B.R. 926, 931 (Bankr. S.D.N.Y. 1994) (stating experts' different valuations arose from their different views of debtor's business strategy, rather than technical considerations). Interestingly, the failure to make an adjustment—that is, the failure to exercise discretion and reason—is itself subjective.

<sup>415</sup> See *In re Stealey*, No. 05-68721, 2006 WL 2792224, at \*4 (Bankr. N.D. Ohio Sept. 26, 2006) ("[T]he court is left with a firm belief that such adjustments involve a high amount of unreliable speculation."); *Coram Healthcare Corp.*, 315 B.R. at 340 (finding valuation was not accurate reflection where evaluator's subjective adjustments took aggressive and optimistic views to produce higher valuation figures). But see *Gilliam v. S. Coop. Dev. Fund Inv. Cooperation*, No. 94-2108, 1994 WL 682659, at \*2 (W.D. Tenn. Nov. 15, 1994) ("[V]aluation is inherently subjective and not capable of mathematical precision."). Think of the expert qualified by experience. Experience is itself subjective. Clearly, a bar against subjective expert testimony would swallow whole any expert qualified by experience. Surely, *Daubert* cannot stand for that proposition. Rather, the bar is against conclusory testimony. In other words, simply adding to the bottom line does not help the trier of fact.

witness testimony could be found to be reliable. In any event, greater pause should have been given to the downward adjustments, not because they were subjective, but because the baseline or starting point was derived from apparently significantly dissimilar comparables. Furthermore, an explanation would have to be included in the opinion as to why a more sensitive series of downward adjustments should not have been applied. As the court noted, it is a very long way down the financial scale from a multiple of 9 to a multiple of 6.5.<sup>416</sup> It does not seem to be the case that a proper valuation would be a dichotomous one, either 6.5 or 9.0. A more sensitive expert analysis should have presented a range of such multiples and values.

### 3. *In re Exide Technologies*

Another key valuation case that created quite the stir was *In re Exide Technologies*.<sup>417</sup> There, Exide and its affiliates (collectively, the debtor) comprised the nation's second largest manufacturer of lead batteries for transportation and industrial uses when it filed for relief under chapter 11 of the Bankruptcy Code in Delaware in April of 2002.<sup>418</sup> The debtors' Third Amended Joint Plan, filed on September 8, 2003 ("Plan"),<sup>419</sup> proposed a nominal distribution of 1.4% to general unsecured creditors;<sup>420</sup> and the conversion of the pre-petition secured lenders' \$600 million in claims to the securities of the reorganized debtor.<sup>421</sup> The three classes of general unsecured creditors rejected the treatment of their respective claims by over 96% in amount.<sup>422</sup> The Official Committee of Unsecured Creditors ("Creditors Committee") objected to the plan on multiple grounds including that it violated the standard of fair and equitable treatment of the claims of the pre-petition general unsecured creditors under sections 1129(b)(1) and (b)(2) of the Bankruptcy Code.<sup>423</sup>

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<sup>416</sup> See *Bush Indus.*, 315 B.R. at 300.

<sup>417</sup> 303 B.R. 48 (Bankr. D. Del. 2003).

<sup>418</sup> *Id.* at 53.

<sup>419</sup> See *id.* at 52 n.3. The Second Disclosure Statement and the Third Amended Joint Plan were distributed to creditors and other parties in interest. After the ballots were tabulated, the debtor filed a Fourth Amended Plan, with non-material modifications. The court referred to the Fourth Amended Plan as the Plan in its opinion denying confirmation. See *id.*

<sup>420</sup> An amount the unsecured creditors found "insulting."

<sup>421</sup> See Debtors' Third Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code, *In re Exide Tech., et al.*, 303 B.R. 48 (Bankr. D. Del. 2003) (No. 02-11125).

<sup>422</sup> See *Exide Tech.*, 303 B.R. at 57.

<sup>423</sup> See *id.* at 58. Section 1129(b)(1) and (b)(2)(B)(ii) (2006) provide, in relevant part

[1] . . . the court shall confirm the plan . . . if the plan does not discriminate unfairly and is fair and equitable with respect to each class of claims or interests that is impaired and has not accepted the plan . . .

[2] for the purpose of this subsection the condition that a plan be fair and equitable with respect to the class, includes the following requirements

[B] with respect to a class of unsecured claims . . .

[ii] the holder of any claim or interest that is junior to the claims of such

The Creditors Committee theorized that the value of the reorganized debtor's securities substantially exceeded the amount of the claims of all pre-petition lenders, the administrative expenses, and the priority creditors, and consistent with the absolute priority rule, the excess value should be distributed to pre-petition unsecured creditors.<sup>424</sup>

The court did not hold a separate hearing to determine the total enterprise value of the reorganized debtor before it proceeded to hold the confirmation hearing, nor did it refer to or rule on any motions to exclude any proposed expert witness testimony. Instead, the court held an omnibus hearing lasting seven days, spread over a three-week period.<sup>425</sup> The omnibus hearing dealt with "a settlement" of the adversary proceeding filed by Creditors Committee against the pre-petition lenders under the Plan (without any negotiations with the plaintiff, the Creditors Committee),<sup>426</sup> the total enterprise valuation of the reorganizing debtor, and the ream of objections to confirmation by the United States trustee, the Official Committee of Equity Security Holders, the U.S. Environmental Protection Agency, the Bank of New York as Indenture Trustee, and other parties in interest.<sup>427</sup> The other objections were directed to the unfairness of the settlement with the pre-petition lenders, to the broad scope of the third-party releases and injunctive provisions of the plan, and to the unfair discrimination in the classification of the unsecured claims.<sup>428</sup> The court denied confirmation of the Plan, largely based upon sustaining the "other objections,"<sup>429</sup> but also upon rejecting the total enterprise valuation of the debtor (and the pre-petition lenders) and accepting, with some minor modifications, the total enterprise valuation of the Creditors Committee's expert witnesses.<sup>430</sup>

As part of its opinion focusing on the issue of enterprise value, the court noted that value ranged from \$950 million to \$1.05 billion according to the debtor's

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class will not receive or retain under the plan on account of such junior claim or interest any property . . . .

<sup>424</sup> See *Exide Tech.*, 330 B.R. at 60–61; see also *In re Genesis Health Ventures, Inc.*, 266 B.R. 591, 612 (Bankr. D. Del. 2001) (stating that it is not fair and equitable for senior class to receive more than full compensation for its claims); *In re MCorp. Fin., Inc.*, 137 B.R. 219, 235 (Bankr. S.D. Tex. 1992) (noting that senior class cannot receive more than full compensation for its claims).

<sup>425</sup> See *Exide Tech.*, 303 B.R. at 52–53.

<sup>426</sup> See *id.* at 71. The court held that in the face of a complete rejection of the Plan by the general unsecured creditors, any settlement negotiations that were limited to the captive senior management of the debtor and the pre-petition lenders could not possibly be approved under the controlling precedents. See *id.* at 77–78. Presumably, acting on the belief that the general unsecured creditors were completely out of the money, except for the nominal amount of the \$4,000,000 pool left on the table, the debtor and the pre-petition lenders may have convinced themselves that they did not have to spend any time negotiating with the Creditors Committee in order effectively to dismiss the adversary proceeding and to secure broad form third-party releases for the officers, directors, employees, and agents of the pre-petition lenders and of the debtor. See *id.* at 71.

<sup>427</sup> See *id.* at 56–57.

<sup>428</sup> See *id.* at 56–57, 66–80.

<sup>429</sup> See *id.* at 66–80 (noting debtors focused their arguments on unfair discrimination objections).

<sup>430</sup> See *id.* at 66.

expert, and from \$1.478 billion to \$1.711 billion according to the Creditors Committee's expert.<sup>431</sup> The court made its own determination that the total enterprise value ranged from \$1.4 billion to \$1.6 billion.<sup>432</sup> Basically, the court's determination paralleled the Committee's, with the variance depending wholly upon which months used for calculating the first year's EBITDA. Since the Creditors Committee pegged the relevant "hurdle amount" to pay all secured, administrative, and priority claims at \$1.19 million, and the debtor calculated that amount at \$1.285 million, the unsecured creditors would be "in the money" by the court's own count under either calculation of the hurdle amount.<sup>433</sup> Not surprisingly, if the debtor's range of values had been accepted by the court, then the unsecured creditors would have been completely "out of the money" under either calculation of the hurdle amount. In a word, the court found that the debtor's expert "low-balled" the value by making "subjective" downward adjustments of the relevant multiples that were otherwise "objectively" derived from the comparable companies and the comparable transactions methods.<sup>434</sup>

In its discussion on total enterprise value, the court began with the premise that the debtor was severely biased in driving toward its low-ball valuation, and proceeded to document that premise.<sup>435</sup> The court reviewed the use and application of each of the three standard methods by the opposing experts: the comparable company method, the similar transaction method, and the discounted cash flow method. The dispute between the opposing experts under the comparable company method was primarily a function of whether the multiple for calculating the total enterprise value should be subject to a downward modification.<sup>436</sup> The debtor's expert modified the range of the multiples on the premise that a more accurate assessment of enterprise value had to take into consideration the probable range of fair market value for the reorganized debtor's business. In this vein, the debtor's expert believed that the value of the industrial division of the debtor, which generated 37% of its annual gross revenues on a consolidated basis, needed to be adjusted downward by as much as 30% based upon a reduction of the multiple of EBITDA from 7.2 to 5 attributable to an imputed lack of marketability.<sup>437</sup> The Committee's expert refused to make any downward adjustments.

With respect to the similar transaction method, the debtor's expert restricted his selection of transactions to two transactions which closed in 2002, given his perception that the market had deteriorated considerably beginning in 2000.<sup>438</sup> The dozen or so comparable transactions used by the Committee's expert included

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<sup>431</sup> See *Exide Tech.*, 303 B.R. at 59.

<sup>432</sup> See *id.* at 66.

<sup>433</sup> See *id.* at 59 n.23.

<sup>434</sup> See *id.* at 66.

<sup>435</sup> See *id.* at 60–65.

<sup>436</sup> See *id.* at 61.

<sup>437</sup> *Exide Tech.*, 303 B.R. at 61–62.

<sup>438</sup> *Id.* at 62–63.

transactions dating back to 1998 and 1999.<sup>439</sup> On this point, the court sided with the debtor's expert's perception of the adverse changes in the market since 2000.<sup>440</sup> However, the court refused to admit the propriety of the debtor's downward adjustments based upon the expert's own direct involvement in these two transactions, and his concern that given the dominance in the lead battery industry—the second largest manufacturer in the United States, any acquisition by another firm would trigger antitrust concerns of the U. S. Department of Justice, a threat that might very well depress the acquisition price.<sup>441</sup>

The real conflict between the experts was manifested in their use and application of the more complex discounted cash flow method. The key variables in this method are the "discount rate" for computing the present (discounted) value of the cash flows to the firm and the calculation of the terminal value.<sup>442</sup> While a whole series of "subjective adjustments" must be made carefully and sensibly at each step in exercising this methodology, persons with the requisite training, discipline, and practical experience—coupled with a deeply ingrained "situation sense"—do and can perform these analyses, consistent with the current state of peer-recognized technical skills.

The court then reviewed each expert's use and application of the discounted cash flow method. Again the court rejected the discount rates used by the debtor's expert and applied the Creditors Committee's figure at each stage of his analysis.<sup>443</sup> In the debtor's expert opinion, the enterprise value under the discounted cash flow method fell between \$1.023 and \$1.254 billion, with the greater value creeping

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<sup>439</sup> *Id.*

<sup>440</sup> *Id.*

<sup>441</sup> *Id.* In their experienced judgment, Professors Mark S. Scarberry, Kenneth N. Klee, Grant W. Newton, and Steve H. Nichols, editors of *BUSINESS REORGANIZATION IN BANKRUPTCY CASES AND MATERIALS*, Third Edition (West Publishing Co.) (2006), entertain a degree of skepticism with the court's disparaging treatment of the Blackstone Group's market-based enterprise valuation. According to these professors

the court in *Exide* placed more emphasis on the pure theory of valuations and less on the judgment and experience of the expert from Blackstone [debtor's expert]. [T]he court gave very little weight to the amount of the prior bids received for the company. (Blackstone had attempted to market the company and had received three comparable bids, but decided not to pursue a sale to any of the bidders.) Other courts have given more emphasis to potential transactions that might be more representative of market value . . . .

The bankruptcy court in *Exide Technologies* focused on the adjustments that Newman, Blackstone's expert, made based on his experience, and the court disallowed such judgments. In doing so the court failed to take into consideration allowances that often need to be made to the multiples to adjust for the specific company risks . . . .

*Id.* at 686, 720. As mentioned previously in this article, there exists a deep debate in the relevant academic literature on whether such adjustments are proper. Both arguments—for and against such adjustments—have merit.

<sup>442</sup> See *Exide Tech.*, 303 B.R. at 63–64.

<sup>443</sup> *Id.* at 64



perilously close to the debtor's hurdle rate of \$1.285 billion.<sup>444</sup> At this level, the joint plan proponent could have generously stretched its distribution to the general unsecured creditors several hundred basis points above 1.4%. Noting inconsistency in some of the rates the debtor used in its analysis and its business plan,<sup>445</sup> the court found the total enterprise value under the discounted cash flow method ran between \$1.538 and \$1.837 billion dollars, with the lesser value about \$250 million above the hurdle rate and with the greater value about \$750 million above the hurdle rate.<sup>446</sup>

In defense of his adjustments to the multiples drawn from comparable companies and similar transactions, the debtor's expert witness relied upon his own direct experience in these cases in supervising the private equity sale process, which failed to generate any offers with an imputed value above \$950 million.<sup>447</sup> The debtor abandoned this process when the holders of the pre-petition lenders' claims decided to support a joint plan under which they would convert their claims to the reorganization securities after canceling the interests of the pre-petition equity security holders.<sup>448</sup> Nevertheless, the debtor's expert testified that he reasonably believed that the private equity process provided a reliable reality check against the overstated values under an unadjusted application of the standard three methods of enterprise valuation.<sup>449</sup>

The opinion of the court is also striking in another respect: the court did not require the same base one-year period for calculating EBIDTA from each expert (or himself for that matter). The selection of the base time period was crucial to comparing the soundness of the assumptions concerning the debtor's business plan on the part of each expert's testimony. These variances in period and amount produce a difference low to high of \$16,600,000—not exactly insignificant. Mechanically, it strikes us that the court should have required each of the opposing witnesses to submit an amended report, each using the same one-year period. Then, if the court desired, to compare the three different periods. Moreover, the amended report should have included a sensitivity analysis tied to these different periods. An amended report could have been generated within a very short period of time. The court would then have an opportunity to "compare apples to apples" rather than strike off on its own.

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<sup>444</sup> *Id.* at 63.

<sup>445</sup> *See id.* at 63–64.

<sup>446</sup> *See id.*

<sup>447</sup> *See id.* at 64.

<sup>448</sup> *Id.* at 66–68.

<sup>449</sup> *See id.* The debtor's expert emphasized that one of the critical components in determining the costs of goods sold was the rapidly increasing price of lead for manufacturing the Exide batteries, and he further criticized the Committee's expert's valuation for not taking that important fact into the latter's valuation of the projected period and the terminal period.

#### 4. *In re Coram Healthcare Corp.*

In *In re Coram Healthcare Corp.*,<sup>450</sup> the bankruptcy court held a contested confirmation hearing<sup>451</sup> in the face of two competing stand-alone plans of reorganization—one proposed by the operating trustee and the note holders ("Trustee's Plan") and the other by Official Committee of Equity Securities Holders ("Equity" or "Equity Plan").<sup>452</sup> Each plan proponent objected to the confirmation of the competing plan.<sup>453</sup> Under the Trustee's Plan, equity would receive \$40 million as its distribution if a settlement under the plan with the insiders were approved,<sup>454</sup> but equity contended that the note holders would receive much more than the value of their claims to the detriment of the equity. Therefore, the Trustee's Plan violated the requirement under section 1129(b)(1) of the Bankruptcy Code that the plan be fair and equitable to each class of claims and interests.<sup>455</sup> Thus, one of the principal issues was the total enterprise value of the reorganized debtor.

The court found the valuation testimony proposed by the trustee's experts more reliable because it was based upon the "conservative" business assumptions and the cash flow projections of the debtor's senior management, in marked contrast to the valuation analysis prepared for equity by its expert consultant.<sup>456</sup> The court found

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<sup>450</sup> 315 B.R. 321 (Bankr. D. Del. 2004).

<sup>451</sup> As a consequence of the exceedingly heavy docket of mega chapter 11 cases and prepackaged chapter 11 plan cases in Delaware, the confirmation hearing was held on twelve days scattered over a seven month period—from September 30, 2003, through April 20, 2004. The court did not release its opinion until October 4, 2004, one year after the beginning of the hearings. *See id.* at 321.

<sup>452</sup> *See id.*

<sup>453</sup> *See id.* at 329.

<sup>454</sup> *See id.* at 328. Since our primary focus is on the issue of valuation, it is appropriate simply to summarize the extended discussion in the opinion that approved a settlement with the debtor, the note holders, and some of the insiders. It appears that the parties, as is often the case, backed into the settlement amount of \$54,000,000. *See id.* That amount was sufficient to pay accrued administrative expenses, the general unsecured creditors (other than the note holders) in full, fund working capital needs of \$10,000,000, and leave \$40,000,000 on the table for the pre-petition shareholders. *See id.* The settlement also called for broad form releases of any claims of the debtor and of non-debtor third parties for the note holders, their officers, directors, and employees, and certain insiders. *See id.* The equity committee opposed the settlement on the ground that the value of the RICO and other claims against the note holders, the investment bankers, and the accountants exceeded a billion dollars. *See id.* at 329, 341. The equity committee also objected to the broad form releases. *See id.* at 329. The court heavily relied upon endorsement of the settlement by the operating chapter 11 trustee who had conducted rounds of shuttle diplomacy between both camps and had made his own independent estimation of the high costs of litigation and low probability of success on the merits. *See id.* at 332–34. The court approved the dollar amount of the settlement and the proposed allocation of the proceeds of the settlement, but declined to approve releases of claims of non-debtor third parties against the note holders and against the settling officers and directors. *See id.* at 352.

<sup>455</sup> *See Coram Healthcare*, 315 B.R. at 337; *see also* 11 U.S.C. § 1129(b) (2006) ("[T]he court . . . shall confirm the plan . . . if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.").

<sup>456</sup> *See Coram Healthcare*, 315 B.R. at 340–41; *see also In re Consul Rest. Corp.*, 146 B.R. 979, 987 (Bankr. D. Minn. 1992) (adopting going concern valuation that incorporated cash flow assumptions of debtor's management and adjustments making projections more conservative); *In re Pullman Constr. Indus., Inc.*, 107 B.R. 909, 932–33 (Bankr. N.D. Ill. 1989) (accepting debtor's valuation in most respects, but adjusting for projections based on wild leap of faith).

equity's expert valuation was predicated upon too many unjustified or unexplained adjustments.<sup>457</sup> The difference in the valuations ranged from \$200 million according to the trustee's experts to \$279 million according to equity's expert.<sup>458</sup> If the court accepted the \$200 million value, there were insufficient funds to pay the total claims of \$243 million; however if the \$279 million valuation were accepted by the court, then equity would be "in the money," and the trustee's plan would have to be denied confirmation as violating the standard of a fair and equitable plan under section 1129(b)(1) of the Bankruptcy Code.<sup>459</sup>

Once the amount of claims was resolved in this manner, the court made several gross adjustments to reach her own bottom line of valuation.<sup>460</sup> The court also rejected any adjustment for goodwill on the premise that the trustee's plan was a stand-alone plan and not a plan to sell the company to a third party, and, therefore, the intangible value of goodwill had to be eliminated, a conclusion that may be incorrect. The court's own valuation came to \$317 million with equity in the money for \$6 million.<sup>461</sup> Because the plan would result in a distribution of \$40 million in value to existing equity, and that exceed the \$6 million in the court's own valuation, the trustee's plan was found to be fair and equitable.<sup>462</sup>

Apparently, the trustee's counsel and valuation expert were very effective in their advocacy. The court was thoroughly satisfied with the senior management's "conservative" business assumptions and cash flow projections; the court did not set forth any basis for independently determining that the conservative assumptions were sound. This gave the trustee and the note holders considerable leverage, as it were, in attacking the equity expert's adjustments to those assumptions and projections—the mere fact so many adjustments were made appeared to be sufficient by itself to call into serious question the propriety of the expert's approach

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<sup>457</sup> See *id.*

<sup>458</sup> See *id.* at 338.

<sup>459</sup> See *id.* at 337–38; see also *Exide Tech.*, 303 B.R. 48, 60–61 (Bankr. D. Del. 2003) (observing that debtor's value is key in determining if proposed plan is fair and equitable); *In re Mcorp Fin., Inc.*, 137 B.R. 219, 235 (Bankr. S.D. Tex. 1992) (stating that proper valuation is needed to ensure senior classes of claims not provided for more than in full). One of the critical issues was whether the unsecured claims were entitled to post-petition interest and, if so, at what rate: the contract rate, the default rate, or the federal judgment rate. See *Coram Healthcare*, 315 B.R. at 343. For separate reasons, both the noteholders' expert and equity's expert shared the premise to their competing valuations that no post-petition interest could be paid to the unsecured creditors. See *id.* As a matter of fact and law, the court rejected that shared premise holding that the unsecured creditors were entitled to be paid an imputed post-petition interest at the federal judgment rate. See *id.* at 346–47. After adding the interest component of \$19 million the amount of the noteholders' claims increased from \$243 million to \$262 million; the amount of all other claims was \$49 million; the grand total was \$311 million. See *id.* at 347.

<sup>460</sup> See *Coram Healthcare*, 315 B.R. at 341–43. Equity's expert's value of the NOLs was reduced from \$32.9 million to \$10 million and the net cash on deposit was added in the amount of \$31.2 million. See *id.* at 342.

<sup>461</sup> See *id.* at 343.

<sup>462</sup> See *id.* at 347. One has the sense that the court viewed equity's objection to confirmation of the trustee and note holders plan as tantamount to its looking the gift horse in the mouth. Assuming that the court's findings of fact and conclusions of law at every step in her comprehensive opinion were solid (most likely the case), equity was jeopardizing a certain \$40,000,000 distribution when her total enterprise valuation showed that the equity in the reorganized debtor was only \$6,000,000.

to valuation. A more nuanced approach would be to closely consider whether equity's expert advanced a sound business justification for his adjustments. In every instance with respect to the equity expert's adjustments, the court rejected them seemingly out of hand by accepting the trustee's expert's criticisms in total: equity's expert pointed out the considerable increment in value to the debtor's special pharmacy business—the court rejected that by observing that the debtor's business primarily consisted in supplying nursing care to its patients, that its profits were narrowed by an acute shortage of nurses reflected in its increasing labor costs, and that the pharmacy division was a small part of the business. When equity's expert testified that the debtor's cash flow projections bore no relationship to historical and current performance, the court rejected that criticism by again embracing management's cash flow projections as "conservative," as if that washed away equity's expert's criticism. With respect to the amount and value of the net operating losses (NOLs), the court commented favorably on the debtor corporation's senior tax officer who testified that the Internal Revenue Service would probably oppose the tax treatment proposed by equity's expert on issues such as consolidation of the debtor and its principal affiliate and the allocation of losses and reduction of payments. The debtor's officer estimated the NOLs as contributing about \$8,000,000 in additional value, which its expert failed to include in its total enterprise valuation; equity's expert's estimation of the NOLs was at \$32,900,000; the court found that another expert's \$10,000,000 was exactly right, but no discussion was included in the court's opinion on the substance of the other expert's estimation of the value of the NOLs.

##### 5. *In re Mirant Corp.*

At present, the most sophisticated opinion on total enterprise valuation in the burgeoning bankruptcy court "literature" is *In re Mirant Corp.*<sup>463</sup> *Mirant* is a chapter

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<sup>463</sup> 334 B.R. 800 (Bankr. N.D. Tex. 2005). After the valuation hearing, the court issued a preliminary letter ruling, as further amended a month later, in which it directed the debtors' experts to recalculate the total enterprise valuation consistent with the court's adjustments to the data, discount rates, and multiples. The debtors' experts protested that it would take a full two months of work to generate these revised calculations of value; nevertheless, the court directed them to proceed and it promised that it would later release a comprehensive opinion to substantiate the grounds for its adjustments. Perhaps exhausted after the two-month ordeal of valuation hearings, the parties then went forward to negotiate a consensual plan in which the plan proponent finally agreed to distribute some of the value of the reorganized debtor to the existing shareholders and the holders of the subordinate debt. With that accomplished, the plan coalition sought an in-chambers conference during which its members asked that the court put a hold on the recalculation of value and not issue its opinion on valuation. The court acquiesced in this request until the confirmation hearing was held in December 2005, and then issued its comprehensive opinion justifying the adjustments it had directed be made six months earlier. Our point is that the court did not determine the value of the reorganized debtor in this opinion, and by the time it was released, the parties had already rendered the opinion largely moot by negotiating a consensual plan that obviated an enterprise valuation. In releasing the opinion, the court mentioned that a dissident shareholder threatened to appeal the order of confirmation and, thus, the district court might find the opinion instructive; moreover, the opinion was also relevant to findings the court had to make that the plan was in the best interest of creditors and to the issue on interest raised by the *Till* decision.

11 conglomerate case in the merchant energy business that filed its petitions in the Northern District of Texas. At the insistence of the Official Committee of Equity Holders ("Equity Committee"), the court agreed to hold an evidentiary hearing to determine the total value of the reorganizing debtors before scheduling a confirmation hearing on the debtors' Joint Second Amended Plan of Reorganization ("Plan").<sup>464</sup> Under the Plan, the interests of the pre-petition equity security holders were cancelled on the premise that there was insufficient value in the reorganized debtor to pay the allowed claims of the unsecured debtors in full. Unfortunately, the plan proponents refused to negotiate a consensual plan and prepared to force the issue of a cram down of the interests of the existing shareholders.<sup>465</sup> In this case, the experts retained by the Equity Committee were prepared to testify that, despite the plan proponents' expert's statements to the contrary, there was sufficient value in the reorganized debtors to cover not only the allowed unsecured claims, including the subordinated unsecured claims, but also to distribute some of that value to the existing shareholders. To the considerable credit of its sense of due process and fairness, the court actually agreed to postpone the confirmation hearing and allow the parties to proceed with an evidentiary hearing on the crucial issue of the total enterprise value of the reorganized debtor, a practice we fully endorse in the appropriate circumstances.<sup>466</sup>

After a two-month period of expedited pretrial discovery, including the filing of eight expert reports and counter-reports and the depositions of three other witnesses, the court conducted a valuation hearing over twenty-seven days within an eleven-week period.<sup>467</sup> At the end of this phase of the chapter 11 cases, the court released a "letter ruling" of its preliminary determinations, with a direction to the experts to submit revised reports that responded to the court's detailed concerns, another procedure we endorse in the appropriate circumstances.<sup>468</sup> As the court noted in its preliminary ruling, it was not prepared to calculate a "melded" valuation by averaging the valuations of the experts for the principal parties in interest; there were far too many adjustments to each expert's report to reflect the changing price for natural gas and other fuels consumed by the debtors in their operation, peak capacity demands for electricity, and the value of additional power plants coming on line.<sup>469</sup>

In its comprehensive opinion following confirmation, the court reviewed the qualifications of the principal expert witnesses proposed by the debtors, by the official committees of creditors at the level of the merchant energy trading companies, the equity security holders committee, and the sub-debt holders. The

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<sup>464</sup> *Id.* at 807.

<sup>465</sup> *Id.* at 806–07. Under this increasingly common circumstance, the only way for the existing shareholders or the subordinated unsecured creditors to bring the plan proponent to the negotiating table is to force a valuation hearing.

<sup>466</sup> *Id.* at 807.

<sup>467</sup> *Id.* at 809.

<sup>468</sup> *Id.* at 810–11.

<sup>469</sup> *Mirant Corp.*, 334 B.R. at 810–11; *see also* Letter Rulings, *id.* at 800 (2005) (No. 10393 & 10723).

three expert witnesses for the Equity Committee were found to be very well qualified, but the court rejected each of their reports on valuation because the projections on future gas prices that lay at their base were riddled with mathematical errors and that unreliability extended to all further computations in the total enterprise valuations.<sup>470</sup> Although the court held that their reports could not be admitted into evidence, it did give some weight to the rebuttal testimony of these experts and adopted some of their objections in directing the debtors and debtor's experts to revise their valuation report.<sup>471</sup>

The court found that the business plan developed by the debtors was well prepared and was reasonably reliable, and the court was prepared to rely upon that report as the basis for determining the total enterprise value of the Mirant Group, with some adjustments it determined to be necessary.<sup>472</sup> In addition, the court found the valuation report prepared by the debtors' experts to be reasonably reliable subject to the same kind of adjustments the court determined to be necessary to the business plan upon which the debtor's experts' valuation report was based.<sup>473</sup> In marked contrast, the court gave very little credence to the expert report and testimony that was prepared for the sub-debt holder entities.<sup>474</sup>

The court then proceeded step by step through its proposed four initial adjustments to the data: the discount rates and the multiples to be used by the debtors and debtors' experts in their revised valuation analysis.<sup>475</sup> In the next section of its opinion, the court ruled on various objections made to the debtors' business plan, noting the inability of the market to project the true value of a reorganizing debtor.<sup>476</sup> To the extent that the debtors' experts sought to project market prices in the immediate post-confirmation period as part of its valuation analysis, the court rejected the approach as unacceptable and directed the debtors and their experts to rely upon the "last twelve months" valuation method in re-computing their valuation analysis in order to ground that analysis in the historical performance of the debtors.<sup>477</sup> The court then upheld as reasonable the debtors and their experts' selection of four comparable public companies in the merchant energy business, and agreed in their rejection of a fifth company, Calpine, proposed by the experts for the Equity Committee and the sub-debt holders.<sup>478</sup> The court also overruled the

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<sup>470</sup> *Id.* at 813–14.

<sup>471</sup> *Id.* at 814, n.40.

<sup>472</sup> *Id.* at 825.

<sup>473</sup> *Id.* at 830–31.

<sup>474</sup> *Id.*

<sup>475</sup> *Mirant Corp.*, 334 B.R. at 836–46.

<sup>476</sup> *Id.* at 832–36 (Bankr. N.D. Tex. 2005) ("It is not sensible in such a situation to establish a value that largely relies on market conditions existing at the time of valuation which would not necessarily obtain as of the date for which the valuation was prepared.").

<sup>477</sup> *Id.* at 835–36.

<sup>478</sup> *Id.* at 836–37 (holding "difference in business between Calpine and Mirant Group are sufficient, when considered together with Calpine's relatively weak financial condition, to disqualify its use as a comparable").

objection to assign different weights to each of the comparable companies; without any elaboration, the court held that equal weights were appropriate.<sup>479</sup>

The court then proceeded to its rulings on the imputed interest rates on debt and imputed returns on equity, the two basic components in applying the discounted cash flow method. The debtors' experts sought to rely upon the pre-confirmation trading of the debtors' debt instruments as a basis for determining the cost of debt as a component of the weighted average cost of capital, but the court rejected that approach, noting the additions and subtractions to the component owing to the chapter 11 process.<sup>480</sup> Under these circumstances, the court held that pre-confirmation market activities in the debtors' debt instruments could not be considered in determining the cost of the debt component to the weighted average cost of capital.<sup>481</sup> Similar considerations applied to determining the cost of the equity component, according to the court.<sup>482</sup> The court continued to impose further adjustments, most of which appeared to be based upon a very thin evidentiary record, at least as reflected in the reported opinion.<sup>483</sup>

The court then wrapped up its analysis by explaining briefly why it overruled a series of objections by the experts for the Equity Committee and the sub-debt holders, calling for additional values arising from the following topics: capacity payments, the capital structure, the value of the Bowling 3 plant (which never went on line and which was sold) and the minority interests of the debtors in other companies.<sup>484</sup> No value would be given for these assets.<sup>485</sup>

In all, the court embraced a sophisticated approach, employing what we consider to be a host of best practices in light of the *Daubert* mandates. First, the court conducted an evidentiary hearing well before the confirmation hearing. Although as we have noted throughout this Article, a separate pre-confirmation or pretrial hearing is not necessary, it does point to best practices. This allows a court to dismiss expert testimony that fails to assist the trier of fact, is irrelevant, or is unreliable without putting to great expense the parties or stakeholders in a bankruptcy matter. Second, the court refrained from the "seek and select" method, eschewing the role of expert and embracing the role of gatekeeper. Third, the court, in its painstaking effort to get it right, sent the experts back to the drawing board with specific instructions to supplement their reports and analysis. Fourth, the court recognized that a qualified expert is retained precisely to exercise sound judgment,

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<sup>479</sup> *Id.* at 838.

<sup>480</sup> *Id.* at 840–41.

<sup>481</sup> *Mirant Corp.*, 334 B.R. at 841 (explaining Blackstone adjusted "based on potential Mirant Group capital structures").

<sup>482</sup> *Id.* (finding that rate must "equal or exceed 12%").

<sup>483</sup> *Id.* (referencing only some sources of evidence, such as testimony from two individuals).

<sup>484</sup> *See id.* at 846–47 (finding "preponderance of the evidence supports the court's decision to use the Business Plan" with respect to capacity payments, "the working capital Debtors propose to maintain going forward is reasonable" with respect to capital structure, "[t]he course chosen by management is reasonable" with respect to Bowline 3, and "no support . . . to direct alteration in calculate of the value of Mirant Group" with respect to minority interests).

<sup>485</sup> *See id.* at 846.

even subjective judgment, and that such exercises of judgment are permissible if relevant, reliable, and not conclusory.

6. *In re Oneida Ltd.*

In *In re Oneida Ltd.*,<sup>486</sup> the bankruptcy court found that the total enterprise value of the debtor was substantially less than the equity hurdle of \$261.5 million. A few facts are necessary to properly frame the valuation issue. On March 19, 2006, Oneida Ltd. and its direct and indirect subsidiaries filed chapter 11 petitions and a prepackaged plan of reorganization with the Bankruptcy Court for the Southern District of New York.<sup>487</sup> These historic manufacturers of household wares, Oneida silverware and Thomas grandfather and mantel clocks, negotiated their proposed plan of reorganization with their secured lenders to complete the restructuring of their indebtedness. In an earlier phase of the restructuring in 2004, the debtors converted \$30 million of the debt into 62% of the common shares, and split the remaining secured debt into two tranches, A and B. The lenders also were granted the authority to appoint six of the nine members of the debtors' board of directors. Under the prepackaged plan, the loan balance in Tranche A would be fully satisfied as part of an exit financing of \$170 million and the loan balance in Tranche B would be converted to 100% of the common shares of the reorganization securities.

The debtors also negotiated a settlement of their unfunded pension plan liabilities with the unsecured interest-bearing unsecured note \$3.0 million note to the Pension Benefit Guaranty Corporation ("PBGC"), converting a secured indebtedness of \$2.7 million dollars; the debtors also stipulated to a fixed amount of unsecured indebtedness of \$21.7, as owing to the PBGC. The plan filed with the petitions presupposed that the debtors had no outstanding fixed and liquidated unsecured debt. Yet, by the date of confirmation, the allowed unsecured claims were \$6.7 million, with disputed unsecured claims of \$9.3 million.<sup>488</sup> The administrative expenses were estimated to be \$18 million. (The plan was amended on July 7, 2006).<sup>489</sup> The secured claims, including post-petition interest, costs, and attorneys fees totaled \$225.2 million as of the date of confirmation. The court noted that the total amount of the uncontested indebtedness was \$261.5 million.<sup>490</sup> Under

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<sup>486</sup> 351 B.R. 79 (Bankr. S.D.N.Y. 2006).

<sup>487</sup> *See id.*

<sup>488</sup> *See id.* at 88. There are some material inconsistencies in this opinion regarding the amount of allowed unsecured claims: at one point, the amount is found to be \$8.0 million and at another point it is \$6,738,868, a far more specific amount. *See id.* at 82, 88. Either of these amounts must exclude the PBGC's stipulated unsecured claim of \$21,075,050, but it is unclear whether this includes the \$3 million in an interest-bearing unsecured claim that had been converted from a \$2.7 million unsecured claim. *See id.* The court also noted that there were disputed or unliquidated claims for another \$17.790 million. *See id.*

<sup>489</sup> *See Oneida Ltd.*, 351 B.R. at 82. There is no statement in the opinion describing what the amendments to the original plan were.

<sup>490</sup> *See id.* at 88. The math discrepancies in this opinion make it difficult to calculate a firm amount of the liabilities that have to go into any solvency analysis. Moreover, the court does not report what the amount of



the proposed plan, the interests of the pre-petition shareholders would be cancelled. Thus, in order to participate in any distribution under the amended plan, the Equity Committee would have to prove that the debtors had a total enterprise value in excess of the hurdle amount of \$261.5 million. If the date of valuation was, however, the petition date, then presumably the administrative expenses of \$18 million and the post-petition accrual of \$8.8 million in interest, costs, and attorney's fees on the secured claims should both be deducted from the \$261.5 million for an adjusted hurdle amount of \$237.7 million.

The Equity Committee objected to confirmation of the amended plan contended on the dual grounds that the plan was not proposed in good faith under 11 U.S.C. § 1129(a)(3) and that it violated the absolute priority rule under 11 U.S.C. § 1129(b)(2)(B)(ii) because the debtor was solvent. Thus, the resolution of the second objection turned on a judicial determination of the total enterprise valuation of the reorganizing debtor as of date of the petition. The contested hearing on confirmation of the amended plan took place over six days in mid to late July 2006.<sup>491</sup>

In support of the Equity Committee's position, it offered into evidence the reports and testimony of its own expert. This expert testified that based upon his discounted cash flow analysis, the total enterprise value ranged from \$260 million to \$330 million, with a mid-point of \$295 million. Given that the court found that the total amount of the uncontested debt amount was slightly above \$261.5 million, this expert's lower limit would exclude any value for old equity, but the midpoint value would allow a distribution under the plan to old equity of \$33.5 million. As noted above, the \$261.5 million could not be aggregate indebtedness as of the petition date, and if the lower limit of valuation was \$260 million, the debtor would be solvent if the adjusted indebtedness was \$237.7 million.

By contrast, the total enterprise valuations submitted by the debtors' expert ranged from \$190 million to \$230 million, with a midpoint value of \$210 million, with no possibility of distribution to old equity. Similarly, the enterprise valuation submitted by the banks' expert ranged from \$190 million to \$225 million, with a midpoint of \$207 million, again with no possibility of distribution to old equity. The Creditors Committee's financial advisor did not perform his own total enterprise valuation, but he did provide detailed critiques of the other three valuations, and in this connection, he made corrections and adjustments to these three valuations. Based upon his reworking of the debtors' discounted cash flow, he

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the Tranche B debt is, so one cannot determine how much of this Tranche B debt is supposed to be converted to equity and how much of the Tranche A debt is supposed to be paid under the exit financing of \$170 million.

<sup>491</sup> See *id.* at 84. The earliest date found in references to the transcript is July 12; there are other references to July 13, 17, 18, 21, and July 25—the final date of the hearings.

derived a total enterprise valuation of \$196 million to \$227 million, with a midpoint of \$212 million.<sup>492</sup>

The Creditors Committee's expert's detailed critique, echoed by the rebuttal reports submitted by the other experts, focused on the allegedly questionable assumptions of the Equity Committee's expert in calculating the weight average cost of capital, one of the key factors for determining the appropriate rate for measuring the presented discounted value of the debtors' projected cash flows. With respect to the cost of equity, all parties agreed that it would be around 20%, but with respect to the cost of debt—the rate the debtors would have to pay for commercial financing—the Equity Committee's expert imputed a rate of 7.9%, which he based upon the cost of debt for comparable companies.<sup>493</sup> The opposing experts not only challenged the comparability of the companies, but also contended that the 12 to 13% rate for exit financing under the debtors' plan was the appropriate rate for computing the debt component of the weighted average cost of capital.<sup>494</sup> Next, the opposing experts contended that the debt to equity ratio of 60/40 used by the Equity Committee's expert was unsupportable. It did help the credibility of the Equity Committee's expert that at a prior hearing, he had posited a 40/60 split on the ratio of debt to equity. The opposing experts also criticized the Equity Committee's expert for "normalizing" the projected cash flows of the debtors as part of his analysis; during his cross-examination, he admitted that he had never used a "normalization" of revenues in his prior valuations. Finally, the Equity Committee's expert was cross-examined about the alleged bias built into his testimony by the discovery that his firm had negotiated a form of contingent fee agreement, which the expert testified he had not been aware of, but this same type of contingent fee arrangement had been the source of sharp criticism in a prior case. This present arrangement seriously undercut his credibility for objectivity as an expert witness.

On August 30, 2006, one month after the conclusion of the hearing on confirmation, the court released its full-dress opinion. In its findings of fact, the court accepted as wholly legitimate each of these detailed criticisms of the Equity Committee's expert's testimony and reports, which resulted in "discounting" his total enterprise valuation. In light of discounting this expert's testimony, the Equity Committee could not sustain its burden of proof in objecting to confirmation on the ground of any alleged violation of the absolute priority rule. As to the Equity Committee's objection on the ground of the lack of good faith, the court held that no proof of any kind was adduced to support that objection despite extensive discovery. The court then proceeded to deny the remaining miscellaneous objections and to confirm the first amended plan subject to the condition that the

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<sup>492</sup> See *id.* at 88. The court acknowledged that this expert witness was the most helpful in determining the range of valuation and in showing the flaws in each of the other experts' reports and testimony. See *id.* at 88, 90.

<sup>493</sup> *Id.* at 88–89.

<sup>494</sup> *Id.*

plan be further amended to provide for post-petition interest on the allowed unsecured claims.

This case is very significant as a further example of the exacting expectations of experts testifying to the total enterprise valuation of chapter 11 debtors in cram-down hearings or in other adversary proceedings in which solvency is a critical issue. The courts are becoming quite comfortable in working their way through each of the variables under the standard formulas in a discounted cash flow analysis, aided considerably by the detailed critiques of opposing experts.

Regrettably from our perspective is the failure of the court to hold a separate valuation hearing with adequate time allocated to the presentation of proofs by each party rather than jamming the valuation hearing into the confirmation hearing in which there tends by the very nature of the process to be a rush to judgment.<sup>495</sup> It further strikes us that with three experts testifying on direct and being cross-examined, and with testimony from a fourth expert who did not prepare his own report, but testified about the corrections that had to be made to three reports that were filed, plus testimony on the other objections, that six days of hearings was an exceptionally compressed time to sort through expert valuations in the \$200 million to \$350 million range for manufacturing companies. From the filing to the final date of hearings on confirmation, the case ran slightly over four months, with the amended plan being filed just a week before the start of the hearings. In our experience, however, expeditious chapter 11 cases are becoming more the rule than the exception. Time is money and delays in a chapter 11 case bring uncertainty and reduced value. If the case presents a truly consensual plan, then speed is everyone's ally. However, where, as we are experiencing now, prepackaged chapter 11 plan cases are presenting nonconsensual dynamics, speed often harms the objecting parties, usually the official committee of unsecured creditors or various creditors treated allegedly unfavorably under the proposed plan. In these situations, it is important for the court to hold fast to the principle that speed in administration be subservient to due process concerns and that the court allow the parties ample opportunity to adduce the evidence necessary to reasonably make their case and to take the time the court needs to reflect properly on the question of total enterprise value.

#### 7. *In re Nellson Nutraceutical, Inc.*

In *In re Nellson Nutraceutical, Inc.*, (*Nutraceutical I*),<sup>496</sup> Nellson Nutraceutical and its U.S. affiliates, all privately held corporations, engaged in the business of manufacturing private-label brands of nutritional bars, filed for relief under chapter 11 in Delaware on January 28, 2006 along with their proposed plan of reorganization.<sup>497</sup> The court held a hearing to determine the enterprise valuation of

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<sup>495</sup> See Bernstein et al., *supra* note 5, at 377, 428 and *passim*.

<sup>496</sup> 356 B.R. 364 (Bankr. D. Del. 2006).

<sup>497</sup> *Id.* at 368.

the debtors before proceeding with a hearing on confirmation of the debtors' plan of reorganization.<sup>498</sup> The principal dispute among the parties was whether there was sufficient enterprise value to reach the interests of the pre-petition shareholders, who were controlled by a venture capital firm. The Secured Banks and the Unsecured Creditors Committee moved to exclude the debtors' expert witness on enterprise valuation on several grounds under the *Daubert/Kumho* standards, but the court limited its first ruling to the issue of the expert's qualification. The expert was qualified, but it reserved the other objections for further determination. The debtors' expert witness testified that based upon the debtors' discounted cash flow, using managements' financial statements and five years of projected cash flows as his data base, the enterprise valuation was \$404.5 million as of June 4, 2006, which exceeded the total liabilities (excluding accrued administration expenses). The secured debt as of December 31, 2006, was \$355 million, inclusive of eleven months of post-petition interest, fees, and charges, and the unsecured debt was \$10 million (ignoring administrative expenses for the moment), for a total of \$365 million. If this enterprise valuation were accepted by the court, then there would be equity of \$39.5 million such that the shareholders would definitely remain "in the money" and they would control the reorganization of the debtors and retain ownership and control of the reorganized debtors.<sup>499</sup>

To reach this valuation amount, the expert deducted projected capital expenditures from the component of the terminal value of his discounted cash flow analysis.<sup>500</sup> As the court explicitly emphasized, the component for the terminal value comprised 68% of the total enterprise valuation so any flaw in calculating the terminal value severely skewed the total valuation. The Banks and the Committee renewed their motion *in limine* to exclude the expert's reports and testimony on grounds of relevance and reliability. This time around, the court granted the motion

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<sup>498</sup> See *id.* at 366. The filing of the plan with the petition would normally be suggestive of a prepackaged plan, but, given the opposition of both the secured creditors and the unsecured creditors at the valuation hearing, this assumption falls away. See *id.* at 377.

<sup>499</sup> See *id.* at 368.

<sup>500</sup> See *id.* at 374. The formula for calculating discounted cash flow uses future cash flow projections and discounts them to arrive at present value. See *Cox Enters., Inc. v. News-Journal Corp.*, 510 F.3d 1350 (11th Cir. 2007) (describing components of discounted cash flow model); *Heilig Meyers Co. v. IRS (In re Heilig Meyers Co.)*, 232 F.App'x 240, 243 (4th Cir. 2007) ("[D]iscounted-cash-flow approach . . . calculates an accurate present value by discounting the future cash flow from the asset to present value at an appropriate discount rate."); *CSX Transp., Inc. v. State Bd. of Equalization*, 472 F.3d 1281, 1284 (11th Cir. 2006):

[A]n appraiser first projects the cash flows of a company for a designated number of years after the assessment date and discounts those expected cash flows to their present value. The appraiser then calculates a terminal or reversion value that represents the value of the company at the end of the projection period. These two values together give the appraiser his unit value for the company.

The first component is derived from discounting to present value the projected cash flow of the subject company for three to five years, and then calculating the terminal value for the indefinite period following that three to five year period, and then adding the two components to generate the enterprise valuation. See *Nutraceutical I*, 356 B.R. 364, 367 (Bank. D. Del. 2006).

on the ground of reliability, finding that even the witness admitted that he had never before deducted capital expenditures in determining enterprise valuation in this manner and that none of the literature on enterprise valuation recognized the validity of this kind of deduction in this manner. Under these circumstances, the standard for determining reliability of an expert's testimony under the prevailing case law could not be satisfied, and as such, the expert's testimony and reports were inadmissible.

In *In re Nutraceutical, Inc. (Nutraceutical II)*,<sup>501</sup> after disqualifying the debtors' valuation expert on the ground of his unreliability in one detailed opinion, the court then proceeded to issue a second opinion regarding its assessment of the reports and testimony of three other experts. One of the experts was engaged by the Unsecured Creditors Committee, another by an informal committee of secured creditors, and a third by the First Lien Creditor. As the court explained in the procedural background to its opinion, the hearing on valuation was brought by the debtors to determine the value of the secured creditors' collateral under 11 U.S.C. § 506(a). This was an odd procedural context because the objective of the debtors was not to cram-down under-collateralized secured loans, but to prove that there was sufficient total enterprise value to cover the equity security interest of their controlling shareholder, Fremont Investors VII, LLC (Fremont). In this sense, this proceeding was comparable to those contested valuation hearings in which old equity seeks to oppose a cram-down plan by trying to prove that the debtor is a solvent entity.

The trial of this contested motion extended over a four month period from September through December 2006. Each of the three expert witnesses testified in detail about the valuation methods he used, the sources of data he relied upon for each method, the application of the standardized formulas for calculating the discounted cash flow analysis, the selection of comparable companies and comparable transactions, the adjustments to the relevant discount rates, and the weight to be given to the particular valuation derived from each method. As it initially turned out, there was only a 10% variance among the midpoints of the three valuations, ranging from a low mid-point of \$314.2 million to a high mid-point of \$349 million.

Of course, each expert testified that the other two experts made some errors in selecting comparable companies and similar transactions and in selecting discount rates. But it was the debtors' counsel who raised the most strenuous objections to each expert's alternate valuations, which the court sorted through point by point, rejecting most of the objections, but accepting others, and as a result, making the necessary adjustments to each expert's valuations. It was quite clear from the substance of the debtors' objections that they were intent on having the court find that the total enterprise value of the debtors was \$400 million. Considering that the debtors were stripped of their expert witness and had no ability to put in either direct or rebuttal testimony, it is extraordinary that their resourceful counsel succeeded in initially persuading the court to increase each of the valuations of the

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<sup>501</sup> No. 06-10072 (CSS), 2007 Bankr. LEXIS 99 (Bankr. D. Del. Jan. 18, 2007).

three witnesses by an average of \$10 million. Thus, the "corrected" valuation ranged from a low of \$325.4 million to a high of \$365.4 million. If the high valuation were adopted by the court, there would be sufficient value to cover the \$355 million in the First and Second Lien balances, including accrued interest, costs, and professional fees through December 31, 2006, with \$10 million left over to cover administrative expenses and the residue perhaps trickling down to the holders of \$5.8 million in general unsecured claims.<sup>502</sup>

The debtors' victory was momentary, for the court then lambasted the debtors' management, which was completely controlled by Fremont, for so grossly manipulating the long range plan issued in May 2006. Unfortunately, each expert relied upon the May 2006 Plan without realizing that the cash flow projections were far too aggressive in years three through six and were not based upon any "bottom-up" analysis that was informed by discussions of future purchases with the debtors' major customers or any other further testing of the data. Indeed, the court took extraordinary pains in reconstructing an exceptionally detailed narrative of these transgressions, with names, dates, drafts, silenced protests by the debtors' senior officers, and the like—each referenced to the trial transcript. This narrative exhausted 122 numbered paragraphs to present the sordid and nefarious details. Only after the court was satisfied that the May 2006 projections were bogus did it then turn to its meticulous discussion of each component of each expert's report and testimony.

As a case study of total enterprise valuations in which a court undertakes to present a painfully thorough critique of the reports and testimony of expert witness, the 122 numbered paragraphs (123 through 244) of this critique would be very hard to beat. In disposing carefully of each of the objections of the debtors to each calculation of the three experts, the court made specific findings, including but not limited to whether the comparable companies were, in fact, reasonably so; whether the public companies undergoing mergers or acquisitions were comparable; and which rates were appropriate for discounting the unlevered cash flow during the five years of projected cash flows to present value. Whether the court should have proceeded to make the adjustments to each component of the valuations in the manner it did is quite another matter.

To indicate the fine kinds of adjustments the court made, we consider just some of the adjustments to one of the three expert's valuation, namely, the valuation presented by the expert for the First Lien Creditor, UBS.<sup>503</sup> In this instance, the debtors objected to the expert's use of a multiple of 8 times the 2006 EBITDA—the last year of the unlevered five year projected cash flow, with the multiple derived from the expert's analysis of comparable companies, and the court granted this objection and increased the multiple to the median value of 8.9. The debtors also objected to this expert's valuation based upon an analysis of similar transactions.

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<sup>502</sup> See *id.* at \*9–12. In order to fund the administrative expenses and unsecured claims, presumably the First and Second Lien Creditors would "have to give up value" toward that goal.

<sup>503</sup> See *id.* at \*73–96 (discussing Chanin's opinion).

Here too the court sustained part of the objection and "corrected" the expert's selection of a multiple of 8.5 times the projected 2006 net revenues and a multiple of 7.0 of the EBITDA for 2006, raising the first multiple to 8.9 and the second multiple to 7.4.

Then the court in very concise terms administrated the *coup de grace* to Fremont and the debtors by reducing the corrected total enterprise valuation of the debtors based upon the bogus May 2006 projections by \$24 million to \$320 million. The court justified this final adjustment by pointing to the reduction in EBITDA for June 2006 and for declining sales in later months. From our perspective, it would have been far more appropriate for the court to invite the three experts to amend their reports based upon a restated set of cash flow projections from May 2006. Judges are frankly not trained to generate total enterprise valuations by their own lights, and we view it as unsettling tendency in the recent cases for bankruptcy judges to make their own ad hoc adjustments to experts' reports and then determine value as if they were the expert witnesses.

Apart from this, the court did not address the consequences arising from the enterprise number it determined was the right one. Given the fact that this four month trial was prosecuted under section 506(a), one can only draw the inference that the bank group could not be especially pleased, because at \$320 million, it was substantially uncollateralized, and the value of its collateral deteriorated during the entire year that it took to have this matter tried. What effect this would have on negotiations for a plan is intriguing, but it would not be surprising, given the detailed findings about Fremont's manipulations, that a motion to appoint a trustee or an examiner would not be filed.

#### CONCLUSION

Greek legend tells of a bandit named Procrustus who guarded a mountain pass, stopping all travelers on their way. He had an iron-framed bed and would force the traveler to lie on it. If the traveler was too tall for the bed, Procrustus cut off his legs; if the traveler was too short, Procrustus stretched the traveler out, pulling out his legs and arms until he fit. *Daubert*, in the context of valuation expert testimony in distressed business situations, is the frame of the iron bed of Procrustus: each of the valuation techniques generally employed in distress business contexts is much like the unwary traveler in Procrustus' day. None seem to fit the bed just right.

Business valuations are inherently uncertain. Whether one employs an income model, a market model, an asset valuation model, or a synthesis of the foregoing models, an expert is offering an opinion, an estimate of value based on some standard, some premise, some vantage point, at some time. Each valuation model also requires assumptions driven by events yet to happen or past events obscured by present realities. Notwithstanding the Procrustean nature of the endeavor, in the context of expert valuation testimony in bankruptcy cases and proceedings, the Federal Rules of Evidence and *Daubert* simply require that a qualified expert

provide testimony that is: (1) relevant; (2) reliable; and (3) will assist the trier of fact. *Daubert* does not require certainty or opinion stripped of discretion; its more modest requirements rest on relevance and reliability. Relevance is a measure of fit; does the expert offer an opinion tailored to address a fact in issue? Reliability is a measure of methodology; has the expert employed an acceptable process, explicitly defended that process, applied that process to relevant data, stated his assumptions clearly, and supported his opinion with the facts and technique.

The development of a valuation narrative drawn from numerous valuation cases points to an impressive judicial display of mastery of methodology, technical process, and procedure. Cases like Judge Carey's *ACV* suggest a thoughtful and deliberate methodology in developing a robust valuation opinion. Cases like Judge Peck's *Iridium* persuasively suggest that for public companies, the market through a market capitalization assessment, may be the most reliable indicator of value, particularly in avoidance actions where the valuation standard is a "fair valuation." These cases often remind us in complex systems, like valuations of businesses, the party with the ultimate burden of persuasion may simply fail to prove its case. Cases like Judge Lynn's *Mirant* thoughtfully suggest that holding a separate hearing on valuation before the confirmation hearing allows a court and parties the opportunity to address valuation in a deliberate and thoughtful environment, at least partially insulated from the momentum and distractions inherent at a confirmation hearing. These cases further remind us that the role of a bankruptcy court is modest; has an expert shown that the testimony she is offering will assist the trier of fact, is relevant to the issues, and is reliable? If the expert's report is flawed, the court should conclude that it is inadmissible or send the expert back to get the methodology right. If new facts have developed between the preparation of the expert report and the valuation hearing, a court should send the experts back to their analysis with the new facts. The court, however, should generally refrain from the "search and select" method, compromising valuation estimates, or cobbling its own "expert" opinion. These cases warn us that courts generally make poor valuation experts.

At one point, it was quite the rage to suggest that "valuation is notoriously unpredictable"<sup>504</sup> and "that many differences in judicially accepted . . . values are quite unwarranted . . . ."<sup>505</sup> Many criticisms, however, misperceive the role of a bankruptcy court in contested valuation contests. A court is not a valuation expert; its institutional role is not to render an opinion on business value. In fact, it should refrain from treading that path. Rather, the institutional roles of a bankruptcy court confronting valuation testimony may be clustered in two spaces: (1) gatekeeper, and (2) trier of fact. Under the gatekeeper function, a court must assess whether the proffered expert testimony will help the court as the trier of fact, is relevant and is reliable. That is all. At this stage, absent systemic bias, a court has completed its

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<sup>504</sup> Keith Sharfman, *Judicial Valuation Behavior: Some Evidence From Bankruptcy*, 32 FLA. ST. U. L. REV. 387, 387 (2005).

<sup>505</sup> James C. Bonbright, *The Problem of Judicial Valuation*, 27 COLUM. L. REV. 493, 518 (1927).



gatekeeper task. This is simply not the stage to determine the persuasiveness of an expert opinion or the weight that a court may accord that testimony. Under the "trier of fact" function, a court must consider all admitted evidence, weigh its credibility and probative force, and make a determination as to the factual support for a particular valuation testimony. Here it is not a court's role to "complete" an uncompleted expert report, to "search and select" through various reports to construct a meta-report that often has no support in the record; to infuse more facts into the expert report and then make adjustments without corresponding expert testimony to support such adjustments; or to synthesize the competing reports assigning, for example, sixty percent of the weight of the valuation to the debtor's expert and forty percent to other experts. Rather, if a court finds expert testimony deficient, it may exclude the report and testimony in its entirety, it may appoint its own expert or technical advisor, or it may send the experts back to consider new facts or techniques. Nothing more, or less, is required of our courts in order to square expert valuation testimony with their institutional duty under *Daubert*.