



## How Bankruptcy Courts Determine A Reasonable Range of Valuation in the Context of Chapter 11 Plan Confirmation

### Introduction

This client memorandum provides background on how bankruptcy courts determine a reasonable range of valuation in the context of Chapter 11 plan confirmation. This client memorandum examines the bankruptcy cases of Exide Technologies, Coram Healthcare, Bush Industries, Chemtura Corp. and Mirant Corp., which involve highly contested valuation disputes in Chapter 11 plan confirmation and how bankruptcy courts determine a reasonable range of valuation in such situations.

The most common valuation methodology used to calculate the going concern value of a company is the income approach, which typically makes use of the discounted cash flow (DCF) method.<sup>1</sup> Under the income approach, a company's value is calculated by estimating the present value of projected future cash flow of the business.<sup>2</sup>

Many valuation experts view the income approach as the most rigorous of valuation methodologies since it takes into account the fundamental elements of value, cash flow, time, growth and risk.<sup>3</sup> The components of the discounted cash flow method are i) projected cash flows of the company; ii) terminal value, and iii) discount rate.<sup>4</sup> For the DCF method, the first step is to create projections to calculate the projected cash flow for each period (e.g. each year).<sup>5</sup> The second step is to calculate the terminal value of the company, which is an estimate of the value of the business at a future point in time and assumes the company operates perpetually.<sup>6</sup> The third step is to determine the appropriate discount rate, which is the rate of return required by investors that provide capital (debt and equity) to the company to compensate the investors for the time value of money and the risk of the specific investment.<sup>7</sup>

The second approach used most frequently in valuing a debtor is the market approach, which uses the "comparable or guideline public company" method and the "comparable or guideline merged and acquired transaction" method.<sup>8</sup> Under the market approach, assets are valued based on how similar assets are priced currently in the market.<sup>9</sup> The market approach seeks to estimate the value of a business based on values set by the markets as a multiple of financial metrics, which include revenues or sales, cash flows or net income.<sup>10</sup>

The third approach is the asset based approach, which is based on the total of the individual values of the underlying assets compared with the total liabilities.<sup>11</sup> Generally, the asset based approach is not the preferred method of valuing a business on a going concern basis given the time and costs in valuing each asset is not justified since it does not result in an improvement in accuracy.<sup>12</sup> An expert usually applies multiple approaches in estimating value.<sup>13</sup>



Under the U.S. Supreme Court's decision in *Daubert*, the party who seeks to call an expert holds the burden of substantiating the expert's qualifications and relevance of the expert's testimony by a preponderance of the evidence.<sup>14</sup>

In re Exide Technologies

In *In re Exide Technologies*, the official committee of unsecured creditors objected to the debtor's valuation since the plan of reorganization the debtor proposed provided minimal distribution to the unsecured creditors.<sup>15</sup> The court chose not to hold a hearing to determine the valuation of the reorganized debtor prior to the confirmation hearing.<sup>16</sup> The court opted instead to hold an omnibus hearing on the debtor's valuation and other matters.<sup>17</sup>

In *Exide*, the debtor's expert asserted the debtor's enterprise value to be between \$950 million and \$1.05 billion.<sup>18</sup> In contrast, the creditors committee's expert asserted a valuation of the debtor to be between \$1.478 billion and \$1.711 billion.<sup>19</sup> Then, the court determined that the valuation of the debtor had a range of \$1.4 and \$1.6 billion, which in essence adopted the creditor committee's valuation rationale.<sup>20</sup> The court arrived at this determination after considering the methods used by the experts, the parties' incentives to overvalue and undervalue the debtor and the supporting evidence offered.<sup>21</sup>

The court determined that the debtors' expert had exercised "subjective" and biased judgment in its valuation by making downward adjustments to certain multiples from comparable companies and transactions and that the expert's rationale for the downward adjustments was insufficient.<sup>22</sup> The court noted that both experts used the same three methods in determining the valuation of the debtor: i) discounted cash flow, ii) comparable company analysis and iii) comparable transaction analysis.<sup>23</sup>

The creditors committee argued that the debtor's expert undervalued the debtor and the plan would result in the prepetition lenders receiving more than full compensation of their claims to the detriment of the unsecured claimants.<sup>24</sup> Also, the creditors committee argued that the most accurate method to determine the valuation of the debtor is carried out via the straight forward application of three standard methods of valuation.<sup>25</sup> In support of its argument, the creditor committee presented the expert testimony of a university professor of finance, who had a background in research in valuing companies.<sup>26</sup> The professor agreed with the creditor committee's argument and stated that while the "inputs" for the methods of valuation may involve some subjectivity the mechanics of calculating the debtor's value based on standard methods should not.<sup>27</sup>

Also, the creditors committee asserted that the professor's research supported its position that the debtor had undervalued the company.<sup>28</sup> The professor in her research compared the value



of chapter 11 debtor companies before plan confirmation, which she calculated via application of the valuation methods to the cash flows in the debtor's disclosure statements, to the market price of the debtor companies after leaving chapter 11.<sup>29</sup>

The professor's research indicated that the cash flows in the debtors' disclosure statement were substantially overvaluing or undervaluing the debtors in some cases.<sup>30</sup> The court noted that Section 1129(b)(2) provides the "absolute priority rule," which allows a plan to be confirmed even if a class of unsecured creditors rejects the plan if the plan does not offer a junior claimant property prior to each unsecured claim receiving full satisfaction of its allowed claims.<sup>31</sup> Further, the court stated that "a corollary of the absolute priority rule is that a senior class cannot receive more than full compensation for its claims."<sup>32</sup>

The experts' valuation based on DCF analysis differed substantially.<sup>33</sup> The debtor's expert calculated value in a range between \$1.023 and \$1.254 billion and the creditor committee's expert calculated value in a range between \$1.583 and \$1.837 billion.<sup>34</sup>

The court rejected the discount rate of the debtor's expert and stated that the expert made "numerous subjective adjustments" to the analysis in determining the discount rate.<sup>35</sup> The court instead relied on the "more straight forward determination" for the discount rate made by the creditor committee's expert.<sup>36</sup>

#### In re Coram Healthcare Corp.

In *In re Coram Healthcare Corp.*, a confirmation hearing took place where the court considered two competing plans of reorganization, one advanced by the trustee and noteholders and the other advanced by the equity holders committee.<sup>37</sup> The equity holders asserted that under the noteholders' plan that the noteholders stood to recover substantially greater than the value of their claims, and thereby resulting in the equity holders recovering substantially less.<sup>38</sup> The equity holders argued that the noteholders' plan violated section 1129(b)(1) of the Code, which requires the plan to be fair and equitable to each class of claims and interests.<sup>39</sup>

The court determined that the valuation asserted by the trustee's experts to be of greater reliability since it relied on "conservative" assumptions and the cash flow projections of the debtor's management.<sup>40</sup> In contrast, the court held that the valuation of the equity's expert was based on an excessive amount of adjustments that were unjustified or unexplained.<sup>41</sup>

The range of valuation between the two competing plans ranged from \$200 million advanced by the trustee's experts and \$279 million advanced by the equity holders committee's expert.<sup>42</sup> The total claims amount of \$243 million meant that the trustee's expert amount of \$200 million if accepted by the court would cause the equity holders to be "out of the money."<sup>43</sup> In contrast, the valuation asserted by the equity holders committee's expert if accepted by the court



would cause equity holders to be “in the money.”<sup>44</sup> After the court resolved the claims amount it made several adjustments to the valuation model.<sup>45</sup> Ultimately, the court determined the valuation to be \$317 million.<sup>46</sup>

#### In re Bush Industries

In *In re Bush Industries*, the bankruptcy court conducted a contested evidentiary hearing to confirm the debtor’s proposed plan of reorganization.<sup>47</sup> Under the proposed plan the equity holders would not receive a distribution.<sup>48</sup> The official committee of equity holders objected to confirmation of the proposed plan by stating that the value in the reorganized debtor was sufficient to justify paying substantial distribution to the equity holders, and thus the plan violated the fair and equitable standard under section 1129(b) of the bankruptcy code.<sup>49</sup>

According to the reports of the debtor’s expert witnesses, the valuation of the debtor was between \$95 million and \$130 million.<sup>50</sup> In contrast, the equity committee’s expert valued the debtor to be \$200 million.<sup>51</sup>

The court opted to weigh the testimony of the expert witnesses rather than hold a Daubert hearing prior to the contested confirmation hearing.<sup>52</sup> The court determined that the differences in the experts’ valuations were mainly due to the varying choices of the multiple in calculating the terminal value of debtor using the DCF method.<sup>53</sup> The expert for the equity committee used a multiple of 9.0, which was obtained directly from its unadjusted analysis; whereas the experts for the debtor made use of a 6.5 multiple.<sup>54</sup> The court ruled that the debtors’ experts’ use of a multiple for calculating the terminal value of the reorganized debtor was justifiable and was in accordance with companies that were sufficiently comparable.<sup>55</sup>

#### In re Chemtura Corp.

In *In re Chemtura Corp.*, the two experts, Lazard and UBS, presented their analysis, to determine the value of Chemtura in chapter 11.<sup>56</sup> Lazard’s valuation of Chemtura ranged between \$1.9 to \$2.2 billion and UBS’ valuation ranged \$2.3 to \$2.6 billion.<sup>57</sup> UBS and Lazard used the three standard valuation methods in determining the debtor’s valuation.<sup>58</sup>

The creditors committee obtained an opinion from a financial advisor that critiqued the valuation analysis of the two valuation experts, Lazard and UBS.<sup>59</sup> The bankruptcy court ultimately agreed with the financial advisor’s opinion.<sup>60</sup> The opinion stated that Chemtura had been trading at a discount compared to its peers before bankruptcy, and thus the valuation should be discounted.<sup>61</sup>

Also, the opinion stated that the debtor’s projections of future cash flows were overstated since the assumptions were not supported by historical evidence.<sup>62</sup> Ultimately, the court



determined that the appropriate valuation would be near the low point of Lazard's valuation range.<sup>63</sup>

In re Mirant Corp.

In *In re Mirant Corp.*, the debtor company was a large merchant energy company that filed for bankruptcy in the Northern District of Texas.<sup>64</sup> In *Mirant*, at the request of equity holders' committee, the court held an evidentiary hearing for determining the valuation of the debtor prior to scheduling the plan confirmation hearing.<sup>65</sup>

The plan as proposed would result in the prepetition equity holders not receiving a distribution and their equity interests being cancelled.<sup>66</sup> The proponents of the plan declined to negotiate a consensual plan and were preparing to cramdown on the existing equity holders.<sup>67</sup>

The equity committee had three expert witnesses, which the court found to be well qualified but their valuation reports were rejected by the court due to their projections on future gas prices being full of mathematical errors and called the reliability of the valuations into question.<sup>68</sup> Despite the reports not being admitted, the court did credit the experts' testimony and agreed with their objections to have the debtor's experts amend their valuation report.<sup>69</sup>

Best Practices & Other Considerations

Best practices for valuation disputes for a court and parties to the bankruptcy case in light of the Daubert decision may include, first, the court conducting the evidentiary hearing well in advance of the confirmation hearing.<sup>70</sup> Second, the court should carefully consider the competing valuation models before deciding whether to borrow certain methods from the various valuation models, and thus ensure that the court does not compromise the structural integrity of the competing valuation models; this can be accomplished by the court instructing the experts to supplement their reports and analysis.<sup>71</sup> Third, the court should realize that a qualified expert's role is to exercise sound judgment, even if subjective, and that such judgment should be permitted if it is relevant, reliable and aids the trier of fact.<sup>72</sup>

In making adjustments and exercising professional judgment, an expert should take care in explaining the data, assumptions and analysis that are the basis for the adjustments and judgment.<sup>73</sup> When an expert makes adjustments that grossly favor a client's position it should be expected that the court will view such expert testimony with skepticism.<sup>74</sup>



Conclusion

In consideration of the Daubert decision and cases of Exide Technologies, Coram Healthcare, Bush Industries, Chemtura Corp. and Mirant Corp. examined in this memorandum, it is imperative that valuation experts thoroughly substantiate the valuations that they determine. Further, given the competing valuations and high stakes in bankruptcy it is crucial that valuation experts ensure that their models are sound and able to withstand rigorous challenges.



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<sup>1</sup> Stan Bernstein, Susan H. Seabury and Jack F. Williams, Admitting Expert Valuation Evidence Before the U.S. Bankruptcy Courts, American Bankruptcy Institute, at 83 (2017).

<sup>2</sup> Id. at 85.

<sup>3</sup> Id.

<sup>4</sup> Id. at 86.

<sup>5</sup> Id. at 87.

<sup>6</sup> Id. at 88.

<sup>7</sup> Id. at 89.

<sup>8</sup> Id. at 97, 98.

<sup>9</sup> Id. at 98.

<sup>10</sup> Id.

<sup>11</sup> Id. at 105.

<sup>12</sup> Id.

<sup>13</sup> Id. at 108.

<sup>14</sup> See Daubert, 509 U.S. at 592 n.10 (S. Ct. 1993)

<sup>15</sup> In re Exide Technologies, 303 B.R. 48, 58 (2003).

<sup>16</sup> Id. at 56-57.

<sup>17</sup> Id. at 56-57.

<sup>18</sup> Id. at 59.

<sup>19</sup> Id.

<sup>20</sup> Id. at 66.

<sup>21</sup> Id. at 66.

<sup>22</sup> Id. at 66.

<sup>23</sup> Id. at 59.

<sup>24</sup> Id. at 61.

<sup>25</sup> Id. at 60.

<sup>26</sup> Id.

<sup>27</sup> Id.

<sup>28</sup> Id.

<sup>29</sup> Id.

<sup>30</sup> Id.

<sup>31</sup> Id. at 61.

<sup>32</sup> Id. In re MCorp Financial, Inc., 137 B.R. 219, 225 (Bankr.S.D.Tex.1992).

<sup>33</sup> In re Exide Technologies, 303 B.R. 48, 63 (2003).

<sup>34</sup> Id.

<sup>35</sup> Id. at 64.

<sup>36</sup> Id. at 64.



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<sup>37</sup> 315 B.R. 321 (Bankr. D. Del. 2004).

<sup>38</sup> 315 B.R. 321 (Bankr. D. Del. 2004).

<sup>39</sup> Id. at 337.

<sup>40</sup> Id. at 340-41.

<sup>41</sup> Id. at 340.

<sup>42</sup> Id. at 338.

<sup>43</sup> Stan Bernstein, Susan H. Seabury and Jack F. Williams, Admitting Expert Valuation Evidence Before the U.S. Bankruptcy Courts, American Bankruptcy Institute, at 155 (2017).

<sup>44</sup> Id.

<sup>45</sup> 315 B.R. 321, 341-43 (Bankr. D. Del. 2004).

<sup>46</sup> Id. at 343.

<sup>47</sup> 315 B.R. 292 (Bankr. W.D.N.Y. 2004).

<sup>48</sup> Id.

<sup>49</sup> Id. at 300.

<sup>50</sup> Id.

<sup>51</sup> Id.

<sup>52</sup> Id.

<sup>53</sup> Id. at 301.

<sup>54</sup> Id. at 300.

<sup>55</sup> Id.

<sup>56</sup> 439 B.R. 561 (Bankr. S.D.N.Y. 2011).

<sup>57</sup> Id. at 573.

<sup>58</sup> Id.

<sup>59</sup> Id.

<sup>60</sup> Id.

<sup>61</sup> Id. at 574.

<sup>62</sup> Id.

<sup>63</sup> Id. at 579.

<sup>64</sup> 334 B.R. 800 (Bank. N.D. Tex. 2005).

<sup>65</sup> Id.

<sup>66</sup> Id.

<sup>67</sup> Id. at 806-07.

<sup>68</sup> Id. at 814.

<sup>69</sup> Id. at 814, n. 40.

<sup>70</sup> Stan Bernstein, Susan H. Seabury and Jack F. Williams, Admitting Expert Valuation Evidence Before the U.S. Bankruptcy Courts, American Bankruptcy Institute, at 160 (2017).

<sup>71</sup> Id.

<sup>72</sup> Id.

<sup>73</sup> Id. at 154.





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<sup>74</sup> Christopher S. Sontchi, Valuation Methodologies: A Judge's View, 20 Am. Bankr. Inst. L. Rev. 1 (2012).

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