# Valuing Companies in Chapter 11

***Courts weigh-in on supportability of assumptions***


## By: Ray Clark, CFA, ASA


## July 2011

Over the last year, there have been a rash of bankruptcy cases and related lawsuits involving challenges to both debtor and creditor financial experts, wherein opposing parties successfully attacked the relevance and reliability of valuation evidence. In a number of cases, even traditional methodologies were disqualified for lack of supportable assumptions, which severely impacted recoveries for various stakeholders.

**Admissibility of Expert Analysis – The *Daubert* Standard**

The *Daubert* standard is a rule of evidence regarding the admissibility of expert witnesses' testimony during United States federal legal proceedings. Pursuant to this standard, a party may raise a *Daubert* motion, which is a special case of motion *in limine* (at the beginning) raised before or during trial to exclude the presentation of unqualified evidence to the jury. Under the *Daubert* standard, the proponent of the expert testimony at issue must establish its admissibility by a preponderance of evidence.[1]

The Supreme Court stated that trial courts are to serve as gatekeepers, which "entails a preliminary assessment of whether the reasoning or methodology underlying the testimony is scientifically valid and of whether that reasoning or methodology properly can be applied to the facts in issue."[2,3] This "gatekeeping" obligation applies to scientific testimony as well as to "testimony based on 'technical' and 'other specialized knowledge.'"[4]

As various courts have explained, Rule 702 (Federal Rules of Evidence) requires a court to make three determinations: (1) whether a witness is qualified as an expert to testify as to a particular matter; (2) whether that opinion is based upon reliable data and methodology; and (3) whether the expert's testimony is relevant.[5]

**Rejection of Unfounded Assumptions – *Kipperman v. Onex Corp.***

The discounted cash flow ("DCF") method, a variation of the income approach, is one of the most commonly used methods for valuing a company in Chapter 11, wherein revenue and cash flow are projected over a specified period of time and then discounted to present day using a risk-adjusted discount rate. In developing the DCF model, analysts sometime use historical average performance as a basis upon which to forecast sales, profit and other key variables. But two associated bankruptcy related lawsuits indicate that using this type of conventional approach simply because it is "commonly" employed will expose the expert and their analysis to rejection by the court.

---

[1] *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 592, n. 10, (1993); *Lippe v. Bairnco, Corp.,* 288 B.R. 678, 685 (S.D.N.Y. 2003).

[2] *Daubert,* 509 U.S. at 592-93; *United States v. Williams*, 506 F.3d 151, 160-61 (2d Cir. 2007).

[3] The Supreme Court lists four factors in *Daubert* that courts should consider when determining whether testimony is reliable: (1) whether the theory or technique can be tested; (2) whether it has been subject to peer review; (3) whether the technique has a known or potential rate of error; and (4) whether the theory has attained general acceptance in the relevant community. 509 U.S. at 593, 113 S.Ct. 2786.

[4] *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137, 141, 119 S. Ct. 1167, 143 L. Ed. 2d 238, (1999).

[5] *See Nimely v. City of New York,* 414 F.3d 381, 396-97 (2d Cir. 2005) (citation omitted); *Schneider v. Fried*, 320 F.3d 396, 404 (3d Cir. 2003)("Rule 702 embodies a trilogy of restrictions on expert testimony: qualification, reliability, and fit." (citing *In re Paoli R.R. Yard PCB Litig. (Paoli, II)*, 35 F.3d 717, 741-3 (3d Cir. 1994), *cert. denied*, 513 U.S. 1190, 115 S. Ct. 1253, 131 L. Ed. 2d 123 (1995))).

In *Kipperman v. Onex Corp*.,[6] the federal district court considered the claims of Richard Kipperman, acting as the trustee of a Litigation Trust arising out of the Magnatrax bankruptcy,[7] that a series of leveraged buyout transactions ("LBOs") engineered by Onex Corp., a private equity firm, involved several transfers by Onex that were "voidable actual or constructive fraudulent conveyances."

A fraudulent transfer claim is made by a creditor who seeks to recover property that was wrongfully transferred by the debtor in an attempt to avoid paying the debt, and is prohibited under federal law as codified in 11 U.S.C. § § 544, 548 and by numerous state statutes. More specifically, the statutes allow a court to set aside a transfer at issue and allow the plaintiff to recover the value of that conveyance. But, in order for a plaintiff to prevail in a constructive fraud claim, it must prove that there was a fraudulent transfer under either section 548 or section 544 and O.C.G.A. §§ 18-2-74(a)(2), 18-2-22(3) by demonstrating that the Company, in this case Maganatrax, (1) received "less than reasonably equivalent value" in consideration for the transfers and (2) was insolvent at the time the transfer was made or was rendered insolvent as a result of the transfer. Accordingly, the case hinges on a valuation/solvency analysis of the LBO transactions.

**The Analysis of Magnatrax**

The trustee hired a business valuation expert, Dennis Logue, Ph.D., who used a DCF approach to determine the fair value of the Company at the various times of the alleged fraudulent transfers. When formulating his DCF analysis, he used debt-free net cash flow as the key metric, and when determining the net cash flow forecast, he had to determine projected sales, profits, changes in working capital and capital expenditures. In each of these areas, Logue rejected management's "nuanced" projections via his analysis of certain industry data and the Company's historical performance, and he replaced them with figures reflecting flat three-year annual averages.

The court found, however, that Logue provided no "scientific or reasoned explanation" or reliable authority in support of key assumptions. "Rather, [the expert] appears to have selected the three-year rate because it produced a revenue growth outcome closest to the…industry numbers." Similarly, the expert used "zone of insolvency" without citation to any authority, legal or financial, and the court dismissed his entire opinion under the *Daubert* standard. The trustee moved for reconsideration—attaching a "supplemental" expert report that cited four treatises supporting the use of three-year historical averages, but the court rejected the effort as barred by discovery rules and *Daubert*.

**Rejecting 'Standard' Methods - *In re* Young Broadcasting, Inc.**

Another recent bankruptcy case demonstrates that a *Daubert* challenge can be leveled against a qualified expert using a "standard" methodology. *In re* Young Broadcasting, Inc., the expert used a method he termed a "levered" discounted cash flow (DCF) approach. According to the expert, the method simply adjusted the typical DCF elements to fit the debtor's reorganization plan. More specifically, he assumed zero projected cash flow until the debtor's proposed sale in 2012, at which point he subtracted net debt and preferred stock (labeling this "terminal value") and applied a discount rate (determined from cost of equity) to reach an equity value. In essence, the expert used "equity" cash flows, as opposed to cash flows available to all providers of capital, i.e., invested capital cash flows, to determine the value of the debtor's equity. Within the business valuation community, this is an acceptable variation of the DCF method and satisfies the four reliability factors as set forth in the Supreme Court's decision in *Daubert*.[8]

---

[6] *Kipperman v. Onex Corp.,* 411 B.R. 805 (Aug. 2009) and *Kipperman v. Onex Corp.*, 2010 WL 761227 (N.D. Ga.)(March 2010).
[7] *In re* Magnatrax Corporation, et al, Debtors, Case No. 03-11402.
[8] *Daubert,* 509 U.S. at 592-93.

However, the federal bankruptcy court found that although the expert may have used traditional terminology, there were "no substantive similarities between the generally accepted DCF method" and his "levered" method. Further, according to the court, the expert made "multiple novel assumptions," such as an assumed sale of the company, and a discount rate that failed to account for both the cost of debt and equity. They indicated that his method may have met the facts of the case, but it failed to match the "intellectual rigor" required of an expert valuation, and the court disqualified the untested approach under *Daubert*.[9] In the final analysis, we believe that the court rejected the methodology because they simply had not seen it before and it was, therefore, considered a non-traditional variation of the otherwise acceptable DCF approach.

**Conclusion**

In the final analysis, these cases demonstrate that despite use of commonly accepted methodologies, the key assumptions upon which analyses are formed must be well reasoned, thoroughly researched and supported with reliable data and reference to authoritative sources so as to not be summarily dismissed by the courts. In the absence of such support, a rigorous critique by aggressive opposing counsel will most assuredly result in disqualification of an expert and his opinion, thereby negatively affecting recoveries for interested stakeholders.

**Restructuring & Valuation Expertise**

During a Chapter 11 proceeding or related preference or fraudulent transfer action, it is often important to assess the value or solvency of an entity and that analysis requires skill and experience. **VALCOR** is uniquely qualified to assist with bankruptcy related valuation and solvency matters and has a considerable track record of analyzing entities experiencing financial distress.

Ray Clark is the Senior Managing Director of **VALCOR Consulting, LLC**, an independent financial advisory that provides corporate restructuring, business valuation and litigation support services to companies and their stakeholders. VALCOR has offices in San Francisco, Los Angeles, Newport Beach, CA and Phoenix, AZ. Ray Clark can be contacted at (949) 644-8022 or by email at Rclark@valcoronline.com.

**Note: VALCOR is not hereby rendering any accounting, legal or tax advice and the reader is encouraged to seek out competent legal and accounting advice when evaluating restructuring options.**

[9] *In re* Young Broadcasting, Inc. (S.D.N.Y., April 19, 2010).