

2017 Mid-Atlantic Bankruptcy Workshop

50 Shades of Valuations

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2017 **ABI** Mid-Atlantic Bankruptcy Workshop

50 Shades of Valuation



Agenda

- Introduction
- Current Valuation Topics
 - Horsehead Holding Corporation
 - Lyondell Chemical Company
 - Issues with Expert Reports
- Audience Q&A



INTRODUCTION



Introduction

Maria Ellena Chavez-Ruark, Saul Ewing, Baltimore, MD

Neil Gupta, SSG Capital Advisors, Philadelphia, PA

Honorable John Sherwood, U.S. Bankruptcy Judge, District of New Jersey, Newark, NJ

Bob Stearn, Richards, Layton & Finger, Wilmington, DE

Anne Eberhardt, Gavin/Solmonese, New York, NY









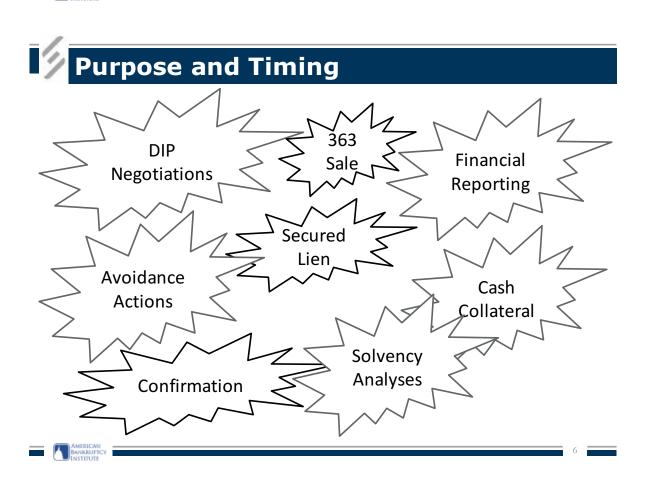
GAVIN/SOLMONESE





The Art and Science of Valuation

- Purpose and Timing
- Approaches and Methods
- Items to be Valued
- Underlying Assumptions





Approaches and Methods

- Income Approach
 - DCF Method
 - Income Capitalization of Earnings Method
- Market Approach
 - Guideline Company Method
 - Transaction Method
- Asset Approach

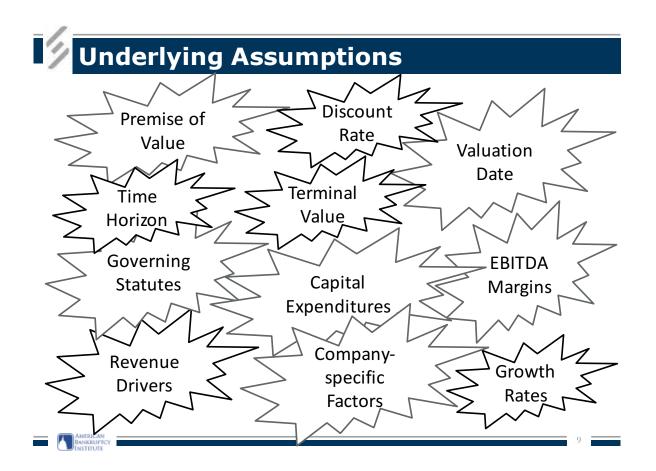




Items to be Valued

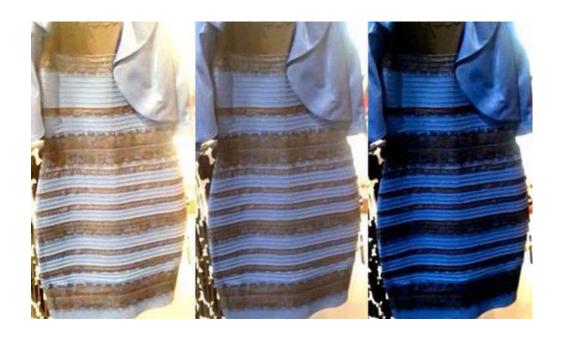
- Companies or Subsidiaries
- Contingent Assets and/or Liabilities
- Receivables
- Complex Financial Instruments
- Commodity Reserves
- Client Lists
- Intellectual Property
- et cetera







Is Valuation a Matter of Perspective?







What Are the Boundaries in Valuation?

- When does "art" become advertising?
- When does "science" become superstition?
- What does it take for a new valuation idea to become widely accepted?





Approaches and Methods





CURRENT **VALUATION TOPICS**

Current Valuation Topics

- Horsehead Holding Corporation
- Lyondell Chemical Company
- Issues with Expert Reports





Current Valuation Topics

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In re: Horsehead Holding Corp., et al.

Case No. 16-10287 (CSS), (Bankr., DE) (C. Sontchi)

Background

- Publicly-traded producer of zinc and nickel-based products throughout the U.S. and Canada
 - Leading recycler of steel industry waste
 - Headquartered in Pittsburgh
 - 150 years+ in the zinc industry
- Precipitous drop in zinc prices, plus constrained liquidity from startup issues at newly constructed zinc processing facility, resulted in default on senior line of credit.
- Filed for bankruptcy protection in Delaware.





Background (cont'd.)

- Reorganization plan negotiated with key constituencies, including a group of hedge funds that acquired controlling interests in secured and unsecured notes.
 - Plan contemplated taking Horsehead private and converting debt to equity, wiping out existing equity.
 - Group of hedge funds served as Plan Sponsor as well as DIP Lender.
 - DIP agreement contained a "no-shop" provision, preventing a formal marketing process.







In re: Horsehead Holding Corp., et al.

Background (cont'd.)

- The Court appointed an Equity Committee:
 - To investigate what happened to the Company's value shortly before and after Petition Date;
 - To determine if public shareholders were unjustly being left with no recovery under the Plan.





Plan of Reorganization

- Plan proposed elimination of \$400 million+ of debt, with Plan Sponsors providing sufficient capital to pay administrative and senior secured claims in full.
- Plan Sponsors committed up to \$100 million additional capital to fund repairs to restart zinc processing facility.
- Senior secured and unsecured noteholders would receive substantially all of the equity in the reorganized entity.
- Plan was overwhelmingly accepted by voting creditors.







In re: Horsehead Holding Corp., et al.

Plan of Reorganization

	Value
Administrative Claims	\$ 55,887,118
Secured Claims (DIP & others)	136,687,407
Secured Noteholders' Claims	222,858,620
Unsecured Claims (includes notes)	32,243,224
Implied Plan Value	447,676,369
UCC Deficiency Claims	193,023,004
Secured Notes Redemption Fee	10,762,500
Equity Hurdle	651,461,873
Additional Capital Commitment	100,000,000
Equity Hurdle & Additional Capital	\$ 751,461,873





Valuation

- Horsehead's Expert Report ~ \$435 million
 - Scenario assumes the company ramps up production at its shut down facility.
 - Valuation is slightly less than the \$448 million implied plan value.
 - Valuation is significantly less than the \$651 million to provide return to equity.
 - Debtors further argue that \$100 million of additional capital commitment should be considered in the overall equity hurdle.



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In re: Horsehead Holding Corp., et al.

Valuation (cont'd.)

- Equity Committee's Expert Report ~ \$843 million
 - The correct hurdle should be \$651 million, i.e., excluding the additional \$100 million capital commitment.
 - The Plan violates the absolute priority rule.
 - As such, its constituency should receive their rightful allocation of estate value.

Given no formal marketing process to dictate value, the Court determined it must rely on expert opinion to establish enterprise value.





Key categories driving most of the valuation differences:

Assumptions	Debtors	Equity Committee	Valuation Impact
Debtors' Valuation:			\$ 435,000,000
Valuation Methodologies	Comps & Do	CF DCF Only	(95,000,000)
Zinc Price Range (per pound)	\$0.80 - \$1.0	00 \$0.94 - \$1.09	205,000,000
Unlevered Beta	1.3	0.99	109,000,000
Terminal Debt / Equity Ratio	30 / 7	70 50 / 50	95,000,000
Perpetuity Growth Rate	2.5	% 3.5%	84,000,000
Other Factors	-	-	10,000,000
Equity Committee Valuation) :		\$ 843,000,000
Equity Hurdle	\$ 751,461,873	\$ 651,461,873	100,000,000



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Current Valuation Topics

- Horsehead Holding Corporation
- Lyondell Chemical Company
- Issues with Expert Reports





567 B.R. 55 (Bankr. SDNY 2017) (J. Glenn)

Background

- December 20, 2007: LBO / merger between Lyondell and Basell, forming LyondellBasell Industries (LBI)
 - Financing \$20.3 billionShareholders \$12.5 billion
- Prior to merger, Basell affiliate Access purchased "toehold position" in Lyondell.
- October 2008:
 - \$300 million draw on Access unsecured credit facility
 - Days later, three transfers repay credit line



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In re: Lyondell Chemical Company

Background (cont'd.)

- January 6, 2009: LBI filed Chapter 11.
- Litigation Trustee sought:
 - \$1.2 billion in payments made to "toehold" stockholders, and
 - \$300 million of credit line repayments.

The Court's Task: Determine solvency as of merger date (**December 2007**) and date of loan repayments to Access (**October 2008**).





Legal Principles of Valuation

- Balance Sheet Insolvency
 - Whether the sum of an entity's debts is greater than all of such entity's property, at a fair valuation.
 - <u>Fair value</u> is determined by the fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts.
 - A combination of valuation methodologies may be employed, but <u>neither cash flow nor the ability to pay</u> current obligations is a factor in determining insolvency under this test.



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In re: Lyondell Chemical Company

Legal Principles of Valuation (cont'd.)

Methods of Valuation include:

- Market Valuation
- Discounted Cash Flow
- Comparable Companies
- Comparable Transactions





Trustee's Arguments for Insolvency

- 1. Payments made to toehold shareholders at the merger are constructively fraudulent transfers, and the loan repayments in October 2008 of \$300 million were preferential transfers.
- 2. Trustee's experts assert pre-merger projections were materially overstated, resulting in a combined company destined to fail. Refreshed projections were improved to achieve a higher purchase price for the stock.
- 3. Trustee highlighted statements and pre-merger concerns that price paid to shareholders was too high and leverage was aggressive.





In re: Lyondell Chemical Company

Court's Analysis

The Trustee failed to prove insolvency on either of the relevant dates

1. Expert Testimony

- Expert relied heavily on proprietary analysis employing "black box" methods to support a conclusion of overstated projections.
- Expert subtracted ~\$500 million from LBI's cash reserves but admitted at trial this was incorrect.
- Expert applied a flat 35% tax rate, but LBI's CFO showed the actual tax rate was much lower.





1. Expert Testimony (cont'd.)

- Expert used projections from December 2008 to determine solvency in October 2008.
- Expert's valuation was inconsistent with the valuation provided to the Creditors' Committee in the same case.
- Expert looked at 31 possible projections but only used 3 of the worst to support conclusions ("cherry picking").







In re: Lyondell Chemical Company

2. Respect for View of Third Party Creditors

- As sophisticated investors and market participants, each of the financing banks was satisfied that LBI would succeed and put millions of dollars at risk. The Court refused to conclude the banks' projections were unreasonable.
- Trustee's experts should have analyzed the banks' models in more detail.
- Made-for-litigation projections should be viewed skeptically. Management projections tested by financing parties are more reliable.





- 3. Unforeseen Events / Market Forces Caused **LBI Downfall**
 - Deadly Crane Collapse
 - Two Destructive Hurricanes
 - Great Recession of 2008





Current Valuation Topics

- Horsehead Holding Corporation
- Lyondell Chemical Company
- Issues with Expert Reports





Daubert Standard

- Courts must play a gate-keeping role with respect to expert testimony under Fed. R. Evid. 702.
 - The expert must be qualified.
 - The methodology used by the expert must be reliable and has been subject to peer review.
 - The opinion must fit the facts of the case at hand, and the data underlying the expert's opinion must pass muster under F.R.E. 104 (the type of data reasonably relied on by experts in the field) and 703.
- Daubert v. Merrell Dow Pharma., Inc., 509 U.S. 579 (1993).



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Issues with Expert Reports

Common Mistake #1: Failing to Include All Required Components in the Report (Fed. R. Civ. P. 26(a)(2)(B))

- Complete statement of all opinions witness will express and basis and reasons for them;
- Facts or data considered by witness;
- Exhibits that will be used to summarize or support witness' opinions;
- Witness' qualifications, including list of all publications authored in previous 10 years;
- List of all other cases in which, during previous 4 years, witness testified as expert; and
- Statement of compensation for testimony and report.





Common Mistake #2: Relying on Opinions or Reports of Others (Fed. R. Evid. 703)

"An expert may base an opinion on facts or data in the case that the expert has been made aware of or personally observed. If experts in the particular field would reasonably rely on those kinds of facts or data in forming an opinion on the subject, they need not be admissible for the opinion to be admitted. But if the facts or data would otherwise be inadmissible, the proponent of the opinion may disclose them to the jury only if their probative value in helping the jury evaluate the opinion substantially outweighs their prejudicial effect."



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Issues with Expert Reports

Common Mistake #3: Failing to Have the Expert Present to Testify

- An expert report is hearsay, i.e., an out of court statement offered to prove the truth of the matter asserted.
- Under Fed. R. Evid. 703, an expert can base his opinion on facts or data not admissible in evidence if the evidence is of a type reasonably relied upon by experts in the particular field in forming opinions.
- Courts routinely admit this sort of evidence, not for the truth of the matter asserted, but to inform the factfinder of the basis of the expert's opinion. See, e.g., In re James Wilson Associates, 965 F.2d 160, 172-73 (7th Cir. 1992).





Common Mistake #4: Being Unable to Defend the Assumptions

- The assumptions are the most critical aspect of the report and the most likely grounds for attack.
- Each assumption must be clearly supported with accepted, authoritative bases.
 - <u>Income approach</u> projections, WACC, and terminal growth rate
 - <u>Market approach</u> selection of comparable companies' transactions, ratios used, and discounts to public company data
 - <u>Cost approach</u> original, depreciated book, replacement, in-use, FMV, and reproduction







Issues with Expert Reports

Common Mistake #5: Failing to Anticipate Attacks by Your Opponent

- Seek to ensure credibility of the report (apply appropriate methodology, support assumptions, test for reasonableness, and apply reality check).
- Anticipate attacks on and weaknesses in assumptions:
 - Disclose assumptions and variables;
 - Disclose valuation framework;
 - Provide alternatives using different assumptions (e.g., ranges); and
 - Proactively address alternative approaches not used or relied upon.





Common Mistake #6: Failing to Anticipate Discovery Obligations

- Draft expert reports are work product and thus NOT discoverable. Fed. R. Civ. P. 26(b)(4)(B).
- Communications between an expert and counsel are not discoverable unless they:
 - relate to the expert's compensation;
 - identify facts or data provided by counsel that the expert considered in forming his opinions; or
 - identify assumptions provided by counsel on which the expert relied in forming his opinion.

Fed. R. Civ. P. 26(b)(4)(C)





Issues with Expert Reports

Common Mistake #6: Failing to Anticipate Discovery Obligations (cont'd.)

- Communications between the expert and the client are NOT given the same protections.
- Generally, an expert's notes are not considered work product (and therefore can be obtained in discovery) because they are facts and data considered by the expert in formulating an opinion. See, e.g., Wenk v. O'Reilly, 2014 U.S. Dist. LEXIS 36735, at *11-12, *18, 2014 WL 1121920 (S.D. Ohio, Mar. 20, 2014); In re Application of the Republic of Equador, 280 F.R.D. 506, 513 (N.D. Cal. 2012).





Practice Tips:

- Review Fed. R. Civ. P. 26(a)(2)(B) with the expert to ensure that all required components are included.
- Make sure you (counsel) understand every aspect of the report, including the methodology and assumptions.
- Use your expert to troubleshoot his report and anticipate attacks, especially with regard to his assumptions.
- Limit written communications between counsel and the expert, and prevent written communications between the client (and other consultants) and the expert.



AUDIENCE Q&A



Today's Panel

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