American Bankruptcy Institute

VALCON 2018

Navigating Issues in Fraudulent Transfers

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2018

VALCON 2018: Cutting-Edge Valuation Solutions

May 16-18, 2018 Four Seasons Hotel Las Vegas • Las Vegas

2:00-3:00 p.m. (1.00 hr.)

Navigating Issues in Fraudulent Transfers

This panel will discuss a number of valuation issues that frequently arise in assessing and litigating fraudulent transfer actions, including (1) valuing contingent assets and liabilities (e.g., environmental liabilities, pending litigation, guarantees, tax attributes, subrogation, contribution and reimbursement claims), (2) avoiding the use of hindsight in assessing solvency and adequate capital, and (3) the use of market-based evidence, including debt and equity trading prices, as well as contemporaneous investments of capital. The panel will also discuss Merit Management Group LP v. FTI Consulting Inc., which is pending before the U.S. Supreme Court, regarding the applicability of the § 546(e) safe-harbor defense.

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Materials

- “How do Market Efficiency and Market Evidence Factor in Valuation Disputes?” PowerPoint
- “Lessons Learned From Real World Litigation: The Role of Hindsight in Valuation in Recent Trials.”
- “Assessing Lehman's Solvency Prior to Its Bankruptcy Filing.” *National Litigation Consultants' Review*, vol. 1, 2015.
- “Letter to the Editor: Key Takeaways from and Updates to the Three Papers.” *Business Valuation Review*, vol. 33, no. 4, 2014.
- "Overview of Fraudulent Transfer Law and the Importance of Valuation." PowerPoint
- “US Supreme Court Limits Securities Safe Harbor Protection From Bankruptcy Clawback Suits .” 1 Mar. 2018.

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How Do Market Efficiency and Market Evidence Factor in Valuation Disputes?

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VALCON
Las Vegas, Nevada
May 2018

Insight in Economics™

Roadmap

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- Market prices versus standard valuation methods in merger appraisal disputes
- What does market efficiency mean for a fair valuation?
- Possible implications for bankruptcy disputes and 363 sales

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Key Takeaways

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- Market efficiency should be considered when evaluating sales processes and transactions.
- Economists have developed tools for analyzing market efficiency, and have applied those tools to other litigation contexts.
- A valuation conclusion reached by using a DCF analysis or the market approach should be consistent with market evidence and if not, the expert should be ready to explain the reasons.
- Economic analysis can provide sophisticated and defensible analyses of market evidence and valuation methodologies.

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Market Prices v. Standard Valuation Methods

Recent Cases in Delaware Court of Chancery

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Case	Did Chancery Court Rely on Deal/Market Price?
AOL (2018)	No
Aruba Networks (2018)	Yes
Dell (2017)	No (Remanded)
DFC (2017)	Yes (Remanded)
Sprint/Clearwire (2017)	No
SWS Group (2017)	No
PetSmart (2017)	Yes
Lender Processing Services (2016)	Yes
Farmers & Merchants Bancorp (2016)	No
ISN Software (2016)	No
BMC Software (2015)	Yes
Ramtron (2015)	Yes
Lynn Cannon, et al. (2015)	No
AutoInfo (2015)	Yes
Ancestry.com (2015)	Yes

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DFC Stock Price History

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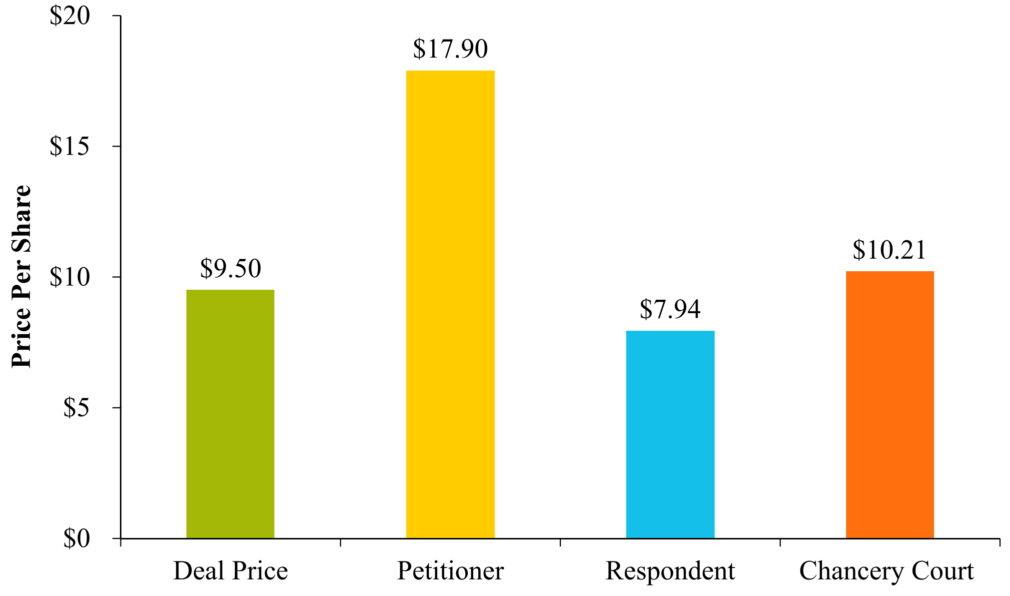
DFC Price Per Share



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Delaware Court of Chancery In re: Appraisal of DFC Global Corp.

- "Although this Court frequently defers to a transaction price that was the product of an arm's-length process and a robust bidding environment, that price is reliable only when the market conditions leading to the transaction are conducive to achieving a fair price."

  – The Honorable Andre G. Bouchard, Chancellor, *In re Appraisal of DFC Glob. Corp.*, (Del. Ch. July 8, 2016)

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Delaware Supreme Court
In re: Appraisal of DFC Global Corp.

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- "Although there is no presumption in favor of the deal price, under the conditions found by the Court of Chancery, economic principles suggest that the best evidence of fair value was the deal price, as it resulted from an open process, informed by robust public information, and easy access to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid."
  - The Honorable Leo E. Strine, Jr., Chief Justice, *DFC Glob. Corp. v. Muirfield Value P'rs, L.P.*, (Del. Aug. 1, 2017)

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Dell Stock Price History

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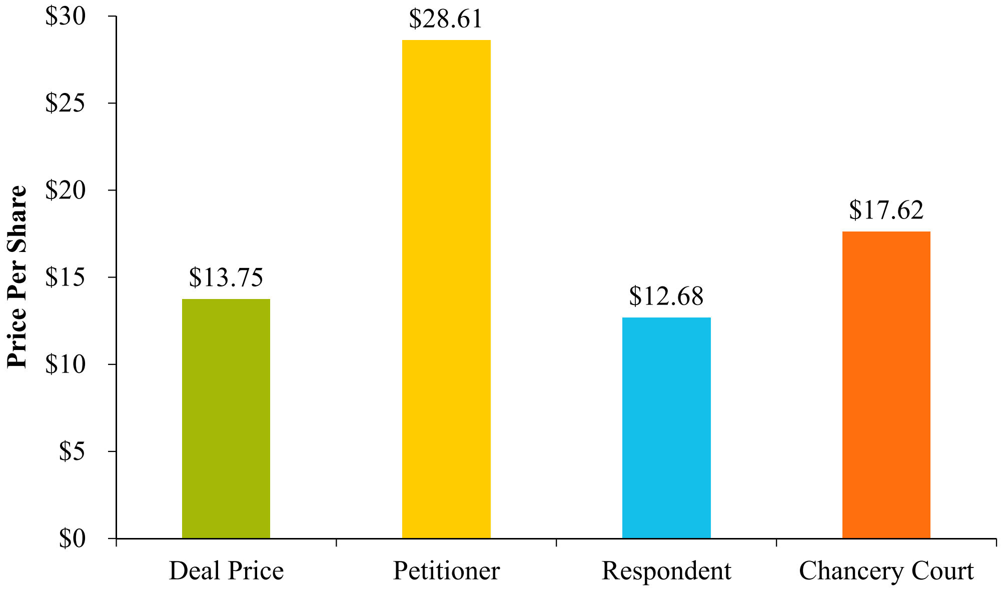
Dell Price Per Share



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Delaware Court of Chancery In re: Appraisal of Dell Inc.

- "The fair value generated by the DCF methodology comports with the evidence regarding the outcome of the sale process. The sale process functioned imperfectly as a price discovery tool, both during the pre-signing and post-signing phases."

- "Because it is impossible to quantify the exact degree of the sale process mispricing, this decision does not give weight to the Final Merger Consideration. It uses the DCF methodology exclusively to derive a fair value of the Company."

  – The Honorable J. Travis Laster, Vice Chancellor, *In re Appraisal of Dell* (Del. Ch. May 31, 2016).

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Supreme Court of Delaware
In re: Appraisal of Dell Inc.

- "[W]e agree with the Company's core premise that, on this particular record, the trial court erred in not assigning any mathematical weight to the deal price. In fact, the record as distilled by the trial court suggests that the deal price deserved heavy, if not dispositive, weight."

  – The Honorable Karen L. Valihura, Justice, *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd* (Del. Dec. 14, 2017).

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Delaware Court of Chancery
In re: Appraisal of AOL Inc.

- Deal price: $50
- Court of Chancery relied on DCF: $48.70
- Rationale: "[T]he sales process was insufficient to this task, and the deal price is not the best evidence of fair value."

  – The Honorable Sam Glasscock III, Vice Chancellor, *In re Appraisal of AOL Inc.*, (Del. Ch. Feb. 23, 2018)

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Dell Compliant Sales Process?

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- Was information sufficiently disseminated to potential bidders?
- Did an informed sale take place?
- Were there undue impediments imposed by the deal structure itself?

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Market Efficiency

Market Efficiency in Economics

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- The theory of efficient markets is concerned with whether prices, at any point in time, fully reflect available information.
  - Strong-form: price fully reflects all public and private information
  - Semi-strong-form: price fully reflects all publicly available information
  - Weak-form: price fully reflects historical prices or returns

Eugene F. Fama, “Efficient Capital Markets: A Review of Theory and Empirical Work,” *Journal of Finance* (May 1970)

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Delaware Court of Chancery Verition v. Aruba Networks, Inc.

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- Deal price: $24.67
- Court of Chancery relied on the 30-day average unaffected market price: $17.13
- Difference between the 30-day average price of $17.13 and the deal price of $24.67 is 31%

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Market Efficiency

- Attributes consistent with efficient markets that the Court of Chancery considered in *Dell*
  - Many stockholders; no controlling stockholder
  - Highly active trading
  - Company information is widely available
  - Share price quickly reacted to news

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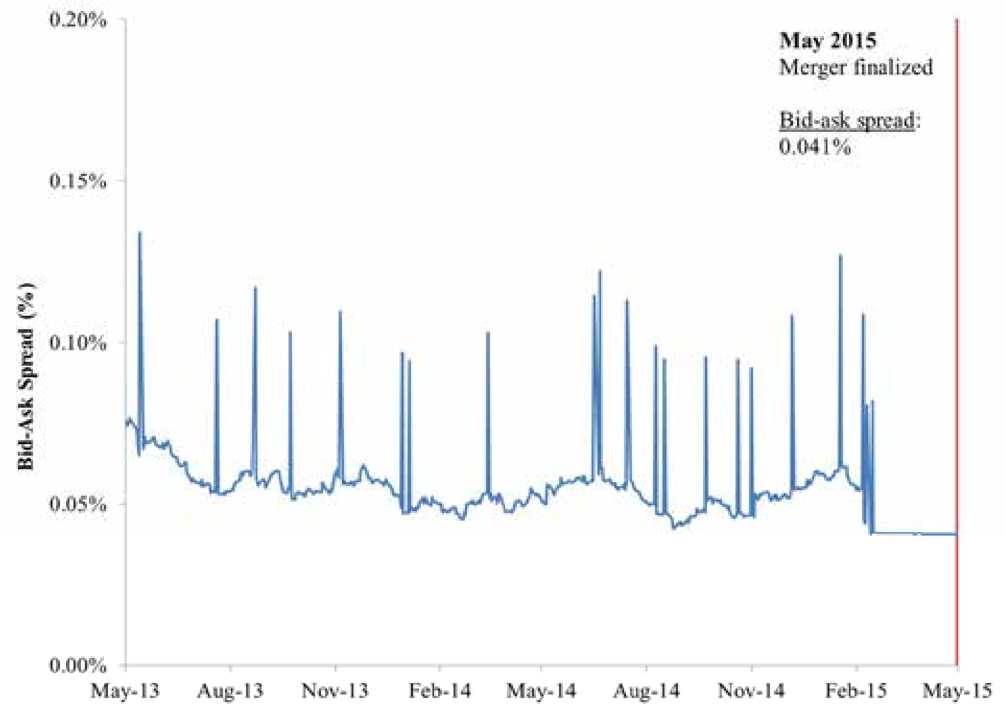
Aruba Bid-Ask Spread History



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Delaware Court of Chancery
Verition v. Aruba Networks, Inc.

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- "The Delaware Supreme Court's recent decisions in DFC and Dell teach that if a company's shares trade in a market having attributes consistent with the assumptions underlying a traditional version of the semi-strong form of the efficient capital markets hypothesis, then the unaffected trading price provides evidence of the fair value of a proportionate interest in the company as a going concern."
  - The Honorable J. Travis Laster, Vice Chancellor, *Verition Partners Master Fund Ltd., et al. v. Aruba Networks, Inc.* (Del. Ch. Feb. 15, 2018).

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Delaware Court of Chancery
Verition v. Aruba Networks, Inc.

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- "In this case, as in *Dell* and *DFC*, no expert offered an opinion, pro or con, on whether the subject company's shares traded in an efficient market. During trial, the parties did not emphasize the attributes of the market for Aruba's common stock."
  - The Honorable J. Travis Laster, Vice Chancellor, *Verition Partners Master Fund Ltd., et al. v. Aruba Networks, Inc.* (Del. Ch. Feb. 15, 2018).

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Possible Implications for Bankruptcy Disputes and 363 Sales

Examples

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1. "In addition to looking at management's projections, courts also look to the views of the market and, in particular, sophisticated investors involved in a transaction."

   – The Honorable Martin Glenn, Judge, *Weisfelner v. Blavatnik (In re Lyondell Chem. Co.)* (Bankr. S.D.N.Y. Apr. 21, 2017)

Examples

2. "But there were two potential computations that might also serve as a 'sanity check' that [the Defendants' expert] did not employ either. One was a DCF analysis of the type [the Plaintiff's expert] employed, even if such a DCF analysis could not by itself support a valuation. Another was Adelphia's Market Cap, which [the Defendants' expert]'s valuation exceeded by approximately 19%."

   – The Honorable Robert E. Gerber, Judge, *Adelphia Recovery Trust v. FPL Group Inc.* (Bankr. S.D.N.Y. May. 4, 2014)

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Additional Market Measures of Solvency

- Trading bond prices
- Access to capital markets
- Ratings
- Credit default swaps
- Others

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LESSONS LEARNED FROM REAL WORLD LITIGATION: THE ROLE OF HINDSIGHT IN VALUATION IN RECENT *TRIALS*

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I. *Weisfelner v. Blavatnik, et al., (In re Lyondell Chemical Co.)*, 567 B.R. 55 (Bankr. S.D.N.Y. 2017) *aff'd* (S.D.N.Y. Jan. 24, 2018).

A. Background:

1. In December 2007, Basell, a Netherlands-based petrochemical company indirectly owned by Access Industries, acquired Lyondell Chemical Company, a U.S.-based chemical company, forming LyondellBasell Industries, or "LBI." LBI struggled in late 2008 as a result of a confluence of events, including two hurricanes, a crane accident at the company's Houston refinery, and the Great Recession, and it filed for bankruptcy in early 2009.

2. A plan-created litigation trustee asserted numerous claims arising out of Basell's acquisition of Lyondell, including constructive fraudulent transfer claims seeking to claw back the billions of dollars that LBI paid to buy out the shareholders of Lyondell.

3. The thrust of these claims was that the financial projections used to support the transaction were massively inflated and that LBI was insolvent and inadequately capitalized at its formation.

4. After a 14-day trial, the Bankruptcy Court rejected all but one of the Trustee's claims, including the constructive fraudulent transfer claim. The court focused its decision on the Trustee's failure to prove that LBI was insolvent or had inadequate capital.

B. Findings relating to hindsight bias:

1. ***Contemporaneous evidence is prime***. The court reaffirmed the importance of beginning the solvency analysis with a review of management's projections. 567 B.R. at 110.

2. ***The focus is not on what ultimately happened***. The court noted that "courts do not focus on what ultimately happened to the company, but will look to whether the company's then-existing cash flow projections (*i.e.*, projected working capital) were reasonable and prudent when made." *Id.*

3. ***Intervening events are evaluated for foreseeability***. The court determined that the fact that "LBI ultimately failed in a colossal manner just one year after the merger does not necessitate a finding that, under the circumstances, LBI was insolvent at the close of the merger, or thereafter." *Id.* at 64. The court pointed to the intervening events that "ravaged" LBI, including the crane accident, hurricanes, and the Great Recession. "Plunging demand and liquidity issues directly related to the recession

were not foreseen by anyone, and indeed, to a large extent, were unforeseeable." *Id.*

II. *Development Specialists, Inc. v. Kaplan (In re Irving Tanning Co.)*, 555 B.R. 70, 76 (Bankr. D. Me. 2016) *aff'd* 574 B.R. 1, 2 (D. Me. 2017) *aff'd* 876 F.3d 384 (1st Cir. 2017).

A. Background:

1. Action brought by plan-created litigation trust to avoid the 2007 acquisition of leather tanning and finishing debtor, Prime Maine, and to recover damages of $23.6 million from Prime Maine's former shareholders under constructive and actual-intent theories of fraudulent transfer. After trial, all of the litigation trust's counts were dismissed.

2. In 2006, the U.S. tanning and finishing industry was already in a state of contraction and Prime Maine had suffered operating losses in fiscal year 2005 and projected losses for fiscal year 2006. Prime Maine understood that its operations were at below break-even and that 2006 net operating cash-flow was positive only as a result of a one-time tax benefit. Moreover, globalization would continue to harm domestic manufacturers.

3. For several months post-closing, Prime Delaware was able to operate and pay its bills, But by January 2008, however, Prime Delaware's accounts were overdrawn and it was in violation of its earnings covenant under its bank facility.

4. By July of 2008, the global recession hit with full force and Prime Delaware was no longer able to pay its bills as they became due. Normal operations ceased. By early 2010, Prime Delaware was seriously insolvent. On December 30, 2010, Prime Delaware filed a voluntary case under chapter 11 of the Bankruptcy Code.

B. Findings relating to hindsight bias:

1. ***Contemporaneous evidence is prime***. The bankruptcy court credited (i) a detailed and extensively researched plan, supported by legal and financial consultants, to merge companies and *to (hopefully) create a profitable business*", (ii) the fact that "considerable due diligence" had been done, and (iii) "that the merger had the *potential* to create efficiencies, expand markets, lessen costs…." 555 B.R. at 82 (emphasis added).

2. ***The focus is not on what ultimately happened***. More critical to the court, was that the parties had "their own motives to ensure that the resulting business, Prime Delaware, was a success" even if such expectations

proved inaccurate in hindsight. *Id.* at 81, n.6. The First Circuit concluded that the Trustee "was not able to *convincingly link* Prime Delaware's inability to pay its bills as they came due in 2009 with the 2007 payments to the Shareholder Defendants." 876 F.3d at 395 (emphasis added).

3. ***Contemporaneous evidence is prime***. The Bankruptcy Court discounted the testimony of the Trustee's lead witness, the debtors' CFO, who testified that he had, "*at the closing*", "concluded that the 'fair valuation' of Prime Maine as of the closing date was zero", noting that the "strength of this testimony was eroded by his concession that he never put the valuation in writing." 555 B.R. at 84. Greater weight was given to contemporaneous audited financial statement and tax returns. *Id.*

4. ***Intervening events are evaluated for foreseeability***. The First Circuit credited defendants' expert witness who opined that "*unforeseeable increases* in chemical and energy prices, along with the financial crisis, significantly contributed to Prime Delaware's insolvency." 876 F.3d at 395 (emphasis added).

III. *Burtch v. Opus LLC (In re Opus East, LLC),* 528 B.R. 30 (Bankr. D. Del. 2015) *aff'd* 2016 WL 1298965 (D. Del. Mar. 1, 2016), *aff'd* 698 F. App'x 711 (3d Cir. 2017).

A. Background:

1. Opus East developed and sold commercial real estate projects and began to struggle during the market collapse of 2008 when it became difficult to find buyers for its developments or obtain financing to complete new projects.

2. Opus East filed for Chapter 7 bankruptcy on July 1, 2009. In 2011, the Trustee commenced an action against Opus Group, seeking to recover certain transfers that it claimed occurred after Opus East's insolvency. On March 23, 2015, following a two-week trial, the Bankruptcy Court ruled in favor of defendants, finding that Opus East was solvent through February 1, 2009.

B. Findings relating to hindsight bias:

1. ***The focus is not on what ultimately happened***. The Third Circuit noted the fact that "Opus East adjusted projections downward as 2007 unfolded, is not dispositive as to whether the projections were reasonable at the time they were made." 698 F. App'x at 717-18.

2. ***Contemporaneous evidence is prime***. The Bankruptcy Court did not err by relying upon the fact that through 2008, Opus East was able to pay

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National Litigation Consultants' Review

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Assessing Lehman's Solvency Prior to its Bankruptcy Filing

By Allen Pfeiffer and Michael Vitti, CFA

Lehman remains the largest American bankruptcy filing in history and demonstrated what could happen when a supposedly "too-big-to-fail" firm…fails. This article provides context for the overall market conditions and the dichotomy of views of Lehman at the time. This context is relevant for assessments of Lehman's solvency prior to its bankruptcy filing.

Shortly after Lehman's bankruptcy filing, the federal government pursued a bevy of bailouts and shotgun mergers to mitigate the effects of the burgeoning credit crisis. Nevertheless, equity indices plummeted. The decline in equity indices, which was not large for a recession prior to Lehman's bankruptcy, reached the lowest depths since the Great Depression shortly after Lehman's collapse.

There are conflicting views of Lehman's financial condition prior to its bankruptcy filing. On the one hand, its highly leveraged business was adversely affected by a "perfect storm" beginning in late 2007. This observation could suggest that Lehman became insolvent several months before its bankruptcy filing on September 15, 2008. On the other hand, Lehman reported all-time high book values of equity and all-time low leverage ratios shortly before its bankruptcy filing. This observation could suggest that Lehman had a relatively strong capital position through the date of its bankruptcy filing.

Lehman's Need to Maintain Market Participants' Confidence

Lehman was highly leveraged. Lehman often had \$30 of liabilities for every \$1 of equity on a "gross" basis.[1] Lehman often had \$16 of liabilities for every \$1 of equity on a "net" basis.[2]

Lehman compounded the risks of high leverage by financing long-term assets with short-term debt. The immediate cause of Lehman's liquidity crisis was

1 The "gross" leverage ratio compares total assets with total equity on a book value basis. Lehman had \$691.1 billion in total assets and \$22.5 billion in total equity as of fiscal year-end 2007. Thus, Lehman's gross leverage ratio was 30.7x (\$691.1/\$22.5=30.7x) at the time.

2 The "net" leverage ratio compares net assets with tangible equity capital on a book value basis. Net assets are lower than total assets because it excludes certain assets. Tangible equity capital was sometimes higher than total equity because it characterized junior subordinated notes as equity. Lehman had \$373.0 billion in net assets and \$23.1 billion in tangible equity capital as of fiscal year-end 2007. Thus, Lehman's net leverage ratio was 16.1x (\$373.0 / \$23.1 = 16.1x) at the time.

Continued on Page 2

Valuation for the Litigation Practitioner

License or Permit Intangible Asset Analyses

By Robert F. Reilly, CPA

Forensic analysts (analysts) are often called on to estimate the value of intangible assets for litigation and other controversy reasons. In addition, analysts may value intangible assets for transaction, taxation, financial accounting, corporate planning, or other reasons. In regard to litigation, analysts are also called on to measure the economic damages to intangible assets related to breach of contract, breach of fiduciary duty, lender liability, bankruptcy, infringement, eminent domain, tortious interference, fraud and misrepresentation, and other claims. Analysts perform such valuation and damages analyses on many different intangible asset categories (or types).

Analysts may apply all generally accepted intangible asset valuation approaches (i.e., Market, Income, and Cost) in the analysis of licenses and permits. This discussion presents an illustrative example of an Income Approach and a Cost Approach analysis of licenses and permits.

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the inability to refinance very short-term repurchase agreements that had to be continually refinanced.

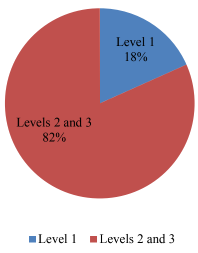
Thus, Lehman was dependent on market participants' confidence. Confidence in Lehman was dependent on (among other things) the perceived reliability of its reported asset valuations. This dependency was due to Lehman's high leverage, which some may say left a molehill-sized amount of equity to support its mountain of assets.

Perhaps nothing demonstrates the notion that a firm's prospects can *quickly* deteriorate than Lehman's rapid demise. Lehman reported record revenues and profits in FY 2007. Nevertheless, Lehman collapsed shortly after it reported its Q3 2008 results as market participants questioned the amount of equity in the business.

Overview of Lehman's Balance Sheet and Fair Value Disclosures

Lehman had a massive balance sheet (over $600 billion in assets) with a significant amount of hard-to-value assets. Lehman needed to value many of these assets on a recurring basis for financial reporting purposes.[3] As shown in Figure 1, the overwhelming majority of these assets were valued through the use of SFAS 157 (now ASC 820) level two and level three inputs.[4] Thus, Lehman personnel used a substantial amount of judgment to value these assets.

Figure 1: Level of Input for Fair Value Assessments[5]



Tension Between Relevance and Reliability

The rapid reporting of Lehman's massive balance sheet[6] demonstrates the tension between two laudable qualities (relevance and reliability) within financial reporting's conceptual framework.[7] On the one hand, it is logical for financial reporting standards to require fair value disclosures. These amounts are clearly more relevant than historical cost-based values. It is also logical for valuations to be disclosed as soon as possible because valuations can quickly become stale. Thus, rapidly reporting the fair value of Lehman's financial inventory was *highly relevant*. On the other hand, *it can be difficult to reliably value* these hard-to-value assets. This is true even if practitioners have 'all of the time in the world' to perform the valuations. It is especially true when the valuations (as they were with Lehman) are finalized shortly after a quarter-end.

Process Used by Lehman to Determine the Fair Value of its Financial Inventory

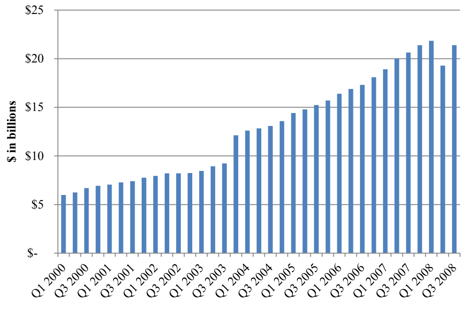
Lehman used a three-step process to arrive at fair value determinations:[8]

1. The Business Desk for each asset-class valued the positions.
2. The Product Control Group reviewed the Business Desk's valuations for reasonableness.
3. Disputes between the Business Desk and Product Control Group were elevated to senior members of the firm.

Book Value of Lehman's Equity

The book value of equity is often relevant for firms such as Lehman because their balance sheet already reflects most of their financial inventory at fair value.[9] Thus, the fair value of equity is typically greater than the book value. (See the price-to-equity multiple discussion below.)

Figure 2: Book Value of Lehman's Common Equity



As shown in Figure 2, Lehman's book value of common equity increased to Q1 2008. The decline in Q2 2008 was the first time Lehman reported a net loss during its 14-year history as a publicly traded company.[10] Lehman's common equity increased during Q3 2008, despite its reporting of another net loss,

3 For example, $249 billion of Lehman's GAAP-based assets as of May 31, 2008, were measured at fair value on a recurring basis. See Lehman's Q2 2008 10Q at [fn: 4] and Examiner Report at 204 [fn: 703]. The Examiner Report is available at http://jenner.com/lehman

4 Level one inputs are quoted prices in active markets for identical assets or liabilities. Level two inputs are observable inputs other than quoted prices in active markets for identical assets or liabilities. Level three inputs are unobservable inputs. [Examiner Report at 203.]

5 Data from Lehman's Q2 2008 Form 10Q, [fn: 4]. The 82% for Levels 2 and 3 was comprised as follows: 65% for level 2 and 17% for level 3 inputs.

6 Lehman reported its financial results within 10 days of its Q2 and Q3 2008 quarter-end dates.

7 Statement of Financial Accounting Concepts No. 2 states, *"[r]elevance* and *reliability* are the two primary qualities that make accounting information useful for decision making...Though, ideally, the choice of an accounting alternative should produce information that is both more reliable and more relevant, it may be necessary to sacrifice some of one quality for a gain in another (emphasis in original)." SFAS No. 2 was superseded (in 2010) with SFAS No. 8, which, among other things, replaced the term *reliability* with *faithful representation*.

8 Examiner Report at 211 ("Across all asset classes, the values Lehman reported were those determined by its business desk, subject to revision pursuant to a price testing process performed by its Product Control Group.") Examiner Report at 241–265 (section titled "Senior Management's Involvement in Valuation.")

9 A large portion of Lehman's assets that were not carried at fair value were low-risk assets (e.g., repurchase and resale agreements) in which book value often approximates fair value.

10 Examiner Report at 10.

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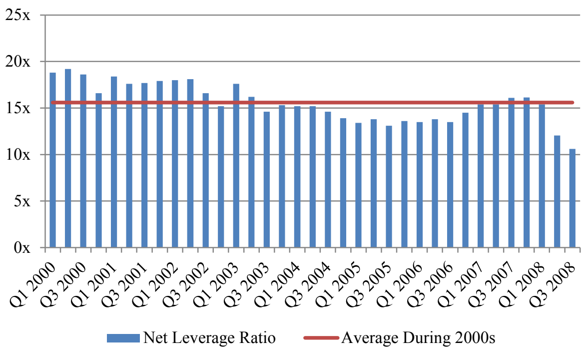
Figure 3: Lehman's Net Leverage Ratio



because it raised new common equity in an amount that exceeded the net loss during the quarter.

Taken at face value, Figure 2 suggests that Lehman was thriving at the end of Q3 2008. Nevertheless, Lehman filed for bankruptcy less than one week after its Q3 2008 financial results were publicly released.

The dichotomy between the trend in Figure 2 and Lehman's swift collapse was predicted by then Treasury Secretary Henry Paulson. Mr. Paulson privately told Lehman's CEO, Richard Fuld, after Lehman reported a net loss in Q2 2008, "If Lehman was forced to report further losses in the third quarter without having a buyer or a definitive survival plan in place, Lehman's existence would be in jeopardy."[11] Lehman reported a net loss in the third quarter, did not have a buyer or definitive survival plan in place, and filed for bankruptcy. Thus, reporting net losses for two quarters in a row may have been more relevant to market participants than Lehman's historically high level of reported equity on a book value-basis.

Lehman's Net Leverage Ratio

As shown in Figure 3, Lehman's net leverage ratio was at a historic low shortly before it filed for bankruptcy. A low leverage ratio, on the surface, suggests Lehman's financial condition was historically strong. Lehman historically targeted a ratio below 20 times (x) in order to maintain its single A credit rating.[12] Reporting low net leverage ratios was important because "Lehman knew it had to report favorable net leverage numbers to maintain its ratings and confidence."[13]

Some of the improvement in Lehman's net leverage ratio was illusory. For example, Lehman's net leverage ratio would have been 13.9x instead of 12.1x at the end of Q2 2008 if the effects of Repo 10 had been removed.[14]

Nevertheless, Lehman's net leverage ratio (even after removing the illusory effect of Repo 105) was below its 20x historical targeted cap, and 15x historical average, in the quarters leading up to its bankruptcy filing. Thus, the trend in Lehman's net leverage ratio also did not indicate that Lehman was on the brink of bankruptcy.

This is a case where absolute analyses are more relevant than relative analyses. Lehman's leverage may have been at historically low levels, but its absolute amount of leverage was still substantial. Lehman had greater than $10 of liabilities for every $1 of equity under the most favorable interpretation of Lehman's leverage (i.e., using the "Net" Method without removing the effects of Repo 105). Thus, there may have been insufficient equity "cushion" for Lehman to absorb incremental losses if market participants believed the reported value of its financial inventory was overstated.

Price-to-Book Equity Multiple

The relevance of Lehman's financial statement depends on the accuracy of the underlying data (e.g., fair value of financial inventory). If the underlying data and other disclosures were reasonable, Lehman's consolidated enterprise was likely solvent and adequately capitalized through August 31, 2008. Lehman's book equity was near all-time highs, its leverage was at all-time lows, and nobody contends that Lehman was insolvent in 2007 or previous years. Alternatively, Lehman may have been insolvent and/or inadequately capitalized before August 31, 2008, if the underlying data and/or other disclosures were unreliable.

There were competing views among contemporaneous market participants and Lehman employees regarding the reasonableness of Lehman's reported valuations of its financial inventory. Many market participants believed the valuations were inflated,[15] whereas many of Lehman's employees believed the valuations were reasonable.[16] Interestingly, some Lehman employees believed the assets were undervalued.[17]

The price-to-book equity multiple is a simple yet powerful way to shed light on this debate. This multiple provides insight into the market's assessment of the reported valuations. Thus, it can be used as Occam's razor, because it often requires relatively few assumptions to interpret its meaning within an order-of-magnitude.

Firms such as Lehman typically trade at a premium to their equity book value because:

1. They report most of their tangible assets at, or near, fair value,[18]
2. A going concern is often worth more than the sum of its tangible parts, and
3. The fair value of intangible assets is typically greater than the book value of these assets.[19]

Lehman's stock historically traded at a premium to its book value. The chart in Figure 4 shows the range of price-to-book equity multiples that Lehman traded at during each fiscal quarter between Q1

11 Ibid.

12 Lehman's 10Q for the period ending May 31, 2001, states, "[c]onsistent with maintaining a single A credit rating, the Company targets a net leverage ratio of under 20.0x."

13 Examiner Report at 5–6.

14 Ibid. at 7. Repo 105 was an accounting device that artificially deflated the size of Lehman's balance sheet, which in turn artificially lowered Lehman's net leverage ratio.

15 For example, the Examiner Report at 206 states, "[a]ccording to the SEC, one of the reasons that the market lost confidence in Lehman was that the market had little confidence in the asset values that Lehman was reporting." Also see the Examiner Report at 241 ("There had been high profile public criticism that Lehman had not properly marked down its asset values [during 2008].")

16 The examiner found that there was insufficient evidence to support the claim that senior management's involvement led to unreasonable valuations, or, in other words, that management drove asset inflation.

17 Certain senior managers were told they would not receive any bonuses in 2008. These senior managers had no incentive "to artificially prop up the values of [their] assets in 2008." Examiner Report at 242 [fn: 850]. Furthermore these senior managers had an incentive to take more markdowns than required during 2008 to set the table for increased profitability (i.e., mark-ups from the artificially low carrying value) in future years when they might receive a bonus. Ibid.

18 Most of Lehman's assets could not experience valuation-related impairments without a corresponding accounting-related impairment. Thus, the book value of equity is often the floor value (on a fair value basis) of equity in firms like Lehman.

19 Most of Lehman's intangible assets were internally generated and thus not recorded on its GAAP-based balance sheet.

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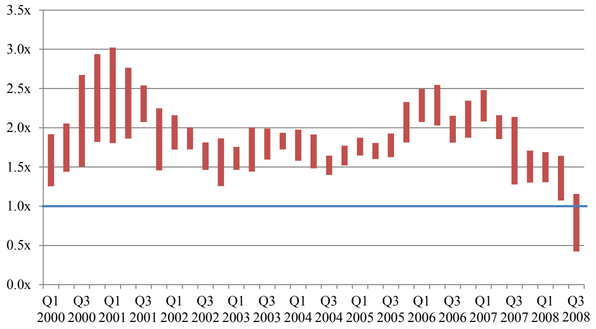
Figure 4: Lehman's Price-to-Book Multiple



2000 and Q3 2008.[20] Lehman's common stock traded at a quarterly range average, between 1.6x and 2.1x book value during this period.

Lehman's price-to-book equity multiple significantly deviated from its historical pattern during Q3 2008. Notably, Lehman's price-to-book equity breached the 1x barrier during this quarter. Lehman's common stock traded at levels during most of Q3 2008 that were less than the value recorded on Lehman's balance sheet as of the end of Q3 2008. This suggests a market perception that the book value of Lehman's financial inventory was inflated, or was not representative of its fair value for other reasons, during Q3 2008 (June 1 thru August 31).

Lehman's low price-to-book equity multiple during Q3 2008 could suggest that Lehman was insolvent at some point during that quarter. However, there is no specific multiple that indicates Lehman was insolvent, because the multiple will always be positive due to limited liability for shareholders.[21] Instead, the examiner focused on a gross approach (enterprise value less debt) instead of a net approach (equity value) when assessing the parent company's solvency. This methodology yields an insolvency determination when the market's valuation of claims on the debtor's assets is low enough.

Interestingly, it is not definitively clear *why* the market's valuation of Lehman's equity during Q3 2008 was significantly less than its book equity even though book equity was based in large part on mark-to-market values. Some practitioners may argue that the market believed Lehman overstated the fair value of its assets.[22] Others may counter that the distressed state of Lehman's business during this time period created an intangible liability. For example, some believe that "the firm as a whole may have been seen as riskier than the sum of its individual assets."[23] The examiner highlighted both possibilities. Regardless of the reason, Lehman was clearly singled out as being worth less than its publicly-traded peers on a price-to-book equity multiple basis during this time period.[24]

20 The data in Figure 1 for Q1 2000 thru Q4 2007 was obtained from Lehman's 10Ks. Data for 2008 was obtained from other sources. The multiples were computed as follows: market capitalization/book value of common equity. Market capitalization is based on the low and high stock price for each fiscal quarter and the number of common shares outstanding for each fiscal quarter. Book value of common equity is based on the average of the amounts as of the first and last day of each fiscal quarter.

21 A negligible value of equity is often referred to as "option value."

22 Supra [fn: 16].

23 Examiner Report at 1575.

24 Ibid.

Transition from Relatively Benign to Great Recession

At this point, it may be helpful to provide additional context for the broader market. Some readers may recall that the syndication markets were "virtually closed"[25] by late 2007 and remained "closed" or "dislocated" throughout 2008.[26] As a result, Lehman's "moving" businesses[27] (i.e., operations that originated positions with the intent to quickly syndicate them) became more like its "storing" businesses (i.e., operations that retained positions for a significant length of time).[28] Lehman personnel called the situation a "perfect storm,"[29] a "market 'implosion,"[30] and a "capital markets meltdown."[31]

Some readers may believe this background shows that Lehman was insolvent by late 2007 or early 2008. By extension, these readers believe the fair value of Lehman's assets was overstated on its financial statements at this time. Simply put, the effect of a "capital markets meltdown" on a highly leveraged balance sheet is often insolvency.

Nevertheless, Lehman reported historically high book values of equity and historically low net leverage ratios at this time. Given this background, some may question why Lehman's common stock traded above book value through Q2 2008 and why Lehman was able to raise new money in the form of common stock at the beginning of Q3 2008.

The contradiction between the narrative (shut down in markets) and contemporaneous leverage ratios (at all-time lows for Lehman) requires an analysis of the overall market performance during this time period. We focus on the Standard & Poor's 500 (S&P 500) and Dow Jones Industrial Average (DJIA) indices because they reflect valuations of equity securities in the broader market and the data is readily available across many decades.[32]

It is self-evident that recessions are generally bad times for the economy. Equity typically declines during a recession.

Some argue the recession that began in December 2007 was worse than the average recession from the beginning. In some ways that is true. The rapid decline in certain residential markets supports this position.

However, the recession that began in December 2007 was not unusual in some respects prior to Lehman's bankruptcy filing on September 15, 2008. The largest decline (start to through) between December 1, 2007, and September 12, 2008,[33] was 17.5 percent for the S&P 500 index and 17.7 percent for the DJIA index.[34] As shown in Figure 5, these amounts were less than the median decline for

25 Ibid. at 224 and 268.

26 This is not hyperbole. We will use the CMBS market to provide context. The quarterly issue of U.S. CMBS fell from over $75 billion in the second quarter of 2007 to approximately $6 billion per quarter during Q1 and Q2 2008 to zero in Q3 and Q4 2008. Examiner Report at 231 [fn: 800].

27 Examiner Report at 266.

28 Ibid. at 266 [fn: 976].

29 Ibid. at 227.

30 Ibid at 372.

31 Ibid at 229.

32 Lehman was in the S&P 500, but not the DJIA, prior to its bankruptcy filing.

33 Lehman filed for bankruptcy on Monday, September 15, 2008. Thus, we used the market index values through the preceding Friday, which was September 12, 2008.

34 Market indices are typically leading indicators that increase prior to the end of a recession. It is for this reason that we focused on the largest decline *during* a recession instead of measuring the change in the indices between the start and end of a recession. We did not use a starting point that preceded the recession under the assumption that any particular data point (e.g., six months prior) may be deemed to be arbitrary and not increase the utility of the analysis.

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Figure 5: Largest Decline in Indices During Recessions (Through Sep. 12, 2008)[35]

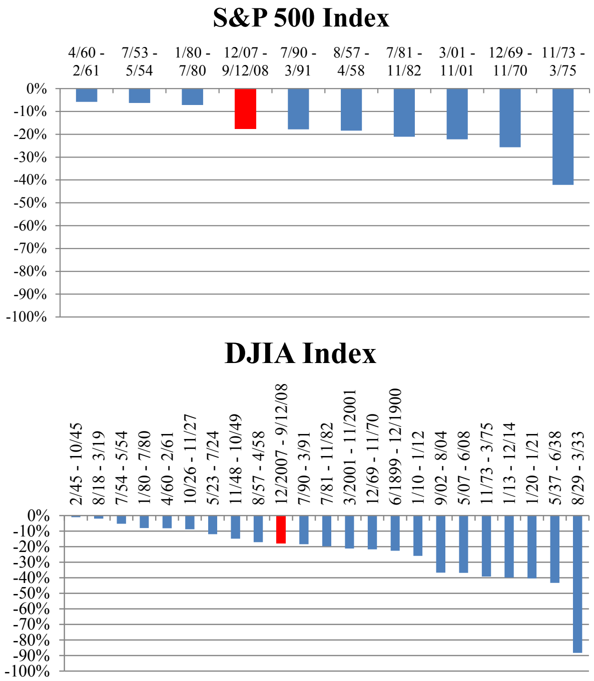
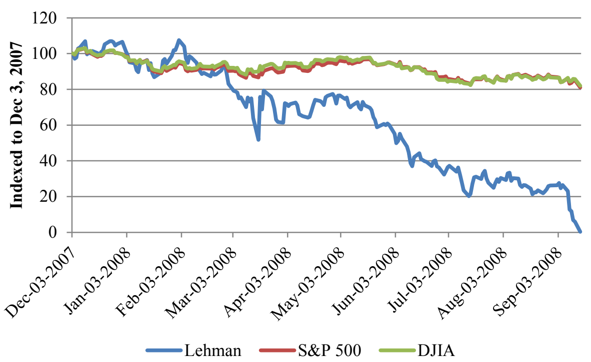


Figure 6: Comparison of Prices from Dec. 3, 2007, through Sep. 12, 2008

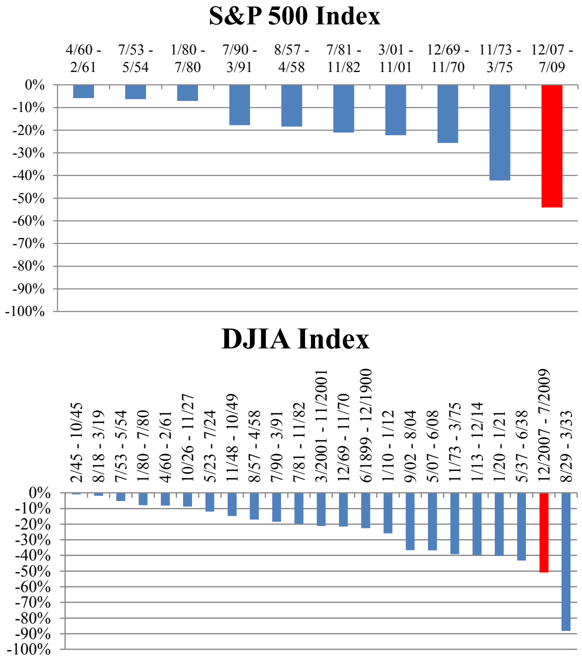


these indices during previous recessions that lasted for, on average, 12 months after WWII.[36] Thus, the effect of the "capital markets meltdown" on market participants' perception of the overall economy was relatively mild when viewed through this prism.

35 These charts contain the largest declines for every recession that occurred during periods when data is available for the S&P 500 or DJIA indices.

36 Dates for recessions were obtained from the National Bureau of Economic Research. The dates were retrieved from: http://www.nber.org/cycles/cyclesmain.html (visited on April 9, 2014). Data for the S&P 500 index goes back to January 3, 1950. Data for the DJIA goes back to May 26, 1896. It is noteworthy that the duration of the recession through September 12, 2008, was approaching the length of the average recession since WWII.

Figure 7: Largest Decline in Indices During Recessions (Through Today)[37]



Lehman was nevertheless a highly leveraged firm that held large positions in assets that became increasingly illiquid. Thus, one might expect Lehman's stock to underperform relative to these indices during this period. As shown in Figure 6, this was in fact the case as Lehman's underperformance began in Q2 2008 (after Bear Stearns' near collapse) and became significantly more pronounced during Q3 2008.[38]

The relatively normal (in this context) recession morphed into the so-called Great Recession *after* Lehman filed for bankruptcy on September 15, 2008. The largest decline (start to through) during the Great Recession (which began in December 2007 and ended in July 2009) in the S&P 500 and DJIA indices exceeded 50 percent. This was the largest decline during a recession in the history of the S&P 500 index (data goes back to 1950) and the second largest in the history of the DJIA index (data goes back to 1896). As shown in Figure 7, the only decline that was greater than the Great Recession occurred during the Great Depression.

Most of the incremental decline that turned the relatively benign recession into the "Great Recession" occurred within a month after Lehman filed for bankruptcy. It was a "tale of two halves," as there was very little net decline during the first two weeks but a dramatic decline in the next two weeks. The lack of a large decline during the first half of the month was presumably due to the assumption that other "too big to fail" firms would not be allowed to fail. The House

37 These charts contain the largest declines for every recession that occurred during periods when data is available for the S&P 500 or DJIA indices.

38 Several market participants shorted Lehman's stock during 2008. Perhaps the most vocal of these market participants was David Einhorn, who publicly questioned the reliability of Lehman's fair value disclosures. Examiner Report at 205.

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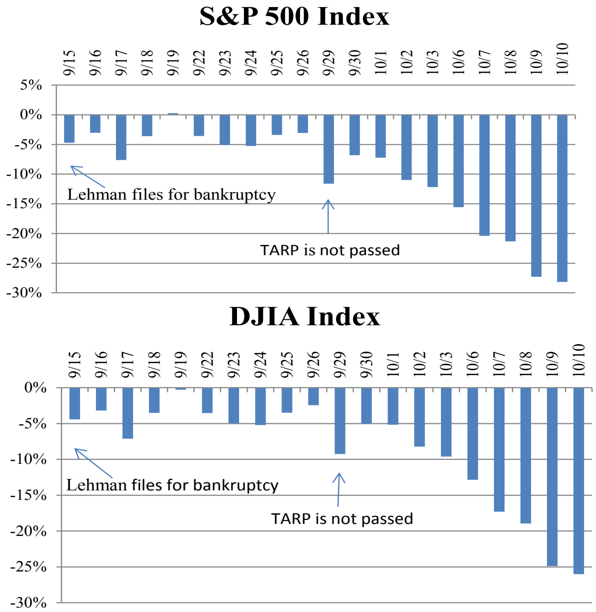
Figure 8: Cumulative Decline Since Sep. 12, 2008



of Representatives' rejection of the proposed $700 billion Troubled Asset Relief Program (TARP) on September 29, 2008, challenged that assumption.[39] As shown in Figure 8, the S&P 500 and DJIA indices declined by over 20 percent during the next two weeks. Some say that Lehman's collapse and its aftermath played a leading role in this massive loss of wealth during such a short time period.

This shows how a "typical" recession (when measured by equity indices) became the so-called "Great Recession" shortly after Lehman filed for bankruptcy. This is important, because it shows that massive deterioration in many asset values across the greater economy did not occur prior to Lehman's bankruptcy filing.[40] This is a relevant context for assessments of Lehman's solvency and the reasonableness of its reported valuations prior to its bankruptcy filing.

Examiner's Conclusions

The examiner concluded there was sufficient evidence to support a finding that the parent company was insolvent beginning two weeks prior to Lehman's bankruptcy filing.[41] The examiner based this on two observations:

1. The haircut, or the difference between market and face value, on the parent company's debt , exceeded the parent company's market capitalization from September 8, 2008 through September 15, 2008.[42] The examiner's approach to solvency was similar to the approach taken by the courts in *Vlasic*, *Iridium*, *TOUSA*, and *Idearc*.[43]
2. The insolvency conclusion could be back solved to September 2, 2008, because that was the date when a potential investor (KDB) privately indicated that it would no longer negotiate with Lehman.[44] The backward projection of the parent company's insolvency from September 8, 2008, to September 2, 2008, was based on the concepts of "retrojection" (a backwards projection) and "current awareness" (a reflection of information that was known but not publicly disclosed).[45]

The examiner further observed that the parent company may have been insolvent before September 2, 2008. This observation was based on similar observations:

1. The haircut on the parent company's debt exceeded the parent company's market capitalization on certain dates in July and August 2008.[46]
2. "… [T]here is sufficient evidence to apply current awareness to the circumstances of Repo 105 and issues of liquidity."[47]

   Thus, it is possible that the parent company was insolvent on other (perhaps all) dates in July and August 2008 and perhaps other dates before July 2008. Nevertheless, the examiner did not resolve this issue due to the inherent difficulties in performing the analysis as the Repo 105 and liquidity issues were never disclosed before Lehman's bankruptcy filing.[48]

[Additional articles relating to Lehman bankruptcy issues will appear in future editions, *Ed.*]

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39 Carl Hulse and David M. Herszenhorn, "House Rejects Bailout Package, 228-205, Stocks Plunge," *The New York Times*, September 29, 2008. The authors reported that "[t]he vote came in stunning defiance of President Bush and congressional leaders of both parties, who said the bailout was needed to prevent a widespread financial collapse."

40 Of course, some asset values deteriorated substantially before Lehman's bankruptcy filing. For example, the residential markets in some locations significantly deteriorated during 2007 and the first half of 2008.

41 Examiner Report at 1573.

42 Ibid at 1584. "Haircut" refers to the difference between the market and face value of these obligations.

43 See Michael Vitti (2013) Grounding Retrospective Solvency Analyses in Contemporaneous Information: Part I. *Business Valuation Review*: Winter 2013, Vol. 32, No. 4, pp. 186-211 for further discussion of this approach to assessing solvency.

44 Examiner Report at 1584 and 1587. Secretary Paulson had told Lehman's CEO that its existence would be in jeopardy if it reported losses during Q3 and did not have a buyer lined up or another survival plan in place.

45 Ibid. at 1583–1587.

46 Ibid. at 1584.

47 Ibid. at 1586.

48 Repo 105 was an accounting device that deflated the size of Lehman's balance sheet and net leverage ratio. Liquidity issues refer to the mischaracterization of Lehman's liquidity pool.

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Letter to the Editor: Key Takeaways from and Updates to the Three Papers

I confronted two problems while writing these papers. First, it is difficult to condense lengthy discussions into simple themes. Second, I became aware of new information after the drafts were submitted (which was several months prior to the publication of each paper). This letter endeavors to address these two problems.

Key Takeaways from Part I

My first paper focused on the debtor's contemporaneous security prices. While the paper took up twenty-six pages in this journal, it could be summarized in just three words: ''the market, stupid.'' This phrase is derived from ''the economy, stupid'' theme from Bill Clinton's presidential campaign during the 1992 election. Courts have consistently focused on the market in the context of retrospective solvency analyses, just as Bill Clinton consistently focused on the economy while campaigning for president in 1992.

Absent proof that the market was misled, courts have consistently deferred to contemporaneous market data in the context of retrospective solvency analyses. Every case discussed in my first paper arrived at determinations that were consistent with contemporaneous market data. This outcome does not appear to be due to selection bias, because ''irrational exuberance'' has never been used to reject contemporaneous market data in the context of a retrospective solvency analysis.[1]

Thus, the reliability of contemporaneous market data typically boils down to arguments over disclosure. These disputes remind me of the 1980s-era Prego® sauce commercials. In these commercials, a person does not believe a good tomato sauce could be found in a grocery store. This person asks if a jar of Prego® sauce contains this ingredient or that ingredient (assuming the ingredients were not included) and is repeatedly told: ''It's in there.'' The skeptic is won over when he (or she) tastes the sauce and confirms that the ingredients were, in fact, all ''in there.''

The plaintiff in these lawsuits is often analogous to the person tasting the sauce (with skepticism over disclosures replacing skepticism over the inclusion of certain ingredients), whereas the defendant is often analogous to the person who says ''it's in there.'' Interestingly, Prego® is owned by Campbell Soup Company (''Campbell''). Campbell was the defendant in *Vlasic* and essentially responded ''it's in there'' every time the plaintiff argued a piece of information was not disclosed and thus not incorporated in contemporaneous market prices. The courts (district and appellate) in *Vlasic* essentially found that the information was, in fact, all ''in there.''

The parties' roles can reverse when contemporaneous market data suggest the debtor was insolvent. For example, the defendant may contend that the market did not fully reflect the value of recent strategic changes to the debtor's business model. The plaintiff in this situation can respond ''it's in there'' by arguing the expected value (i.e., probability-weighted value of potential outcomes) of these strategic changes was incorporated in the contemporaneous value of the debtor's securities.

There may be an exception to the courts' deference to contemporaneous data from reasonably informed markets in the context of retrospective solvency analyses. My second paper contained a discussion regarding *Tronox*, which was decided after the first paper was submitted. The court in *Tronox*, following in the footsteps of the court in *W. R. Grace*, would not defer to contemporaneous market data even if the market was perfectly efficient.[2] The common denominator in *Tronox* and *W. R. Grace* was the presence of sympathetic plaintiffs. Gregory Horowitz predicted, prior to the court's ruling in *Tronox*, that:

> [t]he irrational exuberance argument may be most effectively pressed by ''involuntary creditors,'' such as mass tort claimants who may effectively contend that they did nothing to choose their debtor and should not be made to suffer for the foolhardy optimism of the investing community.[3]

[1]Gregory Horowitz, ''Market Pricing.'' Chap. 4 in *Contested Valuation in Corporate Bankruptcy: A Collier Monograph*. Eds. Robert J. Stark, Howard L. Siefel, and Edward S. Weisfelner, (LexisNexis, 2011), 4–16.

[2]The court stated ''In the *W. R. Grace* case, the fulcrum issue relating to insolvency was the size of its asbestos liability. In the instant case, it is the size of Tronox's environmental liability. *In both cases, the market as a whole, no matter how efficient or inefficient, cannot be relied on to determine solvency or insolvency*. In this case, as further discussed below, there is no substitute for a solvency analysis (emphasis added).'' *Tronox*, 2013 WL 6596696, *42.

[3]Gregory Horowitz, ''Market Pricing.'' Chap. 4 in *Contested Valuation in Corporate Bankruptcy: A Collier Monograph*. Eds. Robert J. Stark, Howard L. Siefel, and Edward S. Weisfelner, (LexisNexis, 2011), 4–17.

The court in *Tronox* did not proclaim that it ignored contemporaneous market data because the plaintiffs were sympathetic. The court instead asserted that the environmental liabilities could not be reliably valued by the market due to insufficient disclosures that are inherent in financial reporting.[4] This is an interesting assertion as the court in *Iridium* deferred to market data for hard-to-value assets (a multibillion-dollar satellite phone system that had not yet activated its system), whereas the court in *Tronox* would ignore market data for hard-to-value (environmental) liabilities.[5] There does not appear to be an economic-related reason for treating debtors with hard-to-value liabilities differently than debtors with hard-to-value assets.

Perhaps a main takeaway from *Tronox* is that a picture is worth a thousand words, but a cartoon is worth more. The fact witnesses employed by the debtor testified that they believed the debtor was solvent. However, a contemporaneous cartoon drawn by an investment banker that depicted a weed (legacy liabilities) choking a flower (the debtor's business) appears to have been given more weight by the court.

Updates to Part I

There were two additional developments after the first paper was submitted that could make the debate over the reliability of contemporaneous market data more interesting going forward. The first was the identification of the recipients for the 2013 Nobel Prize in economics. The second was the Supreme Court's opinion in *Halliburton*.

The 2013 Nobel Prize in economics was awarded to economists on opposite ends of the spectrum regarding market efficiency. Eugene Fama is the founder of the efficient market hypothesis. Robert Shiller is a leading critic of that hypothesis. The fact that both economists won the award may suggest that there is still room to debate the efficacy of the efficient market hypothesis.[6]

There is clearly some dispute among economists and business valuation practitioners over the efficacy of the efficient market hypothesis. The hypothesis can be difficult to defend because it relies on the actions of people who are insane according to believers in the hypothesis.[7] That is, the hypothesis is dependent on the actions of active investors who seek to profit from long positions on ''undervalued'' securities and/or short positions on ''overvalued'' securities. However, according to the hypothesis, these active investors are doomed to fail because they incur costs that exceed the benefits from their actions. Passive investors are the ''winners'' because they benefit from the active investors' actions by getting to trade in efficient markets. The hypothesis is a paradox because its efficacy can *increase* when more people *disagree* with it. The hypothesis is built on the assumption that nonbelievers will *try*, but *fail*, in their attempt to beat the market. Thus, believers in the hypothesis *require* the existence of nonbelievers.

The paradox that is the debate over the efficient market hypothesis reminds me of the classic *Saturday Night Live* skit about the recording of ''Don't Fear the Reaper.'' In the skit, the band keeps stopping midrecording because one member (played by Will Ferrell) annoyingly plays a cowbell, which distracts the other band members. The producer (played by Christopher Walken) enters the recording studio to find out why the band won't finish the recording. The band members tell the producer they stopped because the cowbell was distracting. Any viewer would agree that the cowbell was distracting. However, to their surprise, the producer tells the band members that he wants Ferrell to become even more distracting, as he states: ''I got a fever, and the only prescription is more cowbell!'' The band members relent because the producer was very successful,[8] whereas the band had not recorded any hits up until that point. This skit is similar to debates over the efficient market hypothesis because believers should ironically want to encourage the distracting arguments from nonbelievers. Thus, the believers should want ''more cowbell.'' Of course, a nonbeliever is not swayed by this circular reasoning.

Halliburton[9] was an attempt by the defendant in a shareholder lawsuit to overturn *Basic*. The Supreme Court in *Basic* allowed individual shareholders to be certified as a class in so-called ''fraud-on-the-market'' cases under the premise (based on the efficient market hypothesis) that all of these shareholders were affected by the alleged misinformation. The defendant in *Halliburton* argued that the efficient market theory has ''lost its luster,'' which takes away the basis for certifying shareholders as a class. The Supreme Court in *Hallibur-*

[4]The court also found that the market for the debtor's securities in this particular instance was not aware of material information.

[5]This is an oversimplification, as the court in *Iridium* found that the plaintiff did not carry its burden of proof. Thus, it is possible that a different argument sponsored by the plaintiff could have, in theory, convinced the court that the market was ''wrong.''

[6]For example, an article in *The New York Times* stated ''[y]et in jointly honoring the work of Mr. Fama and Mr. Shiller, the committee also highlighted how far the economics profession remains from agreeing on the answer to a basic and consequential question: How do markets work?'' Binyamin Appelbaum, ''Economists Clash on Theory, but Will Still Share the Nobel,'' *The New York Times*, October 14, 2013.

[7]A definition of insanity that is often attributed to Albert Einstein is ''doing the same thing over and over again and expecting different results.''

[8]He was, after all, ''*The* Bruce Dickinson.'' He may put his pants on one leg at a time like everyone else, but he made gold records after his pants were on. (One has to be familiar with the skit to appreciate this reference.)

[9]This is a recently decided case that does not yet have a case caption.

ton ultimately made a small modification to *Basic* but allowed the main precedent to remain in force.[10]

Halliburton was a unanimous decision in judgment (presumably due to the narrow opinion), but the justices did not share the same views regarding the efficient market hypothesis. More specifically, three of the justices believed *Basic* ''should be overruled,'' in part because the efficient market hypothesis ''has garnered substantial criticism since *Basic*.'' Interestingly, one of the justices who sponsored this opinion wrote the dissent in *Till* ten years ago.[11] The dissent in *Till* would defer to the prepetition terms of a used car loan given to a subprime borrower in the context of a cramdown loan based on an argument that the market for prepetition used truck loans to subprime borrowers was reasonably efficient. It seems hard to reconcile a view that the market for loans to subprime used car borrowers *is* reasonably efficient, yet the market for shares that trade on a large stock exchange *is not* reasonably efficient. There were other issues that affected the matters in *Halliburton* and *Till*, so practitioners should consider that context when assessing specific statements regarding market efficiency in these (and other) matters.

Many advocates for the belief that the efficient market hypothesis has not been proven, or has ''lost its luster,'' would point to Warren Buffet's sustained success in picking stocks. However, that argument is perhaps best rebutted by…Buffet himself. Buffet may believe that he can identify ''mispriced'' securities, but he also believes that his previous success is extremely difficult to replicate. Thus, Buffet appears to be generally supportive of the efficient market hypothesis because he believes it is nearly impossible to consistently beat the market on a risk-adjusted and cost-adjusted basis.[12] Buffet stated in his most recent letter to Berkshire Hathaway shareholders:

> …the ''know-nothing'' investor who both diversifies and *keeps his cost minimal* is virtually certain to get satisfactory results. Indeed, the unsophisticated investor who is realistic about his shortcomings is likely to obtain better long-term results than the knowledgeable professional who is blind to even a single weakness…
>
> My money, I should add, is where my mouth is: What I advise here is essentially identical to certain instructions I've laid out in my will…My advice to the trustee could not be more simple: Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors—whether pension funds, institutions, or individuals—who employ high-fee managers (emphasis in original).[13]

To the extent there is a legitimate debate over the efficacy of the semistrong form of the efficient market hypothesis, practitioners should recognize that the criticism should only go so far. This observation is particularly relevant in retrospective solvency matters due to the binary (pass/fail) nature of the financial tests. There may very well be a legitimate debate over the valuation of shares in a company within an order magnitude (say between $45 and $50 per share). However, it is much more difficult to credibly argue a stock that traded at $50 per share was really only worth a few dollars (option value) per share due solely to a ''mispricing'' of the stock.

Key Takeaways from Part II

My second paper was an extension of the first paper as they both focused on contemporaneous indicators of a debtor's solvency or insolvency. My first paper focused on security prices, whereas the second paper focused on other indicators.

Some practitioners have argued that the cases mentioned in the first paper only focus on security prices. That is not a fair argument as these cases focused on other contemporaneous indicators too. Schwartz and Bryan published an article in *The Business Lawyer* that demonstrated the variety of contemporaneous solvency indicators that were not based on security prices. My second paper builds on their observations by focusing on other indicators of solvency (e.g., fairness and solvency opinions) and indicators of insolvency (such as those that were found in *TOUSA* and *ASARCO*).

Schwartz and Bryan proposed a new motion requirement for many valuation-related cases. They propose that valuation-related testimony should not *automatically* be accepted by courts. Some may find it interesting that this proposal, which was made by lawyers, is based on the belief that the best way to adjudicate matters centered on business valuation is to increase the role of lawyers and reduce the role of valuation-related testifying experts. I am not a lawyer and have no opinion on this proposed requirement.

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[10]The defendant can now introduce evidence prior to class certification to rebut the presumption that the asserted misrepresentation affected the stock price.

[11]The time period is relevant because some of the studies cited in *Halliburton* regarding criticism of the efficient market hypothesis were published prior to the date of the opinion in *Till*.

[12]Any assessment of a stock picker's performance must take into account relative risk (to control for differences in the trade-off between risk and return) and costs (to account for the fact that a stock picker wins the battle but loses the war if he or she generates excess returns that are exceeded by the costs incurred to generate them).

[13]Available at http://www.berkshirehathaway.com/letters/2013ltr.pdf (accessed July 21, 2014).

However, I worked with Schwartz and Bryan on the *Vlasic* matter and consulted with them on their article and appreciate why they made their proposal. Their reaction to the way some of these cases are tried reminds me of a recurring skit on *Saturday Night Live* during the ''Weekend Update'' segment. This skit focused on a statement (or action) that was made (or taken) during the week that was so contrary to common sense that the statement (or action) could be rebutted (or ridiculed) with a one word response: ''Really!?!?''

In the *Vlasic* matter, the plaintiff focused on an alleged lack of disclosure. However, the debtor's chief executive officer (CEO) wrote a letter to his shareholders about a year after the transfer date that essentially said, ''If we knew then what we know now (i.e., the information that was allegedly not disclosed), the debtor's stock price would be lower but the debtor would still be solvent by a comfortable margin.'' Overall market conditions deteriorated between the transfer date and the date of this letter. Shortly after this letter was written, the debtor raised a substantial amount of new debt that was unsecured, subordinated, and not convertible into equity. The debtor's stock traded at prices that suggested the debtor was solvent at this time. Notwithstanding this fact pattern, the plaintiff sponsored testifying experts who opined that the debtor was insolvent on the transfer date. The defendant's rebuttal of these testifying experts could be summarized in one word: ''Really!?!?!?''

Some attorneys are sympathetic with the views espoused by Schwartz and Bryan to an extent but do not believe that their proposed motion requirement should be enacted. The second paper contained a discussion related to the views proffered by Stark, Williams, and Maxwell. Unfortunately, in an oversight on my part, I was not aware of another rebuttal that was published at the time.[14] Gregory Horowitz agrees with Schwartz and Bryan on the ''primacy of market evidence,'' but he differs with them in the sense that he believes market evidence should be interpreted by testifying experts. Horowitz explains that insolvent firms can have positive market capitalizations, and solvent firms can have debt that trades at a discount to par. The economic-related views espoused by Horowitz are generally consistent with the views contained in my first paper. My first paper provided some guidance related to finding information in the fact record to address these issues. I defer to the legal profession as to whether that information *always* needs to be interpreted by testifying experts.

[14]Gregory Horowitz, ''A Further Comment on the Complexities of Market Evidence in Valuation Litigation,'' *The Business Lawyer* 69 (2013):1071.

Interestingly, there should be no need, in theory, to enact a new motion requirement in order to accomplish Schwartz's and Bryan's objectives. This observation is based on:

> [t]he often-inconvenient reality of facts; the requirement that lawyers may only advance arguments where there is a colorable good-faith basis; and the (too often overlooked) ethical obligation that experts testifying under oath must present only opinions that they sincerely and objectively hold.[15]

Many of the issues that are addressed in this debate can be addressed with a common sense solution. Practitioners should not sponsor an opinion that can be effectively rebutted with one word: ''Really!?!?!?''

Key Takeaways from Part III

My third paper is independent of the first two papers. While my first two papers focused on the role of contemporaneous indicators of solvency or insolvency, my third paper focused on the nuts and bolts of the three financial tests. A few themes were developed in this paper.

First, the standard of value can be very relevant, and the precedent may be a bit confusing. Case law consistently refers to a hypothetical sale standard, but some cases (e.g., *Vlasic*) recognize that a willing seller would not consent to a value-destroying sale. Our profession tends to get bogged down in the weeds when we argue that this synergy should be considered in the valuation, while that synergy should not. I propose a simple question to address these issues: What would rational business managers do? If it is rational for the debtor to not sell, then assume the business would remain in the hands of the current owners. If it is rational for a synergistic buyer to ''overpay'' for the debtor's business, then assume the synergistic buyer will do so. Simply put, our valuations should conform to what was reasonably expected to happen in the real world.

Second, the key disputes among the parties are often binary. One side will often argue that the contemporaneous projections were reasonable, while the other side will say they were not reasonable. Similarly, one side will often argue that there are guideline companies that are reasonably similar to the debtor, whereas the other side will disagree. These are fundamental debates that result in a wide chasm of valuations sponsored by the parties. It is perhaps for this reason that courts have often placed more emphasis on contemporaneous indicators of solvency or insolvency when this type of evidence is available.

[15]*Ibid.* at 1079.

Third, courts and practitioners often urge against the use of hindsight, yet they frequently use it anyway. Hindsight can be confusing, as one party may argue that it ''confirms'' what was knowable on the transfer date, while the other party can respond that it does not. Two rules should be followed regarding hindsight. First, if hindsight is to be used, *all* of it should be considered. One side should not ''cherry pick'' certain information while the other side ''cherry-pit picks'' other information. Second, some hindsight is much more relevant than other hindsight. *Vlasic* is an example where a specific piece of hindsight (i.e., the subsequent sale of unsecured, subordinated bonds) was used to compellingly demonstrate the ''line in the sand'' that a backwards projection (retrojection) of the debtor's subsequent bankruptcy filing could not cross.

Fourth, the adequate capital test may become increasingly important, yet its application can be confusing. There is no formal definition of this test or what is required to pass it, which is why this test has been called ''fuzzy.'' Some may say that the practical definition for this test is similar to Justice Potter Stewart's definition of hardcore pornography: ''I know it when I see it.'' This paper explores some of the themes developed in case law and proposes some additional concepts that may be applicable in future matters.

Update to Part III

An interesting case (*Adelphia*)[16] was published after this paper was submitted. This case is related to the buyback of approximately $150 million of stock in a large cable company. The plaintiff sought to claw back the proceeds by arguing that it was a fraudulent conveyance.

Adelphia is interesting because there was a large fraud at the debtor, but the fraud had not yet reached its massive proportions (which ultimately led to its bankruptcy filing) as of the transfer date. Thus, it was possible that the fraudulent activity was not large enough to render the debtor insolvent on the transfer date.

Adelphia is unusual for two reasons. First, there was a relatively ''blank slate,'' as the fraudulent activity rendered contemporaneous indicators of solvency unreliable. Second, the testifying experts chose to paint on different canvases: The plaintiff's expert relied solely on the discounted cash flow (DCF) method, whereas the defendant's expert relied only on the guideline company and guideline transaction methods. This resulted in a true ''battle of the approaches,'' as there was no overlap.

[16]In re Adelphia Communications Corp., No. 02-41729 (REG) (Bankr. S.D.N.Y. May 6, 2014).

There was no valuation approach that was unaffected by the fraudulent activity. The plaintiff's expert had to develop his own projections in order to execute the DCF method because the contemporaneous projections were unreliable. The defendant's expert had to rely on historical financial information that was affected by the fraud in order to execute the guideline company and guideline transaction methods.

The court found the defendant's testifying expert's methodology and assumptions to be more reliable than the plaintiff's testifying expert's methodology and assumptions. The debtor's industry appears to have played an important role in this dispute, as cable companies are often valued based on a multiple of subscribers. The court found that the debtor's ''count of the number of its subscribers was one of the most accurate of its financial data.'' Thus, the defendant's testifying expert's application of the guideline company and guideline transaction methods was deemed to be more reliable than the plaintiff's testifying expert's application of the DCF method, which was based on projections prepared in connection with the litigation.

The debate over the capital adequacy test centered primarily on the debtor's ability to meet its capital needs.

The plaintiff argued that the debtor could not meet its capital needs due to the cascading effect of too much debt, which would lead to covenant defaults, which in turn would lead to the inability to sell assets. To the extent that the debtor would somehow still have access to capital after taking into account these factors, the plaintiff argued that the debtor's access would be ''cut off'' after the ''fraud at the [debtor] became known to investors.''

The defendant countered that the debtor (and a guideline company) proved that it could access the capital markets notwithstanding high leverage ratios, the debt covenants did not prohibit the debtor from selling assets to deleverage, and other debtors have been able to raise additional capital after disclosures of a fraud.[17]

The court found that the plaintiff ''failed to meet its burden in proving that capital markets would be closed to [the debtor] if [the debtor's] fraud, which was in its infancy [on the transfer date], was disclosed.'' The court found the defendant's testifying expert's analysis of other debtors that raised capital after disclosures of a fraud to be the ''most persuasive aspect of [the defendant's] position.''

[17]The defendant's testifying expert opined that the debtor could still borrow, but the cost would increase by approximately 100 basis points. This conclusion was based on ''an empirical study on access to capital markets after disclosure of fraud,'' which included ''five large companies that had disclosed fraudulent activities (Cendant, Waste Management, Rite-Aid, Enron, and WorldCom).''

The third paper may be independent from the first two papers, but the underlying issues within the three papers should be synthesized because the financial tests are not executed in a vacuum. Courts will often find the conclusion from the DCF method (comparable company method) to be more credible when it is reliably buttressed with a conclusion from the comparable company method (DCF method) too. Similarly, courts will often find a testifying expert's conclusions to be more credible when they are consistent with the contemporaneous indicators of solvency and/or insolvency.

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VALCON 2018: CUTTING-EDGE VALUATION SOLUTIONS

OVERVIEW OF FRAUDULENT TRANSFER LAW AND THE IMPORTANCE OF VALUATION

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1

Overview

- Signs of Fraud
- Overview of Types of Fraud
- Actual Fraud
- Constructive Fraud
- Valuation Issues
  - Reasonably Equivalent Value
  - Determining Solvency
  - Unreasonably Small Capital
  - Determining Value
- Section 546(e) Defense/*Merit Management*
- The Importance of Valuation in Fraudulent Transfer Litigation
- Takeaways

2

Signs of Fraud

- Inconsistent financial statements, books and records;
- Large swings in accounts receivable, inventory and/or accounts payable;
- Over advances of debt;
- Non-recorded liens;
- Complex financial structures coupled with significant inter-company transfers;
- Financial statements prepared by small or unknown auditors;
- Opaque and non-responses to inquiries concerning hard data on assets and liabilities; and
- Unrealistic guaranteed returns.

3

Signs of Fraud

- Pre-billing or fraudulent invoicing of account – recognition of false income;
- Fraudulent inventory purchases – false inflation of assets on the balance sheet;
- Ponzi Schemes – payment of returns to previous investors from later-acquired funds;
- Diversion of assets – illegal transfer of assets; and
- Misstated financial records – falsification of records concerning financial health.

4

Overview of Fraudulent Transfer Laws

- Protects creditors from unfair transactions that hamper their efforts to collect from the debtor;
- Deters a creditor from taking assets for little or no consideration;
- Permits a debtor to set aside and recover a transfer that places the debtor's property out of the reach of creditors;
- Preserves assets of the estate for all creditors.

5

Overview of Fraudulent Transfer Laws

- Fraud is perpetrated on public and private entities owned by business owners, insiders, financial officers and subsequent transferees.
- Types of fraud:
  - Actual
  - constructive
- To bring either type of fraud claim, the debtor must have had an interest in the property that was transferred.
  - "interest" tracks section 541's definition of property of the estate, <u>French v. Liebmann (In re Betty I. French)</u>, 440 F.3d 145 (4^{th} Cir. 2006)
- <u>Constructive Fraud</u> (Fraud in Law)
  - Does **not** require actual fraudulent intent.
  - Did the debtor receive "**reasonably equivalent value**" for selling its assets at a time when it was insolvent.

6

Overview of Fraudulent Transfer Laws

- The Bankruptcy Code -- 11 U.S.C. §§ 544, 548, 550
  - Section 548 of the Code:
    - Automatic standing of the Trustee/Debtor,
    - Can avoid fraudulent transfers made within 2 years of filing bankruptcy (used to be only 1 year).
  - Section 544(b) of the Code:
    - Allows Trustee/Debtor to bring state law fraudulent transfer claims,
    - Trustee/debtor must be able to point to creditor of the debtor in existence at the commencement of the case who can avoid the transfer or obligation under applicable state law. In re Image Worldwide, Ltd., 139 F.3d 574, 576-77 (7th Cir. 1998); see also Official Comm. of Asbestos Claimants of G-I Holding, Inc. v. Heyman, 277 B.R. 20, 29 (S.D.N.Y. 2002).
    - Allows for longer lookback period (often 4-6 years).
  - With one limited exception, Trustee/Debtor has two years after filing of the bankruptcy case to bring suit. 11 U.S.C. § 546(a)(1).
- State Law – Uniform Fraudulent Conveyance Act (UFCA); Uniform Fraudulent Transfer Act (UFTA).
  - Creditors have standing outside of bankruptcy to file fraudulent transfer actions under state law.

7

Overview of Fraudulent Transfer Law-General Pleading Requirements

- Complaint must:
  - allege the date(s) and amount of each transfer, Angell v. Ber Care et. al (In re Caremerica, Inc.), 409 B.R. 737 (Bankr. E.D.N.C) (dismissing complaint with leave to amend because the complaint failed to allege the dates and amount of each transfer);
  - state a claim that is "plausible on its face", Bell Atlantic v. Twombly, 550 U.S. 544 (2007) ("threadbare recitals" of a cause of action's elements supported by mere conclusory statements is insufficient to survive a motion to dismiss for failure to state a claim);
  - factual content of complaint must allow court to draw the reasonable inference that defendant is liable for misconduct alleged Ashcroft v. Iqbal, 556 U.S. 662 (2009).
    - In the ITT bankruptcy (Case No. 16-07207, pending in the U.S. Bankruptcy Court, Southern District of Indiana), the Defendant argued that the Debtor had received equivalent value for the challenged transactions and transfers because the transactions essentially amounted to a 12 year loan with a less than a 4% annual interest rate which was not an unrealistic rate of interest and constituted an exchange of reasonably equivalent value and; therefore, the Court could not draw the necessary inferences. The case settled prior to the court making a final determination on a motion to dismiss.

8

Actual Fraud

- Actual Fraud (Fraud in Fact)
  - Requires **actual fraudulent intent** in transferring assets to a third party.
  - E.g., transferring assets to your **brother-in-law** for no consideration.
  - E.g., transferring assets to a purported **"bankruptcy remote" corporation** for no value as part of pre-bankruptcy "planning" for a corporation.
- To determine whether actual intent exists, courts use "badges of fraud". Common examples include:
  - lack or inadequacy of consideration;
  - The family, friendship or close associate relationship between the parties;
  - The retention or possession, benefit or use of the property in question;
  - The financial condition of the party sought to be charged before and after the transaction in question;
  - The existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or singular threat of suits by creditors; and
  - The general chronology of the events and transactions under inquiry.

  Max Sugarman Funeral Homes, Inc. v. A.D.D. Investors, 926 F.2d 1248 (1st Cir. 1991).

9

Constructive Fraud

- Section 548(a)(1)(B)
  - Trustee may avoid any transfer of an interest of debtor in property or any obligation incurred that was made or incurred within 2 years before the date of bankruptcy filing if the debtor voluntarily or involuntarily:
    - Received less than "**reasonably equivalent value**" in exchange for the transfer or obligation AND
      - Was **insolvent** when the transfer was made or obligation was incurred (or became insolvent as a result);
      - Was engaged in a business or transaction for which any property remaining was **unreasonably small capital**;
      - Intended to incur, or believed the debtor would incur, debts **beyond its ability to pay** as the debts matured; OR
      - Made the transfer to or for the benefit of an **insider**, or incurred the obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

10

Valuation Issues
Reasonably Equivalent Value

- **Reasonably Equivalent Value**
  - *What constitutes reasonably equivalent value?*
    - No precise formula. In re Wise, 119 B.R. 392, 394 (E.D.N.Y. 1990).
    - Question of fact. In re Adler, Coleman Clearing Corp., 263 B.R. 406, 466 (S.D.N.Y. 2001).
    - More than the mere consideration required to support a contract. In re Joy Tech. Corp., 286 B.R. 54, 75 (Bankr. N.D. Ill. 2002).
    - "Considerable latitude" given to bankruptcy court in determining reasonably equivalent value.
    - Depends on all the circumstances surrounding the transaction.
    - Do not need a dollar-for-dollar equivalent.
    - Factors: While no exact mathematical formula exists, courts will look at:
      - The market value of the asset;
      - Whether the value of asset transferred is equal/substantially equal to value of what was received;
      - Whether the sale was an arm's length transaction between a willing buyer and a willing seller;
      - Good faith of transferee.

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Valuation Issues
Reasonably Equivalent Value

- *When is reasonably equivalent value measured?*
  - At the time of the transfer. In re Chomakos, 69 F.3d 769, 771 (6th Cir. 1995).
  - "Courts will not look with hindsight at a transaction because such an approach could transform fraudulent conveyance law into an insurance policy for creditors."
  - If no evidence available, courts will look to evidence before and/or after transfer.

12

Valuation Issues
Reasonably Equivalent Value

- **One of 4 Other Factors Is Required in Addition to Lack of Reasonably Equivalent Value:**
  - The debtor was insolvent or rendered insolvent by the transfer;
  - The transfer left the debtor with unreasonably small capital;
  - The debtor intended or believed that it would incur debts that it could not pay when those debts matured; OR
  - The debtor made the transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.
    - An "insider" of a corporate debtor includes (i) a director; (ii) an officer; (iii) a person in control; (iv) a partnership in which the debtor is a GP; (v) a GP of the debtor; or (vi) a relative of a general partner, director, officer or person in control.
- Must be demonstrated by preponderance of the evidence.
- Practical Application: Constructive fraud is easier to establish than actual fraud. It is easier to establish insolvency and less than reasonably equivalent value than it is to prove actual intent to hinder, delay or defraud creditors.

13

Valuation Issues
Determining Solvency

- **Insolvency**
  - *What is insolvency?*
    - A debtor is insolvent if the "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. § 101(32)(A).
    - The valuation is exclusive of (i) property transferred, concealed or removed with intent to hinder, delay or defraud creditors and (ii) certain exempt property under section 522 of the Bankruptcy Code.
    - Often described as a "balance sheet" test (although in practice it will be often be more involved than a review of a GAAP balance sheet).
    - Contingent assets and liabilities should be included in review.
  - *When is insolvency measured?*
    - Split of authority exists:
      - Insolvency required on date of transfer.
      - Insolvency may be shown proximately before or immediately after the time of the transfer. In re Sullivan, 161 B.R. 776, 783 (Bankr. N.D. Tex. 1993) (insolvency established by showing debtor was insolvent six months before and after transfer); see also In re Join-In Int'l., 56 B.R. 555, 560) (Bankr. S.D. N.Y. 1986) (same); Inland Security Co., Inc. v. Estate of Kirshner, 382 F. Supp. 338, 346 (W.D. Mo. 1974) ("the alleged lack of direct proof of insolvency [on the date of the transfer] is adequately counterbalanced by the totality of the evidence, of the bankrupt's financial condition during the year [in which the transfer took place]").

14

Valuation Issues
Unreasonably Small Capital

– *What does it mean to be left with unreasonably small capital?*

- In the Third Circuit, the Court reiterated in Whyte v. SemGroup Litigation Trust (In re SemCrude LP), No. 14-4356, 2016 U.S. App. LEXIS 7690 (3d Cir. Apr. 28, 2016), that the test for unreasonably small capital is "when it is reasonably foreseeable that [a company] will fail, but at the same time takes into account that 'businesses fail for all sorts of reasons, and that fraudulent [conveyance] laws are not a panacea for all such failures." Id. (quoting Moody v. Sec. Pac. Bus. Credit Inc., 971 F.2d 1056, 1071 (3d Cir. 1992)).
  - Takeaway—it is not a foregone conclusion that just because a business fails, the capitalization is unreasonably small.
- Different interpretations exist.
  - Transaction must put debtor "on the road to ruin." In re Joy Recovery Tech. Corp., 286 B.R. 54, 76 (Bankr. N.D. Ill. 2002).
  - Focus on debtor's ability "to generate sufficient cash flow from operations and the sale of assets to pay its debts and remain financially stable." In re C.F. Foods, L.P., 280 B.R. 103, 116 (Bankr. E.D. Pa. 2002).
  - Encompasses financial difficulties that are short of equitable insolvency (e.g., inability to pay debts as they become due) or bankruptcy insolvency but are likely to lead to some type of insolvency eventually. In re O'Day Corp., 126 B.R. 370, 407 (Bankr. D. Mass. 1991).

15

Valuation Issues
Determining Value

- The valuation standard is not defined in the Code.
- Common Standards of Value include:
  - Fair market/arm's length standard,
  - Fair value as defined by statute or case law in a particular jurisdiction,
  - Fair value under GAAP principals,
  - Investment value.
- The value and type of methodology used further depends on the type of asset and whether the asset(s) are a going concern or the assets will be liquidated.
- Timing – in fraudulent transfer actions, the value is usually determined as of the date of the transfer.

16

Valuation Issues
Determining Value

- Approaches for Determining Value
  - Market Approach
    - Comparable Companies – look value of comparable public company,
    - Comparable Transactions - look at value of similar transactions.
  - Discounted Cash Flow Analysis – calculating current value of company using projected cash flows adjusted for the time value of money.
  - Cost Approach – using cumulative value of assets based on replacement costs of each asset (adjusted for utility and age).

17

Valuation Issues
Determining Value

- *What is the market approach?* It looks at the value of comparable public companies or looks at the value of similar private transactions.
  - In re VFB LLC v. Campbell Soup Co., 482 F.3d 624 (3d Cir. 2007) – "[a]bsent some reason to distrust it, the market price is a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses."
  - In re American Home Mortgage Holdings, No. 09-4295 2011 WL 522945(3d Cir. 2011) – Market price is usually used to determine asset value if the market was functioning properly. If the market was dysfunctional, the court noted that discounted cash flow was a commercially reasonable determinant of value.

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Valuation Issues
Determining Value

- *What is the Discounted Cash Flow ("DCF") approach?* It calculates the current value of company using projected cash flows adjusted for the time value of money.
  - Nellson Nutraceutical, 356 B.R. 364 (Bankr. D. Del. 2006) – court noted that expert testimony calculating "value" solely using the projected EBITDA was acceptable when calculating the DCF.
- **Trend**: While DCF used to be more popular valuation method, the trend is towards using market evidence because market evidence eliminates some biases, including hindsight bias.

19

Valuation Issues
Determining Value

- *What is the Cost Approach?* Value is calculated by using the cumulative value of assets based on replacement costs of each asset (adjusted for utility and age).
  - Mishkin v. Ensminger (In re Adler Coleman Clearing Corp.), 247 B.R. 51, 111 (Bankr. S.D.N.Y 1999) – method usually only used when liquidation value of assets is greater than going concern value, essentially used at the point where the company is on its "deathbed".
  - This is the least used approach.

20

Section 546(e) As A Defense to A Fraudulent Transfer

1. 11 U.S.C. § 546(e) - Notwithstanding sections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in section 101, 741, or 761 of this title, or settlement payment, as defined in section 101 or 741 of this title, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in section 741(7), commodity contract, as defined in section 761(4), or forward contract, that is made before the commencement of the case, except under section 548(a)(1)(A) of this title.

  - <u>Recent case</u>*:* <u>Merit Management Group, LP v. FTI Consulting, Inc.</u>, 138 S. Ct. 883 (2018) – Supreme Court resolved circuit split providing, in effect, that funds flowing through a bank did not, itself, convert transfer into a protected transfer. Safe harbor only applies if the transferor or transferee was an entity protected under section 546(e)--using a protected entity as a intermediary is not sufficient to invoke the protections of the statute.
    - Takeaway: Section 546(e) has a more limited use in light of the Supreme Court decision.

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The Importance of Valuation in Fraudulent Transfer Litigation

The main elements of a constructive fraudulent transfer (the most common type of fraudulent transfer) emphasize the importance of valuation.

(1) Carefully document the value/consideration to be given:

- Include recitals regarding consideration given for the transfer,
- Cite to appraisals and other beneficial financial documentation.
  - When management's projections over the business are part of a valuation, strongly consider obtaining an **independent review** of those projections.
- Require the transferor to include express representations regarding its solvency.
  - <u>Ex.</u> Solvency Certificate/Opinion,
  - <u>Ex.</u> Supporting Projections stating party's ability to pay debts as they mature.

(2) Advise clients to use common sense when documenting the transaction and valuation:

- Consider impact of future discovery,
- Documents/correspondence – particularly e-mail -- may be used to demonstrate the transferee's intent, knowledge, belief, and good faith at the time of the transaction.
  - While it is natural for executives to gloat about buying a business at a discount, be aware of the implications of putting those thoughts in any kind of writing.

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The Importance of Valuation in Fraudulent Transfer Litigation

(3) Sale of an asset using 11 U.S.C. section 363 - allows a bankruptcy debtor or trustee to sell property of the bankruptcy estate free and clear of any liens, claims and interests in such property.

- Hard to attack the valuation of the asset because the entire sale process is scrutinized by the Bankruptcy Court.
- Avoids the risk of the transaction being characterized as a fraudulent transfer or a preference.
- Minimizes the risk of successor liability.
- The buyer has a convenient and accessible forum to enforce it's rights (i.e., the Bankruptcy Court).

Takeaways—Valuation in Fraudulent Transfer Actions

- Deal at arm's length –properly document any transfer and take all appropriate steps to complete it;
- Ensure adequate consideration – consider requesting an appraisal as evidence of market value;
- Rely on professional advice – consult with attorneys and accountants prior to buying assets;
- If an offer seems too good to be true, do your due diligence and keep your documentation, In re Dreier LLP, 462 B.R. 474, 492 (Bankr. S.D.N.Y. 2011) (allegation that terms of investment were "too good to be true" precluded finding that transferee gave fair consideration as a matter of law);
- Consider including releases in purchase documents;
- Consider using a section 363 sale process where the bankruptcy court will oversee the sale and enter an order approving the sale, making it harder to attack in the future.

Schulte Roth & Zabel

Alert

US Supreme Court Limits Securities Safe Harbor Protection From Bankruptcy Clawback Suits

March 1, 2018

The securities safe harbor protection of Bankruptcy Code ("Code") § 546(e) does not protect allegedly fraudulent "transfers in which financial institutions served as mere conduits," held the U.S. Supreme Court on Feb. 27, 2018. *Merit Management Group LP v. FTI Consulting Inc.*, 2018 WL 1054879, *7 (2018). Affirming the Seventh Circuit's reinstatement of the bankruptcy trustee's complaint alleging the insolvent debtor's overpayment for a stock interest, the Court found the payment not covered by §546(e) and thus recoverable. The district court had dismissed the trustee's claim. See *FTI Consulting Inc. v. Merit Management Group LP*, 830 F.3d 690 (7th Cir. 2016), *reversing* 541 B.R. 850 (N.D. Ill. 2015).

Code § 546(e) provides a defense to constructive fraudulent transfer and preference claims arising out of securities transactions. Defendants often assert the defense when bankruptcy trustees seek to recover pre-bankruptcy payments by a corporation to its shareholders in a leveraged buyout. The defense requires, among other things, that the payment be made "by or to (or for the benefit of)" certain qualified transferees, including a "financial institution." Because security trades are commonly settled through financial institutions, most appellate courts had found the presence of a financial institution, even if it had no beneficial interest in the underlying transaction, to be sufficient to meet the Code's requirement that the transfer be "made by or to" a financial institution.

Relevance

The Court had granted certiorari in *FTI* to "resolve a conflict among the Circuit Courts as to the proper application of the § 546(e) safe harbor." 2018 WL 1054879 at *7. Appellate courts had generally agreed on the vitality and breadth of the safe harbor defense contained in § 546(e). It insulates from the trustee's fraudulent transfer or preference attack a "settlement payment," "margin payment" or transfer related to a "securities contract . . . made by or to (or for the benefit of)" certain protected parties, including "financial institutions," except when the debtor makes the payment with "actual intent to hinder, delay or defraud" creditors under Code § 548(a)(1)(A). As the Seventh Circuit noted below, neither the debtor nor the debtor transferee in *FTI* had been "parties in the securities industry," but were simply corporations that wanted to exchange money for privately held stock. 830 F.3d at 696.

The Seventh Circuit in *FTI* had refused to "interpret the safe harbor so expansively that it covers any transaction involving securities that uses a financial institution . . . as a conduit for funds." 830 F.3d at 697, agreeing with *In re Munford Inc.*, 98 F.3d 604, 610 (11th Cir. 1996) (2-1) (Code § 546(e) inapplicable to payments made by debtor to shareholders when financial institutions acted as mere conduits). As the Seventh Circuit stressed, Congress never said "that acting as a conduit for a transaction between non-named entities is enough to qualify for the safe harbor . . . ." 830 F.3d at 697. The Seventh Circuit, of course, recognized that it was "taking a different position from the one adopted by five of our sister circuits, which have interpreted § 546(e) to include the conduit situation." *Id*.

Facts
"Buyer" (the debtor here) agreed to buy all of the shares of an entity known as B from certain entities, including "Seller," a 30 percent shareholder of B, for a total of $55 million, borrowing the funds from a group of lenders, with the transfer of the funds flowing through "Bank." Thus, Buyer and Seller were corporate entities "that wanted to exchange money for privately held stock." *Id*. at 696.

After Buyer later filed a Chapter 11 petition, its litigation trustee sued Seller under Code § 548 and applicable state law to recover $16.5 million, representing Seller's 30 percent equity interest paid by Buyer to Seller. Seller argued that the transfer was "made by or to (or for the benefit of)" an entity named in Code § 546(e), namely, a "financial institution" (i.e., Bank), and was, therefore, protected by the safe harbor. Because the funds passed through Bank, the district court dismissed the trustee's complaint, agreeing with Seller that the transfer had passed through a financial institution. Seller "did not rely on its own status, because neither Buyer nor Seller contended that either [of them] is a 'financial institution' or other covered entity . . ." 2018 WL at *12. Rather, Seller argued that the safe harbor applied because "the component parts [of the stock sale] include transactions by and to financial institutions." *Id*., at *7.

Analysis
The Supreme Court examined "the language of § 546(e), the specific context in which that language is used, and [its] broader statutory structure . . ." *Id.*, at *8. In its view, "the relevant transfer . . . is the overarching transfer that the trustee seeks to avoid under one of the [Code's] substantive avoidance provisions". Here, "the only relevant transfer for . . . the safe harbor inquiry is the overarching transfer between [Buyer] and [Seller] of $16.5 million for purchase of the stock [—] the transfer that the trustee seeks to avoid . . . . [T]hat transfer was not made by, to, or for the benefit of a financial institution." *Id*. at *7.

Statutory Language
First, said the Court, the "text reminds us that the focus of the inquiry is the transfer that the trustee seeks to avoid." *Id*. at *8. Because Code § 548 refers to the avoidance of transfers to or for the benefit of entities subject to fraudulent transfer liability, "Congress signaled that the [§ 546(e)] exception applies to the [challenged] overarching transfer . . ., not any component part of that transfer." *Id*. Thus, the "safe harbor provides that 'the trustee may not avoid' certain transfers." *Id*., at *9. The "trustee may not avoid . . . a transfer that *is*," said the Court, "either a 'settlement payment' or made 'in connection with a securities contract'." *Id*. According to the Court, § 546(e) applies only to a transfer that is a covered "securities transaction"; "Not a transfer that involves. Not a transfer that comprises." *Id*. The "otherwise avoidable transfer [must] itself be a transfer that meets the safe-harbor criteria." *Id*.

Statutory Structure
A trustee asserting an avoiding power (e.g., preference, fraudulent transfer) must identify the challenged transfer. But the defendant "is free to argue that the trustee failed to properly identify an avoidable transfer under the Code, including any available arguments concerning the role of component parts of the transfer." *Id*., at *10. If the trustee does properly identify an avoidable transfer, though, the court may not "examine the relevance of component parts," which "are simply irrelevant to the analysis under § 546(e)." *Id*. Here, Seller argued that the district court could not "ignore" the intermediate Bank "component parts" of Buyer's payment. *Id*.

The Supreme Court rejected Seller's argument "that a transaction 'by or to' a financial institution such as [Bank] would meet the requirements of § 546(e) [when] the financial institution is acting as an intermediary without a beneficial interest in the transfer." *Id*., at *10. In its view, neither the "Code or legislative history" shows "that Congress sought to abrogate [the Eleventh Circuit's] *Munford*" decision. *Id*.

More important, said the Court, if the challenged transfer "was made 'by' or 'to' a securities clearing agency . . ., then § 546(e) *will* bar avoidance . . . without regard to whether the entity acted only as an intermediary . . . [Also] [t]he safe harbor will . . . bar avoidance if the transfer was made 'for the benefit of' that securities clearing agency, even if it was not made 'by' or to that entity." *Id*., at *11 (emphasis added). But the Court did not address "the impact, if any, [Code] § 101(22)(A) would have in the application of the § 546(e) safe harbor," for neither party claimed to be a "financial institution" due to its "customer" status. *Id*., at *5n.2.

Legislative Purpose

The Court finally rejected Seller's reliance on Congress' "purpose in enacting the safe harbor." *Id*., at *12. Declining to address the argument, the Court explained that Seller had, in any event, "failed to support" its argument which "the plain language of the safe harbor" contradicts. *Id*. Although the safe harbor insulates certain securities transactions "made by or to (or for the benefit of)" covered entities, transfers *through* a covered entity "appear nowhere in the statute" (emphasis added). *Id*.

Comment

FTI confirms that, on certain facts, entities defending fraudulent transfer claims will not be able to rely on the § 546(e) securities safe harbor defense solely because of the flow of funds through a "financial institution" intermediary. These defendants will still be able to argue that the § 546(e) safe harbor applies because of their own status as a "financial institution," "financial participant" or other protected entity, which will leave the safe harbor defense available to many large or active players in the financial markets. *FTI* also expressly leaves open the possibility that any "customer" of a "financial institution" is also a "financial institution" for purposes of the § 546(e) safe harbor.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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