Valuation Standards and Their Application and Relevance in the Courts

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Presentation Overview

- Panel Introduction
- Introduction to Valuation Standards and Their Application in Court Decisions
- From the Valuer’s Perspective, the BIG Issues in Court
- Case Studies
- Closing Observations and Issues Facing the Valuation Profession
- Case Law Addendum
- Standards Article Addendum

Issues Recognized in Distressed Business Valuation Compared To Traditional Business Valuation

– Excessive or changing leverage effects on risk adjusted returns

– Significant changes to business strategy affecting profitability and cash flows

– Liquidity constraints to implement business strategy

– Greater probability of not achieving operating and financial plans (risk of turnaround)

[Source: Pages 9 and 10 of Standards for Distressed Business Valuation]

Issues Recognized in Distressed Business Valuation Compared To Traditional Business Valuation

- Forecasting the degree and duration of declining revenues/margins
- Amount, timing and probability of asset/division/ product line divestitures
- Extent of contingent obligations arising from operational restructure
- Higher lending rates, transaction costs and cost of capital

[Source: Pages 9 and 10 of Standards for Distressed Business Valuation]

Issues Recognized in Distressed Business Valuation Compared To Traditional Business Valuation

- Lack of comparability to healthy companies
- Unrecorded future operating losses necessary to turnaround business
- Reconstitution of tax attributes
- Greater reliance on one primary approach or method of value (DCF v. Cap Earnings or Market Approach?)

[Source: Pages 9 and 10 of Standards for Distressed Business Valuation]

Standards Apply To All AIRA Members Offering "Opinions of Value"

- Standards Apply When Engagement Results In:
  a) "Estimate of Value";
  b) "Opinion of Value";
  c) "Conclusion of Value";
  d) Applying "Valuation Approaches and Methods"; and
  e) Utilizing "Professional Judgment"
- The Purpose of the Value Opinion May Be for:
  a) Reorganization value or related equity value;
  b) Sale of assets or segment of business;
  c) Solvency or insolvency of business enterprise - Balance Sheet Test Only;
  d) Confirmation of plan, conversion to Chapter 7 or adequate protection; or
  e) Financial reporting including fresh start accounting and impairment of carrying value of assets
- Standards Include a Binding Development Standard and a General Report Writing Exception

Standards Do Not Directly Apply To Advisory & Consulting Services

Ten (10) Assignments Specific To The Exceptions Standards:

- Attest Exception
- Government Regulation Exception
- Client Provided Value Exception
- Sensitivity Analysis Exception
- Internal Use Employer-to-Employee Exception
- Economic Damages and Lost Profits Exception
- Mechanical Value Computations Exception
- Insufficient Data and Information Exception
- Financial Advice Exception
- Tangible Asset Exception

Distressed Valuation Issues – Basics and Fundamental Elements

– What is the appropriate **Definition (Standard) of Value**? Fair Market Value, Fair Value, Investment Value, Intrinsic Value, Reorganization Value, Reasonably Equivalent Value

– **Premise of Value**? Going Concern or Orderly or Forced Liquidation

– **In Use** (with other assets) or **In Exchange** (as an individual asset for sale)

– **Valuation Date**

– **Approaches:** Market, Income and Cost (Asset Accumulation)

Distressed Valuation Issues –
The Challenge of Defining "Value"

- "Determined in Light of the Purpose of the Valuation and the Proposed Disposition or Use of the Subject Property"
- "Value does not Necessarily Contemplate Forced Sale or Liquidation Value of the Collateral; Nor Does It Always Imply a Full Going Concern Value; Courts will have to Determine Value on a Case-By-Case Basis, taking into Account the Facts of Each Case and the Competing Interests in the Case"

[Source: Pages 12 and 13 of Standards for Distressed Business Valuation]

Distressed Valuation Issues – Market Approach

– Selection of too broad a set of comparables
– Medians or averages, or adjustments, or "haircuts", to comps
– Comparability of public comps to privately held targets
– Which is better: performance multiples of Guideline Companies or Transaction multiples?

Distressed Valuation Issues – Income Approach-1

- Reliance on prospective financial information by management v. public market data
- Management's forecast-top down or bottom up
- Application of a Company Specific Risk Premium in the cost of equity
- Historic or Supply Equity Risk Premium
- Beta- use of it and proper deployment (relevered, 5-year)
- Use of exit multiples v. perpetual growth adjusted last year forecast amount for terminal value

Distressed Valuation Issues – Income Approach-2

- Use of target company's capital structure v. market comps "ideal" capital structure
- Use of target company's cost of debt v. Moody's Baa as a proxy
- Capital cash flow versus free cash flow methodology in DCF method of valuation: (i) highly leveraged entities; and (ii) entities with highly variable tax positions over the projection period

Distressed Valuation Issues – Cost/Asset Approach

- Contingent Assets and Liabilities, probabilities, use of hindsight and differences with GAAP
- Evolving methods for valuing Intangible Assets
- Negative Goodwill/Intangibles

Distressed Valuation Issues – Correlation of Value

- Rev Ruling 59-60 calls for professional judgment over averaging or formulas
- Standards call for consideration of all indications of value in reaching opinion
- Any over reliance on a single valuation approach must be justified with factual evidence

Recovery Actions and Reasonably Equivalent Value - 1

- Compilation and forensic assessment of asset values (from existing appraisals); actual sale transactions (of the subject asset); realizable amounts; and fair value impairment writedown for GAAP purposes) for insolvency measurement versus an "opinion of value" for insolvency purposes
- Use of hindsight, ex-ante and ex-post valuation methods or insolvency measurement and/or reasonably equivalent value measurement

Recovery Actions and Reasonably Equivalent Value - 2

-Value Defined Broadly as Follows:

"We have interpreted 'value' to include 'any benefit[,] . . . whether direct or indirect.' *R.M.L.*, 92 F.3d at 150. As noted above, the mere 'opportunity' to receive an economic benefit in the future constitutes 'value' under the [Bankruptcy] Code."

-Considering the Totality of Circumstances as:

i. The "Fair Market Value" of the Benefit Received as a Result of the Transfer
ii. "The Existence of an Arm's-Length Relationship Between the Debtor and the Transferee"
iii. The Transferee's Good Faith. *R.M.L.*, 92 F.3d at 148-49, 153

Case Study 1

Mercury Company, Inc. v. FNF Security Acquisition, Inc. et al., Adv. No. 10-01133 (MER); *In re: Mercury Companies, Inc.*, Bankruptcy 08-23125 MER

- § 548 Recovery Actions – Stipulation Regarding Insolvency; Parties Contested Reasonably Equivalent Value
- Appraiser A: negative $5MM; Appraiser B: positive $15MM
- Both Selected DCF Method and Gordon Growth Model for Terminal
- Marketing Sale Period – Appraiser A: Immediate; Appraiser B: 30-60 Days

Case Study 1 (Cont.)

- Debt-Equity Structure – Appraiser A: 6% / 94%; Appraiser B: 30% / 70%
- Reliability of management projections – Appraiser A: relied on optimistic projections without adjustment
- Standard of Value – Appraiser A: Fair Value; Appraiser B: Fair Market Value
- Totality of Circumstances – Various Tests: Receipt of Value; FMV; Arms-length; Good Faith
- Debtor's Use of Hindsight – Debtor argued panic, coercion, sharp dealing, depressed value below FMV; does quick sale and lack of typical due diligence preclude "willing buyer and willing seller"?

Case Study 2

Adelphia Recovery Trust v. FPL Group, Inc. et al., Adv. No. 04-03295 (REG); *In re: Adelphia Communications Corp. et al.*, Bankruptcy 02-41729 (REG)

- Cable Industry Business Valuation
- Fraudulent and Misstated Financial Data
- § 548 Recovery Actions – Repurchase of Stock Transaction
- Appraiser A: negative $1.0B; Appraiser B: positive $3.7B
- Appraiser A: Selected only One Method – DCF
- Appraiser B: Selected only One Approach – Market Approach – employing Two Methods – Comparable Companies and Precedent Transactions
- Both Appraisers Encountered Difficulty in Relying on the Accuracy of Management’s Projections
- Appraiser B: Declined to Perform a DCF Due to Unreliability of Management Projections

Case Study 2 (Cont.)

- Appraiser A: Developed his Own Projection to Utilize in the DCF
- Appraiser A: Relied Upon Penetration Rates, Growth Rates, Revenue Per Subscriber, Margins and CAPX from Third Party Analyst Reports
- Appraiser A: Utilized Perpetuity Method for Terminal Value as opposed to Multiple Method – Growth in Perpetuity @ 4%
- Appraiser B: Selected 6 Guideline Companies – Used only Cable Components of the Guideline Companies
- Appraiser B: Utilized a "Value Per Subscriber" Multiple
- Appraiser B: Selected the "Lowest Quartile" Value Per Subscriber Multiple
- Appraiser B: Applied a 25% Control Premium to the Minority Basis Value Per Subscriber and Added "Cash On Hand" to Obtain Total Enterprise Value

Case Study 2 (Cont.)

- Appraiser A: Assigned No Value to a Related Entity A – Due to Contingent Liability of Issuing Fraudulent Stock
- Appraiser B: Utilized a “Speculative Asset and Liability Bucket” Approach to Address Contingent Assets/Liabilities
- Appraiser A: Valued Related Entity B at the Recent Purchase Price/ Cost (8 Months Earlier) of Debtor
- Appraiser B: Relied Upon a Valuation of Entity B by Another Expert
- Appraiser A: Debts Were \$0.7B Higher Than Appraiser B – Only Accounting for \$0.7B of the \$4.7B Difference in Equity Value for Solvency Purposes
- Court Concluded: Net Worth To Be \$2.5B Compared to <\$1.0B> Appraiser A and \$3.7B Appraiser B
- Court Concluded: Use of DCF Alone was “Inappropriate” and Market Approach was “Superior”

Case Study 2 (Cont.)

- Court Concluded: Appraiser A Failure to Use Alternative Valuation Methodologies as a “Sanity Check” to test Reasonableness of Conclusions Based Upon Single Methodology was a “Material Deficiency”
- Court Concluded: DCF Works When:
  i. Company has Accurate Projection;
  ii. Projections not Tainted By Fraud; and
  iii. At Least Some Cash Flow is Positive
- Court Concluded: DCF was “Excessively Arbitrary and Speculative”
- Court Concluded: Fraud would not Exclude Debtor from Capital Markets or Access to Some Capital
- Court Concluded: No Basis to Collapse the Stock Repurchase and the Redemption into “One Single Integrated Transaction”

Issues and Challenges Facing The Valuation Profession

- Alphabet Soup - Many valuation sets of standards: USPAP, ASA, RICS, AICPA, NACVA, IBA, CICBV and now AIRA
- History of governmental regulation of Real Estate less than ideal
- SEC Chief Accountant’s “Shot Across the Bow”
- Still little progress in reaching a unified set of standards – NIMBY in action

Hon. Michael Romero

Hon. Michael E. Romero was appointed to the United States Bankruptcy Court for the District of Colorado in 2003, and also serves on the Tenth Circuit Bankruptcy Appellate Panel. Judge Romero received an undergraduate degree in economics and political science from Denver University in 1977 and his juris doctor degree from the University of Michigan in 1980. In his years in private practice, he considered himself as a trial attorney, specializing in bankruptcy related matters. Since becoming a judge, he has served on numerous committees and advisory groups for the Administrative Office of the United States Courts, is the past chair of the Bankruptcy Judges Advisory Group, and just concluded his term as the sole Bankruptcy Court representative to the Judicial Conference of the United States, the governing arm of the federal judiciary.

He recently served on the Board of Governors of the National Conference of Bankruptcy Judges and actively participates in several committees of that body. Judge Romero also serves on the Executive Board of *Our Courts*, a joint activity between the Colorado Judicial Institute and the Colorado Bar Association which provides programs to further public understanding of the federal and state court systems. He is a member of the Colorado Bar Association, the American Bankruptcy Institute, the Historical Society of the Tenth Circuit and the Colorado Hispanic Bar Association. In what little spare time he has, Judge Romero can be been seen participating in musical theater productions throughout Colorado. While he admits he can sing a bit, his dancing skills leave much to be desired.

David Payne, CIRA/CDBV, ASA

Mr. Payne is President of *D. R. Payne & Associates, Inc.,* with over thirty (30) years of accounting and consulting experience in both public and private industry. *D. R. Payne & Associates, Inc.* provides forensic accounting and damage assessment services as well as providing turnaround, interim and/or court supervised fiduciary services to troubled companies. Mr. Payne also serves as Managing Directors of *Business Valuators and Appraisers, L.L.C.*, a firm specializing in valuation and appraisal matters. The firms maintain offices in Oklahoma City and serves clients throughout the Southwest. Mr. Payne previously worked in a number of financial positions in industry including serving as Controller and Chief Accounting Officer of a publicly-traded company, in addition to working as a partner at KPMG.

Jeff Davine, Esquire

Jeffrey R. Davine, a partner at Ballard Spahr LLP, works in the areas of federal and local taxation (including international tax planning), tax planning, estate planning, business transactions and agreements, real estate taxation, employee benefits, tax controversies, and trusts, estates, and probate. He is a frequent speaker and writer on tax matters.

Bruce Bingham, FASA, FRICS

Bruce Bingham has over twenty-five years of experience in the areas of business valuation, financial feasibility, business planning, investigative due-diligence, and litigation consulting. He has served as an expert witness in numerous Federal and State civil and bankruptcy trials and in arbitrations. Mr. Bingham has extensive experience valuing and representing companies in strategic planning, family disputes, fraud and disaster-based damages and diminution in value, divorce, and tax matters.

Valuation Standards and Their Application and Relevance in the Courts

Addendum

Case Law Addendum

AIRA Valuation Standards and Their Application and Relevance in the Courts

A Sampling of the Case Law

I. Fraudulent Conveyance Cases:

A. Guarantees:

1. *Nordberg v. Arab Banking Corp. (In re Chase & Sanborn Corp)*, 904 F 2d 588, 595 (11th Cir 1990)

Concerning the fraudulent conveyance issue, the court noted that it is largely a question of fact as to which considerable latitude must be allowed to the trier of facts. The burden of proving lack of "reasonably equivalent value" rests on the trustee challenging the transfer. In this case, payments by a guarantor which was an affiliate of the debtor on the debtor's loan were preceded by payments by the debtor to the guarantor that were reasonably equivalent to the amount paid on the guarantee.

The satisfaction of a guarantee obligation is not "value" in exchange for the payments and such payments can and do constitute a voidable preference. The court indicated that if new value included credit toward such debts, thus rendering such transfers categorically unavoidable, section 547 (11 U.S. Code § 547 concerning preferences) would be rendered a tautological nullity.

2. *In re: Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988)

Subsidiary guaranteed an obligation of its parent. It ordered some chemicals for a price of approximately $124,000 and paid the invoice with two checks that cleared in January 1984. Xonics Photochemical as debtor in possession brought this proceeding under 11 U.S.C. § 547(b)(3). Was Xonics insolvent when it made the payments to Mitsui? Yes, and the court said, "Mitsui has presented no grounds on which we are authorized to set aside the voiding of the payments made to it."

B. Loan Fees:

1. *Mellon Bank, N.A. v.Official Comm of Unsecured Creditors of R.M.L., Inc, (In re R.M.L., Inc.)*, 92 F.3d 139 (10th Cir., 1996)

This was an action under section 548 of the bankruptcy code to recover $515,000 in payments made by the debtor Intershoe, Inc. to Mellon Bank. The court noted that for purposes of section 548, insolvency is defined as the situation where the sum of debts is greater than assets, at fair valuation. The relevant test date is the time of the alleged transfer. On the relevant date, August 31, 1991, the debtor's liabilities exceeded its assets by approximately $4 million.

The bankruptcy court noted that by all accounts, the debtor's financial survival was contingent upon the refinancing of its indebtedness by Mellon which refinancing in turn contingent on dozens of conditions including an equity infusion. The court explained that bankruptcy courts are not necessarily strictly bound by GAAP in insolvency determinations. These same courts have concluded that subsequent events, such as actual collection rates for receivables that may not be technically recognized under GAAP may be considered by a bankruptcy judge. The court therefore determined that the creditors committee established that the debtor was insolvent on that date.

The bankruptcy court determined that the debtor generally did not receive reasonably equivalent value when it paid Mellon Bank $515,000 for a loan commitment on a loan that never closed. In order to recover under 11 U.S.C. § 548, it must be shown that (1) the debtor had an interest in the property; (2) the transfer of the interest occurred within one year of the petition; (3) the debtor was insolvent at the time of the transfer or became insolvent as a result thereof; and (4) the debtor received less than a reasonably equivalent value in exchange for such transfer. The court concluded that at the time of the transfer, the debtor was insolvent. In determining whether the debtor received reasonably equivalent value, the bankruptcy court applied a totality of the circumstances test. As to the three deposits made by the debtor to the lender, the bankruptcy court determined that no value had been conferred particularly since the loan failed to close. Nevertheless, the bankruptcy court determined that Mellon could retain the first $125,000 deposit based on the fact that it would incur that much in expenses with respect to the proposed loan and some contractual value was received by the debtor and the transaction was of an ordinary commercial nature. However, no reasonably equivalent value was provided for the second $125,000 deposit. The fact that Mellon may have incurred further expenses was irrelevant if no value was conferred. The court further noted that at that time, the bank had the opportunity to extract fees not ordinarily warranted on an arm's-length commercial basis due to the debtor's weakening bargaining power. The Third Circuit affirmed the bankruptcy court holdings essentially on the grounds that substantial fees were paid for "an extremely remote opportunity" to receive value in the future. That extremely remote opportunity was not reasonably equivalent to the lending fees.

C. Payment of Debts of Debtor

1. *In re Davis (v. Sudervo),* 148 BR 165, 176 (Bankr ED NY 1992) (citing Covey v Commercial Nat'l Bank, 960 F 2d 657 (7th Cir 1992)); *Davis v Sunderov (In re Davis),* 169 BR 285, 299 (ED NY 1994)

   Describes a transaction in which the debtors themselves were defrauded in a scheme to acquire their home and lease it back to them in a transaction that rendered the debtor insolvent. The court explained that economic coercion or fraud and misrepresentations have been held to render a transfer involuntary. In this case, because the debtors were induced to convey their residence to a predatory lender, the court concluded that the transfer was involuntary. It was made within one year before the date of the filing of the bankruptcy petition and is voidable if the debtors received less than a reasonably equivalent value and were then or were rendered insolvent.

The defendant (purchaser/lender) argued that the debtor received a benefit by reason of the transfer because the lender paid off the indebtedness encumbering the residence. The court said that the debtor would have benefited had the debtor retained the house, but since the house was transferred simultaneously to the lender, there was no benefit to the debtor. The court easily concluded that the transfer should be avoided.

II. Reasonably Equivalent Value

A. Promissory Notes

1. *In re Lindell,* 334 B.R. 249, 255 (Bankr. D. Minn. 2005)

Debtors, husband and wife, received promissory notes from the sale of their business secured by real estate which, at the time of their sale, had a value of approximately $263,000. All of the notes were sold by them to JNG Corporation for a total of $50,000. Less than one year later, the debtors filed for bankruptcy and the trustee initiated this action to avoid the transfer under Bankruptcy Code section 548. The debtors were insolvent at the time of the transfer. The trustee presented testimony of an expert witness that the notes had a value of between $120,000 and $130,000 at the time of their sale. The court concluded that the value of the notes was $130,000. The only question was whether a sale for $50,000 in cash was for a reasonably equivalent value. While acknowledging that there is no bright line test, the court concluded based on the totality of the circumstances that the sale was not for reasonably equivalent value in the transfer was avoidable.

B. Related Stock Purchase (or capital contribution)

1. *Creditors' Comm of Jumer's Castle Lodge, Inc. v. Jumer (In re Jumer's Castle Lodge, Inc.),* 338 B.R. 344, 354 (C.D. Ill. 2006)

The question in this case was whether a shareholder who owned all of the stock of a corporation provided reasonably equivalent value when he purchased assets of the corporation. The court indicated that the question of reasonably equivalent value involves both questions of fact and law. The legal standards are subject to de novo review. Once the correct legal standard has been applied, the question becomes a question of fact subject to review only for clear error.

Factors cited by the court were, (1) whether the value of what was transferred is equal to the value of what was received, (2) the market value of what was transferred and received, (3) whether the transaction took place at arms-length; and (4) the good faith of the transferee. The court pointed out that indirect benefits can constitute value and include a wide range of intangible such as goodwill or increased ability to borrow working capital, the general relationship between affiliates or synergy within a corporate group and a corporation's ability to retain an important source of supply or an important customer. The transaction must be viewed from the vantage of the creditors.

In this case, as part of the transaction a corporation received $2 million from a purchaser acquiring 30% of the corporation's stock. The creditors argued that the receipt of that $2 million should not be taken into account in determining whether an exchange between the corporation and its existing shareholder was for reasonably equivalent value. The court noted that the $2 million stock acquisition was expressly related to and conditioned upon the execution of the agreement between the corporation and its existing shareholder and that in essence the two agreements together constituted a single integrated transaction.

C. Public Sales

1. *Durrett v. Washington National Insurance Co.*, 621 F.2d 201 (1980)

In this case, the debtor in possession sought to set aside and vacate a transfer of real property effected 9 days prior to the filing of the petition under Chapter 11. The transfer was a foreclosure under a deed of trust where the purchaser was an unrelated party who bid the amount of the indebtedness. The district court determined that the value of the property was $200,000, a fact that neither of the parties took issue with. At the foreclosure sale, the property was sold for $115,400. The district court held that the consideration was fair and a fair equivalent within the meaning of 11 U.S.C. section 67(d)(1) and (e)(1).

In reviewing whether the price paid was a "fair equivalent" for the transfer of the property, the court concluded that it was not. The price paid was just under 58% of the value of the property involved in the sale deprive the bankruptcy estate of an equity in the property of $84,600. The court noted that it was unable to locate a decision of any district or appellate court dealing only with the transfer of real property under section 67(d) of the Act where a transfer for less than 70% of the fair market value was approved.

2. *Madrid v. Lawyers Title Ins. Co.,* 21 B.R. 424 (Bankr. 9th Cir. 1982), affd. on other grounds, 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833, 105 S.Ct. 125, 83 L.Ed.2d 66 (1984)

In this case, the holder of a 2nd deed of trust in the original sum of $142,500 commenced foreclosure proceedings after note secured by that deed of trust was paid down to $75,300. The property was sold in foreclosure and the successful bidder purchase the property, subject to the 1st deed of trust, for the amount outstanding on the loan secured by the 2nd deed of trust at the time. The owner filed for bankruptcy within one year and as debtor-in-possession, brought an action against the purchaser at the foreclosure sale. Two theories were advanced: 1. The sale did not comply with state law; 2. The sale constituted a fraudulent conveyance under 11 U.S.C. section 548. The court determined that the lenders bid was approximately 65% of the property's fair market value at the time of sale and concluded that it was not reasonably equivalent value.

The court was aware of only 2 cases holding that a purchase at a nonjudicial sale under a deed of trust could be set aside as a fraudulent conveyance. One of the cases was *Durette v. Washington National Insurance Co*. The court considered two questions. The first was whether the foreclosure sale constituted a transfer and the second was whether "reasonably equivalent value" was paid. Finding that there was reasonably equivalent value, the first question was not determined. The court found that even though less than 70% of the fair market value of the property was received in the foreclosure sale, it declined to follow the Durett case because the sale was a public sale open to all bidders and all creditors. That provided a safeguard against the evils of private transfers to relatives and favorites. The court concluded that mere inadequacy of consideration will not upset foreclosure sale.

3. *Tracht Gut, LLC v. County of Los Angeles Treasurer*, BAP No. cc-13-1229-PaTaD (B.A.P. 9th Cir. 2014)

In this case, several properties were delinquent with respect to real estate taxes and were sold pursuant to tax sales. Shortly after the tax sales occurred, the debtor filed for bankruptcy and then commenced an adversary proceeding alleging that the properties were sold at tax sale of substantially less than their value and requesting the bankruptcy court to grant relief, essentially to avoid the tax sales as fraudulent transfers, for a declaratory judgment, for an injunction, for violation of the automatic stay and for unjust enrichment. The bankruptcy court dismissed the complaint without leave to amend in the debtor appealed. The trial court ruling was upheld in full, primarily on the grounds that the properties sold at the duly conducted tax sale were not properties of the debtor's estate for purposes of 11 U.S.C. § 541; the post-petition recording of the deeds could never be considered a violation of the automatic stay as it was solely a ministerial act; the tax sale could not be the basis of an action under 11 U.S.C. §§ 548 or 549.

4. *Bundles v. Baker*, 856 F.2d 815 (7th Cir. 1988) [attempts to reconcile the disparate holdings of Durett and Madrid]

The issue in this case was whether the trustee could avoid the sale of the debtor's personal residence upon foreclosure of the mortgage. The district court held that the sale could not be avoided and that reasonably equivalent value should be deemed satisfied where the property is sold at a regularly conducted, non-collusive foreclosure sale to a third-party purchaser and where the deed to the property is executed and recorded before the debtor filed his bankruptcy petition.

The court noted that the two seminal cases are *Durett v. Washington National insurance Co.* and *Lawyers Title Insurance Co. v. Madrid*. Courts interpreted *Durett* as standing for the proposition that reasonably equivalent value in a foreclosure context should be determined as a set percentage of fair market value with 70% being the appropriate benchmark. Courts have interpreted *Madrid* as representing the position that the sales price obtained a regularly conducted, non-collusive foreclosure sale should be presumed conclusively to be reasonably equivalent value for purposes of § 548(a)(2)(A). In this case, both the bankruptcy court and the District Court followed *Madrid*. In essence, the court concluded that the "reasonably equivalent value" test had to be considered even in the case where there is an absence of collusion. An irrebuttable presumption would be contrary to the policy underlying the statute. In considering what the appropriate standard should be, the court declined to approve a conclusive presumption in the case of a regularly conducted noncollusive foreclosure and also rejected a simple comparison of the sales price to the fair market value. The court said, "Reasonable equivalence should depend on all the facts of each case." While fair market value is a starting point, the court must focus on fair market value as affected by the fact of foreclosure. The court should consider such factors as whether there was a fair appraisal of the property, whether the property was advertised widely and whether competitive bidding was encouraged.

D. Leveraged Transactions (Buyouts)

1. *Friedman v. American Capital, LTD.*, Case No. 09-12066-DK (2012)

In this case, the trustee filed an avoidance action under 11 U.S.C. §§ 544 and 548 and under various provisions of state law. The transaction in question involved a loan by American Capital, LTD to the debtor in connection with a leveraged buyout transaction. As part of the transaction, the debtor received substantial loan proceeds and granted to American

Capital a note and security interest on its assets. The debtor was required to distribute a substantial portion of the loan proceeds to the holding company in order to enable it to pay for the shares of the debtor it had recently acquired. The trustee argued that the debtor received neither reasonably equivalent value for fair consideration for the transfers.

American Capital disputed that the debtor neither received fair consideration nor reasonably equivalent value in its motion to dismiss. The motion to dismiss was denied on all grounds allowing the dispute to continue. The trustee's claims included the transactions were undertaken with actual intent to hinder, delay or defraud creditors; that the transfers were made without fair consideration; that the transfers were made by the debtor while insolvent or rendered insolvent by the transfers; that the debtor engaged in transfers where the property remaining after the conveyance was unreasonably small; as a result of the transfers, debts would be incurred that were beyond the debtors ability to pay them as they matured; within 2 years before the date of filing the debtor made transfers or incurred obligations with actual intent to hinder, delay or defraud. The court held that the trustee's complaint alleged facts that if true, could support a conclusion that the debtor did not receive reasonably equivalent value.

2. *Bay Plastics v. BT Commercial Corp. (In re Bay Plastics, Inc.)*, 187 B.R. 315 (Bankr. C.D.Cal 1995)

This case involved the leveraged buyout of three shareholders. They sold their stock to a subsidiary of the acquiring corporation. The subsidiary was formed for the purpose of making the acquisition and it caused the target corporation, the debtor in this case, to borrow all of the cash portion of the purchase price. The debtor then distributed up to the acquiring corporation the borrowed funds which used them to pay the shareholders. To effect the transaction, the corporation's principal supplier was persuaded to reduce its security interest and its guarantees prior to the sale. The LBO character of the transaction was not disclosed to the supplier. By reason of the borrowings, the debtor was rendered insolvent except for the addition of $2.26 million in good will to its balance sheet which permitted the balance sheet to show a modest shareholder equity of $250,000.

Ultimately, the debtor was unable to service the debt and it filed its bankruptcy petition 15 months after the transaction. The debtor was unable to use the fraudulent transfer provision of the bankruptcy code, section 548 because it is applicable to transfers made or obligations incurred within one year before the date of the filing of the petition. Instead, it relied upon California's law fraudulent conveyance statute. The court concluded that there were no triable issues of material fact and entered summary judgment setting aside the fraudulent transfer in this case to the selling shareholders. In substance, the court indicated that selling shareholders received payment for their shares that was secured by assets of the debtor and that the transaction defrauded an existing creditor.

3. *Moody v. Security Pacific Business Credit, Inc.*, 127 B.R. 958 (W.D. Pa. 1991)

This case involved the leveraged buyout followed by a suit by the bankruptcy trustee to recover in excess of $12 million from its participants. Jeannette Corporation was sold for 12.1 million to J. Corp., a holding company owned by the buyer group. The buyer borrowed $11.7 million of the purchase price from Security Pacific Business Credit and the loan was secured by a lien on all of Jeannette's assets. Fifteen months after the transaction occurred, a creditor filed an involuntary bankruptcy petition against Jeannette under Chapter 7.

Among the arguments raised was that the transaction was intentionally fraudulent. The transaction was also attacked under the constructive fraud provisions of state law and Bankruptcy Code § 548. After noting that the plaintiff bears the burden of demonstrating intent through "clear and convincing evidence" the court concluded that the defendants did not know or believe that Jeannette's creditors could not be paid and did not intend to hinder, defraud or delay the creditors. No badges of fraud were found. The court then turned to the question of whether the transaction should be set aside under state law fraudulent conveyance statute in the bankruptcy code. The question was whether the conveyances were made and obligations incurred "without a fair consideration" under Pennsylvania law. The court did note that Jeannette Corporation received nothing in the transaction that would constitute fair consideration for the encumbrance of its assets and that receipt of new management did not fall within the definition of fair consideration. Noting that the conveyances could not be set aside unless Jeannette was rendered insolvent, the court looked at the solvency of Jeannette after the transactions. In its analysis of the insolvency question the court indicated that in considering the present fair salable value of Jeannette's assets, it held that they must be valued on a "going concern basis, rather than on a liquidation basis."

The court also considered, in evaluating the state law issue, the requirement that "Every conveyance made without fair consideration, when the person making it is engaged, or about to engage, in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors, and as to other persons who become creditors during the continuance of such business or transaction, without regard to his actual intent." 39 Pa. Stat. Section 355.

The court concluded that Jeanette was able to and did pay its creditors until it experienced a dramatic downturn in orders and sales. While delays in payments to creditors did occur to some extent, the court was not convinced that this proved Jeanette was insolvent or left with unreasonably small capital. Specifically, the court determined that it was not forced to delay payments to creditors because of the leveraged buyout transaction. Therefore, the court concluded that the plaintiff could not recover under Pennsylvania law or the bankruptcy code.

4. *Credit Managers Association of Southern California v. Federal Co.*, 629 F.Supp 175 (C.D. Cal. 1985)

The transaction in this case was a leveraged management buyout. Prior to the buyout, the debtor was a subsidiary of a publicly traded corporation. In May 1982, the stock was sold to a new entity formed by top management of the subsidiary. Seventeen months after the transaction occurred, the subsidiary executed a general assignment for the benefit of its creditors. This case was brought by a creditor on various legal theories including fraudulent conveyance, unlawful distribution of assets and equitable subordination.

The court acknowledged that after the transaction, Crescent (the debtor) was much more heavily leveraged than prior to the sale. But after the sale, a number of setbacks occurred independent of the transaction including creditors extending less credit because it was no longer part of a publicly traded company, slower payments by customers, a strike, and loss of business. The court noted, however, that even after the transaction, the fair market value of Crescent's fixed assets exceeded the book value of those assets.

The court noted that most of the creditor's claims arose after the transaction and the creditors at the time of the assignment for the most part were not the same as those who were creditors at the time the buyout occurred. Thus, most creditors extended credit after the transaction. These creditors had knowledge of the change in ownership. The court noted as a matter of fairness, "it would seem that if leveraged buyouts are to be susceptible to attack on fraudulent conveyance grounds, only those who were creditors at the time of the transaction should have a right to attack the transaction."

The court then noted that the California fraudulent conveyance act does indicate that conveyances made without fair consideration when one is about to engage in a business for which, after the conveyance, there is an unreasonably small capital, the conveyance "is fraudulent as to creditors and as to other persons who became creditors during the continuation of such business." Finding that the transaction was without fair consideration, the issue was whether the transferor was left with unreasonably small capital. The court stated that whether the debtor was undercapitalized is "a question of fact that must be ascertained on a case-by-case basis." The court then went through a detailed analysis looking at the facts at the time of the transaction including projected sales, gross profit margins and inventory turnover, accounts receivable collection periods and balance sheet and ratios. Concluding that subsequent events were primarily responsible for the decline in value, the court held that Crescent was not left undercapitalized. There was also no evidence that the price paid for the stock at the time of the transaction was "out of line with what it was worth." The court also held against the plaintiff on the remaining causes of action.

III. Approval of Bankruptcy Plans

A. Valuing the Enterprise

1. Determining When a Class is Impaired

In re Lakeside Global II, Ltd., 116 B.R. 499 (Bankr. S.D. Tex 1989)

This is a case in which the court was called on to determine whether to approve a plan of reorganization. The court noted that a class of claims is impaired if the plan alters the claimant's legal, equitable or contractual rights or if the plan fails to provide for payment on the effective date of cash equal to the amount of the allowed claim. Out of nine classes, seven of them were impaired.

Also at issue was whether the equity holders can retain assets over the objection of the senior creditor (a cramdown situation). In order to approve a plan under those circumstances, the present value of the package of rights offered to the secured creditor must at least equal the value of that secured creditors interest in the collateral. More particularly, the sum of the deferred cash payments must equal the present value of the lien holders' claims in full. The court noted that in this case, certain lenders were being offered a package of rights that is less than the current value of the properties which serve as security for their loans. The court further noted, "According the value of the package of rights offered to the rejecting impaired secured claim holder classes is less than what a willing buyer would get if the properties were to be sold in a fair market." Confirmation of the plan was denied that the parties were urged to reopen negotiations.

Standards Addendum

<u>Distressed Business Valuation Standards</u>

By David R. Payne, CPA/ABV, CIRA/CDBV, CTP, ASA

The AIRA Board of Directors ("Board") approved Standards For Distressed Business Valuation ("Standards") effective March 1, 2014. A summary of certain critical elements of the Standards are summarized below:

A. <u>Standards Apply To Developing And Issuing An "Opinion of Value"</u>

As described in the Standards, the term "engagement to estimate value" refers to an engagement or any part of an engagement that involves "estimating and/or developing an opinion of the value" of a subject interest. In the process of estimating value, the valuation analyst applies valuation approaches and methods, and uses professional judgment. The use of "professional judgment" is an essential component of "estimating value". The Standards do not draw any distinction between a full-scope or detailed engagement versus a restricted use or limited scope engagement or between a valuation engagement versus a calculation engagement.[1] The Standards apply "when performing engagements to <u>estimate value that culminate in an expression of an opinion or conclusion of value"</u> including but not limited to the following:

(i) Developing an opinion of value regarding the reorganization value of the business enterprise or the related equity value available for old or new equity holders.

(ii) Developing an opinion of value regarding a sale of assets or a segment of the business.

(iii) Developing an opinion of value on the insolvency/solvency of the business enterprise at points in time.

(iv) Developing an opinion of value for assets and/or the business on a going concern, orderly or forced liquidation basis for purposes of assessing confirmation of a plan, conversion to Chapter 7 or for adequate protection.

(v) Developing an opinion of value for financial reporting purposes including fresh start accounting.

B. <u>Standards Apply and Are Binding on Certified Members</u>

[1] These types of engagement distinctions are identified by other appraisal organizations such as the AICPA, ASA and others. The AIRA has no opinion regarding the priority of standards among these organizations, and the AIRA has no opinion regarding the appropriate application of any standards that may differ between these organizations as they apply to the facts and circumstances of individual valuation engagements

The Standard are binding on "AIRA Members who are a Certified Insolvency and Restructuring Advisor ("CIRA") and AIRA Members who have received a Certification in Distressed Business Valuation ("CDBV")".

C. Standards Do Not Apply To Traditional Insolvency and Reorganization Consulting Services

Consulting services rendered in bankruptcy engagements as well as in other troubled debt situations are not subject to the Standards although such consulting services may rely, in part, on valuation techniques/calculations including:

(i) Preparing and/or evaluating cash flow projections, sensitivity analysis and present value analysis for purposes of assessing viability and feasibility of the debtor.

(ii) Advising and assisting clients with forecasts and analysis of cash collateral, replacement collateral and collateral values provided by third parties.

(iii) Identifying an appropriate capital structure upon emergence, negotiating with creditors, assisting with developing a plan of reorganization and advising the client on potential plan actions utilizing third party indications of value.

(iv) Advising Chapter 11 creditors about voting to accept or reject a plan of reorganization based upon various financial metrics including valuation metrics provided by third parties. The reorganization plan outlines payouts to the different classes of creditors based on the value of the reorganized debtor. A creditor may vote to accept or reject a proposed plan. The financial advisor may advise the creditor to accept or reject a plan based upon the proposed payout under the plan as compared with the potential payout under an alternative scenario

(v) Performing the "best interests of creditors test" regarding the treatment of creditors under a proposed plan of reorganization under the U.S. Bankruptcy Code by evaluating (as opposed to developing an independent opinion) going concern versus liquidation values of the debtor.

(vi) Assessing the potential for (as opposed to developing an independent opinion) for insolvency at various dates in order to evaluate possible recovery actions.

D. The Standards Include a Binding "Development Standard" To Support An Opinion of Value

The Development Standard included in the proposed AIRA Standards is generally consistent with the development standard set forth by other valuation/appraisal organizations including those published by the ASA, NACVA, IBA, CFA and AICPA[2]. The Development Standard

[2] Statement on Standards For Valuation Services No. 1

requires that all appraisal principles, approaches, methods and calculations are required to be considered, rejected and/or applied in developing an opinion of value. However, a written valuation report is not required although quantitative exhibits, demonstratives, work schedules, data tables and/or summaries are usually necessary to support such an opinion. The valuators' work file should generally contain the same data and calculations whether or not a written valuation report is issued.

A valuation engagement requires written and/or oral narrative disclosure of the assumptions, methods and approaches used to determine a conclusion of value. In certain situations where the third party users are knowledgeable of the business, omission of certain narrative disclosures regarding the business, its assets and liabilities can be appropriate. The degree to which narrative disclosures may be omitted to satisfy the purpose, facts and circumstances of each particular engagement is a matter of professional judgment.

The Development Standard invokes a documentation requirement for information obtained and analyzed, procedures performed, valuation approaches and methods considered and used, and the conclusion of value. The quantity, type, and content of documentation are matters of the valuation analyst's professional judgment and experience considering the nature and purpose of the assignment. Documentation may include:

E. <u>The Standards Include a "General-Report (Writing) Exception" Even When An Opinion of Value is Performed and Oral Reports are Acceptable</u>

The reporting Standards do not apply to litigation engagements in which a valuation analyst is engaged to testify as an expert witness in valuation, accounting, auditing, taxation, or other matters, given certain stipulated or assumed facts. A valuation performed for any matter before a court, an arbitrator, a mediator or other facilitator, or a matter in a governmental or administrative proceeding (herein referred to individually or collectively as "Controversy Proceedings"), is exempt from the reporting provisions of the Standards. The reporting exemption applies whether the matter proceeds to trial or settles. This exemption applies only to the reporting provisions of the Standards. The developmental provisions of the Standards still apply whenever the valuation analyst expresses a conclusion of value even in Controversy Proceedings.

An oral report may be used in a valuation engagement. An oral report should include "all information the valuation analyst believes necessary to relate the scope, assumptions, limitations, and the results of the engagement" so as to limit any misunderstandings between the analyst and the recipient of the oral report. The member should "document in the working papers" the substance of the oral report communicated to the client.

F. <u>The Standards Include a "General-Jurisdictional Exception" Even When An Opinion of Value is Performed</u>

If any part of the Standards differs from published governmental, judicial, or accounting authority, or such authority specifies valuation methods or valuation reporting procedures, then the valuation analyst should follow the applicable published authority or stated procedures with respect to that part applicable to the valuation in which the valuation analyst is engaged. The other parts of the Standards continue in full force and effect.

One example of a jurisdictional exception in bankruptcy proceedings would be the consideration and/or use of "hindsight" in developing an opinion of value. In certain situations, bankruptcy courts have relied upon latter occurring events and data to determine value at an earlier date. Some examples include the decisions issued in the *Sunset Sales*[3] and *CFS*[4] cases regarding the measure of value for insolvency purposes in recovery actions. Ultimately, the use or application of any hindsight regarding subsequent events will depend on the purpose of the valuation and the intended user and should be fully disclosed in the valuation report.

G. <u>The Standards Include "Ten (10) Assignment – Specific Exceptions" Which Are Not Deemed To Encompass An Opinion of Value</u>

(i) Attest Exception – "The Standards are not applicable to a valuation analyst who participates in estimating the value of a subject interest as part of performing an attest engagement defined by Rule 101 of the AICPA Code of Professional Conduct (for example, as part of an audit, review, or compilation engagement)."

(ii) Government Regulation Exception – "The Standards are not applicable to a valuation that is performed pursuant to governmental regulation with a proscribed methodology, such as an ESOP valuation; however, if such a valuation is being performed in an insolvency context within the scope of these Standards, the analyst is expected to comply with these Standards and is expected to comply with the relevant reporting requirements of these Standards."

(iii) Client Provided Value Exception – "The Standards are not applicable when the value of a subject interest is provided to the valuation analyst by the client or a third party, and the member does not apply independently developed valuation approaches and methods, as discussed in the Standards. Sensitivity analysis performed on values determined by third parties is not considered an opinion of value subject to the Standards."

(iv) Sensitivity Analysis Exception – "The Standards are not applicable when the value of a subject interest is provided to the valuation analyst by the client or a third party, and the member does not apply independently developed valuation approaches and methods, as discussed in the Standards. Sensitivity analysis performed on values

[3] *In re Sunset Sale, Inc.; Payne v. Clarendon National Insurance, et al.,* BAP WO-97-100 (Bankr. W.D. Okla. 1992)
[4] *In re Commercial Services; NGU, Inc. v. Chase Manhattan, et al.,* 350 B.R. 520 (Bankr. N.D. Okla. 2005)

determined by third parties is not considered an opinion of value subject to the Standards."

(v) Internal Use Employer-to-Employee Exception – "The Standards are not applicable to internal use assignments from employers to employee members of the AIRA."

(vi) Economic Damages and Lost Profits Exception – "The Standards are not applicable to engagements that are exclusively performed for the purpose of determining economic damages such as lost-profits unless those determinations include an engagement to estimate value. If a valuation analyst performs an engagement to estimate value to determine the loss of value of a business or intangible asset in connection with financial advisory services being rendered in the areas of business turnaround, restructuring and bankruptcy practice, then the Standards apply. A valuation analyst acting as an expert witness should evaluate whether the particular damages calculation constitutes an engagement to estimate value with respect to the business, business interest, security, or intangible asset or whether it constitutes a lost-profits computation. Present value calculations of future loss of profits are generally not considered an opinion of value even when income approach techniques are applied."

(vii) Mechanical Value Computations Exceptions – "The Standards are not applicable to mechanical computations that do not rise to the level of an engagement to estimate value; that is, when the valuation analyst does not apply valuation approaches and methods and does not use independent professional judgment and does not issue an opinion or conclusion on value."

(viii) Insufficient Data and Information Exception – "The Standards are not applicable when it is not practical or not reasonable to obtain or use relevant information; as a result, the valuation analyst is unable to apply valuation approaches and methods that are described in the Standards. Unless prohibited by statute or by rule, a valuation analyst may use the client's estimates for compliance reporting to a third party if the valuation analyst determines that the estimates are reasonable based on the facts and circumstances known to the valuation analyst."

(ix) Financial Advice Exception – "Providing financial advice, without reference to developing independent values for various assets, is not subject to the Standards. However, if a valuation analyst independently calculates a value to illustrate various planning options, the analyst may fall under the Standards. Merely performing sensitivity analysis to value indications provided by third parties or the client is not subject to the Standards. If one or more of the assets for which value is to be determined is a business, business ownership interest, security, or intangible asset and is part of an engagement involving the fields of business turnaround, restructuring, bankruptcy and insolvency, and the client or a third party does not provide the values for these assets, or the valuation analyst does not use assumed or hypothetical values as part of the overall engagement, then the valuation analyst performing the valuation(s) is subject to the Standards with regard to these assets when determining an opinion of value."

(x) Tangible Asset Exception – "The Standards do not apply to the assets or interests which constitute tangible assets as defined by the International Glossary of Business Valuation Terms, and which do not constitute a subject interest."

H. <u>The Standards Include a Binding Requirement to Disclose "Relevant and Materially Significant Restrictions and Limitations"</u>

All relevant and materially significant restrictions or limitations should be reasonably disclosed in any oral or written report including written materials that convey the results. For example, if a client instructed the valuator to apply only one approach or method to the exclusion of all other approaches there would be a scope limitation present. If, in the course of a valuation engagement, restrictions or limitations on the scope of the valuation analyst's work or the data available for analysis are so significant that the valuation analyst believes that he or she cannot, even with disclosure in the valuation report of the restrictions or limitations, adequately perform a valuation engagement leading to a conclusion of value, then the valuation analyst should consider terminating the valuation services subject to the Standards and assess the applicability of other consulting/advisory services.

I. <u>The Development Standard Requires Consideration of "Generally Recognized Valuation Principles, Approaches and Methods To Develop An Opinion of Value":</u>

In performing a valuation engagement, the valuation analyst should analyze the subject interest, consider and apply appropriate valuation approaches and methods, reconcile the indication of value to reach a conclusion of value, and maintain appropriate documentation. The development standards and generally recognized report disclosures include:

(i) Identify and Define the Subject Business Ownership Interest and/or Assets and Their Nature

(ii) Define the Purpose of Intended Use of the Valuation

(iii) Identify the Premise of Value

(iv) Identify the Standard of Value

(v) Identify and Select a Valuation Date

(vi) Compile Non-Financial and Qualitative Information

(vii) Compile Financial and Qualitative Information

(viii) Identify Key Assumptions and Limited Conditions

(ix) Identify Valuation Approaches

(x) Consider and Apply Valuation Adjustments (Premiums and Discounts)

(xi) Develop Reconciliation and/or Correlate a Conclusion or Opinion of Value

The Board has been highly cognizant of the nature and extent of financial advisory/consulting services provided by its members which should, and should not, be subject to the proposed Standards. The Valuation Standards Committee has incorporated numerous general and assignment-specific exceptions to the Standards which meet the Board's objectives of fostering best practices in the provision of advisory services that promulgate basic Standards of practice regarding distressed situations. These Standards should be followed by members of the AIRA who are practicing valuation services, and should generally not be in conflict with other professional standards the members may hold.

Case Law Addendum

AIRA Valuation Standards and Their Application and Relevance in the Courts

A Sampling of the Case Law

I. Fraudulent Conveyance Cases:

A. Guarantees:

1. *Nordberg v. Arab Banking Corp. (In re Chase & Sanborn Corp)*, 904 F 2d 588, 595 (11th Cir 1990)

Concerning the fraudulent conveyance issue, the court noted that it is largely a question of fact as to which considerable latitude must be allowed to the trier of facts. The burden of proving lack of "reasonably equivalent value" rests on the trustee challenging the transfer. In this case, payments by a guarantor which was an affiliate of the debtor on the debtor's loan were preceded by payments by the debtor to the guarantor that were reasonably equivalent to the amount paid on the guarantee.

The satisfaction of a guarantee obligation is not "value" in exchange for the payments and such payments can and do constitute a voidable preference. The court indicated that if new value included credit toward such debts, thus rendering such transfers categorically unavoidable, section 547 (11 U.S. Code § 547 concerning preferences) would be rendered a tautological nullity.

2. *In re: Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988)

Subsidiary guaranteed an obligation of its parent. It ordered some chemicals for a price of approximately $124,000 and paid the invoice with two checks that cleared in January 1984. Xonics Photochemical as debtor in possession brought this proceeding under 11 U.S.C. § 547(b)(3). Was Xonics insolvent when it made the payments to Mitsui? Yes, and the court said, "Mitsui has presented no grounds on which we are authorized to set aside the voiding of the payments made to it."

B. Loan Fees:

1. *Mellon Bank, N.A. v.Official Comm of Unsecured Creditors of R.M.L., Inc, (In re R.M.L., Inc.)*, 92 F.3d 139 (10th Cir., 1996)

This was an action under section 548 of the bankruptcy code to recover $515,000 in payments made by the debtor Intershoe, Inc. to Mellon Bank. The court noted that for purposes of section 548, insolvency is defined as the situation where the sum of debts is greater than assets, at fair valuation. The relevant test date is the time of the alleged transfer. On the relevant date, August 31, 1991, the debtor's liabilities exceeded its assets by approximately $4 million.

The bankruptcy court noted that by all accounts, the debtor's financial survival was contingent upon the refinancing of its indebtedness by Mellon which refinancing in turn contingent on dozens of conditions including an equity infusion. The court explained that bankruptcy courts are not necessarily strictly bound by GAAP in insolvency determinations. These same courts have concluded that subsequent events, such as actual collection rates for receivables that may not be technically recognized under GAAP may be considered by a bankruptcy judge. The court therefore determined that the creditors committee established that the debtor was insolvent on that date.

The bankruptcy court determined that the debtor generally did not receive reasonably equivalent value when it paid Mellon Bank $515,000 for a loan commitment on a loan that never closed. In order to recover under 11 U.S.C. § 548, it must be shown that (1) the debtor had an interest in the property; (2) the transfer of the interest occurred within one year of the petition; (3) the debtor was insolvent at the time of the transfer or became insolvent as a result thereof; and (4) the debtor received less than a reasonably equivalent value in exchange for such transfer. The court concluded that at the time of the transfer, the debtor was insolvent. In determining whether the debtor received reasonably equivalent value, the bankruptcy court applied a totality of the circumstances test. As to the three deposits made by the debtor to the lender, the bankruptcy court determined that no value had been conferred particularly since the loan failed to close. Nevertheless, the bankruptcy court determined that Mellon could retain the first $125,000 deposit based on the fact that it would incur that much in expenses with respect to the proposed loan and some contractual value was received by the debtor and the transaction was of an ordinary commercial nature. However, no reasonably equivalent value was provided for the second $125,000 deposit. The fact that Mellon may have incurred further expenses was irrelevant if no value was conferred. The court further noted that at that time, the bank had the opportunity to extract fees not ordinarily warranted on an arm's-length commercial basis due to the debtor's weakening bargaining power. The Third Circuit affirmed the bankruptcy court holdings essentially on the grounds that substantial fees were paid for "an extremely remote opportunity" to receive value in the future. That extremely remote opportunity was not reasonably equivalent to the lending fees.

C. Payment of Debts of Debtor

1. *In re Davis (v. Sudervo),* 148 BR 165, 176 (Bankr ED NY 1992) (citing Covey v Commercial Nat'l Bank, 960 F 2d 657 (7th Cir 1992)); *Davis v Sunderov (In re Davis),* 169 BR 285, 299 (ED NY 1994)

Describes a transaction in which the debtors themselves were defrauded in a scheme to acquire their home and lease it back to them in a transaction that rendered the debtor insolvent. The court explained that economic coercion or fraud and misrepresentations have been held to render a transfer involuntary. In this case, because the debtors were induced to convey their residence to a predatory lender, the court concluded that the transfer was involuntary. It was made within one year before the date of the filing of the bankruptcy petition and is voidable if the debtors received less than a reasonably equivalent value and were then or were rendered insolvent.

The defendant (purchaser/lender) argued that the debtor received a benefit by reason of the transfer because the lender paid off the indebtedness encumbering the residence. The court said that the debtor would have benefited had the debtor retained the house, but since the house was transferred simultaneously to the lender, there was no benefit to the debtor. The court easily concluded that the transfer should be avoided.

II. Reasonably Equivalent Value

A. Promissory Notes

1. *In re Lindell,* 334 B.R. 249, 255 (Bankr. D. Minn. 2005)

Debtors, husband and wife, received promissory notes from the sale of their business secured by real estate which, at the time of their sale, had a value of approximately $263,000. All of the notes were sold by them to JNG Corporation for a total of $50,000. Less than one year later, the debtors filed for bankruptcy and the trustee initiated this action to avoid the transfer under Bankruptcy Code section 548. The debtors were insolvent at the time of the transfer. The trustee presented testimony of an expert witness that the notes had a value of between $120,000 and $130,000 at the time of their sale. The court concluded that the value of the notes was $130,000. The only question was whether a sale for $50,000 in cash was for a reasonably equivalent value. While acknowledging that there is no bright line test, the court concluded based on the totality of the circumstances that the sale was not for reasonably equivalent value in the transfer was avoidable.

B. Related Stock Purchase (or capital contribution)

1. *Creditors' Comm of Jumer's Castle Lodge, Inc. v. Jumer (In re Jumer's Castle Lodge, Inc.),* 338 B.R. 344, 354 (C.D. Ill. 2006)

The question in this case was whether a shareholder who owned all of the stock of a corporation provided reasonably equivalent value when he purchased assets of the corporation. The court indicated that the question of reasonably equivalent value involves both questions of fact and law. The legal standards are subject to de novo review. Once the correct legal standard has been applied, the question becomes a question of fact subject to review only for clear error.

Factors cited by the court were, (1) whether the value of what was transferred is equal to the value of what was received, (2) the market value of what was transferred and received, (3) whether the transaction took place at arms-length; and (4) the good faith of the transferee. The court pointed out that indirect benefits can constitute value and include a wide range of intangible such as goodwill or increased ability to borrow working capital, the general relationship between affiliates or synergy within a corporate group and a corporation's ability to retain an important source of supply or an important customer. The transaction must be viewed from the vantage of the creditors.

In this case, as part of the transaction a corporation received $2 million from a purchaser acquiring 30% of the corporation's stock. The creditors argued that the receipt of that $2 million should not be taken into account in determining whether an exchange between the corporation and its existing shareholder was for reasonably equivalent value. The court noted that the $2 million stock acquisition was expressly related to and conditioned upon the execution of the agreement between the corporation and its existing shareholder and that in essence the two agreements together constituted a single integrated transaction.

C. Public Sales

1. *Durrett v. Washington National Insurance Co.*, 621 F.2d 201 (1980)

In this case, the debtor in possession sought to set aside and vacate a transfer of real property effected 9 days prior to the filing of the petition under Chapter 11. The transfer was a foreclosure under a deed of trust where the purchaser was an unrelated party who bid the amount of the indebtedness. The district court determined that the value of the property was $200,000, a fact that neither of the parties took issue with. At the foreclosure sale, the property was sold for $115,400. The district court held that the consideration was fair and a fair equivalent within the meaning of 11 U.S.C. section 67(d)(1) and (e)(1).

In reviewing whether the price paid was a "fair equivalent" for the transfer of the property, the court concluded that it was not. The price paid was just under 58% of the value of the property involved in the sale deprive the bankruptcy estate of an equity in the property of $84,600. The court noted that it was unable to locate a decision of any district or appellate court dealing only with the transfer of real property under section 67(d) of the Act where a transfer for less than 70% of the fair market value was approved.

2. *Madrid v. Lawyers Title Ins. Co.*, 21 B.R. 424 (Bankr. 9th Cir. 1982), affd. on other grounds, 725 F.2d 1197 (9th Cir.), cert. denied, 469 U.S. 833, 105 S.Ct. 125, 83 L.Ed.2d 66 (1984)

In this case, the holder of a 2nd deed of trust in the original sum of $142,500 commenced foreclosure proceedings after note secured by that deed of trust was paid down to $75,300. The property was sold in foreclosure and the successful bidder purchase the property, subject to the 1st deed of trust, for the amount outstanding on the loan secured by the 2nd deed of trust at the time. The owner filed for bankruptcy within one year and as debtor-in-possession, brought an action against the purchaser at the foreclosure sale. Two theories were advanced: 1. The sale did not comply with state law; 2. The sale constituted a fraudulent conveyance under 11 U.S.C. section 548. The court determined that the lenders bid was approximately 65% of the property's fair market value at the time of sale and concluded that it was not reasonably equivalent value.

The court was aware of only 2 cases holding that a purchase at a nonjudicial sale under a deed of trust could be set aside as a fraudulent conveyance. One of the cases was *Durette v. Washington National Insurance Co*. The court considered two questions. The first was whether the foreclosure sale constituted a transfer and the second was whether "reasonably equivalent value" was paid. Finding that there was reasonably equivalent value, the first question was not determined. The court found that even though less than 70% of the fair market value of the property was received in the foreclosure sale, it declined to follow the Durett case because the sale was a public sale open to all bidders and all creditors. That provided a safeguard against the evils of private transfers to relatives and favorites. The court concluded that mere inadequacy of consideration will not upset foreclosure sale.

3. *Tracht Gut, LLC v. County of Los Angeles Treasurer*, BAP No. cc-13-1229-PaTaD (B.A.P. 9th Cir. 2014)

In this case, several properties were delinquent with respect to real estate taxes and were sold pursuant to tax sales. Shortly after the tax sales occurred, the debtor filed for bankruptcy and then commenced an adversary proceeding alleging that the properties were sold at tax sale of substantially less than their value and requesting the bankruptcy court to grant relief, essentially to avoid the tax sales as fraudulent transfers, for a declaratory judgment, for an injunction, for violation of the automatic stay and for unjust enrichment. The bankruptcy court dismissed the complaint without leave to amend in the debtor appealed. The trial court ruling was upheld in full, primarily on the grounds that the properties sold at the duly conducted tax sale were not properties of the debtor's estate for purposes of 11 U.S.C. § 541; the post-petition recording of the deeds could never be considered a violation of the automatic stay as it was solely a ministerial act; the tax sale could not be the basis of an action under 11 U.S.C. §§ 548 or 549.

4. *Bundles v. Baker*, 856 F.2d 815 (7th Cir. 1988) [attempts to reconcile the disparate holdings of Durett and Madrid]

The issue in this case was whether the trustee could avoid the sale of the debtor's personal residence upon foreclosure of the mortgage. The district court held that the sale could not be avoided and that reasonably equivalent value should be deemed satisfied where the property is sold at a regularly conducted, non-collusive foreclosure sale to a third-party purchaser and where the deed to the property is executed and recorded before the debtor filed his bankruptcy petition.

The court noted that the two seminal cases are *Durett v. Washington National insurance Co.* and *Lawyers Title Insurance Co. v. Madrid*. Courts interpreted *Durett* as standing for the proposition that reasonably equivalent value in a foreclosure context should be determined as a set percentage of fair market value with 70% being the appropriate benchmark. Courts have interpreted *Madrid* as representing the position that the sales price obtained a regularly conducted, non-collusive foreclosure sale should be presumed conclusively to be reasonably equivalent value for purposes of § 548(a)(2)(A). In this case, both the bankruptcy court and the District Court followed *Madrid*. In essence, the court concluded that the "reasonably equivalent value" test had to be considered even in the case where there is an absence of collusion. An irrebuttable presumption would be contrary to the policy underlying the statute. In considering what the appropriate standard should be, the court declined to approve a conclusive presumption in the case of a regularly conducted noncollusive foreclosure and also rejected a simple comparison of the sales price to the fair market value. The court said, "Reasonable equivalence should depend on all the facts of each case." While fair market value is a starting point, the court must focus on fair market value as affected by the fact of foreclosure. The court should consider such factors as whether there was a fair appraisal of the property, whether the property was advertised widely and whether competitive bidding was encouraged.

D. Leveraged Transactions (Buyouts)

1. *Friedman v. American Capital, LTD.*, Case No. 09-12066-DK (2012)

In this case, the trustee filed an avoidance action under 11 U.S.C. §§ 544 and 548 and under various provisions of state law. The transaction in question involved a loan by American Capital, LTD to the debtor in connection with a leveraged buyout transaction. As part of the transaction, the debtor received substantial loan proceeds and granted to American

Capital a note and security interest on its assets. The debtor was required to distribute a substantial portion of the loan proceeds to the holding company in order to enable it to pay for the shares of the debtor it had recently acquired. The trustee argued that the debtor received neither reasonably equivalent value for fair consideration for the transfers.

American Capital disputed that the debtor neither received fair consideration nor reasonably equivalent value in its motion to dismiss. The motion to dismiss was denied on all grounds allowing the dispute to continue. The trustee's claims included the transactions were undertaken with actual intent to hinder, delay or defraud creditors; that the transfers were made without fair consideration; that the transfers were made by the debtor while insolvent or rendered insolvent by the transfers; that the debtor engaged in transfers where the property remaining after the conveyance was unreasonably small; as a result of the transfers, debts would be incurred that were beyond the debtors ability to pay them as they matured; within 2 years before the date of filing the debtor made transfers or incurred obligations with actual intent to hinder, delay or defraud. The court held that the trustee's complaint alleged facts that if true, could support a conclusion that the debtor did not receive reasonably equivalent value.

2. *Bay Plastics v. BT Commercial Corp. (In re Bay Plastics, Inc.)*, 187 B.R. 315 (Bankr. C.D.Cal 1995)

This case involved the leveraged buyout of three shareholders. They sold their stock to a subsidiary of the acquiring corporation. The subsidiary was formed for the purpose of making the acquisition and it caused the target corporation, the debtor in this case, to borrow all of the cash portion of the purchase price. The debtor then distributed up to the acquiring corporation the borrowed funds which used them to pay the shareholders. To effect the transaction, the corporation's principal supplier was persuaded to reduce its security interest and its guarantees prior to the sale. The LBO character of the transaction was not disclosed to the supplier. By reason of the borrowings, the debtor was rendered insolvent except for the addition of $2.26 million in good will to its balance sheet which permitted the balance sheet to show a modest shareholder equity of $250,000.

Ultimately, the debtor was unable to service the debt and it filed its bankruptcy petition 15 months after the transaction. The debtor was unable to use the fraudulent transfer provision of the bankruptcy code, section 548 because it is applicable to transfers made or obligations incurred within one year before the date of the filing of the petition. Instead, it relied upon California's law fraudulent conveyance statute. The court concluded that there were no triable issues of material fact and entered summary judgment setting aside the fraudulent transfer in this case to the selling shareholders. In substance, the court indicated that selling shareholders received payment for their shares that was secured by assets of the debtor and that the transaction defrauded an existing creditor.

3. *Moody v. Security Pacific Business Credit, Inc.*, 127 B.R. 958 (W.D. Pa. 1991)

This case involved the leveraged buyout followed by a suit by the bankruptcy trustee to recover in excess of $12 million from its participants. Jeannette Corporation was sold for 12.1 million to J. Corp., a holding company owned by the buyer group. The buyer borrowed $11.7 million of the purchase price from Security Pacific Business Credit and the loan was secured by a lien on all of Jeannette's assets. Fifteen months after the transaction occurred, a creditor filed an involuntary bankruptcy petition against Jeannette under Chapter 7.

Among the arguments raised was that the transaction was intentionally fraudulent. The transaction was also attacked under the constructive fraud provisions of state law and Bankruptcy Code § 548. After noting that the plaintiff bears the burden of demonstrating intent through "clear and convincing evidence" the court concluded that the defendants did not know or believe that Jeannette's creditors could not be paid and did not intend to hinder, defraud or delay the creditors. No badges of fraud were found. The court then turned to the question of whether the transaction should be set aside under state law fraudulent conveyance statute in the bankruptcy code. The question was whether the conveyances were made and obligations incurred "without a fair consideration" under Pennsylvania law. The court did note that Jeannette Corporation received nothing in the transaction that would constitute fair consideration for the encumbrance of its assets and that receipt of new management did not fall within the definition of fair consideration. Noting that the conveyances could not be set aside unless Jeannette was rendered insolvent, the court looked at the solvency of Jeannette after the transactions. In its analysis of the insolvency question the court indicated that in considering the present fair salable value of Jeannette's assets, it held that they must be valued on a "going concern basis, rather than on a liquidation basis."

The court also considered, in evaluating the state law issue, the requirement that "Every conveyance made without fair consideration, when the person making it is engaged, or about to engage, in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors, and as to other persons who become creditors during the continuance of such business or transaction, without regard to his actual intent." 39 Pa. Stat. Section 355.

The court concluded that Jeanette was able to and did pay its creditors until it experienced a dramatic downturn in orders and sales. While delays in payments to creditors did occur to some extent, the court was not convinced that this proved Jeanette was insolvent or left with unreasonably small capital. Specifically, the court determined that it was not forced to delay payments to creditors because of the leveraged buyout transaction. Therefore, the court concluded that the plaintiff could not recover under Pennsylvania law or the bankruptcy code.

4. *Credit Managers Association of Southern California v. Federal Co.*, 629 F.Supp 175 (C.D. Cal. 1985)

The transaction in this case was a leveraged management buyout. Prior to the buyout, the debtor was a subsidiary of a publicly traded corporation. In May 1982, the stock was sold to a new entity formed by top management of the subsidiary. Seventeen months after the transaction occurred, the subsidiary executed a general assignment for the benefit of its creditors. This case was brought by a creditor on various legal theories including fraudulent conveyance, unlawful distribution of assets and equitable subordination.

The court acknowledged that after the transaction, Crescent (the debtor) was much more heavily leveraged than prior to the sale. But after the sale, a number of setbacks occurred independent of the transaction including creditors extending less credit because it was no longer part of a publicly traded company, slower payments by customers, a strike, and loss of business. The court noted, however, that even after the transaction, the fair market value of Crescent’s fixed assets exceeded the book value of those assets.

The court noted that most of the creditor’s claims arose after the transaction and the creditors at the time of the assignment for the most part were not the same as those who were creditors at the time the buyout occurred. Thus, most creditors extended credit after the transaction. These creditors had knowledge of the change in ownership. The court noted as a matter of fairness, “it would seem that if leveraged buyouts are to be susceptible to attack on fraudulent conveyance grounds, only those who were creditors at the time of the transaction should have a right to attack the transaction.”

The court then noted that the California fraudulent conveyance act does indicate that conveyances made without fair consideration when one is about to engage in a business for which, after the conveyance, there is an unreasonably small capital, the conveyance “is fraudulent as to creditors and as to other persons who became creditors during the continuation of such business.” Finding that the transaction was without fair consideration, the issue was whether the transferor was left with unreasonably small capital. The court stated that whether the debtor was undercapitalized is “a question of fact that must be ascertained on a case-by-case basis." The court then went through a detailed analysis looking at the facts at the time of the transaction including projected sales, gross profit margins and inventory turnover, accounts receivable collection periods and balance sheet and ratios. Concluding that subsequent events were primarily responsible for the decline in value, the court held that Crescent was not left undercapitalized. There was also no evidence that the price paid for the stock at the time of the transaction was "out of line with what it was worth." The court also held against the plaintiff on the remaining causes of action.

III. Approval of Bankruptcy Plans

A. Valuing the Enterprise

1. Determining When a Class is Impaired

In re Lakeside Global II, Ltd., 116 B.R. 499 (Bankr. S.D. Tex 1989)

This is a case in which the court was called on to determine whether to approve a plan of reorganization. The court noted that a class of claims is impaired if the plan alters the claimant's legal, equitable or contractual rights or if the plan fails to provide for payment on the effective date of cash equal to the amount of the allowed claim. Out of nine classes, seven of them were impaired.

Also at issue was whether the equity holders can retain assets over the objection of the senior creditor (a cramdown situation). In order to approve a plan under those circumstances, the present value of the package of rights offered to the secured creditor must at least equal the value of that secured creditors interest in the collateral. More particularly, the sum of the deferred cash payments must equal the present value of the lien holders' claims in full. The court noted that in this case, certain lenders were being offered a package of rights that is less than the current value of the properties which serve as security for their loans. The court further noted, "According the value of the package of rights offered to the rejecting impaired secured claim holder classes is less than what a willing buyer would get if the properties were to be sold in a fair market." Confirmation of the plan was denied that the parties were urged to reopen negotiations.

Standards Addendum

Distressed Business Valuation Standards

By David R. Payne, CPA/ABV, CIRA/CDBV, CTP, ASA

The AIRA Board of Directors ("Board") approved Standards For Distressed Business Valuation ("Standards") effective March 1, 2014. A summary of certain critical elements of the Standards are summarized below:

A. Standards Apply To Developing And Issuing An "Opinion of Value"

As described in the Standards, the term "engagement to estimate value" refers to an engagement or any part of an engagement that involves "estimating and/or developing an opinion of the value" of a subject interest. In the process of estimating value, the valuation analyst applies valuation approaches and methods, and uses professional judgment. The use of "professional judgment" is an essential component of "estimating value". The Standards do not draw any distinction between a full-scope or detailed engagement versus a restricted use or limited scope engagement or between a valuation engagement versus a calculation engagement.[1] The Standards apply "when performing engagements to estimate value that culminate in an expression of an opinion or conclusion of value" including but not limited to the following:

(i) Developing an opinion of value regarding the reorganization value of the business enterprise or the related equity value available for old or new equity holders.

(ii) Developing an opinion of value regarding a sale of assets or a segment of the business.

(iii) Developing an opinion of value on the insolvency/solvency of the business enterprise at points in time.

(iv) Developing an opinion of value for assets and/or the business on a going concern, orderly or forced liquidation basis for purposes of assessing confirmation of a plan, conversion to Chapter 7 or for adequate protection.

(v) Developing an opinion of value for financial reporting purposes including fresh start accounting.

B. Standards Apply and Are Binding on Certified Members

[1] These types of engagement distinctions are identified by other appraisal organizations such as the AICPA, ASA and others. The AIRA has no opinion regarding the priority of standards among these organizations, and the AIRA has no opinion regarding the appropriate application of any standards that may differ between these organizations as they apply to the facts and circumstances of individual valuation engagements

The Standard are binding on "AIRA Members who are a Certified Insolvency and Restructuring Advisor ("CIRA") and AIRA Members who have received a Certification in Distressed Business Valuation ("CDBV")".

C. Standards Do Not Apply To Traditional Insolvency and Reorganization Consulting Services

Consulting services rendered in bankruptcy engagements as well as in other troubled debt situations are not subject to the Standards although such consulting services may rely, in part, on valuation techniques/calculations including:

(i) Preparing and/or evaluating cash flow projections, sensitivity analysis and present value analysis for purposes of assessing viability and feasibility of the debtor.

(ii) Advising and assisting clients with forecasts and analysis of cash collateral, replacement collateral and collateral values provided by third parties.

(iii) Identifying an appropriate capital structure upon emergence, negotiating with creditors, assisting with developing a plan of reorganization and advising the client on potential plan actions utilizing third party indications of value.

(iv) Advising Chapter 11 creditors about voting to accept or reject a plan of reorganization based upon various financial metrics including valuation metrics provided by third parties. The reorganization plan outlines payouts to the different classes of creditors based on the value of the reorganized debtor. A creditor may vote to accept or reject a proposed plan. The financial advisor may advise the creditor to accept or reject a plan based upon the proposed payout under the plan as compared with the potential payout under an alternative scenario

(v) Performing the "best interests of creditors test" regarding the treatment of creditors under a proposed plan of reorganization under the U.S. Bankruptcy Code by evaluating (as opposed to developing an independent opinion) going concern versus liquidation values of the debtor.

(vi) Assessing the potential for (as opposed to developing an independent opinion) for insolvency at various dates in order to evaluate possible recovery actions.

D. The Standards Include a Binding "Development Standard" To Support An Opinion of Value

The Development Standard included in the proposed AIRA Standards is generally consistent with the development standard set forth by other valuation/appraisal organizations including those published by the ASA, NACVA, IBA, CFA and AICPA[2]. The Development Standard

[2] Statement on Standards For Valuation Services No. 1

requires that all appraisal principles, approaches, methods and calculations are required to be considered, rejected and/or applied in developing an opinion of value. However, a written valuation report is not required although quantitative exhibits, demonstratives, work schedules, data tables and/or summaries are usually necessary to support such an opinion. The valuators' work file should generally contain the same data and calculations whether or not a written valuation report is issued.

A valuation engagement requires written and/or oral narrative disclosure of the assumptions, methods and approaches used to determine a conclusion of value. In certain situations where the third party users are knowledgeable of the business, omission of certain narrative disclosures regarding the business, its assets and liabilities can be appropriate. The degree to which narrative disclosures may be omitted to satisfy the purpose, facts and circumstances of each particular engagement is a matter of professional judgment.

The Development Standard invokes a documentation requirement for information obtained and analyzed, procedures performed, valuation approaches and methods considered and used, and the conclusion of value. The quantity, type, and content of documentation are matters of the valuation analyst's professional judgment and experience considering the nature and purpose of the assignment. Documentation may include:

E. <u>The Standards Include a "General-Report (Writing) Exception" Even When An Opinion of Value is Performed and Oral Reports are Acceptable</u>

The reporting Standards do not apply to litigation engagements in which a valuation analyst is engaged to testify as an expert witness in valuation, accounting, auditing, taxation, or other matters, given certain stipulated or assumed facts. A valuation performed for any matter before a court, an arbitrator, a mediator or other facilitator, or a matter in a governmental or administrative proceeding (herein referred to individually or collectively as "Controversy Proceedings"), is exempt from the reporting provisions of the Standards. The reporting exemption applies whether the matter proceeds to trial or settles. This exemption applies only to the reporting provisions of the Standards. The developmental provisions of the Standards still apply whenever the valuation analyst expresses a conclusion of value even in Controversy Proceedings.

An oral report may be used in a valuation engagement. An oral report should include "all information the valuation analyst believes necessary to relate the scope, assumptions, limitations, and the results of the engagement" so as to limit any misunderstandings between the analyst and the recipient of the oral report. The member should "document in the working papers" the substance of the oral report communicated to the client.

F. <u>The Standards Include a "General-Jurisdictional Exception" Even When An Opinion of Value is Performed</u>

If any part of the Standards differs from published governmental, judicial, or accounting authority, or such authority specifies valuation methods or valuation reporting procedures, then the valuation analyst should follow the applicable published authority or stated procedures with respect to that part applicable to the valuation in which the valuation analyst is engaged. The other parts of the Standards continue in full force and effect.

One example of a jurisdictional exception in bankruptcy proceedings would be the consideration and/or use of "hindsight" in developing an opinion of value. In certain situations, bankruptcy courts have relied upon latter occurring events and data to determine value at an earlier date. Some examples include the decisions issued in the *Sunset Sales*[3] and *CFS*[4] cases regarding the measure of value for insolvency purposes in recovery actions. Ultimately, the use or application of any hindsight regarding subsequent events will depend on the purpose of the valuation and the intended user and should be fully disclosed in the valuation report.

G. <u>The Standards Include "Ten (10) Assignment – Specific Exceptions" Which Are Not Deemed To Encompass An Opinion of Value</u>

(i) Attest Exception – "The Standards are not applicable to a valuation analyst who participates in estimating the value of a subject interest as part of performing an attest engagement defined by Rule 101 of the AICPA Code of Professional Conduct (for example, as part of an audit, review, or compilation engagement)."

(ii) Government Regulation Exception – "The Standards are not applicable to a valuation that is performed pursuant to governmental regulation with a proscribed methodology, such as an ESOP valuation; however, if such a valuation is being performed in an insolvency context within the scope of these Standards, the analyst is expected to comply with these Standards and is expected to comply with the relevant reporting requirements of these Standards."

(iii) Client Provided Value Exception – "The Standards are not applicable when the value of a subject interest is provided to the valuation analyst by the client or a third party, and the member does not apply independently developed valuation approaches and methods, as discussed in the Standards. Sensitivity analysis performed on values determined by third parties is not considered an opinion of value subject to the Standards."

(iv) Sensitivity Analysis Exception – "The Standards are not applicable when the value of a subject interest is provided to the valuation analyst by the client or a third party, and the member does not apply independently developed valuation approaches and methods, as discussed in the Standards. Sensitivity analysis performed on values

[3] *In re Sunset Sale, Inc.; Payne v. Clarendon National Insurance, et al.,* BAP WO-97-100 (Bankr. W.D. Okla. 1992)
[4] *In re Commercial Services; NGU, Inc. v. Chase Manhattan, et al.,* 350 B.R. 520 (Bankr. N.D. Okla. 2005)

determined by third parties is not considered an opinion of value subject to the Standards."

(v) Internal Use Employer-to-Employee Exception – "The Standards are not applicable to internal use assignments from employers to employee members of the AIRA."

(vi) Economic Damages and Lost Profits Exception – "The Standards are not applicable to engagements that are exclusively performed for the purpose of determining economic damages such as lost-profits unless those determinations include an engagement to estimate value. If a valuation analyst performs an engagement to estimate value to determine the loss of value of a business or intangible asset in connection with financial advisory services being rendered in the areas of business turnaround, restructuring and bankruptcy practice, then the Standards apply. A valuation analyst acting as an expert witness should evaluate whether the particular damages calculation constitutes an engagement to estimate value with respect to the business, business interest, security, or intangible asset or whether it constitutes a lost-profits computation. Present value calculations of future loss of profits are generally not considered an opinion of value even when income approach techniques are applied."

(vii) Mechanical Value Computations Exceptions – "The Standards are not applicable to mechanical computations that do not rise to the level of an engagement to estimate value; that is, when the valuation analyst does not apply valuation approaches and methods and does not use independent professional judgment and does not issue an opinion or conclusion on value."

(viii) Insufficient Data and Information Exception – "The Standards are not applicable when it is not practical or not reasonable to obtain or use relevant information; as a result, the valuation analyst is unable to apply valuation approaches and methods that are described in the Standards. Unless prohibited by statute or by rule, a valuation analyst may use the client's estimates for compliance reporting to a third party if the valuation analyst determines that the estimates are reasonable based on the facts and circumstances known to the valuation analyst."

(ix) Financial Advice Exception – "Providing financial advice, without reference to developing independent values for various assets, is not subject to the Standards. However, if a valuation analyst independently calculates a value to illustrate various planning options, the analyst may fall under the Standards. Merely performing sensitivity analysis to value indications provided by third parties or the client is not subject to the Standards. If one or more of the assets for which value is to be determined is a business, business ownership interest, security, or intangible asset and is part of an engagement involving the fields of business turnaround, restructuring, bankruptcy and insolvency, and the client or a third party does not provide the values for these assets, or the valuation analyst does not use assumed or hypothetical values as part of the overall engagement, then the valuation analyst performing the valuation(s) is subject to the Standards with regard to these assets when determining an opinion of value."

(x) Tangible Asset Exception – "The Standards do not apply to the assets or interests which constitute tangible assets as defined by the International Glossary of Business Valuation Terms, and which do not constitute a subject interest."

H. <u>The Standards Include a Binding Requirement to Disclose "Relevant and Materially Significant Restrictions and Limitations"</u>

All relevant and materially significant restrictions or limitations should be reasonably disclosed in any oral or written report including written materials that convey the results. For example, if a client instructed the valuator to apply only one approach or method to the exclusion of all other approaches there would be a scope limitation present. If, in the course of a valuation engagement, restrictions or limitations on the scope of the valuation analyst's work or the data available for analysis are so significant that the valuation analyst believes that he or she cannot, even with disclosure in the valuation report of the restrictions or limitations, adequately perform a valuation engagement leading to a conclusion of value, then the valuation analyst should consider terminating the valuation services subject to the Standards and assess the applicability of other consulting/advisory services.

I. <u>The Development Standard Requires Consideration of "Generally Recognized Valuation Principles, Approaches and Methods To Develop An Opinion of Value":</u>

In performing a valuation engagement, the valuation analyst should analyze the subject interest, consider and apply appropriate valuation approaches and methods, reconcile the indication of value to reach a conclusion of value, and maintain appropriate documentation. The development standards and generally recognized report disclosures include:

(i) Identify and Define the Subject Business Ownership Interest and/or Assets and Their Nature

(ii) Define the Purpose of Intended Use of the Valuation

(iii) Identify the Premise of Value

(iv) Identify the Standard of Value

(v) Identify and Select a Valuation Date

(vi) Compile Non-Financial and Qualitative Information

(vii) Compile Financial and Qualitative Information

(viii) Identify Key Assumptions and Limited Conditions

(ix) Identify Valuation Approaches

(x) Consider and Apply Valuation Adjustments (Premiums and Discounts)

(xi) Develop Reconciliation and/or Correlate a Conclusion or Opinion of Value

The Board has been highly cognizant of the nature and extent of financial advisory/consulting services provided by its members which should, and should not, be subject to the proposed Standards. The Valuation Standards Committee has incorporated numerous general and assignment-specific exceptions to the Standards which meet the Board's objectives of fostering best practices in the provision of advisory services that promulgate basic Standards of practice regarding distressed situations. These Standards should be followed by members of the AIRA who are practicing valuation services, and should generally not be in conflict with other professional standards the members may hold.