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VALUATION ISSUES

Judge Favors Market Data Over Experts in Valuation Dispute

Iridium *May Have Dramatic Impact on Avoidance Actions*

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U.S. Bankruptcy Court Judge James M. Peck's decision in *Statutory Comm. of Unsecured Creditors on behalf of Iridium Operating, LLC, et al. v. Motorola, Inc. (In re Iridium Operating LLC),*[1] rejected expert testimony in favor of market evidence in evaluating whether a company was insolvent for purposes of an action to avoid fraudulent conveyances and preferences. If followed, this approach is likely to have a dramatic impact on the prosecution and defense of future avoidance actions.

Chapter 5 of the U.S. Bankruptcy Code provides debtors in possession and trustees with the ability to bring so-called avoidance actions,[2] which fall into two key categories: preferences and fraudulent transfers.

Fraudulent transfers may be made with actual intent to hinder, delay, or defraud creditors, or they may be constructively fraudulent — that is, not made with any intent to defraud, but nevertheless fraudulent as to creditors of an insolvent company because of the inadequacy of the consideration. A preference is a transfer of an interest of a debtor in property, to or for the benefit of a creditor, on account of an antecedent debt, made while the debtor was insolvent, within 90 days of the petition date (or one year if the creditor was an insider), that enabled a creditor to receive more than it would have in a liquidation under Chapter 7 of the Bankruptcy Code.[3]

Preferential transfers include cash payments, transfers of assets, and the granting or perfection of a lien to a previously unsecured creditor or secured creditor whose lien was unperfected. The Bankruptcy Code permits assets that are transferred or debts that are incurred while a company is insolvent (or that rendered a company insolvent) to be avoided as constructive fraudulent transfers if the debtor did not receive reasonably equivalent value.[4]

Under state law, assets that are conveyed or debts that are incurred while a company is insolvent (or that rendered a company insolvent) can be avoided as constructive fraudulent conveyances if the debtor did not receive fair consideration or reasonably equivalent value.[5] These state law rights to avoid constructive fraudulent conveyances can be invoked in bankruptcy cases.[6]

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To promote equality of distribution among all creditors, both preferences and constructive fraudulent transfers can only be brought if the debtor was insolvent at the time of the transfer. A company is insolvent if the sum of its debts is greater than all of its property (other than property that is exempt or has been transferred with intent to defraud).[7] Insolvency is determined using the fair value of the company's assets, not book value.

Both the Bankruptcy Code and state law also permit avoidance of constructive fraudulent transfers if the company was undercapitalized or intended or believed it would incur debts beyond its ability to repay.[8] The statutes that permit constructive fraudulent transfers and preferences to be avoided are intent neutral—that is, it does not matter that everyone involved in the transaction believed that the debtor was solvent or adequately capitalized at the time of the transfer.

Preferences can only be assailed if they were made within 90 days of the petition date; but if the transferee was an insider, then the reach-back period is one year. Transactions can be assailed as constructive fraudulent transfers under the Bankruptcy Code if they occurred within two years prior to the bankruptcy filing,[9] but the reach-back period for constructive fraudulent conveyances under state law is generally four to six years.[10]

The question then arises, was the company really insolvent so many years before a bankruptcy filing? In *Iridium,* Peck answered this question in the negative.

Iridium worked closely with Motorola to conceive, develop, own, and operate a global telecommunications system. The venture was intended to provide voice communication and paging services anywhere in the world so long as the antenna of a subscriber's portable telephone or paging unit could make radio contact with one of Iridium's 66 low earth orbiting satellites.

Iridium was spun off from Motorola in the early 1990s. Thereafter, Motorola served as Iridium's patron and contract counterparty. It provided substantial technical and financial support and received progress payments aggregating $3.7 billion pursuant to its contracts with Iridium during the four years prior to bankruptcy,

Iridium launched its commercial service in November 1998, but it was plagued by technical problems, including line-of-sight limitations and bulky, expensive handsets. On August 13, 1999, about nine months after commercial activation of its telecommunications system, involuntary petitions were filed against Iridium and were converted to voluntary petitions by September 1999. Thereafter, Iridium's assets were sold for $25 million.

The *Iridium* Decision

In 2001, the creditors' committee commenced an adversary proceeding to recover $3.7 billion

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from Motorola under various theories, including the avoidance of fraudulent conveyances made within four years preceding the petition date under applicable non-bankruptcy law. Unlike the committee's breach of fiduciary duty, breach of contract, and equitable subordination counts, the fraudulent conveyance and preference claims required the committee to establish that Iridium was insolvent or undercapitalized. After a five-day trial, Peck dismissed the fraudulent conveyance and preference counts because the committee failed to do so.

The committee attempted to prove insolvency through expert testimony. The committee's expert considered all of the standard valuation methodologies — the cost approach, precedent transactions, market comparables (or guideline companies), and the discounted cash flow (DCF) methodology — but concluded that only the DCF methodology should be used to value Iridium.

Motorola also used a DCF approach, but importantly, also established the following contemporaneous reference points of Iridium's value, which were ignored by the committee's expert in his solvency analysis: stock price, market capitalization, analyst reports, investment banker valuations, comparable company analyses, and the fact that Iridium's auditors (KPMG) had not issued going concern qualifications[11] for the company.

Specifically, Motorola introduced evidence that Iridium knew that its system had line-of-sight limitations and such technological limitations were publicly disclosed to investors. Iridium spent considerable effort developing and refining its business plan and projections. On December 19, 1997, Iridium entered into an agreement with a syndicate of banks for a $1 billion credit facility, which was 1.7 times oversubscribed and was increased from the originally proposed amount of $750 million. Additional credit was extended in December 1998 after substantial due diligence concerning Iridium's overall capital structure and financing plan.

During the mid to late 1990s, when the company was purportedly insolvent, Iridium and its affiliates were also able to raise substantial capital in the public debt and equity markets, after significant due diligence by investors and underwriters. Throughout 1997 and 1998, Iridium's stock prices ranged from $17 to more than $70, implying an equity valuation between $2.3 billion and $10 billion. Significantly, "Iridium's implied market value based on price per share was lower than the discounted cash flow…values reached by investment bankers at the time. This correlation between the DCF analysis and the value implied by the public markets is an indication that irrational exuberance did not distort Iridium's stock price."[12]

From January 1998 to January 1999, analysts believed that Iridium's equity value ranged between $4 billion and $14 billion. Iridium had a conservative debt-to-equity ratio and was able to pay its debts as they came due until shortly before its demise. Finally, Motorola introduced evidence that as of December 31, 1996, 1997, and 1998, KPMG had concluded that Iridium was a going concern, and as late as March 1999, KPMG reexamined the company and concluded that no substantial doubt existed about its ability to continue as a going concern.

Basically, before calling its experts, Motorola marshaled substantial contemporaneous market evidence supporting its position that Iridium was solvent at the time of the transfers.[13] Motorola's experts relied on this substantial record and their own DCF analysis in concluding that Iridium was solvent.[14]

Peck started his analysis by observing that: "Courts generally look at a combination of valuation methodologies to determine valuation, including: (a) actual sale price, (b) discounted cash flow method, commonly referred to as DCF, (c) adjusted balance sheet method, (d) market multiple approach, (e) comparable transactions analysis, and (f) market capitalization."[15] In determining capital adequacy, courts look to "such factors as the company's debt to equity ratio, its historical capital cushion, and the need for working capital in the specific industry at issue," but the focus is on the reasonableness of projections at the time they were made, not on what ultimately happened to the company.[16]

In analyzing the value of Iridium's business, Peck placed heavy emphasis on market evidence that reflected positive enterprise value, including the stock price, assessments of market analysts, and the company's ability to raise debt and equity capital during the time it was supposedly insolvent. Peck declined to take into consideration the fact that Iridium failed so spectacularly after the transfers had been made because that would constitute "improper hindsight analysis in valuing a company's pre-bankruptcy assets."[17]

Instead, the *Iridium* decision followed the 3d U.S. Circuit Court of Appeals' decision in *VFB LLC v. Campbell Soup Co.*,[18] in which the court relied on the post-spin market price of Vlasic's stock to determine that the spin-off was not a fraudulent conveyance. The *Iridium* decision quoted *Campbell* approvingly: "Absent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'"[19]

Peck also cited Supreme Court precedent on the importance of the markets in determining value:

> "With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price."[20]

Importantly, in *Campbell*, the 3d Circuit also pointed out that if the market capitalization had been inflated by the company's manipulations of the financial statements, then it would not have been good evidence of value. This does not appear to have been an issue in *Iridium*, where sophisticated market participants were simply spectacularly wrong about the company's prospects.

Peck also gave significant weight to contemporaneous projections of Iridium's management, because they were "reasonable and prudent when made."[21] Next, the judge relied on the contemporaneous analysis of value performed by investment bankers, underwriters of Iridium's debt and equity, and lenders, all of which supported the view that the company was solvent. Basically, private parties "putting their money where their mouths are" is more reliable than expert reports done for purposes of litigation, which can be "too subjective and too subject to manipulation."[22]

Finally, Peck turned to the committee's DCF analysis. First, in performing his gatekeeper function mandated by the Supreme Court in *Daubert*,[23] Peck noted that expert evidence could only be admitted if it is both reliable and relevant, and that *Daubert* also applies to weight and credibility determinations.[24] The *Iridium* court found that plaintiff's DCF analysis was not credible because the

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committee's experts failed to adequately explain, rebut, or analyze the conflicting market evidence.[25]

The *Iridium* court found that contemporaneous market data is more reliable than expert testimony, which can be tainted by improper "hindsight bias" and may reflect an advocate's point of view. This was consistent with Peck's observation at the outset of his opinion: "Any reader of *The Wall Street Journal* knows that the markets are risky and unpredictable and that share prices frequently are influenced by a variety of factors unrelated to the fundamentals and potential of a particular company. Nonetheless, the public trading market constitutes an impartial gauge of investor confidence and remains the best and most unbiased measure of fair market value and, when available to the Court, is the preferred standard of valuation."[26]

Future Disputes

In light of *Iridium* and *Campbell*, courts in the two most common venues for Chapter 11 cases — the Southern District of New York and Delaware (which is in the 3d Circuit) — have adopted a rule favoring market evidence over expert testimony in evaluating whether a debtor was insolvent for purposes of avoidance actions. If followed, the *Iridium* decision will make it far more difficult to establish insolvency in the years preceding bankruptcy when there is market evidence to support positive valuations.

Thus, where stock prices reflected positive value, bonds traded at or above par, or a company was able to raise additional capital, transfers should be insulated from subsequent avoidance action attack, unless the financials can be shown to have overstated the company's true condition. This will protect defendants from improper 20/20 hindsight and results-driven valuations.

Importantly, even under the approach adopted by *Iridium* and *Campbell*, market evidence can be rebutted if a plaintiff can demonstrate that the market failed to take into account relevant information. The most obvious example of this would be a situation in which a company engaged in financial fraud, but the same result should apply if the financial statements on which market participants relied are otherwise flawed.

Likewise, market evidence of solvency might be overcome if the market was too thinly traded to be a reliable indicator of value, if market manipulation can be established, or if other exogenous events distorted the market price. "Irrational exuberance" comes to mind, although Peck specifically found that was not the case in *Iridium*.

Credit default swaps may also have an impact on prices of debt instruments. Situations in which stock traded for only a nominal amount could presumably be explained as reflecting "option" or control value, rather than being evidence of solvency. Finally, defensive loans from existing lenders trying to protect their positions should not be viewed in the same light as fresh capital from new investors who performed substantial due diligence.

As market valuation becomes more common in bankruptcy cases, situations may arise when market indicators conflict. For example, how would a court evaluate a company that has stock trading at a non-nominal value and debt trading at a significant discount from par? The price of debt is usually considered a fair market assessment of the likelihood that the debt will either be repaid or that the issuer might default. A bond price could be signaling a significant risk of default while the stock is still trading at meaningful levels.

The parties to a valuation dispute obviously will advocate the valuation based on the securities that best suit their point of view. Ironically, a situation like this may mean that the courts will have to return to the traditional valuation methodologies to resolve future valuation disputes. CR

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[1] 373 B.R. 283 (Bankr. S.D.N.Y. 2007).

[2] Creditors' committees and other creditor representatives (such as trustees under liquidating trusts) are also sometimes empowered to bring avoidance actions and other claims that belong to the debtor's estate.

[3] 11 U.S.C. Section 547(b).

[4] 11 U.S.C. Section 548(a)(1)(B).

[5] See, *e.g., New York Debtor and Creditor Law* Section 273.

[6] 11 U.S.C. Section 544.

[7] 11 U.S.C. Section 101(32).

[8] 11 U.S.C. Section 548(a)(1)(B)(ii)(II)-(III); New York Debtor and Creditor Law Section 274-75.

[9] 11 U.S.C. Section 548(a)(1)(two-year reach-back for cases filed on or after April 17, 2006).

[10] Transactions that occurred six years before a bankruptcy filing can be challenged if New York law governs. 11 U.S.C. Section 544 & 108(a); New York Debtor and Creditor Law Section 273, et seq.; New York Civil Practice Law and Rules Section 213(8). The reach-back period under the Uniform Fraudulent Transfer Act, which has been adopted in most states and which was applicable in *Iridium*, is four years.

[11] 373 B.R. at 339.

[12] *Id.* at 334.

[13] *Id.* at 311-37.

[14] *Id.* at 337-39.

[15] *Id.* at 344 (citations omitted).

[16] *Id.* at 345.

[17] *Id.*

[18] 482 F.3d 624 (3rd Cir. 2007).

[19] 373 B.R. at 347, citing *Campbell*, 482 F.3d at 633.

[20] *Id.* at 347, quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 244 (1988).

[21] *Id.* at 347 (citations omitted).

[22] *Id.* at 348 (citations omitted).

[23] *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993) (holding that expert evidence should be admissible only after it has been established that the evidence is reliable and scientifically valid, that trial judges have the duty to act as gatekeepers charged with preventing junk science from entering the courtroom, and discussing four factors: testing, peer review, error rates, and acceptability in the relevant scientific community).

[24] 373 B.R. at 349 (citations omitted).

[25] *Id.* at 350-51.

[26] *Id.* at 293.

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