

## Campbell, Iridium, and the Future of Valuation Litigation

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*Five years ago, two landmark federal court valuation decisions, Campbell and Iridium, held that market evidence—rather than the testimony of paid litigation experts—should be relied on to value corporations for purposes of litigation. While a number of decisions have followed Campbell and Iridium, their full potential to make business valuation litigation less costly and less susceptible to hindsight bias has yet to be realized. Courts can and should take greater advantage of the full panoply of types of market evidence relied upon by the United States District Court in Campbell, and ordinarily equally available to the finder of fact in other business valuation disputes—even in cases where, unlike Campbell and Iridium, the company to be valued has no publicly traded securities. Such market evidence includes the contemporaneous actions of company executives and directors, who make career and investment decisions based on their views of value; the contemporaneous actions and views of lenders, creditors, investors, and other market participants; and the contemporaneous views of expert advisors expressed at or near the valuation date. Moreover, courts should not routinely permit litigants to retain and present paid valuation experts in valuation disputes; this practice subjects courts and litigants to massive expense and delay that in most cases is wholly unnecessary given the availability of contemporaneous market evidence. Hence, a litigant wishing to present expert testimony in a valuation dispute should be required to establish by motion that the non-expert contemporaneous market evidence is insufficient to permit the finder of fact to make a reasoned determination of value.*

It is now five years since two important federal court rulings embraced the view that contemporaneous market evidence, rather than expert testimony based on discounted cash flow or other after-the-fact analyses created for purposes of litigation, should control corporate valuation determinations. First came the Third Circuit's decision in *VFB LLC v. Campbell Soup Co.*<sup>1</sup> Affirming the dismissal, after trial, of a fraudulent transfer challenge to an unsuccessful corporate spin-off, the Court of Appeals held that the value the stock market had

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1. 482 F.3d 624 (3d Cir. 2007).

placed on the spun-off company was decisive for determining whether it had received “reasonably equivalent value” in the transaction.<sup>2</sup> The stock market evidence—confirmed by evidence of the prices at which the company’s public debt had traded—also was decisive on the related fraudulent transfer issues of solvency and adequacy of capitalization, and on the plaintiff’s contention that Campbell had breached fiduciary duties in structuring the spin-off.<sup>3</sup>

The Court of Appeals unqualifiedly endorsed the trial court’s reliance on market data and its refusal to accept instead the much lower valuations claimed by the plaintiff’s valuation experts.<sup>4</sup> Using stronger language than the District Court had, the Court of Appeals read the trial court’s opinion as having treated the competing claims of the parties’ experts as a “side-show.”<sup>5</sup>

Hard on the heels of the Third Circuit’s ruling, the Bankruptcy Court for the Southern District of New York followed *Campbell* in its rejection of fraudulent transfer and preference claims brought against Motorola arising from the spin-off of its “Iridium” satellite telephone business.<sup>6</sup> Echoing *Campbell*, the court concluded that “the public markets constitute a better guide to fair value than the opinions of hired litigation experts whose valuation work is performed after the fact and from an advocate’s point of view.”<sup>7</sup>

Thus, in two important venues for major bankruptcy litigation, a judicial preference for market valuation evidence over expert valuation evidence was established. Not only in fraudulent transfer cases, but in confirmation contests and reviews of section 363 asset sales as well, courts in the Third Circuit and in the Southern District of New York have based valuation determinations in bankruptcy contexts on “the behavior in the marketplace [as] the best indicator of enterprise value,”<sup>8</sup> and disregarded the views of litigation experts, citing *Campbell* and *Iridium*.

But the full potential of *Campbell* and *Iridium* to make valuation litigation fairer and less expensive has yet to be realized. Several substantive issues not specifically resolved by those decisions, and a common procedural practice that is at odds with the view of expert testimony they express, may be operating today to limit their utility across the broad spectrum of corporate valuation disputes to which they are germane. As discussed below, however, each of the substantive issues can and should be disposed of in a manner permitting market evidence to decide most corporate valuation disputes in bankruptcy, and a modest alteration in litigation practice should be implemented that will enable courts to eliminate or greatly reduce the use of expert testimony in these cases.

First, many companies to be valued in litigation—probably most of them—do not have publicly traded securities, as the *Campbell* spin-off and *Iridium* did.

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2. *Id.* at 633–34.

3. *Id.* at 633–36.

4. *Id.* at 633.

5. *Id.* at 629.

6. *In re Iridium Operating LLC*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007).

7. *Id.* at 291.

8. *In re Boston Generating, LLC*, 440 B.R. 302, 325 (Bankr. S.D.N.Y. 2010).

Are *Campbell* and *Iridium* of assistance in these situations? Or are their holdings limited to situations in which there is evidence from the public securities markets?

*Second*, both cases were decided before the market declines and recession that began to occur in 2008. Although *Campbell* and *Iridium* have been cited and followed in post-recession decisions,<sup>9</sup> doubts concerning the efficiency of capital markets triggered by the downturn may call the persuasiveness of those decisions into some (or at least into temporary) question. Needless to say, the credibility of values set by capital markets had plenty of doubters and detractors even before the stock market declines. Indeed, in *Campbell* itself, which was tried in 2004, the plaintiff anticipated this challenge, advancing an argument that public trading prices should not be relied on because the markets are prone to “irrational exuberance,” and thus are not always reliable indicators of true value.<sup>10</sup> Must the erosion of public confidence in the securities markets since *Campbell* and *Iridium* were decided mean that those rulings are of less utility today, even where the company to be valued has issued publicly traded securities?

*Third*, and relatedly, once courts regularly turn valuation cases into “market” cases, litigants inevitably will argue that the capital markets were, for one reason or another, distorted or not to be trusted. Indeed, in *Campbell* itself, the unsuccessful appellant, in urging the Third Circuit to adopt its experts’ views, argued principally that the market values on which the District Court had relied were skewed upward because of incomplete and inaccurate disclosures by Campbell concerning financial and business problems at the spin-off.<sup>11</sup> Must valuation cases always become “fraud-on-the-market” cases?

*Fourth*, there is also a major procedural hurdle to achieving the full benefits of the *Campbell* and *Iridium* approach to corporate valuation: the deeply ingrained judicial practice of allowing bankruptcy litigants routinely to hire and present expert valuation witnesses. Parties and courts in valuation disputes regularly incur enormous expenditures of time and money associated with the expert process under Federal Rule of Civil Procedure 26 and the Rules of Evidence—direct and rebuttal reports, expert depositions, and motion practice over expert qualifications and methodologies—even though, at the end of the day, that laborious and costly process contributes nothing to the resolution of the disputes. There seems, in short, to be a *de facto* presumption operating in bankruptcy litigation that litigants in valuation disputes are entitled to retain and proffer valuation experts regardless of the state of the non-expert record. Is there a way to reverse this wasteful and erroneous presumption?

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9. See, e.g., *In re Wash. Mut., Inc.*, 442 B.R. 314, 342 (Bankr. D. Del. 2011); *In re Boston Generating, LLC*, 440 B.R. 302, 326 (Bankr. S.D.N.Y. 2010); *In re Chemtura Corp.*, 439 B.R. 561, 586 n.106 (Bankr. S.D.N.Y. 2010); *In re TCI 2 Holdings, LLC*, 428 B.R. 117, 156 (Bankr. D.N.J. 2010); *In re Summit Global Logistics, Inc.*, No. 08-11566, 2008 Bankr. LEXIS 896, at \*32 (Bankr. D.N.J. Mar. 26, 2008).

10. *Campbell*, 482 F.3d at 629–30.

11. *Id.* at 631.

Considering first the three substantive questions identified, *Campbell*—and particularly the opinion of the District Court that the Third Circuit affirmed—and *Iridium* supply ample means for establishing corporate value even in cases where the subject company does not have publicly traded securities. Further, where the company is publicly traded, the principles of *Campbell* and *Iridium* supply a number of means of testing the accuracy and reliability of the publicly available trading values.

The opinion of the Court of Appeals in *Campbell*, which was the subject of much commentary and discussion when it was published,<sup>12</sup> somewhat eclipsed the extremely important decision the District Court had filed.<sup>13</sup> While the Third Circuit was correct in stating that the District Court had placed primary reliance on the trading prices of the securities of the spun-off company (“VFI”),<sup>14</sup> the trial court’s decision also relied on no fewer than six other avenues of proof to establish that VFI’s value far exceeded the amount of its debt, and that there was no basis to believe that VFI was insolvent or inadequately capitalized at the time it was spun off.<sup>15</sup> None of these avenues of proof was dependent on the company having a public stock or bond float, and each of them strongly confirmed what the stock market showed—that VFI had a very substantial positive equity value. Use of similar evidence in other cases will enable the finder of fact reliably to value companies that do not have publicly traded shares and, in the case of publicly traded companies, to confirm—or invalidate—what the trading markets show.

What all of these avenues of proof share is a focus on actions taken at or near the valuation date by what one may broadly call (in the non-Bankruptcy Code sense) “knowledgeable insiders” of the company to be valued—senior executives, their representatives and advisors—as well as “knowledgeable outsiders”—such as company lenders and investors. This evidence is of extremely high probative value: it reflects what real people with close knowledge of the business and a real financial stake in the enterprise actually did at the time of the valuation. It is thus immune both from the criticism that the actors had inadequate knowledge of the business, and from the criticism that they were swept up in some sort of “tulip craze” in the public markets. As Judge Easterbrook aptly put it in a related context:

[S]elf-interest concentrates the mind, and people who must back their beliefs with their purses are more likely to assess . . . value . . . accurately than are people who simply seek to make an argument. Astute investors survive in competition; those

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12. See, e.g., Stuart Larsen, *Court Obeys the Market: Third Circuit Deems Campbell’s Subsidiary Spin-Off Not to Be a Fraudulent Transfer*, AM. BANKR. INST. J., Sept. 2007, at 26; Jessica L. Wasserstrom, *The Judicial Search for Objectivity in Valuation: Third Circuit Rules that Market Capitalization Is Preferred Method of Valuing Assets in the Fraudulent Transfer Context*, AM. BANKR. INST. J., June 2007, at 58.

13. *VFB LLC v. Campbell Soup Co.*, No. 02-137, 2005 U.S. Dist. LEXIS 19999 (D. Del. Sept. 13, 2005) (Jordan, J.). Judge Jordan has since been elevated to the Third Circuit.

14. *Id.* at \*81.

15. *Id. passim*.

who do not understand the value of assets are pushed aside. There is no similar process of natural selection among expert witnesses and bankruptcy judges.<sup>16</sup>

Equally, this kind of evidence gives the same high level of assurance as does stock and bond market evidence that the valuation is being arrived at without the benefit of hindsight. The strict focus on what knowledgeable insiders and outsiders said and did when the future outcome was unknown wards off second-guessing by Monday morning quarterbacks. This is essential both because reliance on hindsight undercuts the integrity of the business and corporate decision-making process based on facts unavailable to the decision makers, and because it is fundamentally unfair to judge any person or firm based on facts that were not known.

Both parties in *Campbell* presented extensive evidence of this nature. The District Court relied on six avenues of such proof in its decision:

1. *Contemporaneously expressed views and actions of executives familiar with the business*: The District Court paid close attention to the views and actions of the executives who were to manage and run the spin-off. It considered evidence of their contemporaneous views of the business to be highly probative of value—particularly when the executives involved made career and investment decisions based on those views.

For example, the District Court found that the executive who had been running the principal businesses comprising VFI before the spin-off “wanted to be chosen to lead the contemplated spin-off company.”<sup>17</sup> She believed that VFI’s businesses would be *more* valuable out from under the Campbell corporate bureaucracy than they were within it.

Likewise, the executive who ultimately was chosen to lead VFI sought out the post after narrowly failing to be chosen as head of Campbell itself.<sup>18</sup> In addition, a seventeen-year veteran of Campbell’s legal department who stood to become the parent company’s General Counsel chose to become General Counsel of VFI instead “based on what she termed ‘a lot of knowledge’ she had acquired about the Spin-off.”<sup>19</sup> That intimate knowledge of VFI’s businesses by VFI’s future executive management team was also particularly important to the District Court’s conclusion that the negotiations between Campbell and VFI “were at arm’s length, with qualified and competent negotiators on both sides of the table”—thus suggesting that the terms of the transaction were fair and that VFI received reasonably equivalent value in exchange.<sup>20</sup> As the District Court also found, “[m]any other well-regarded Campbell executives who were familiar with the VFI Businesses chose to cast their lot with VFI [rather than stay at Campbell].”<sup>21</sup>

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16. *In re Central Ice Cream Co.*, 836 F.2d 1068, 1072 n.3 (7th Cir. 1987).

17. *Campbell*, 2005 U.S. Dist. LEXIS 19999, at \*12–13.

18. *Id.* at \*10–11.

19. *Id.* at \*14.

20. *Id.* at \*18.

21. *Id.* at \*14.

The District Court concluded: “That seasoned executives familiar with the businesses that came to constitute VFI chose to join VFI demonstrated that thoroughly knowledgeable people believed the Spin-off would be a successful venture.”<sup>22</sup> Evidence of this kind, on the basis of which real people put themselves, their careers, their families, and their net worths on the line, strongly tends to establish that the business has a positive value.

2. *Actions of contemporaneous creditors*: Particularly because valuation determinations are often made at the insistence of disappointed creditors, evidence of valuation determinations made by contemporaneous creditors is highly persuasive. In *Campbell* itself, as the District Court found, the banks that loaned substantial sums to the spun-off company “exhaustively examined VFI’s finances” within just a few months of the spin-off.<sup>23</sup> At the conclusion of that due diligence process, the lead bank concluded that VFI warranted a BB credit rating—as the District Court noted, “equal to or greater than that of 60% of the consumer packaged goods companies in the United States.”<sup>24</sup>

As the District Court also found, fifteen months after VFI was spun off by Campbell, VFI successfully sold \$200 million of unsecured, subordinated bonds to a total of twenty-nine sophisticated institutional investors.<sup>25</sup> The District Court observed that credit markets “had tightened” in the intervening fifteen months between the spin-off and the bond issuance.<sup>26</sup> It also found that the rating agencies gave VFI a corporate rating of BB at the time of the bond offering.<sup>27</sup> In addition, as the District Court found, “the bonds continued to trade at or near par value” for several months after the offering.<sup>28</sup>

This type of evidence goes a long way to establishing, if not proving conclusively, that a plaintiff’s contentions that the company to be valued was insolvent or fatally undercapitalized lack merit.

3. *Contemporaneous views of business and financial experts*: In sharp contrast to opinions formulated by experts retained for purposes of litigation years after the events in question, the views of experts who advise parties to a transaction at the time it is being planned and consummated may have real evidentiary value. Thus, in *Campbell*, the District Court noted that investment bankers advising the Campbell Board of Directors on the spin-off gave a specific dollar estimate for the value of VFI, which turned out to be almost exactly what the market valuation in fact was after the spin-off.<sup>29</sup> Likewise, an investor survey of enterprise value conducted by an independent outside advisor hired by VFI estimated a value for the company’s equity consistent with the investment bankers’ estimate, and consistent with what the market price actually turned out to be.<sup>30</sup>

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22. *Id.* at \*15.

23. *Id.* at \*45.

24. *Id.* at \*46 n.40.

25. *Id.* at \*54.

26. *Id.* at \*57.

27. *Id.* at \*54.

28. *Id.* at \*57.

29. *Id.* at \*50.

30. *Id.*

Other outside professional firms gave similar advice at and near the time of the spin-off.<sup>31</sup> As the District Court found, “[s]uch contemporaneous evidence of fair market value has the advantage of being untainted by hindsight or post-hoc litigation interests.”<sup>32</sup>

4. *Contemporaneous business planning documents*: Evidence of how company insiders planned for the business at the time of the transaction also provides information about value that is free from hindsight taint. In *Campbell*, the District Court found that VFI’s managers created business plans that showed VFI being profitable from year one.<sup>33</sup> And, as the District Court found, “[t]he VFI managers had personal financial incentives to be conservative and realistic in preparing the 1999 operating plans, since 70% of their compensation depended on their achieving at least 90% of the operating plan results.”<sup>34</sup> Of course it is always possible that contemporaneous business planning documents prepared by knowledgeable insiders may reflect undue optimism—although managers are often inclined, to the precise contrary, to “under-promise” so that they can “over-deliver”—but the incentives working on such executives would certainly seem to be far less likely to lead to a distorted result than the incentives working upon experts hired for the purpose of achieving a particular litigation outcome.

5. *Other contemporaneous assessments of enterprise value by management and outside professional advisors*: The District Court in *Campbell* also relied on several estimates of value by VFI insiders and knowledgeable outsiders immediately upon or shortly after the spin-off. In July 1998, less than four months after the spin-off, in an internal VFI document, VFI’s senior management estimated the new company’s enterprise value at \$1.56 billion.<sup>35</sup> And just over a year after the spin-off, VFI’s CEO wrote a letter to his shareholders discussing negative information about VFI that had come to light in the intervening period. Had this information been known at the time of the spin-off, VFI’s CEO concluded, the market would have valued the enterprise at \$1.15 billion (rather than \$1.6 billion)—more than twice the amount of VFI’s debt at the time of the spin-off.<sup>36</sup> Finally, two years after the spin-off, even when VFI was on the verge of bankruptcy, the investment banking firm hired by VFI to explore strategic alternatives estimated the break-up value of the firm to be between \$615 and \$845 million.<sup>37</sup> The District Court stressed that all of these estimates were formed “[i]ndependently” of the litigation.<sup>38</sup>

6. *The dog that did not bark*: It is also highly probative if the party attacking the transaction is unable to proffer evidence that the values its trial experts would assign to the business after-the-fact were values identified by actual, real-time

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31. *Id.*

32. *Id.*

33. *Id.* at \*52.

34. *Id.* at \*51.

35. *Id.* at \*49–50.

36. *Id.* at \*91.

37. *Id.* at \*92.

38. *Id.* at \*90.

participants in, or witnesses to, the transaction. Thus in *Campbell*, the plaintiff was unable to show that any insider or knowledgeable outsider had contemporaneously acted as if he or she believed that VFI was worth less than its debt, or was insolvent or inadequately capitalized. The District Court stated, in rejecting the plaintiff's principal trial expert: "If anyone actually making decisions at the time held the utterly bleak view espoused by [the expert], I have seen no evidence of it."<sup>39</sup>

Although less extensively than in *Campbell*, the *Iridium* court's decision to credit the market and reject contrary expert testimony was also based not only on the public trading prices of Iridium's securities, but on contemporaneous insider and knowledgeable outsider evidence. Notably, in addition to Iridium's market capitalization, the court looked to and relied on: Iridium's own contemporaneous projections of its future cash flows; analyses performed by investment bankers and accountants at the time of the challenged payments, confirming their belief in Iridium's cash flow forecasts; contemporaneous views of sophisticated Wall Street firms that underwrote Iridium's equity and debt offerings; valuation work performed by experts at the time the transactions were undertaken, rather than in hindsight for purposes of litigation; and Iridium's demonstrated ability to obtain financing to make the challenged transfers by accessing substantial bank loans and the capital markets.<sup>40</sup>

Market evidence of these kinds—or other similar proof of market conduct at the valuation date—should be available in virtually every corporate valuation case. There are always "knowledgeable insiders"—executives and Board members, professional advisors—who are making real-world decisions about whether to commit their time to the business or make investments in it, and making plans for the future of the business, just as there were in abundance in *Campbell* and *Iridium*. Such "knowledgeable insider" evidence has the particular advantage of being wholly immune from challenges to public market price evidence as being skewed based on undisclosed or hidden information known only to corporate insiders, and thus incapable of being taken into account by, or reflected in, public securities trading prices. And there are always "knowledgeable outsiders" too—creditors and lenders, investors and potential investors—who are judging the value of the business, in real time, and with real financial interests, also as in *Campbell* and *Iridium*. As suggested above, these kinds of evidence can both establish value in cases where there is no public market for the company's securities, and test whether the market was "rational" in cases where there is one.

Even before *Campbell* and *Iridium*, an important decision from the District of Delaware, relied on in both *Campbell* and *Iridium*, used contemporaneous market evidence to decide a valuation challenge as to a company that had no publicly traded securities.<sup>41</sup> There, the liquidating trustee of a bankrupt technology com-

39. *Id.* at \*102–03.

40. *In re Iridium Operating LLC*, 373 B.R. 283, 347–49 (Bankr. S.D.N.Y. 2007).

41. *Peltz v. Hatten*, 279 B.R. 710 (D. Del. 2002), *aff'd sub nom. In re USN Commc'ns, Inc.*, 60 F. App'x 401 (3d Cir. 2003).



pany sought to recover as a fraudulent transfer \$68 million paid by the debtor to purchase a privately held telecommunications company (“CT Tel”).<sup>42</sup> The trustee claimed that the debtor had vastly overpaid, and the key issue was the value of CT Tel on the purchase date.<sup>43</sup> While both sides presented expert witnesses who sponsored competing discounted cash flow (“DCF”) analyses of CT Tel prepared for purposes of advocacy in the litigation, the District Court disregarded this evidence and relied instead on various forms of contemporaneous market evidence in deciding that the debtor had not overpaid.<sup>44</sup>

The District Court thus examined the debtor’s decision-making process in undertaking the acquisition, based on its view that “it is not the place of fraudulent transfer law to reevaluate or question [such] transactions with the benefit of hindsight.”<sup>45</sup> What the court found was that the debtor had “engaged in appropriate internal and external processes in its purchase decision, including conducting due diligence, consulting with investment bankers, venture capitalists, and . . . an accounting and consulting firm with expertise in cellular companies.”<sup>46</sup>

Further, the court observed that “[t]he informed and sophisticated parties in this case, which included [the debtor and its outside advisors], did not believe that \$68 million was unreasonable and their beliefs were confirmed by both market comparables and DCF studies.”<sup>47</sup> Of course, these contemporaneous studies (which were similar to methodologies often employed by *post-hoc* expert witnesses in litigation) were performed *at the time of the transaction*.<sup>48</sup> As to the contemporaneous DCF analysis in particular, the court noted that “any such study is open to differences of view. . . . While the Liquidating Trustees’ [sic] experts’ views about the growth prospects for CT Tel may in hindsight be accurate, their views alone do not convince the court that at the time of the transaction, [the debtor’s] contemporaneous DCF studies that supported the \$68 million price were unreasonable.”<sup>49</sup> The court also described the analyses the debtor and its advisors had made of four different comparable transactions.<sup>50</sup> Again, these analyses—in form, similar to much expert litigation testimony—had the virtue of having been performed contemporaneously with the transaction, not in years-later litigation.

Following *Campbell* and *Iridium*, the Bankruptcy Court for the Southern District of New York made extensive use of both knowledgeable insider and knowledgeable outsider contemporaneous fact evidence in resolving a business valuation dispute, this time in the context of a contested chapter 11 plan confirmation fight.<sup>51</sup> In *Chemtura*, the equity holders objected to confirmation of the

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42. *Id.* at 712.

43. *Id.* at 735.

44. *Id.* at 738–42.

45. *Id.* at 738.

46. *Id.*

47. *Id.* at 740.

48. *Id.* at 738–39, 742.

49. *Id.* at 739–40.

50. *Id.* at 722–24.

51. *In re Chemtura Corp.*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010).

debtors' plan of reorganization, alleging that it undervalued the debtors and thus paid creditors—who were entitled to receive stock as well as cash distributions under the plan—more than in full.<sup>52</sup> Trial experts on both sides estimated the debtors' total enterprise value ("TEV") using three analytical methods that have traditionally been employed by expert valuation witnesses: DCF, comparable companies, and comparable transactions.<sup>53</sup> Using the same valuation constructs, however, the competing trial experts—as often happens (and unsurprisingly so) given the litigants' polar-opposite interests in the outcome—reached very different results: the debtors' expert estimated TEV at \$1.9 to \$2.2 billion, the equity holders' expert at \$2.3 to \$2.6 billion.<sup>54</sup>

In considering this sharply divergent testimony, the Bankruptcy Court placed great emphasis on the *Campbell* principle that "the marketplace is often as good or better an indication of a company's value than expert testimony alone would be."<sup>55</sup> Because two forms of contemporaneous market information available to the Bankruptcy Court corroborated the debtors' contention as to value, but clashed with the equity holders', the debtors prevailed. That market evidence, unlike the expert presentations, was not subject to hindsight or outcome-driven bias. First, the equity holders had made extensive efforts to market the debtors for sale, but were unable to find a buyer at any price within their (higher) valuation range.<sup>56</sup> Second, while the debtors' plan offered creditors the option to take their recoveries in cash or stock, the overwhelming majority chose cash. If the debtors' business in fact were worth as much as the equity holders contended, the court reasoned, those creditors—"hedge funds and other distressed debt investors, sophisticated in financial analysis"—surely would have elected stock, yielding an immediate upside return on investment of 20–25 percent under the total enterprise value for the reorganized enterprise advocated by the equity holders.<sup>57</sup> In short, these actual and potential buyers' unwillingness to behave in the real world as if the equity holders' valuation was correct convinced the Bankruptcy Court and vindicated the debtors' proposed TEV, resulting in confirmation of the debtors' chapter 11 plan.<sup>58</sup>

Other Southern District bankruptcy courts likewise have embraced *Campbell* and *Iridium*'s preference for real-world contemporaneous market evidence of value, and their rejection of contrary expert trial testimony, in contexts where there are no publicly traded securities. Particularly notable is *In re Boston Generating, LLC*,<sup>59</sup> where the court was called upon to assess the value of power generating plants being sold by the debtors under section 363 of the Bankruptcy Code. The market value of the debtors' assets was proven at trial by an extensive

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52. *Id.* at 567.

53. *Id.* at 573.

54. *Id.*

55. *Id.* at 586 n.106 (quoting *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624, 633 (3d Cir. 2007)).

56. *Id.* at 572, 586.

57. *Id.* at 587–88.

58. *Id.* at 588.

59. 440 B.R. 302 (Bankr. S.D.N.Y. 2010).

fact record showing that the sale price was the product of a robust, arm's-length auction, run by experienced investment bankers, in which over 200 potential purchasers participated.<sup>60</sup> As the Bankruptcy Court described it, this "heavily marketed sale . . . involved a multitude of steps, a bevy of professionals, and enormous amounts of information exchange and diligence."<sup>61</sup>

Subordinated second lienholders, unhappy that the auction left their junior claims out of the money, objected to Bankruptcy Court approval of the sale, contending that "the market" (i.e., the auction process) supposedly had failed to assimilate future regulatory changes positively affecting the value of the debtors' business.<sup>62</sup> The objectors presented an expert who testified that the higher valuation arising from his DCF model (unlike, in his view, the auction sale price) correctly "priced in" the effects of the positive regulatory changes he perceived.<sup>63</sup>

In strongly market-oriented terms, the Bankruptcy Court rejected the lienholders' objection. Concluding that the same regulatory information relied on by the objectors' expert was widely known to the marketplace and auction participants, the court placed substantial weight on its finding that "although armed with unfettered access to [their own trial expert's] knowledge and expertise"—and having been afforded every opportunity to do so—the objecting creditors had failed to come forward with any bid exceeding the auction price—let alone one remotely approaching the value espoused by their expert.<sup>64</sup> Nor did a competing reorganization plan proposed by a primary objector garner sufficient support, even among junior creditors, to convince the court that the plan was worth the sum the objectors' trial expert ascribed to it.<sup>65</sup> The failure of the objectors to put their money where their expert's mouth was spoke volumes more to the court than did his testimony itself.

In sum, there is considerable evidence that the substantive issues left open by *Campbell* and *Iridium* are being resolved in a manner consistent with their preference for market evidence of value.<sup>66</sup> But, viewed through a *Campbell/Iridium* lens, what is equally striking—and far less encouraging—is that in each of these cases, just as in *Campbell* and *Iridium*, the courts routinely tolerated the presentation of expert valuation testimony, even though the cases could have been decided without any reliance on such testimony. Indeed, the courts were often sharply critical of it<sup>67</sup>—just as they were of the plaintiffs' expert presentations in *Campbell* and *Iridium*. Thus, the courts and the parties in all of these

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60. *Id.* at 310–14.

61. *Id.* at 310–12.

62. *Id.* at 326.

63. *Id.* at 325–26.

64. *Id.* at 326–27.

65. *Id.* at 324.

66. A post-*Campbell/Iridium* decision arguably at odds with this approach to valuation is the District of Delaware's decision in *In re American Classic Voyages Co.*, 384 B.R. 62 (D. Del. 2008), discussed at *infra* notes 80–82 and accompanying text.

67. See, e.g., *In re Boston Generating, LLC*, 440 B.R. 302, 324–28 (Bankr. S.D.N.Y. 2010); *In re Chemtura Corp.*, 439 B.R. 561, 588–90 (Bankr. S.D.N.Y. 2010).

lawsuits incurred the substantial delay and expense involved in retaining and deposing valuation experts, challenging their qualifications, and making and opposing pretrial motions to exclude expert testimony—for no eventual purpose at all. More “side-show[s],” to use the Third Circuit’s apt description of the expert phase in *Campbell*. This brings us to what we believe to be the most important issue identified above—the procedural quandary of how to avoid the routine presentation of expert valuation testimony even where substantial non-expert market evidence of value is both available and sufficient to resolve the valuation dispute at issue.

It is worth taking a moment to emphasize just how costly and wasteful this routine practice really is. In *Campbell*, for example, fully one-third of the trial days that the District Court devoted to the case were taken up by expert testimony—all of it ultimately treated by the court as a “side-show.” The plaintiff creditors retained no fewer than five different valuation experts, and roughly a half-dozen subsidiary experts, none of whose testimony contributed to the decision of the case. Each of the valuation experts had to be deposed over several days, as did Campbell’s own expert. Disputes over the retention of the various experts embroiled the court in serial motion practice. Two of the five valuation experts—on whom the plaintiff spent well over \$1,000,000 in fees, and whom the defendants had to depose and prepare to rebut at very considerable expense—were never even called at trial.

Nor is that experience at all unusual. A recent study by PriceWaterhouse-Coopers (“PwC”) shows that over half of the retained expert trial witnesses in the valuation area likewise never get to testify. According to PwC, even as the number of challenges to financial expert witnesses has risen almost threefold from 2000 to 2010, the fraction of successful challenges has remained fairly constant at around 45 percent.<sup>68</sup> In 2010, there were 150 such pretrial challenges to financial experts; the testimony of over half (76) was excluded in whole or in part.<sup>69</sup> And, of course, motions challenging the admissibility and seeking the exclusion of expert testimony at trial—which are typically far from simple or inexpensive affairs—come only *after* the parties have already incurred huge expense and delay: the cost of retaining experts, assisting them in preparing all of the expert and rebuttal reports for which Rule 26 calls, preparing for, taking, and defending expert depositions, and the like.

Expert testimony is not only time-consuming and expensive; it inevitably is also deeply infected with hindsight. Thus, apart from its superfluousness, reliance on *ex-post-facto* expert testimony—had the *Campbell* and *Iridium* courts placed any—would have imposed severe unfairness on the defendants. An important recent article on corporate valuation presents extensive proof that the testimony of financial experts always and inevitably injects a large dose of hindsight into valuation litigation, and that even judges are—with the best will and

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68. Daubert Challenges to Financial Experts: An 11-Year Study of Trends and Outcomes 6, PwC (Feb. 2011), <http://www.pwc.com/us/en/forensic-services/publications/daubert-study-2010.jhtml>.

69. *Id.* at 9.

intentions in the world—simply unable to avoid employing hindsight in considering such testimony.<sup>70</sup>

Specifically, the authors describe that as of 2003, over 150 published articles demonstrated the existence of hindsight bias: the “human tendency to overestimate, after the fact, the foreseeability of events that have occurred.”<sup>71</sup> Valuation testimony does not enjoy some special exemption from this basic human tendency. If anything, given that valuation experts are paid to advance a particular litigation position, knowing how things turned out is an essential part of their stock in trade.

Hindsight bias is not limited to the layperson or juror. The authors cite several studies establishing that judges as well find it impossible to screen out knowledge of post-valuation-date events when ruling on valuation issues—even when they know the law requires it. In one of these studies, ninety-six actual judges were given detailed business and financial information about a manufacturing company, and asked to evaluate the propriety of an auditor’s opinion that the company would continue as a going concern for at least one additional year. The judges were told that this contemporaneous information was “ALL OF THE PERTINENT INFORMATION AVAILABLE” at the time the audit opinion was issued.<sup>72</sup> One group of judges received no more information, while another group (the “hindsight group”) was told in addition that the company had in fact been driven into bankruptcy within a year after the auditor’s opinion. The study found that judges in the hindsight group were significantly more likely to find the auditor’s opinion to be inappropriate than were judges in the uninformed group.<sup>73</sup>

These studies strongly suggest that in making valuation determinations at trial, both judges and juries will tend to accept expert testimony that closely matches what actually happened. In the context of fraudulent transfer analysis, this gives the plaintiff an enormous advantage not permitted by law, since the court is legally required to evaluate the financial condition of the debtor when the transfer was made *without* the use of hindsight.<sup>74</sup> Further studies have demonstrated that attempts to “de-bias” judges, for example by directing their attention to possible outcomes other than bankruptcy, are largely ineffectual.<sup>75</sup>

Plainly, in some kinds of litigation, expert evidence has to be received notwithstanding the attendant risk of hindsight bias because there is no non-expert evidence available. Many complex medical procedures or engineering decisions, for example, cannot be understood without expert guidance. But given that in many—probably most—valuation cases there will be reliable, contemporaneous market evidence of value—trading prices in the case of public companies, knowledgeable insider and outsider proof in others—the full effectuation of

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70. Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, The Problem of Hindsight Bias, and the Credit Default Swap Solution*, 2011 COLUM. BUS. L. REV. 118.

71. *Id.* at 151.

72. *Id.* at 155 n.117.

73. *Id.* at 154–55.

74. See, e.g., *In re R.M.L., Inc.*, 92 F.3d 139, 155 (3d Cir. 1996).

75. See Simkovic & Kaminetzky, *supra* note 70, at 156.

*Campbell* and *Iridium* would best be achieved by requiring a party wishing to call a valuation expert to make a motion by the close of fact discovery affirmatively showing that the trier of fact cannot reach a reasoned decision about value by relying on market evidence in the fact record. No longer should it be a matter of course that, as is now common practice, expert reports are filed within a short time after fact discovery has closed, automatically putting into motion a costly sequence of expert reports and depositions, followed by rebuttal reports and more depositions, and setting the stage for a substantial commitment of valuable trial time—all for a species of evidence that may be wholly unnecessary to a just and reasoned decision of the case.

It bears emphasis that the “expert” motion proposed here is not one brought under the Supreme Court’s decisions in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*<sup>76</sup> and *Kumho Tire Co. v. Carmichael*.<sup>77</sup> Such motions focus on the expert’s qualifications and the substance of his or her proposed testimony, and generally are made at the close of the lengthy, expensive expert report and deposition process, and then not decided until at or near the time of trial. Rather, the motion proposed here would be brought and addressed by the court preliminarily, before those questions are permitted to arise: the proponent of expert valuation evidence should, by the close of fact discovery, have to meet an initial burden of establishing that the non-expert evidentiary record is in some degree insufficient so as to warrant the expense, delay, and hindsight problems associated with presenting valuation experts.

The Federal Rules of Civil Procedure and the Federal Rules of Evidence provide a firm foundation for imposing such a requirement. A subsection of Civil Rule 16 governing pretrial conferences explicitly contemplates that early in the case the court should consider and take appropriate action on, among other matters, “avoiding unnecessary proof and cumulative evidence, and limiting the use of testimony under Federal Rule of Evidence 702,” i.e., expert testimony.<sup>78</sup> The Advisory Committee notes on the 1993 amendments to Rule 16 state that among the reasons why such evidence may be excluded or limited, “[e]ven when proposed expert testimony might be admissible,” is “the other evidence available at trial”—in the valuation context, market evidence of value.<sup>79</sup> Likewise, Civil Rule 26(a)(2)(D), governing “*Time to Disclose Expert Testimony*,” vests the trial courts with broad discretion to order the timing of and sequence for the expert reports called for by Rule 26(a)(2)(B), thus permitting it to defer the filing of such reports in valuation cases while the parties marshal the non-expert record on value.

The proposed motion would be made under Rule 702(a) of the Federal Rules of Evidence, which permits the presentation of expert testimony only when it will “help the trier of fact to understand the evidence or to determine a fact in

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76. 509 U.S. 579 (1993).

77. 526 U.S. 137 (1999).

78. FED. R. CIV. P. 16(c)(2)(D).

79. FED. R. CIV. P. 16 advisory committee’s note.

issue.” Given the availability of contemporaneous market evidence in a great many cases, the proponent of expert testimony will have to show that such evidence is untrustworthy or lacking in credibility or otherwise insufficient to enable the trier of fact—in bankruptcy cases, usually the court—to reach an intelligent decision as to value without hearing from the proponent’s expert.

Other provisions of the Rules of Evidence underscore the appropriateness of imposing this requirement. Thus Rule 102 provides that “[t]hese rules should be construed so as to administer every proceeding fairly [and] eliminate unjustifiable expense and delay.” And Rule 403 specifically authorizes the courts to exclude even relevant and otherwise admissible evidence where its probative value is “substantially outweighed by a danger of one or more of the following: unfair prejudice, confusing the issues, misleading the jury, undue delay, wasting time, or needlessly presenting cumulative evidence.”

To see how the proposed Rule 702 motion might work, consider *In re American Classic Voyages Co.*, a case from the District of Delaware.<sup>80</sup> The Bankruptcy Court had dismissed the debtors’ adversary proceeding seeking to avoid as a preferential transfer the repayment of funds loaned under a revolving line of credit. The debtors argued on appeal that under *Campbell*, issued a month before the Bankruptcy Court’s decision but after the submission of post-trial briefs, it was error for the Bankruptcy Court to rely on expert testimony (specifically, DCF analysis) regarding solvency when there was a public market for the debtors’ stock.<sup>81</sup> The District Court affirmed the dismissal of the debtors’ complaint, noting that, while in *Campbell* “the plaintiffs made no attempt to reconcile the disparity between the testimony of their expert witnesses and the objective value of the company at issue in the marketplace . . . [i]n contrast, the data and analysis accepted by the Bankruptcy Court in this case was consistent with the available marketplace data.”<sup>82</sup> But, as the Bankruptcy Court’s decision shows, the data used by the defendants’ expert for his DCF analysis included cash flow projections that had been prepared by the debtors at the time of the loan repayment—just the kind of contemporaneous market evidence that was present and relied upon by the courts in *Campbell* and *Iridium*, as discussed above.<sup>83</sup> The defendants’ expert also relied on the fact that the capital markets had continued to provide financing to the debtors through the date of the challenged repayment—more of the type of contemporaneous proof of capital adequacy upon which the *Campbell* and *Iridium* courts specifically relied.<sup>84</sup>

Had a Rule 702 motion of the type recommended here been required, the expert testimony in *American Classic Voyages* would likely have been found unnecessary. Given the availability of realistic cash flow projections at the time of the transfer, the actions of contemporaneous creditors, the continued support by the capital markets, and the publicly traded stock price of the parent company,

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80. 384 B.R. 62 (D. Del. 2008).

81. *Id.* at 63–64.

82. *Id.* at 65 (citation omitted).

83. *In re Am. Classic Voyages Co.*, 367 B.R. 500, 509–10 (Bankr. D. Del. 2007).

84. *Id.* at 508.

the Bankruptcy Court could readily have concluded that expert testimony on solvency was cumulative and would occasion unnecessary delay and expense, and therefore denied the Rule 702 motion.

On the other hand, there may well be valuation cases where a court concludes that expert testimony will assist the trier of fact and should be received—even where substantial market evidence of value is present. *In re Lehman Brothers Holdings Inc.*<sup>85</sup> would appear to be such a case. There, the Bankruptcy Court for the Southern District of New York considered challenges to its earlier order approving the section 363 sale of Lehman Brothers' brokerage assets to Barclays during the immediate aftermath of Lehman's bankruptcy filing. Objectors claimed that Barclays had obtained an unjustified windfall.<sup>86</sup> Although the Bankruptcy Court had before it extensive market evidence establishing the assets' value, it nevertheless received expert testimony the Court deemed relevant to "determining whether contemporaneous valuation judgments performed by Barclays were reasonable."<sup>87</sup> Considering how significantly the Court relied on Barclays' expert in assessing the very complex facts the case presented, it is reasonable to conclude that it would have granted a Rule 702 motion, on the basis that the benefit of expert assistance outweighed the expense and delay it involved.

In *Campbell*, the recognition that the expert trial presentations were a useless "side-show" was reached only after the parties had wasted many millions of dollars, and the court a full week of its valuable trial time. The same is true in many other cases discussed above: the parties had developed discovery records containing substantial fact evidence bearing on value, and the court relied on that evidence to dispose of the case. The proposed Rule 702 motion would put the proponent of expert valuation testimony to the burden of showing, before the vastly expensive and time-consuming expert process is launched, why the non-expert evidence is not adequate to decide the valuation question in dispute.

The proposed Rule 702 motion requirement would not effect any significant change to that Rule's vesting of the expert "gatekeeping" function in the discretion, judgment, and wisdom of the trial court. Rather, it would merely initiate the exercise of that gatekeeping function at an earlier stage in the proceedings. Obviously, creating a new motion requirement entails some additional time and expense compared to present practice, but by weeding out at the threshold expert evidence that is unnecessary in light of the non-expert market record, it is likely to produce substantial net savings of time, cost, and judicial resources. Even in cases where the court is not inclined to preclude expert testimony altogether, by focusing on the fact record before the expert process gets started, the court may be able to limit the scope of any such expert evidence as it deems warranted, again avoiding undue expense and delay that, under current practice, is

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85. 445 B.R. 143 (Bankr. S.D.N.Y. 2011).

86. *Id.* at 152.

87. *Id.* at 186.



left entirely up to the unchecked judgments and perceived self-interests of the parties.

It bears emphasis that it is not intended that the Rule 702 motion requirement proposed here create an insurmountable obstacle to a court's admission of expert valuation testimony in the presence of *any* contemporaneous market-based fact evidence in a particular case. Nor need the motion requirement create any increased risk of reversal or other negative consequences on appeal. *First*, long-standing Supreme Court precedent commits the decision whether to admit or exclude expert testimony to the sound discretion of the trial court: "All evidentiary decisions are reviewed under an abuse-of-discretion standard," and hence "the question of admissibility of expert testimony . . . is reviewable under the abuse-of-discretion standard" as well.<sup>88</sup> Accordingly, courts considering the proposed Rule 702 motion can and should exercise the discretion conferred upon them to consider, on a case-by-case basis, whether the proponent of expert valuation testimony has established that the volume, type, quality, credibility, and reliability of the non-expert market evidence will not, standing alone, permit the trier of fact to make a reasoned valuation determination. All that the Rule 702 motion would do would be to create a pause in the practice now normally followed—where expert reports and expert discovery commence immediately, without judicial intervention, following the close of fact discovery. The court will presumably be in a much better position at that stage of the proceedings than at an early pretrial conference to make the determination contemplated by Civil Rule 16(c)(2)(D)—whether expert testimony should be limited or precluded in light of the other evidence in the fact record. *Second*, conscientious exercise of the court's discretion in evaluating the need for valuation experts would not expose the court to any risk of appellate reversal beyond what already exists under the abuse-of-discretion standard of review over Rule 702 determinations generally.

Finally, in addition to promoting a more efficient and effective litigation process, the Rule 702 motion practice requirement advocated here will also produce valuable benefits during the planning stages of corporate transactions. Eliminating, or at least greatly reducing, the threat of *ex-post-facto* expert-witness-fueled valuation contests, with the inevitable attendant hindsight bias that inheres in all such testimony, will strengthen the ability of corporate decision makers to structure and execute with certainty transactions that make sound business sense to them at the time, and to which the contemporaneous market participants and knowledgeable observers attribute positive value.

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88. Gen. Elec. Co. v. Joiner, 522 U.S. 136, 141–43 (1997).

