Delaware Bankruptcy Inns of Court
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VALUATION AND
CONFIRMATION ISSUES

Valuation And Confirmation Issues

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Valuation 101

Valuation 101: Overview

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- Applicable Bankruptcy Code Sections
- Valuation Approaches
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Valuation at Confirmation

"At heart, chapter 11 is a simple exercise. In bankruptcy parlance, it is to gather the property of the estate, determine the amount and nature of the claims and confirm a plan of reorganization that distributes the property of the estate to the creditors in accordance with the requirements of the Bankruptcy Code."

Hon. Christopher S. Sontchi

Valuation Methodologies: A Judge's View

Valuation at Confirmation

Valuation is the process of determining the value of an asset, both tangible and intangible, including the value of a business.

The need for valuation in plan confirmation proceedings is typically driven by the *best-interests-of creditors*, *fair and equitable* and *feasibility tests*

§ 1129 (a) (7) of the Code is referred to as the ***best-interests-of-creditors*** test, which requires that a creditor who is impaired, and who has not voted, or voted against the plan, must retain or receive property not less in value than that if the debtor were liquidated in Chapter 7

§ 1129 (b) (1) of the Code allows the Court to confirm (***"cram down"***) a plan regardless of whether each class of claims or interests has accepted or is not impaired, so long as the plan does not discriminate unfairly (**"absolute priority rule"**), and is ***fair and equitable*** in its treatment of each such class of interests or claims or interests as stated in § 1129 (b) (A) (B) (C)

§ 1129 (a) (11) of the Bankruptcy Code ("Code") requires that a plan of reorganization must be ***feasible*** to be confirmed, meaning that liquidation or further reorganization are ***not likely*** unless provided for by the plan

Valuation at Confirmation

- No matter which methodology is used, the purpose remains the same – to determine as accurately as possible what the sale price would be – i.e., the "price recovery."

- Conflicting Incentives in Valuation of a Reorganizing Chapter 11 Debtor –

(1) Senior Debt (undervalue)
(2) Unsecured Debt (overvalue)
(3) Equity Holders (overvalue)
(4) Management (undervalue)

Valuation Approaches

Valuation requires the implementation of generally accepted methodology or protocol. Broadly speaking, a firm, its assets and/or its equity can be valued in one of four ways:

(1) asset-based valuation where one estimates the value of a firm by determining the current value of its assets ("Asset Approach");

(2) discounted cash flow or "DCF" valuation where one discounts cash flows to arrive at a value of the firm or its equity ("Income Approach");

(3) relative valuation approaches, which include the "comparable company analysis" and the "comparable transaction analysis" that base value on how comparable assets are priced ("Market Approach"); and

(4) contingent claim valuation ("Option Pricing").

Asset Approach

- Asset Approach focuses on the current value of the company's underlying assets.

- This approach is particularly appropriate for holding companies, companies in underperforming industries, companies with significant tangible assets and/or real estate, some investment companies, and failed businesses that seek some form of liquidation.

- This method can reveal whether a company is more valuable if the underlying assets are sold as a going concern or piecemeal.

Income Approach

- Income Approach estimates the present value of the projected future cash flows to be generated by the business.

- This approach is based on a fundamental assumption that value can be estimated upon expected cash flow and risk.

- That the enterprise is a going concern is a fundamental premise to the income approach because the value is determined by future cash flows generated by continued operations of the company.

- Three fundamental components of the discounted cash flow approach:
  (1) projected discrete period cash flow;
  (2) terminal value; and
  (3) discount rate.

Market Approach

- Market Approach contains the fundamental assumption that a prudent investor will pay no more for the assets than it would cost to acquire a substitute property of the same utility.

- This approach attempts to capture the valuation of an enterprise based upon values determined by the markets as a multiple of various metrics, including, but not limited to, revenues or sales, cash flows, or net income.

- Two basic markets relied upon:

  (1) market for publicly traded securities (e.g., equity in particular comparable public companies); and

  (2) market for entire companies which are sold or acquired (i.e., comparable transactions).

Option Pricing Approach

- Option Pricing Approach – a contingent claim or option is a claim that pays off only under certain contingencies – if the value of the asset exceeds a pre-specified value for a call option or is less than a pre-specified value for a put option.

- The use of option pricing models in valuation is a relatively new technique and continues to develop.

- One instance in which such an approach may be appropriate in bankruptcy is a start-up pharmaceutical company that is awaiting an FDA decision as to whether its only asset can be brought to market.

Statutory Predicate for Expert Witness Testimony – FRE 702

Testimony by Expert Witnesses

A witness who is qualified as an expert by knowledge, skill, experience, training, or education may testify in the form of an opinion or otherwise if:

(a) the expert's scientific, technical, or other specialized knowledge will help the trier of fact to understand the evidence or to determine a fact in issue;

(b) the testimony is based on sufficient facts or data;

(b) the testimony is the product of reliable principles and methods; and

(d) the expert has reliably applied the principles and methods to the facts of the case.

Statutory Predicate for Expert Witness Testimony – FRE 703

Bases of an Expert's Opinion Testimony

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

Statutory Predicate for Expert Witness Testimony – FRE 705

Disclosing the Facts or Data Underlying an Expert's Opinion

Unless the court orders otherwise, an expert may state an opinion — and give the reasons for it — without first testifying to the underlying facts or data. But the expert may be required to disclose those facts or data on cross-examination.

Admission of Expert Testimony

Daubert - creates a "gatekeeping" obligation by holding that, pursuant to FRE 702, judges must ensure expert testimony is rooted in reliable foundation and is relevant.

Daubert v. Merrell Dow Pharm., Inc., 509 U.S. 579, 597 (1993).

Admission of Expert Testimony

Kumho Tire – holding *Daubert* "gatekeeping" obligation applicable to all expert testimony as FRE 702 does not differentiate between scientific and other knowledge

Kumho Tire Co. v. Carmichael, 526 U.S. 137, 138 (1999).

FRCP 26(a)(2) Disclosure of Expert Testimony

(A) ***In General.*** In addition to the disclosures required by Rule 26(a)(1), a party must disclose to the other parties the identity of any witness it may use at trial to present evidence under Federal Rule of Evidence 702, 703, or 705.

(B) ***Witnesses Who Must Provide a Written Report.*** Unless otherwise stipulated or ordered by the court, this disclosure must be accompanied by a written report—prepared and signed by the witness—if the witness is one retained or specially employed to provide expert testimony in the case or one whose duties as the party's employee regularly involve giving expert testimony. The report must contain:

(i) a complete statement of all opinions the witness will express and the basis and reasons for them;

(ii) the facts or data considered by the witness in forming them;

(iii) any exhibits that will be used to summarize or support them;

(iv) the witness's qualifications, including a list of all publications authored in the previous 10 years;

(v) a list of all other cases in which, during the previous 4 years, the witness testified as an expert at trial or by deposition; and

(vi) a statement of the compensation to be paid for the study and testimony in the case.

(C) ***Witnesses Who Do Not Provide a Written Report.*** Unless otherwise stipulated or ordered by the court, if the witness is not required to provide a written report, this disclosure must state:

(i) the subject matter on which the witness is expected to present evidence under Federal Rule of Evidence 702, 703, or 705; and

(ii) a summary of the facts and opinions to which the witness is expected to testify.

(D) ***Time to Disclose Expert Testimony.*** A party must make these disclosures at the times and in the sequence that the court orders. Absent a stipulation or a court order, the disclosures must be made:

(i) at least 90 days before the date set for trial or for the case to be ready for trial; or

(ii) if the evidence is intended solely to contradict or rebut evidence on the same subject matter identified by another party under Rule 26(a)(2)(B) or (C), within 30 days after the other party's disclosure.

(E) ***Supplementing the Disclosure.*** The parties must supplement these disclosures when required under Rule 26(e).

Expert Testimony Issues

- Selection of expert / Challenges to qualification
- Potential Liability of Experts
- Privilege Issues
- Waiver of Work-Product Privilege
- Fees and Costs
- Preparing engagement letter
- Orienting the expert
- Drafting the written report

Recent Case Law Regarding Valuation and Confirmation Issues

Case Law on Valuation and Confirmation Issues

Any company seeking to reorganize under Chapter 11 of the Bankruptcy Code will likely require an enterprise value determination. *See* Pantaleo & Ridings, *Reorganization Value*, 51 BUS. LAW. 419, 419 (1996) ("The outcome of every Chapter 11 case, whether litigated or negotiated turns on reorganization value."); 7 COLLIER ON BANKRUPTCY ¶ 1129.06[2] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004) ("Entity valuation is ever present in non-consensual confirmation."); H.R. Rep. No. 95-595, at 414 (1977) ("[A] valuation of the debtor's business . . . will almost always be required under Section 1129(b) in order to determine the consideration to be distributed under the plan."). At confirmation, a debtor company's viability will often be at the center of a confirmation hearing. "Will the reorganized company be a viable going concern? Will it be liquidated? Will it need further financial reorganization in the foreseeable future? The answer is often contested and disputed throughout the confirmation process." Shaked & Reilly, A PRACTICAL GUIDE TO BANKRUPTCY VALUATION 460 (Am. Bankr. Inst. 2013).

Case List:

A. ***In re Heritage Highgate, Inc.*, 679 F.3d 132 (3d Cir. 2012)**

B. ***U.S. Bank N.A. v. Verizon Communications, Inc.*, 2013 WL 230329 (N.D. Tex. Jan. 22, 2013)**

C. ***In re Red Mountain Machinery Co.*, 471 B.R. 242 (D. Ariz. 2012)**

D. ***In re GAC Storage Leasing, LLC*, 485 B.R. 174 (Bankr. N.D. Ill. 2013)**

E. ***In re 785 Partners LLC*, 2012 WL 959364 (Bankr. S.D.N.Y. 2012)**

F. ***In re PTL Holdings LLC*, 2011 WL 5509031 (Bankr. D. Del. 2011)**

G. ***In re Young Broadcasting Inc.*, 430 B.R. 99 (Bankr. S.D.N.Y. 2010)**

H. ***In re Spansion*, 426 B.R. 114 (Bankr. D. Del. 2010)**

Case Summaries:

A. In re Heritage Highgate, Inc., 679 F.3d 132 (3d Cir. 2012)

Facts:

Debtors entered into construction loan agreements for the development of a residential subdivision consisting of townhouses and single family detached homes (the "Project"). The first agreement was entered into with a group of banks (the "Bank Lenders") in which the Bank Lenders obtained a security interest in the Project. Subsequently, the Debtors entered into another agreement with other groups, collectively known as the Cornerstone Investors, wherein the Debtors granted the Cornerstone Investors liens on the same assets. The Cornerstone Investors agreed to subordinate their secured claims to the Bank Lenders.

The Debtors filed Chapter 11 petitions during construction and filed a plan of reorganization. The plan included a projected budget that would pay the Bank Lenders and Cornerstone Investors in full and then pay approximately 45% to unsecured claimants.

The Official Committee of Unsecured Creditors filed a motion to value the secured claim pursuant to Section 506(a) and F.R.B.P. 3012 ("506 Motion"). The parties agreed that the Plan would be confirmed and that Cornerstone Investor's treatment as a secured creditor would be determined later as part of the 506 Motion. The Committee sought to value the Cornerstone Investors' secured claim at zero for plan purposes. The Bankruptcy Court for the District of New Jersey granted the Committee's Motion and the District Court for the District of New Jersey affirmed. On appeal, the Third Circuit affirmed.

At the hearing on the 506 Motion, the parties stipulated to the fair market value of the Project at the time of confirmation. However, the Cornerstone Investors argued that the fixing their claim at the fair market value of the Project at confirmation deprived the Cornerstone Investors of the Project revenue to be generated over and above the appraised value and constituted an impermissible lien stripping. The Bankruptcy Court disagreed and found that the proper method of valuing the Cornerstone Investor's secured claims was the fair market value of the Project as of the confirmation date. The Bankruptcy Court noted that Cornerstone Investors did not dispute the appraisal but instead relied on the Plan budget which indicated that there was sufficient revenue to pay off the Cornerstone Investors' secured claim. The Bankruptcy Court held that the amount owed to the Bank Lenders exceeded the sum of the Project's fair market value and the value of other collateral at confirmation; therefore, no collateral remained to secure the Cornerstone Investors' claims. Consequently, the Cornerstone Investors should be treated as an unsecured creditor. The District Court affirmed.

Holding:

On appeal, the Third Circuit affirmed. The Third Circuit addressed the proper method for valuing the asset for confirmation purposes and the burden of proof.

Analysis:

The Third Circuit noted that neither the Bankruptcy Code nor the Federal Rules of Bankruptcy Procedure allocates the burden of proof as to value for purposes of a Section 506(a) determination of secured status. The Court found that, under the circumstances, the

appropriate burden of proof is a burden-shifting approach. The Court found that the party challenging the secured claim has the initial burden as to value because Section 502(a) and Bankruptcy Rule 3001(f) grant prima facie effect to the validity and amount of a properly filed claim. However, once the movant establishes with sufficient evidence that the proof of claim overvalues a creditor's secured claim, the burden of persuasion shifts to the creditor to demonstrate by a preponderance of the evidence both the extent of the lien and the value of the collateral securing the claim.

The Third Circuit then addressed the appropriate valuation method in connection with the confirmation of a plan of reorganization. The Court noted generally that collateral should be valued by a flexible approach that takes into account what is being done with the property – liquidation, surrender or retention. Further, the phrase "proposed disposition or use" in Section 506(a) is an important factor in making this determination.

In this context, the property is being retained. Therefore, the Court held the proper measure under Section 506(a) is the collateral's fair market value. The Court rejected the wait-and-see approach, as suggested by the Cornerstone Investors. Although the Plan did include projections of future income, the Court noted that both the Bankruptcy Court and the District Court accurately characterized those projections as supporting feasibility, not measuring the Cornerstone Investor's interest in the Project. The Court further noted that the valuation must be based on realistic measures of present worth.

The Court noted that the discounted fair market value of the property as of the confirmation date was the best indicator of the value of the liens held by the creditors.

The Third Circuit also addressed Cornerstone Investor's argument that this approach effectuated a lien stripping in contradiction of the Supreme Court's ruling in Dewsnup. The Court held, however, that the principles of Dewsnup should not be imported into the Chapter 11 context. The Court reasoned that Chapter 7 liquidation proceedings involve the sale of liened property; whereas, Chapter 11 cases involve the retention and use of that property in the debtor's reorganized business. In Chapter 11, the creditor receives payments equal to the value of its collateral over time and is not involved in a one-time foreclosure sale. Therefore, the Third Circuit found that the Bankruptcy Court ruling that the secured creditor's claims were wholly unsecured did not violate Dewsnup or any other bankruptcy law provision.

The Court held that the Committee met its initial burden by providing an appraisal prepared by a veteran appraiser using well-accepted techniques of real estate appraisal to calculate the fair market value. The appraisal concluded that the fair market value of the collateral was not sufficient to pay off the Bank Lenders in full. The burden then shifted to the Cornerstone Investors who did not dispute the appraisal calculation, but instead chose to rely upon the plan budget as providing the proper valuation. Consequently, the Third Circuit held that the Bankruptcy Court and the District Court properly held that the Cornerstone Investors failed to satisfy their burden of persuasion. The Third Circuit affirmed the Bankruptcy Court's determination that Cornerstone Investors' secured claims should be valued at zero.

Lessons:

1. The Third Circuit applies a burden shifting approach to valuation under Section 506(a). The initial burden is on the movant to provide sufficient evidence that the proof of claim

improperly values the collateral. The burden then shifts and the creditor has the burden of persuasion by a preponderance of the evidence on the valuation issue.

2. Section 506(a) requires the Court to determine the purpose for the valuation—liquidation, retention, surrender.

3. In confirmation of a Chapter 11 reorganization plan where the debtor will retain and use the property, the correct valuation method is the fair market value of the collateral at the time of plan confirmation.

4. Dewsnup's holding should not be imported into Chapter 11 cases.

B. U.S. Bank National Association v. Verizon Communications Inc., 2013 WL 230329 (N.D. Tex. Jan. 22, 2013)

Facts:

The litigation trustee (U.S. Bank) created from the confirmed chapter 11 plan of Idearc, Inc., a former subsidiary of Verizon, sued Verizon and certain other defendants on a variety of claims arising out of Idearc's spinoff from Verizon. The Court decision, rendered after a 10-day bench trial, was devoted to the sole issue of what was Idearc's value on November 17, 2006, the date of its spinoff from Verizon. In connection with the spinoff, Verizon contributed its domestic print and electronic directories business to Idearc in exchange for approximately $7.115 billion in Idearc debt, $2.5 billion in cash, and 146 million shares of Idearc common stock. Thereafter, Verizon distributed the Idearc common stock to its existing shareholders. In connection with the spinoff, Idearc incurred $9.115 billion in indebtedness and received commitments from financial institutions to lend it up to an additional $250 million through a revolving credit facility.

The litigation trustee presented one expert (Taylor), but the Court rejected the expert's conclusion that the value of Idearc was $8.15 billion on the date of the spinoff. The litigation trustee's expert made three separate calculations of Idearc's value on the spinoff date – one based on discounted cash flow (DCF), a second based on EBITDA multiples of similar public companies ("market multiple method"), and a third based on EBITDA multiples implied by transactions involving similar public companies ("comparable transaction method"). Verizon's expert (Hopkins) testified that Taylor's analysis was flawed because the financial projections used were unreliable and the assumptions used were inappropriate for certain of the valuation methods Taylor was using.

Holding:

The Court held that the total enterprise value of Idearc on November 17, 2006 was at least $12 billion.

Analysis:

The Court seemed to find significant in rejecting the litigation trustee's expert's opinion that she refused to look at Idearc's stock price in determining a total enterprise value because she believed that material information had been withheld from the market, apparently the first time she had ever opinioned that the market price of stock was completely unreliable as to a

firm's value. The Court agreed with Verizon's expert that Taylor's DCF valuation was flawed in significant ways and that it produced an extreme outlier even within her own analysis. The litigation trustee focused its arguments at trial on trying to convince the Court that the market did not accurately reflect the true value of Idearc due to omissions and misrepresentations in public filings with the SEC. The Court was not convinced and found that each of the items of information was available to the market.

Lessons:

1. Although this case involved post-confirmation litigation regarding the value of a former chapter 11 debtor, it is a reminder that valuation is an ever-present consideration in bankruptcy, not just at confirmation (although confirmation is often the most common and critical time that valuation is tested and contested).

2. Experts should exercise caution when deviating from commonly accepted methods of valuation, particularly with public companies. Here, the expert for the litigation trustee refused to consider Idearc's stock price as part of the valuation because it did not produce a favorable valuation. Parties taking similar approaches face an uphill battle in trying to convince a court that the market did not accurately reflect the value of a company due to misrepresentations or omissions in public filings.

C. In re Red Mountain Machinery Co., 471 B.R. 242 (D. Ariz. 2012)

Facts:

This case involved an appeal by creditors raising three claims of error in context of confirmation and the treatment of their claims: a) the treatment of claims pursuant to the Section 1111(b) election; b) the adequacy of the equity holder's value contributed to retain their equity; and c) the determination of the appropriate interest rate for their claim.

Appellees filed motions to dismiss on the basis of mootness and on the basis of lack of appellate jurisdiction because the appeal was untimely. The District Court granted the motion to dismiss in part and denied in part. The District Court refused to dismiss the issues relating to the treatment of the Section 1111(b) election and the interest rate as moot, but dismissed the adequacy of the equity holder's contribution as moot. The District Court did dismiss the issue on appeal of the question of the formula for the treatment of the Section 1111(b) issue since that was finally determined in connection with the approval of the disclosure statement and not the confirmation order and therefore the appeal of just the confirmation order was an untimely appeal of that decision.

First, the Appellees argued that the appeal should be dismissed for mootness. The District Court explained that an appeal from a bankruptcy court's order is moot "when in the absence of a stay events occur that make it impossible for the appellate court to fashion effective relief." The Court analyzed equitable mootness and real or constitutional mootness.

The Appellant raised three errors on appeal---namely a) the bankruptcy court erred in allowing in part and denying in part Appellant's Section 1111(b) election; 2) the bankruptcy court erred in determining the adequacy of the value of the contribution by Owen and Linda

Cowing; and 3) the bankruptcy court erred in determining the interest rate Appellant would be paid going forward.

Holding:

The Debtor's motion to dismiss the appeal as moot was granted in part and denied in part.

Analysis:

The Appellee/Debtor argued that the appeal was equitably moot because the plan was consummated and changes to the plan would impact a variety of parties and have far reaching consequences. The Court observed that Appellee's argument should be considered more in the nature of constitutional mootness and analyzed the argument under equitable and constitutional mootness.

As to the Section 1111(b) election issue, the Appellant argued that the Court could grant relief because the court could determine that the Appellant's claim is entitled to treatment as fully secured and the Debtor's payments to Appellant would have to be incrementally higher over the Plan's terms. The Appellee argued that this change would impact the new lender who provided exit financing and the Cowings who provided additional equity contribution. Appellees also argued that because the Plan was consummated the District Court could not remand to the Bankruptcy Court to determine whether the Cowings made a substantial enough financial contribution for the interest they received. Specifically, the Court noted that the Cowings contributed $480,000 for the equity they retained. Similar arguments were made with respect to the interest rate to be paid to the Appellant under the Plan.

The District Court noted that granting the Appellant relief on the Section 1111(b) issue and interest rate issue may require that the Debtor pay the Appellant more money over the next 15 years. However, the Court failed to see how this would result in unwinding the entire Plan. The Court noted that changing the Debtor's repayment obligations could potentially have a domino effect on other aspects of the Plan. However, the Court found that based on the record, and not knowing for certain that requiring the Debtor to make a higher payment would impact the Debtor's ability to go forward, the Court did not find the appeal of these issues to be constitutionally or equitably moot.

The Court viewed the new equity contribution as a separate issue because the money had already been contributed and spent. The Court noted that a change in the amount would change the effectiveness of the Plan and may impact the exit lender's willingness to provide financing. Further, multiple creditors had already been paid and would be affected by a revised equity contribution. Therefore, the Court held that the appeal to change the equity amount was moot.

The court then addressed whether the appeal should be dismissed because it was not timely. The parties agreed that the Bankruptcy Court's January 6, 2011 Order on the objection to the disclosure statement resolved the formula the court would use if the creditor made the statutory election under Section 1111(b) to be treated as fully secured was the basis for the current appeal. The Order confirming the Plan was entered on May 24, 2011. The appeal was filed on June 7, 2011. The issue is whether the January 6 Order or the May 24 Order was the final appealable order.

Appellee argued that the Court should liken this appeal to appeal of a Section 506(a) motion. Appellee argued that in the Section 506(a) context factual determinations of value are not immediately appealable, however, the formula for valuation can be final prior to plan confirmation because no future order would affect that calculation. The Appellees argued that the formula the Bankruptcy Court applied to the Section 1111(b) election closely resembled the Section 506(a) election and therefore, should be governed by the same finality/appealability standard.

The Court employed the pragmatic approach, which considers an order to be final and appealable, "where it 1) resolves and seriously affects substantive rights and 2) finally determines the discrete issue to which it is addressed." Applying this approach, the Court held that the January 6, 2011 Order was the final order because it was a final determination on the formula the Bankruptcy Court would use for purposes of the Section 1111(b) election. The Court further reasoned that the Appellant's substantive rights were seriously affected by this January Order and all that remained was to factually determine the dollar value of the two classes of claim. The June 7, 2011 appeal was therefore not timely and the motion to dismiss for lack of jurisdiction was granted.

Finally, the Court addressed the appeal of the cramdown interest rate to be applied to the secured claim. The Court determined that the standard of review on appeal would be to review the methodology de novo, but give substantial deference to the factual calculation of the interest rate. The parties acknowledged that the Bankruptcy Court's determination of the cramdown interest rate must be fair and equitable. The Court noted that the market rate of interest can be determined by "1) determining the market interest rate for similar loans in the region; or 2) using a formula." The Court noted that the Bankruptcy Court did not err in using the formula approach where there was no efficient market for an equivalent loan. The Bankruptcy Court's opinion recites that this determination "requires a court to discount a stream of deferred payments back to their present dollar value." Finally, the Court found that the Bankruptcy Court did not err in failing to consider loan-to-collateral value as a characteristic of the loan. The Bankruptcy Court gave a detailed analysis of the facts it considered in applying the formula approach and consequently, the District Court, giving the Bankruptcy Court substantial deference, refused to reverse the Bankruptcy Court's determination of the interest rate.

Lessons:

1. Equitable and/or constitutional mootness must be argued with specificity.
2. A final appealable order is determined by a pragmatic approach that is flexible and if uncertain, party may need to appeal to protect rights on appeal. Can't necessarily wait to appeal confirmation order where rights were substantively impacted as part of the ruling on the objection to the disclosure statement order.
3. Standard of review of interest rate may be bifurcated – methodology is reviewed de novo, but factual calculation is given substantial deference.

D. In re GAC Storage Lansing, LLC, 485 B.R. 174 (Bankr. N.D. Ill. 2013)

Facts:

Debtor GAC Storage Copley Place, LLC, the owner and operator of a self-storage facility in San Diego, sought confirmation of its plan of reorganization over the objection of secured creditor Bank of America ("BOA"). The Debtor proposed a plan that would pay down BOA's $10.2 million claim with: (a) a lump sum payment of $200,000 from a Guarantor Contribution, (b) monthly principal and interest payments, and (c) a balloon payment of approximately $8.7 million at the end of a 7-year term. BOA objected that the plan was not feasible because it was based on unsupported projections and the value of the property would not be sufficient to make the required balloon payment. The Debtor and BOA put on competing valuation experts at the confirmation hearing.

The Debtor's expert, a commercial real estate appraiser, made a determination of the property's as-is value, a 7-year prospective market value, and a liquidation analysis. To determine the as-is value, he employed the income approach using the direct capitalization method which converts an estimate of stabilized net operating income into an indication of value by dividing it by an overall capitalization rate. The expert measured the physical occupancy rate (how many units were occupied by tenants) and the economic occupancy rate (factoring in discounts, concessions, and credit loss). He applied a combined rate of 10% to account for vacancies and rent concessions and arrived at an as-is value of $10.9 million. In reaching this 10% rate, he applied a vacancy factor of 5.6% despite his acknowledgement that (1) 10-20% vacancy rate is the industry standard for the market and (2) the occupancy rate for the Debtor at the time of his inspection was well below market at 66%. He did not account for the Debtor's standard rental concessions in his analysis. To determine the 7-year value, he used the direct capitalization method which took the estimated future income at the 7 year mark and divided it by a future capitalization rate resulting in a prospective value of $12.6 million. The expert testified that "when you're looking forward at future income, there's a bunch of uncertainties in the future" so he applied, without offering any support, a growth rate of 3% to the income beginning in 2014 and an increase of 3% a year to account for increased expenses.

BOA's expert, a commercial real estate appraiser with 25 years experience and more than three times the volume of business of the Debtor's expert, also used the direct capitalization method for his income approach, but focused his analysis on the property's existing revenue and a comparison with five area self-storage facilities. He concluded that the stabilized occupancy rate was 88% resulting in a stabilized value of $9.9 million. With respect to the free rent and concession analysis, BOA's expert determined that a 6% effective rent loss/concession discount was appropriate because the Debtor offers one month free rent out of 12 months. Additionally, he applied a 12% discount to account for additional vacancy and collection losses based on the historic vacancy rates of the property in comparison with the rates of the comparable properties. The result under this method is a value of $9.6 million. His analysis of the property's as-is value resulted in a value of $8.1 million after applying a discount rate of 15% of the stabilized value estimate and subtracting an additional $54,000 advertising expense. He further testified in response to the Debtor's expert's analysis that applying projected rates 7 years out in the future is not something that could be done with any degree of

accuracy and therefore would not make a 7-year projected calculation for the purpose of valuation.

Holding:

The Debtor failed to establish that its plan was feasible due to the inadequacy of its projections and failed to prove by a preponderance of the evidence that it would have sufficient equity or other resources to pay off BOA's claim in 7 years.

Analysis:

The Court found that the Debtor's expert was not credible due to the lack of data supporting his conclusions and the inconsistencies in his report. The "most damaging to [his] credibility was his failure to properly provide for rental concessions and the vacancy rate when calculating gross potential rent under the income approach." (p. 185). The Court also found his 7-year prospective market value unreliable because the aggressive projections did not line up with economic reality. The Debtor's expert testified that the storage facility market remains highly uncertain and that he does not consider San Diego to be in true recovery from the recession. In the face of these weak economic indicators, he applied a 3% growth rate annually 7 years into the future. In contrast, BOA's expert testified that he would not make a 7-year projection to establish value due to the uncertainties outlined by the Debtor's expert. The Court went on to find that the aggressive projections that form the basis of the Debtor's plan are unrealistic and not consistent with the Debtor's current market performance or current market conditions. Accordingly, the Debtor failed to meet its burden and the Court accepted BOA's expert as-is valuation of $8.1 million.

Lessons:

1. Take care in selecting your expert. Make sure your expert's conclusions are supported by evidence. Don't conclude testimony about bad economic conditions with aggressively optimistic projections.

E. In re 785 Partners LLC, 2012 WL 959364 (Bankr. S.D.N.Y. Mar. 20, 2012)

Facts:

The Debtor in this single asset real estate case sought confirmation of its plan. The two most significant and contested issues for confirmation were the value of the principal secured creditor's claim (First Manhattan Development REIT or "FM") and the value of the Debtor's building – a new (and vacant) 43-story building with 122 apartments and retail/commercial space located in Manhattan. The Court conducted a five-day evidentiary hearing to determine the value of the building, and both the Debtor and FM put on competing experts that reached different building values. The Debtor contended the highest and best use for the building is as a rental, arguing that the building was worth $103 million as a rental but only $93.3 million as a condominium (condo). FM contended that the highest and best use for the building is as a condo, arguing that the building was worth $76.4 million as a condo and $70.3 million as a rental.

Both experts valued the building as a condo on a net sellout basis – i.e., a discounted cash flow analysis that assumes a buyer will buy the entire building at wholesale and then sell the apartments over time at retail; the net income realized over the period of the sellout is then discounted back to present day. The difference in the experts' opinions on the value as a condo was $16.9 million. A number of factors affected the valuation: (1) absorption of sellout period; (2) assumed selling price of the apartments and retail/commercial space; and (3) expenses buyer must pay during the period of the sellout.

Both experts valued the building as a rental using the income capitalization approach – i.e., compute a single year's stabilized net operating income, divide the amount by an overall capitalization rate, make some further adjustments, then arrive at a value. The difference in the experts' opinions on value as a rental was almost $33 million. The factors affecting valuation for rental value are: (1) rental value per square foot of the residential and commercial space; (2) amount of time it will take to reach a stabilized rental; (3) the operating and lease up expenses; and (4) the capitalization rate.

Holding:

In the end, the Court held that the highest and best use for the building was as a rental and found that the rental value is $91.7 million.

Analysis:

On the valuation of the building as a condo, the Court found that: (1) the Debtor's expert had overestimated the selling price of the condo units since the majority of the units were smaller one-bedroom units; (2) the selling price of retail/commercial units was lower than what the Debtor's expert indicated but higher than what FM's expert indicated but the difference between the experts on this issue was immaterial; and (3) the Debtor's expert did not appropriately consider assumptions regarding sellout expenses to reflect expenses an owner would have to make to ready the building for unit sales, such as putting aside a working capital fund to address water damage to certain apartments and other items in need of repair. On the appropriate discount rate, the Court split the different between the experts' opinions and held that 8% was the appropriate rate. The Court accordingly held that the present value of the building as a condo was $81,650,000.

On the valuation of the building as a rental, the Court found that that the principal differences in the appraisals centered on the assumptions regarding the capitalization rate (cap rate) and the rental value per square foot. The cap rate examines recent building sales in the local area. The Court rejected the Debtor's expert's cap rate because it was incomplete and inexact, including use of some buildings outside Manhattan. FM's expert's information did not support his conclusion. The Court, however, arrived at a figure close to the cap rate opinioned by FM's expert. For the rental value per square foot, both experts examined rents from comparable buildings. The Court found that the comparable buildings used by the Debtor's expert were outdated and inferior, while FM's expert used more appropriate comparables.

Lessons:

1. In single asset real estate cases, where real property value is contested at confirmation, experts and counsel should: (1) consider what purpose the building is being

valued for; (2) determine whether all appropriate factors are being used/considered for each part of the valuation analysis; and (3) always have data to back up the conclusions.

2. In single asset real estate cases, if using comparable properties/buildings as part of a valuation analysis, remember that location is key and the court may see through attempts to cherrypick comparables that help the expert reach a valuation result favorable to the expert's side. And what is "comparable" may vary – in Manhattan, "comparable" is what is across the street or on the same block but in less congested areas "comparable" may include any similar properties in the same town, city, or county.

F. In re PTL Holdings LLC, Case No. 11-12676 (BLS), 2011 WL 5509031 (Bankr. D. Del. Nov. 10, 2011)

Facts:

Debtors operated a trailer leasing company whose business consisted of purchasing semi-trailers and then leasing them to customers for long-term, short-term, or storage use. At the hearing to consider the request of Debtors for confirmation of their prepackaged Joint Plan of Reorganization, the Debtors and their first lien secured creditor (the "First Lienholder") contended that the business was worth less than the amount of the first lien debt. The second lien secured creditor (the "Second Lienholder"), whose claims were to be wiped out under the Plan, contended that it was in the money, and that because the Plan proposed to permit the First Lienholder to recover more than its allowed claims, the Plan could not be confirmed when subjected to the good faith standard imposed by 11 U.S.C. § 1129(a)(3) and the "fair and equitable" test under 11 U.S.C. § 1129(b).

Debtors' management team prepared the financial projections (the "Projections") at the heart of the valuation dispute. The Projections anticipated substantial increases in both revenue and EBITDA over the next four years due to factors such as high utilization, price, fleet composition, the state of the economic environment generally, and the anticipated direction of the company's business.

The Second Lienholder strongly criticized the Projections as being premised on unduly pessimistic and faulty assumptions, and contended that the Projections were manufactured to produce a valuation that placed the Second Lienholder out of the money. The Second Lienholder contended that the Projections were inconsistent with other sources' more robust estimates of projected growth in domestic GDP. Furthermore, the Second Lienholder argued that the Projections' information differed from the information contained in a memorandum (the "Memorandum") issued during an unsuccessful prepetition capital raising effort.

Both parties' experts utilized the Projects to testify about the Debtors' enterprise value. The Debtors' expert filed a stand-alone valuation report (the "Debtors' Report") which utilized three business valuation methodologies: discounted cash flow ("DCF"), comparable companies ("CC"), and precedent transactions ("PT"); the Second Lienholder's expert offered a rebuttal report, but not a stand-alone valuation report.

Consistent with the Projections, the Debtors' Report assumed the reorganized Debtors would have $20 million in working capital financing available to them post-confirmation, all of which would go to purchase new trailers. Using that, the Debtors' DCF analysis arrived at a

valuation range of $62 million to $100 million. The Second Lienholders' expert recommended a wide range of adjustments to the DCF analysis, including a reduced projected CapEx, increased depreciation rate, and the Debtors' expert's weighted average cost of capital. With these adjustments, the second Lienholders calculated two valuation ranges: $87 million to $222 million (perpetuity method) and $100 million to $145 million (exit multiple method).

For the CC analysis, the Debtors' expert selected six publicly-traded companies that he deemed to be comparable to the Debtors. He considered, but excluded, eight other companies that were included in the Memorandum; these other companies were excluded due to their incomparable business markets, products, or length of products' usable lives. Under this analysis, the Debtors' expert arrived at a valuation range of $78 million to $103 million. The Second Lienholder objected, alleging that four of the excluded Memorandum companies should be added; otherwise, the results are skewed, thereby depressing the Debtors' total enterprise value.

For the PT analysis, the Debtors' expert identified fourteen precedent transactions involving equipment-related rental businesses like the Debtors, arriving at a valuation range for the Debtors of $86 million to $105 million. The Second Lienholder objected that the PT analysis omitted several of the transactions identified in the Memorandum, inclusion of which would raise the valuation range to $99 million to $188 million.

Holding:

The Second Lienholder's objection was overruled. Debtors carried their burden to demonstrate that the total enterprise value of the Debtors' business was insufficient to provide for a recovery to the Second Lienholder.

Analysis:

First, the Court found that the Projections were reliable. The Court noted that "[t]he Debtors' projections reflect the Debtors' optimism that both revenue and EBITDA will grow through 2015 . . . though [the Second Lienholder] accuses the Debtors of not being optimistic enough. [Debtors' CFO] testified regarding his expectations as to overall utilization rates, and acknowledged that there are substantial risks regarding the overall weak global and domestic economic recovery and the prospect of another (or prolonged) recession, as well as execution risk in the Debtors' effort to implement their business plan. These factors, considered in light of [Debtors' CFO's] credible testimony, lead the Court to conclude that the Debtors' projections, which underlie [Debtors' expert's] valuation, are not fatally flawed or otherwise materially unreliable."

The Court further found that the differences between the Projections and the Memorandum were not determinative, because the Memorandum "was drafted to serve an entirely different purpose than the projections filed with the Disclosure Statement filed in this bankruptcy case. Moreover, while the Court notes that the [Memorandum] is somewhat more optimistic about the Debtors' prospects and overall value, the fact remains that the prepetition capital raise was a failure. To the extent the Court can derive any lessons from the [Memorandum], it may be that the marketplace was unwilling to lend significant credence to a robust valuation for the Debtors."

As for the DCF dispute, the Court found that "the record developed at trial reflects that [Debtors' expert's] valuation is based upon the projections prepared by management and was prepared in accordance with standard and generally-accepted methodologies and assumptions." While recognizing that the Second Lienholder's expert "would have made a number of different decisions or assumptions . . .[,] [Debtors' expert's] valuation is predicated upon reliable projections and generally-accepted valuation principles[; thus,] the Court does not conclude that the differences of opinion and judgment between [the parties' experts] render the discounted cash flow analysis in the [Debtors' expert's] valuation flawed or materially unreliable.

Regarding the CC analysis, the Court found that [Debtors' expert's] selection of comparable companies was reasonable, notwithstanding the fact that reasonable valuators could differ on the matter.

Lastly, the Court addressed the PT analysis, finding that with respect to the additional transactions the Second Lienholder argued should be included in the PT analysis, "other than the fact that they were included in the [Memorandum], [the Second Lienholder] did not offer much guidance on why he believed they should be included in the [Debtors' Report]." The Court again noted that the Memorandum was relevant, but not dispositive to the present valuation. Moreover, the Court struggled with "the broad range of value calculated as a result of [the Second Lienholder's] adjustments to [the Debtors' Report]: a range of $99–$188 million is sufficiently wide so as to impair its usefulness as a value metric."

With that said, the Court found the Debtors carried their burden to demonstrate that the plan was fair and equitable.

Lessons:

1. Prepetition valuations should be considered relevant, but not dispositive vis-à-vis valuations conducted after the petition date
2. Management prepared cash flow projections can be credible, despite the need for added scrutiny for the potential self-interest and bias.

G. In re Young Broad. Inc., 430 B.R. 99 (Bankr. S.D.N.Y. 2010)

Facts:

Young Broadcasting, Inc. ("YBI" or "Debtors") owned and operated ten television stations in geographically diverse markets and a national television sales representation firm when it filed for chapter 11 relief on February 13, 2009 as Case No. 09-10645. Both the Official Committee of Unsecured Creditors (the "Committee") of YBI and YBI submitted competing plans of reorganization. At the confirmation hearing, the Committee moved for confirmation of the Committee's Plan (the "Committee Plan"). In the event that the Court denied confirmation of the Committee Plan, the Debtors moved for confirmation of the joint plan of YBI and its subsidiaries (the "Debtors Plan").

One of the first issues addressed at the Confirmation Hearing was the admissibility of the Committee's expert (the "Committee Expert") report and testimony regarding the Reorganized Debtors' (the "Company") ability to sell or refinance and his expert report and testimony regarding the Debtors' valuation. The Debtors' were parties to a credit agreement

(the "Credit Agreement") with its secured lenders (the "Lenders"), the latter of whom asserted that the Committee Expert's testimony regarding valuation of the Debtors was inadmissible because the Committee Expert's levered discount cash flow (the "Levered DCF") analysis was not a reliable method for purposes of valuation. The Committee Expert performed both comparable company analysis and precedent transaction analysis, though he attributed little weight to those two methods and relied primarily on the Levered DCF analysis to determine a range of valuations for the Debtors. The Lenders argued that the Committee Expert misleadingly labeled his analysis a Levered DCF without having undertaken the necessary steps in a DCF analysis, which rendered his valuation opinion unreliable and inadmissible. The Committee, on the other hand, contended that the Committee Expert utilized a method that was a reliable variation of the DCF analysis and simply made adjustments to fit the Debtors' circumstances. The initial question before the Court was twofold: (1) whether the Committee Expert conducted an acceptable variant of DCF analysis, and hence a DCF analysis, and (2) if the Committee Expert did not conduct a DCF analysis, whether the Levered DCF was a reliable method under the Daubert standard.

The Committee attempted to distinguish the facts of this case by contending that, unlike experts who could not offer any explanation as to why they failed to utilized the DCF method, the Committee Expert clearly stated that the Levered DCF was more appropriate to the facts of this case because it accounted for the value of the substantially below-market terms of the reinstated debt under the Committee Plan.

The Committee Expert performed his analyses based on projections (the "Projections") prepared and provided by the Debtors (the "Base Case") and a more conservative scenario for projections (the "Stress Case") that it created. The Committee Expert concluded that, under the Committee Plan, the Company would have sufficient financial resources to cover its Capital Expenditure ("Capex") requirements, service financial obligations, and pay the balance due when the Debt matures in November 2012.

For purposes of valuation, the Committee Expert testified that he did not determine the total enterprise value ("TEV") of the Debtors upon emergence from Chapter 11 because he did not consider it relevant to the issue of the Company's ability to service the Debt through a sale or refinancing in November 2012. The Committee Expert further opined that, in the event that the Company chose not to sell, it would still be well-positioned to obtain refinancing in November 2012 because the net debt balance implies a debt to 2012/2013 EBITDA ratio of 5.4x and 6.9x under the Base Case and the Stress Case, respectively, which are both leverage ratios below the multiples at which historical broadcast transactions have been financed.

Countering the Committee Expert's report was that of the Lenders' retained expert (the "Lenders' Expert"). In valuing the Debtors, the Lenders' Expert considered comparable company analysis, precedent transactions analysis, DCF, as well as the result of a recent auction. The Lenders' Expert concluded that the TEV of the Debtors, based on projections of the Base Case, was $250—$300 million upon emerging from Chapter 11. Using the same methodologies and under the Stress Case projections, the Lenders' Expert concluded the Debtors' TEV is $200—$250 million. With respect to meeting their obligations under the reinstated Credit Agreement through the prospect of a sale, the Lenders' Expert opined that the assumption of a sale of the Company in 2012 based on 9.0x 2012/2013 BCF was unreasonable in light of (1) the bids generated in the previous auction for the Debtors, which were significantly below 9.0x BCF,

and (2) current trading levels of comparable companies at approximately 7.0x 2009/2012 BCF, which is also significantly lower than the Company's 9.0x multiple.

Holding:

The Court denied confirmation of the Committee Plan and granted confirmation of the Debtors Plan.

Analysis:

The Court first addressed the Daubert motion. The Court found that, although the Committee Expert used DCF terminologies, there were practically no substantive similarities between the generally accepted DCF method and the Levered DCF method. The Committee Expert made multiple novel assumptions that do not exist in the DCF analysis, such as an assumed sale of the company and a discount rate that accounts for the cost of equity instead of both the cost of debt and equity. The Committee Expert's analysis altered another key component of the DCF method, which is the way a company's terminal value should be calculated. In light of this, the Court found that he did not conduct an appropriate DCF analysis.

The inquiry did not end there, however, as the Court noted that the Committee Expert's valuation analysis may still be admissible if the Court determines that the Levered DCF contains sufficient indicia of reliability under Daubert; the Court concluded that it did not. The Levered DCF fails to meet any of the Daubert factors: it was not a method that has been tested or relied upon by other experts, it had never been subjected to peer review or discussed in any publication, the potential rate of error was unknown, and there was no evidence that this method was ever employed, discussed, and certainly not generally accepted in any academic or professional community. Thus, the portion of the Committee Expert's report and testimony regarding valuation was inadmissible under Rule 702.

The Court then reviewed the Debtors' projections and found as follows:

Revenue Growth

"Although the Debtors' management alleges that the Projections are conservative and reflect slow, consistent growth, the Court disagrees and finds the Company's projected growth to be aggressive and unrealistic." Moreover, "the Court is particularly troubled by the aggressive EBITDA and BCF projections for 2012, which are approximately twice the EBITDA and BCF Projections for 2008, the last presidential election year."

Capex

The Court also found that the Debtors provided for inadequate Capex to support the rate of growth reflected in the Projections. Though the Debtors asserted that the projections were created using a bottom-up process, the Court found that, although the opinions of station managers were solicited and considered, Capex budgets were principally generated by upper management and did not necessarily reflect the Company's Capex needs. Further, the Debtors also failed to create a Capex budget for its biggest station, KRON. The key deficiency in the Debtors' business plan was that the projected rate of growth in revenue necessarily presumes either a substantial improvement in the industry, increased industry market share within 2.5 years of emerging from bankruptcy, or both.

Assumed Sale of the Company

Pursuant to the Court's holding in the Daubert Motion, any conclusions reached by the Committee Expert based upon the Levered DCF were excluded. Thus, the Committee Expert's opinion that the Debtors would be able to satisfy the Debt upon maturity through an assumed sale in November 2012 was excluded from the record. However, even if that portion of the Committee Expert's testimony were not excluded, the Court found that the assumed sale of the Company in November 2012 at a price that is equivalent to its future common equity value was not supported by any reasonable analysis. In sum, the Court found that the prospect of the Company's assumed sale at a price equivalent to its future common equity value in November 2012 was both unsubstantiated and purely speculative.

Refinancing

Aside from an assumed sale, the Committee argued that the Company would be able to refinance the Debt before it comes due. But as the Court found it unlikely that the Company could achieve its Projections, it was therefore unlikely that the purported amount of cash could be accumulated to achieve the net debt balance upon which the net debt to EBITDA ratio was premised.

In sum, the Court found that the Committee Plan was not feasible under section 1129(a)(11) because the Committee failed to establish that the Company could satisfy the debt upon maturity in November 2012 through either a sale or by refinancing. The Debtors' motion to confirm the Debtors Plan was thus granted.

Lessons:

1. Exercise caution when utilizing a valuation expert that uses valuation methodologies that differ from or augment the traditionally accepted methodologies.

H. In re Spansion, Inc., 426 B.R. 114 (Bankr. D. Del. 2010)

Facts:

On March 1, 2009, Spansion, Inc. and its affiliated debtors (the "Debtors") filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code with the objective of a financial restructuring. The Debtor's semiconductor device business and operations focused on the design, development, manufacture, marketing and sale of Flash memory products and solutions. Following negotiations with various constituencies, the Debtors filed a joint plan of reorganization (as subsequently amended, the "Plan"). On December 18, 2009, the Court entered an order approving the Debtors' disclosure statement, establishing voting and objection procedures and scheduling a hearing to consider confirmation of the Plan (the "Confirmation Hearing").

At the Confirmation Hearing conducted in February and March, 2010, the Court addressed several matters, including: (i) the Debtor's request for confirmation of the Plan and objections thereto and (ii) a motion, among other things, to vacate (the "Motion to Vacate") the order approving the Debtor's disclosure statement submitted by an ad hoc group of noteholders. Prior to considering confirmation of the Plan, the Court first dispensed of the Motion to Vacate. Having addressed the Motion to Vacate, the Court next considered plan confirmation and the objections thereto. Several of these objections required the Court to first consider the valuation of the Debtors, including: (i) whether the Plan proponents undervalued

the Debtors, thereby unfairly impairing unsecured creditors and violating sections 1129(a)(3) (plan has been proposed in good faith), 1129(b)(1) and (2) (plan does discriminate unfairly and is fair and equitable with respect to each impaired and non-accepting class of claims or interests) of the Bankruptcy Code; (ii) whether the Debtors' proposed equity incentive plan provided too much value to management and employees, at the expense of unsecured creditors, in light of the appropriate valuation of the Debtors, thereby violating sections 1129(a)(3) and 1129(b)(1) and (2) of the Bankruptcy Code; and (iii) whether the Debtors presented false and misleading information in the Plan and disclosure statement with respect to the Debtors' future prospects, thereby violating section 1129(a)(2) (plan proponent complies with applicable provisions of the Bankruptcy Code).

Holding:

Notwithstanding the Court's conclusions on the Debtors' enterprise value and rulings in favor of the Debtors with respect to certain Plan objections, the Court ultimately held that the Plan could not be confirmed because: (i) the Debtors did not demonstrate that the equity incentive plan was proposed in good faith and fair and equitable to creditors; (ii) certain third-party release provisions did not pass muster under applicable law; and (iii) the Plan failed to establish a reserve for a particular administrative claim.

Analysis:

Before addressing the objections, the Court first conducted an extensive analysis of three competing views on the Debtors' enterprise value presented by the Debtors, a group of senior noteholders (the "Senior Noteholders"), and an ad hoc committee of convertible noteholders (the "Convert Committee"). Each presented the report and testimony of an expert witness who, in formulating their views on the Debtors' value, used three customary valuation methodologies: (i) discounted cash flow analysis; (ii) comparable company analysis; and (iii) comparable M&A transaction analysis. At the Confirmation Hearing, the Debtors' expert witness testified that the Debtors' total enterprise value was within the range of $700 million to $850 million. The Senior Noteholders' expert witness testified that the Debtors' total enterprise value was within the range of $799 million to $944 million. The Convert Committee's expert witness testified that the Debtors' total enterprise value was within the range of $1.054 billion and $1.419 billion.

After reviewing each expert's methodology and conclusions, as well as each expert's criticisms of the others, the Court determined that the Senior Noteholders' valuation "was appropriately weighted and rested on assumptions that, of the three reports, were the most sound for determining the Debtors' worth at this time and in this industry." Specifically, the Court found that the report of the Senior Noteholders' expert was "more transparent" and "more in line with common valuation practices." In reaching his conclusions on value, the Senior Noteholders' expert, among other things: (i) properly included and appropriately weighted both a base case projection and contingency case projection prepared by the Debtors' management (while the Debtors' expert similarly used both projections, the Convert Committee's expert included only the base case projection), including with respect to the discounted cash flow analysis; (ii) appropriately used only EBITDA multiples in the comparable company analysis and excluded revenue multiples in such calculations; and (iii) considered and

included an appropriate set of relevant transactions and multiplier in the comparable M&A transaction analysis.

Based upon the record before it, the Court concluded that the Debtors' enterprise value was in the range of $872 million to $944 million. A gross "distributable value" for the Debtors, which was determined by adding sources of additional value (e.g., net operating losses, potential litigation recoveries, proceeds from the sale of certain assets), was calculated to be in the range of $1.368 billion to $1.440 billion.

Having determined the Debtors' appropriate enterprise value, the Court next addressed certain of the Plan confirmation objections, concluding: (i) the Plan treated all unsecured creditors fairly and equitably; (ii) the Debtors' proposed equity incentive plan set forth in the Plan was not reasonable under then-current market conditions; and (iii) the Debtors' did not provide false and misleading information in the Plan and disclosure statement regarding the Debtors' future prospects.

Lessons:

1. By the Motion to Vacate, the ad hoc group argued that the order approving the disclosure statement should be vacated due to "fundamental misrepresentations" contained in the disclosure statement and asserting that "the assumptions underlying the low valuation case set forth in the Disclosure Statement are intentionally, i.e., knowingly, disingenuous and misleading." In denying the Motion to Vacate, the Court determined that, in effect, the ad hoc group was challenging the assumptions underlying the valuation of the Debtors, which issue is more appropriately considered as an objection to plan confirmation.

2. Although the Debtors argued initially that "the Plan is confirmable no matter what value the Court determines for the Debtors," the Court noted that several issues concerning confirmation of the Plan required a valuation analysis, including whether the Plan was proposed in good faith as required by section 1129(a)(3) of the Bankruptcy Code and fair and equitable to rejecting classes as required by section 1129(b)(1) of the Bankruptcy Code.

3. Certain objectors posited that the claims buying market should be used as an indicator of the Debtors' enterprise value. In this case, while there was some evidence presented regarding the amounts being paid for the various types of claims against the Debtors, there was no evidence introduced regarding such factors as trading volume, the applicable trading term, or the openness of the market to participants. The Court noted that at least one court had determined that claims trading is not an accurate indicator of a debtor's value.

4. In this case, the Court relied upon and evaluated the expert opinions in the record to determine the Debtors' enterprise value. In doing so, the Court was fully cognizant that "in a contested matter such as this, the hired experts often approach their valuation task from an advocate's point of view."

H

United States Court of Appeals,
Third Circuit.
In re HERITAGE HIGHGATE, INC. and Heritage Twin Ponds, L.P., Debtors.
Charles Scagliotti IRA, Frank Cortese IRA, Gerald Bowes IRA, Gary Cortese IRA, George Mee Marital Trust, TomParks IRA, Pollock Family L.P., Robert Preston IRA, John Rogers, Lynne Summers Marital Trust, John R. Yaissle IRA, Yee III Trust Highgate and Robert Preston (collectively "Cornerstone Investors"), Appellants.

No. 11–1889.
Argued March 20, 2012.
Opinion Filed: May 14, 2012.

Background: Unsecured creditors committee in debtors' joint Chapter 11 case moved to determine value of lenders' secured claims, contending that claims should be valued at zero. Lenders opposed motion. The United States Bankruptcy Court for the District of New Jersey granted motion. Lenders appealed. The United States District Court for the District of New Jersey, Jerome B. Simandle, J., 449 B.R. 451, affirmed. Lenders appealed.

Holdings: The Court of Appeals, Rendell, Circuit Judge, held that:
(1) fair market value of debtors' real estate subdivision, which was collateral for loans, as of confirmation date of reorganization plan, controlled extent to which lenders' claims were secured;
(2) stripping of liens on real estate subdivision was permitted;
(3) unsecured creditors satisfied burden of overcoming presumed validity and amount of secured claims in real estate subdivision, by submitting appraisal that, as adjusted, determined subdivision's fair market value to be insufficient to satisfy higher-priority lien; and
(4) lenders failed to satisfy their burden of persuading that appraisal undervalued real estate subdivision and that subdivision was instead worth enough to secure lenders' claims.

Affirmed.

West Headnotes

[1] Bankruptcy 51 ⚿3782

51 Bankruptcy
51XIX Review
51XIX(B) Review of Bankruptcy Court
51k3782 k. Conclusions of law; de novo review. Most Cited Cases

Because the district court sits as an appellate court, reviewing an order of the bankruptcy court, Court of Appeals' review of the district court's determinations is plenary. 28 U.S.C.A. § 158(d).

[2] Bankruptcy 51 ⚿3779

51 Bankruptcy
51XIX Review
51XIX(B) Review of Bankruptcy Court
51k3779 k. Scope of review in general. Most Cited Cases

Bankruptcy 51 ⚿3782

51 Bankruptcy
51XIX Review
51XIX(B) Review of Bankruptcy Court
51k3782 k. Conclusions of law; de novo review. Most Cited Cases

Bankruptcy 51 ⚿3786

51 Bankruptcy
51XIX Review
51XIX(B) Review of Bankruptcy Court
51k3785 Findings of Fact
51k3786 k. Clear error. Most Cited Cases

In reviewing the bankruptcy court's determinations, Court of Appeals exercises the same standard

of review as did the district court; accordingly, the bankruptcy court's findings of fact are reviewed only for clear error, while legal determinations are reviewed de novo. 28 U.S.C.A. § 158(d).

[3] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Burden-shifting framework controls valuations of collateral to decide the extent to which a creditor's claims are secured. 11 U.S.C.A. § 506(a).

[4] Bankruptcy 51 ⚿2926

51 Bankruptcy
51VII Claims
51VII(E) Determination
51k2925 Evidence
51k2926 k. Presumptions and burden of proof. Most Cited Cases

Bankruptcy 51 ⚿2928

51 Bankruptcy
51VII Claims
51VII(E) Determination
51k2925 Evidence
51k2928 k. Effect of proof of claim. Most Cited Cases

Under the burden-shifting framework controlling the valuation of collateral to decide the extent to which a creditor's claims are secured, the initial burden should be on the party challenging a secured claim's value, because prima facie effect is granted to the validity and amount of a properly filed claim and it is only fair that the party seeking to negate the presumptively valid amount of a secured claim, and thereby affect the rights of a creditor, bear the initial burden. 11 U.S.C.A. §§ 502(a), 506(a); Fed.Rules Bankr.Proc.Rule 3001(f), 11 U.S.C.A.

[5] Bankruptcy 51 ⚿2926

51 Bankruptcy
51VII Claims
51VII(E) Determination
51k2925 Evidence
51k2926 k. Presumptions and burden of proof. Most Cited Cases

Bankruptcy 51 ⚿2927

51 Bankruptcy
51VII Claims
51VII(E) Determination
51k2925 Evidence
51k2927 k. Weight and sufficiency. Most Cited Cases

Under the burden-shifting framework controlling the valuation of collateral to decide the extent to which a creditor's claims are secured, if the movant challenging a secured claim's value first establishes with sufficient evidence that the proof of claim overvalues a creditor's secured claim because the collateral is of insufficient value, the burden shifts, and the creditor thereafter bears the ultimate burden of persuasion to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim. 11 U.S.C.A. §§ 502(a), 506(a); Fed.Rules Bankr.Proc.Rule 3001(f), 11 U.S.C.A.

[6] Bankruptcy 51 ⚿2575

51 Bankruptcy
51V The Estate
51V(D) Liens and Transfers; Avoidability
51k2575 k. Liens securing claims not allowed. Most Cited Cases

Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Secured creditors' claims are divided into secured and unsecured portions, with the secured por-

tions of the claims limited to the value of the collateral. 11 U.S.C.A. § 506(a).

[7] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

The proposed disposition or use of the collateral is of paramount importance to the valuation of the collateral when deciding the extent to which a creditor's claims are secured. 11 U.S.C.A. § 506(a).

[8] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

The appropriate standard for valuing collateral, when deciding the extent to which a creditor's claims are secured, must depend upon what is to be done with the property: whether it is to be liquidated, surrendered, or retained by the debtor. 11 U.S.C.A. § 506(a).

[9] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Where a Chapter 11 plan of reorganization provides for a debtor to retain and use collateral to generate income with which to make payments to creditors, a collateral valuation based upon a hypothetical foreclosure sale would not be appropriate, as it would be inconsistent with the statutory dictate that the collateral's value must be determined in light of its proposed disposition or use. 11 U.S.C.A. § 506(a).

[10] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Bankruptcy 51 ⚿3564

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3563 Fairness and Equity; "Cram Down."
51k3564 k. Secured creditors, protection of. Most Cited Cases

In ordinary circumstances, where a Chapter 11 plan of reorganization provides for a debtor to retain and use collateral to generate income with which to make payments to creditors, the present value of the income stream would be equal to the collateral's fair market value. 11 U.S.C.A. § 506(a).

[11] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Where a Chapter 11 plan of reorganization provides for a debtor to retain and use collateral to generate income with which to make payments to creditors, the proper measure for valuing the collateral to determine the extent of creditors' secured claims must therefore be the collateral's fair market value because it is most respectful of the property's anticipated use. 11 U.S.C.A. § 506(a).

[12] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3784

51 Bankruptcy
51XIX Review
51XIX(B) Review of Bankruptcy Court
51k3784 k. Discretion. Most Cited Cases

Like the appropriate measure of collateral's fair market value, the appropriate time as of which to value collateral, when determining the extent of a creditor's secured claims, may differ depending on the facts presented, and bankruptcy courts are best situated to determine when is the appropriate time to value collateral in the first instance, and Court of Appeals therefore defers to bankruptcy courts' considered judgment. 11 U.S.C.A. § 506(a).

[13] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Fair market value of debtors' real estate subdivision, which was collateral for loans made by banks and investors, as of confirmation date of Chapter 11 reorganization plan, controlled extent to which lenders' claims were secured; plan called for debtors to retain ownership of subdivision in order to complete development, and discounted fair market value of property as of confirmation best approximated how secure lenders' liens were at relevant point in bankruptcy. 11 U.S.C.A. § 506(a).

[14] Bankruptcy 51 ⚿2575

51 Bankruptcy
51V The Estate
51V(D) Liens and Transfers; Avoidability
51k2575 k. Liens securing claims not allowed. Most Cited Cases

Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Congress expressly provided for the division of allowed claims supported by liens into secured and unsecured portions during the reorganization, before the plan's success or failure is clear, and the fact that the collateral's proposed disposition or use should be factored into the collateral valuation when determining the extent of the secured claims does not mean that the time as of which collateral is valued is to be postponed or altered. 11 U.S.C.A. §

506(a).

[15] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Federal Rules of Bankruptcy Procedure allow interested parties to request that a bankruptcy court value claims and therefore necessarily requires that collateral's worth, which determines the extent of secured claims, be affixed in advance of a reorganization's completion. Fed.Rules Bankr.Proc.Rule 3012, 11 U.S.C.A.

[16] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Where the purpose of the valuation of collateral is to determine the treatment of a claim by a reorganization plan as secured or unsecured, the values determined must be compatible with the values that will prevail on the plan's confirmation date. 11 U.S.C.A. § 506(a).

[17] Bankruptcy 51 ⚿2575

51 Bankruptcy
51V The Estate
51V(D) Liens and Transfers; Avoidability
51k2575 k. Liens securing claims not allowed. Most Cited Cases

Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Bankruptcy 51 ⚿3564

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3563 Fairness and Equity; "Cram Down."
51k3564 k. Secured creditors, protection of. Most Cited Cases

Stripping of investors' liens on Chapter 11 debtors' real estate subdivision, which secured investors' loans, was permitted, by valuing subdivision at fair market value as of confirmation date of reorganization plan, which had effect of rendering investors' claims wholly unsecured because subdivision's value was insufficient to satisfy banks' higher-priority lien, and thus denied to investors any future lot-sale proceeds that exceeded value determined at confirmation. 11 U.S.C.A. §§ 506(a), 1123(b)(5), 1129(b).

[18] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims

51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿2926

51 Bankruptcy
51VII Claims
51VII(E) Determination
51k2925 Evidence
51k2926 k. Presumptions and burden of proof. Most Cited Cases

Bankruptcy 51 ⚿2927

51 Bankruptcy
51VII Claims
51VII(E) Determination
51k2925 Evidence
51k2927 k. Weight and sufficiency. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Unsecured creditors satisfied burden of overcoming presumed validity and amount of investors' secured claims in Chapter 11 debtors' real estate subdivision, which was collateral for loans by investors and banks, by submitting appraisal that, as adjusted, determined subdivision's fair market value as of plan confirmation to be insufficient to satisfy banks' higher-priority lien; appraisal used income capitalization method that accurately considered time and expense to be incurred developing subdivision, and was appropriately adjusted for development risks and lot sales that occurred between appraisal date and confirmation. 11 U.S.C.A. § 506(a).

[19] Bankruptcy 51 ⚿2852

51 Bankruptcy
51VII Claims
51VII(B) Secured Claims
51k2852 k. Amount secured; partial security. Most Cited Cases

Bankruptcy 51 ⚿2927

51 Bankruptcy
51VII Claims
51VII(E) Determination
51k2925 Evidence
51k2927 k. Weight and sufficiency. Most Cited Cases

Bankruptcy 51 ⚿3538

51 Bankruptcy
51XIV Reorganization
51XIV(B) The Plan
51k3538 k. Valuation. Most Cited Cases

Investors failed to satisfy their burden of persuading court that appraisal undervalued Chapter 11 debtors' real estate subdivision, which was collateral for loans by investors and banks, and that subdivision was instead worth enough to secure investors' claims, by relying on plan budget that anticipated full payment of both banks' higher-priority lien and investors' liens through the development and sale of lots; plan budget was not a valuation, but, rather, a projection. 11 U.S.C.A. § 506(a).

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Samuel H. Israel, Esq. [ARGUED], Joshua T. Klein , Esq., Michael G. Menkowitz, Esq., Fox Rothschild, Philadelphia, PA, Michael J. Viscount, Jr., Esq., Fox Rothschild, Atlantic City, NJ, for Defendant–Appellee, Unsecured Creditors Committee.

Before: RENDELL, FISHER and CHAGARES, Circuit Judges.

OPINION OF THE COURT

RENDELL, Circuit Judge.

This appeal requires us to decide how bankruptcy courts should value collateral retained by a Chapter 11 debtor in order to determine the amount of a creditor's ***136** secured claim under 11 U.S.C. § 506(a). Appellants, a group of creditors known as the Cornerstone Investors, claim that the Bankruptcy Court erred by valuing their secured claims at zero based on an appraisal of Debtors' real estate offered by the Official Committee of Unsecured Creditors. We conclude that the Bankruptcy Court did not err in its valuation of the real estate, and that it properly determined that the Cornerstone Investors held only unsecured claims. In so concluding, we also clarify the burden of proof with respect to such valuations in the § 506(a) context.

I. *Background*

Debtors Heritage Highgate, Inc. and Heritage–Twin Ponds II, L.P. embarked upon the development of a residential subdivision in Lehigh County, Pennsylvania (the "Project") in August 2005. The Project was to consist of townhouses and single-family detached homes.

Debtors entered into a series of construction loan agreements, first borrowing from a group of banks led by Wachovia (the "Bank Lenders"). Pursuant to their agreement, the Bank Lenders retained a lien on substantially all of Debtors' assets as collateral for the loan. Debtors subsequently borrowed from several individuals and entities, known collectively as the Cornerstone Investors. Pursuant to those agreements, the Cornerstone Investors similarly received liens, of equal priority with the Bank Lenders and each other, on substantially all of Debtors' assets. The Cornerstone Investors, however, later agreed to subordinate their secured claims to the secured claim of the Bank Lenders in a set of intercreditor agreements.

On January 20, 2009, after building and selling approximately a quarter of the planned units, Debtors filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. On June 9, 2009, Debtors filed a joint proposed plan of reorganization, which provided that they would complete development of the subdivision and make distributions to their creditors according to a set of projections. In the initial proposed plan, Debtors projected that they would first pay the secured claim of the Bank Lenders in full, then pay the secured claims of the Cornerstone Investors in full, and thereafter pay all unsecured claims at a rate of approximately 20% each, from the funds earned through lot sales.

In connection with a contested cash collateral hearing,[FN1] Debtors offered an appraisal of the Project prepared by an experienced real estate appraisal company, Reaves C. Lukens, in February 2009 to demonstrate the worth of their collateral. The 140–page appraisal set forth in detail the company's estimation of the real estate development's fair market value pursuant to two well-accepted appraisal methodologies, the sales comparison approach and ***137** the income capitalization approach.[FN2] According to the appraiser, both analyses "were well supported by market evidence" and yielded virtually identical estimations. The appraiser favored the results of the latter because it "more accurately considered the time and expenses" related to a real estate development like the Project. The Bankruptcy Court accepted the appraiser's calculation of the Project's fair market value as approximately $15 million, which was then sufficient to cover the entirety of the secured debt.

> FN1. Cash collateral includes "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents ... in which the estate and any entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property." 11 U.S.C. § 363(a). To continue using the cash collateral of a secured lender, a Chapter 11 debtor must either obtain consent from the secured lender or obtain the Bankruptcy Court's authorization. *Id.* § 363(c)(2). In the event a secured creditor

does not consent and the Bankruptcy Court's authorization is sought in a contested hearing, the Chapter 11 debtor must demonstrate that the secured creditor is adequately protected. *Id.* § 363(e), (p). Forms of adequate protection are set forth at 11 U.S.C. § 361, and include other collateral that has value in excess of the secured creditor's claim or a budget that provides for the continued operation of the debtor's business without detriment to the secured lender's position.

FN2. The sales comparison approach and income capitalization approach are two techniques frequently used by appraisers in arriving at the fair market value of land. *See In re Tamarack Trail Co.*, 23 B.R. 3, 5 (Bankr.S.D.Ohio 1982) (noting that there are "three appraisal techniques ... available to appraisers," two of which are the sales comparison and income capitalization approaches). The sales comparison approach is a method of analyzing sales of similar recently sold parcels to arrive at a probable sale price for the property being appraised. The income capitalization approach is a method in which the appraiser estimates the value of land based upon the present value of the income stream to be generated by the sale of the individual lots within the development over an estimated holding period.

On September 4, 2009, the Official Committee of Unsecured Creditors (the "Committee") filed a motion to value the secured claims of the Cornerstone Investors pursuant to 11 U.S.C. § 506(a) and Federal Rule of Bankruptcy Procedure 3012. The Committee claimed that the Bankruptcy Court should value the secured claims at zero because the collateral securing the Cornerstone Investors' liens, the Project, was worth less than the Bank Lenders' senior secured claim. As proof of the collateral's worth, the Committee submitted the February 2009 appraisal previously accepted by the Bankruptcy Court as evidence of the Project's fair market value at the contested cash collateral hearing. However, when reduced by interim sales, the fair market value was approximately $9.54 million.[FN3] The Committee urged that, because this amount was insufficient to pay the Bank Lenders in full, the secured claims of the Cornerstone Investors were valueless. In response, the Cornerstone Investors argued that their claims should be deemed wholly secured because projections that accompanied the plan filed by Debtors estimated that Debtors would derive revenue from the Project sufficient to pay their claims in full. The parties agreed to postpone consideration of the motion until after confirmation of the reorganization plan.

FN3. Sales following the appraisal generated approximately $5.45 million in proceeds, which were used to fund operations, including payment of some principal and interest to the Bank Lenders.

On March 2, 2010, Debtors submitted their final plan of reorganization. The plan specified that claims of the Cornerstone Investors would be secured to the extent determined by the Bankruptcy Court in ruling on the Committee's motion. The final plan included a projected budget that anticipated full payment of both the Bank Lenders' senior secured debt and the Cornerstone Investors' junior secured debt through the development and sale of lots with completed townhouses and single-family homes over the course of 47 months. According to the budget, unsecured claimants would receive distributions amounting to approximately 45% of their claims. No interested party, including the Cornerstone Investors, objected to Debtors' final plan of reorganization. On April 1, 2010, the Bankruptcy Court entered an order confirming the plan. The Bankruptcy Court concluded, as required by 11 U.S.C. § 1129(a)(11), that the plan was feasible, i.e., that further liquidation or ***138** reorganization beyond the plan's provisions would be unlikely.

With the plan confirmed, the Bankruptcy Court

took up the Committee's motion to value the Cornerstone Investors' secured claims. On April 14, 2010, the parties filed joint stipulations of fact to assist the Bankruptcy Court in ruling on the motion. They agreed that the Bank Lenders were then owed approximately $12 million, while the Cornerstone Investors were owed approximately $1.4 million. Debtors and the Cornerstone Investors stipulated that the appraised value of the Project should be reduced due to Debtors' sale of lots since the appraisal's completion on February 21, 2009, and that, "[b]ased on the Appraisal, the total fair market value of the Project as of the Confirmation Date [wa]s $9,543,396.23." Additional assets held by Debtors raised the total value of the collateral securing liens to $11,165,477.15.

On May 3, 2010, the Bankruptcy Court held a hearing on the Committee's motion. At the hearing, the Committee reiterated its argument that the appraisal, as adjusted, reflected the worth of the Project in accordance with § 506(a)—namely, its fair market value as of confirmation. The appraisal, argued the Committee, demonstrated that the fair market value was less than the Bank Lenders' secured claim, such that no value remained to secure the Cornerstone Investors' liens. While they agreed that the appraisal depicted the Project's fair market value, the Cornerstone Investors contended that it did not control because § 506(a) requires that the value of property "be determined in light of [its] proposed disposition or use" and the plan budget demonstrated that the Debtors would be able to pay their claims in full over time as more homes were sold. They also urged the court to adjudge their claims fully secured, arguing that to deprive them of Project revenue to be generated over and above the appraisal value would constitute impermissible lien stripping.

The Bankruptcy Court agreed with the Committee. It determined that the proper method of valuing the Cornerstone Investors' secured claims was the fair market value of the Project as of the plan's confirmation date. The Cornerstone Investors did not dispute the accuracy of the fair market value set forth in the appraisal, choosing instead to rely upon the plan budget. The Bankruptcy Court accepted the appraisal as a proper basis for the valuation. Because the amount remaining due on Debtors' obligation to the Bank Lenders exceeded the sum of the Project's fair market value and the value of other assets held by Debtors, no collateral remained to secure the Cornerstone Investors' claims. Therefore, the Bankruptcy Court ruled, the Cornerstone Investors would be treated as unsecured creditors.

The Cornerstone Investors appealed the Bankruptcy Court's ruling to the District Court for the District of New Jersey. The District Court affirmed the Bankruptcy Court's ruling. Relying upon the Supreme Court's decision in *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997), it considered the Project's fair market value controlling and found the appraisal to have accurately measured that value. The District Court rejected the Cornerstone Investors' suggestion that the plan budget constituted the appropriate basis for valuing their secured claims because they knew that the amount of their secured claims would be determined pursuant to the Committee's motion, as the plan specifically so stated. The plan budget, the District Court stated, merely constituted projections meant to demonstrate the plan's feasibility, not the Project's present value. The District ***139** Court noted that, while the Supreme Court has prohibited lien stripping in liquidation cases, *see Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L.Ed.2d 903 (1992), nothing prohibited lien stripping in the reorganization context.

This timely appeal followed. The Cornerstone Investors make two interrelated arguments, emphasizing throughout that § 506(a) requires that property be valued "in light of ... [its] proposed disposition or use." First, the Cornerstone Investors contend that the Project's discounted present value, as reflected in the appraisal, cannot control the ex-

tent to which their claims are secured because the plan calls for Debtors to develop and sell homes in the subdivision over time. The Bankruptcy Court, the argument proceeds, could only have valued the Project in a manner respectful of its "proposed disposition or use" by awaiting the results of the planned build-out. Second, the Cornerstone Investors contend that, by pinning a value to the Project prior to the plan's completion in violation of § 506(a)'s dictates, the Bankruptcy Court denied them revenue that would ultimately be realized from the Project in excess of its appraisal value. They urge that depriving them of any increase in the worth of their collateral beyond its judicially determined value violates restrictions on lien stripping imposed by the Supreme Court in *Dewsnup*.

After briefly turning to the burden of proof, we address each aspect of the Cornerstone Investors' argument in turn.

II. *Jurisdiction and Standard of Review*

The Bankruptcy Court had jurisdiction over the instant dispute pursuant to 28 U.S.C. § 1334. The District Court had jurisdiction to review the final order of the Bankruptcy Court pursuant to 28 U.S.C. § 158(a). We have jurisdiction pursuant to 28 U.S.C. § 158(d).

[1][2] "Because the District Court sat as an appellate court, reviewing an order of the Bankruptcy Court, our review of the District Court's determinations is plenary." *In re Rashid*, 210 F.3d 201, 205 (3d Cir.2000), *superseded on other grounds as stated in In re Warfel*, 268 B.R. 205, 212 n. 7 (9th Cir. BAP 2001). In reviewing the Bankruptcy Court's determinations, we exercise the same standard of review as did the District Court. *Fellheimer, Eichen & Braverman, P.C. v. Charter Techs., Inc.*, 57 F.3d 1215, 1223 (3d Cir.1995). Accordingly, the Bankruptcy Court's findings of fact are reviewed only for clear error, while legal determinations are reviewed *de novo*. *In re Engel*, 124 F.3d 567, 571 (3d Cir.1997).

III. *Discussion*

A. *Burden–Shifting Framework*

[3] Neither the Code nor the Federal Rules of Bankruptcy Procedure allocates the burden of proof as to the value of secured claims under § 506(a). In the absence of explicit direction, courts have arrived at divergent formulations. Although neither the Bankruptcy Court nor the District Court considered this issue, addressing it informs our review of the question on appeal and provides guidance to courts generally. Accordingly, we requested supplemental briefing on the issue. We now hold that a burden-shifting framework controls valuations of collateral to decide the extent to which claims are secured pursuant to § 506(a).

Three approaches to the burden of proof in proceedings to value secured claims under § 506(a) have predominated in bankruptcy cases. Some courts have concluded that the secured creditor bears the burden of proof. *See, e.g., In re Sneijder*, 407 B.R. 46, 55 (Bankr.S.D.N.Y.2009). Other courts have held that the party challenging ***140** the value of a claim, usually the debtor, bears the burden of proof. *See, e.g., In re Weichey*, 405 B.R. 158, 164 (Bankr.W.D.Pa.2009). A third group of courts has settled on a burden-shifting analysis, pursuant to which "the debtor bears the initial burden of proof to overcome the presumed validity and amount of the creditor's secured claim," but "the ultimate burden of persuasion is upon the creditor to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim." *In re Robertson*, 135 B.R. 350, 352 (Bankr.E.D.Ark.1992).

[4][5] "The circumstances will dictate the assignment of the burden of proof on the question of value." *In re Young*, 390 B.R. 480, 486 (Bankr.D.Me.2008). Cognizant of this principle, a burden-shifting approach strikes us as most appropriate in the instant scenario. The initial burden should be on the party challenging a secured claim's value, because "11 U.S.C. § 502(a) and Bankruptcy Rule 3001(f) grant prima facie effect to the validity and amount of a properly filed claim." *In re Willi-*

ams, 381 B.R. 742, 744 (Bankr.W.D.Ark.2008). It is only fair, then, that the party seeking to negate the presumptively valid amount of a secured claim—and thereby affect the rights of a creditor—bear the initial burden. *See In re Brown,* 244 B.R. 603, 609–10 (Bankr.W.D.Va.2000). If the movant establishes with sufficient evidence that the proof of claim overvalues a creditor's secured claim because the collateral is of insufficient value, the burden shifts. The creditor thereafter bears "the ultimate burden of persuasion ... to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim." FN4 *In re Robertson,* 135 B.R. at 352.

> FN4. Allocating the ultimate burden of persuasion to the creditor whose proof of claim has been challenged is consistent with the rest of the Code. "Throughout the Code, the burden of proving the 'validity, priority, and extent' of security interests lies upon the creditors asserting such interests." *In re Buick,* 126 B.R. 840, 851 (Bankr.E.D.Pa.1991).

Before applying the burden-shifting framework to this dispute, we must first grapple with the two more fundamental challenges raised by the Cornerstone Investors: that use of the collateral's fair market value violated § 506(a)'s "proposed disposition or use" language; and, that the collateral's increase in value after the § 506(a) valuation rightly accrues to their benefit. That is because, if either contention is correct, the appraisal would not have constituted a proper basis for the Bankruptcy Court's ruling.

B. *Section 506(a) Valuation Standards*

[6] Central to resolution of this matter is the text of § 506(a). It provides in pertinent part:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property ... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim. *Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property....*

11 U.S.C. § 506(a) (emphasis added). The provision, therefore, calls for the division of secured creditors' claims into "secured and unsecured portions, with the secured portion[s] of the claim[s] limited to the value of the collateral." *Rash,* 520 U.S. at 961, 117 S.Ct. 1879.

***141** [7] Though the statute requires that collateral be valued, it does not specify the appropriate valuation standard. *See In re Winthrop Old Farm Nurseries, Inc.,* 50 F.3d 72, 73–74 (1st Cir.1995) ("The statute does not direct courts to choose any particular valuation standard in a given type of case."). According to a House Report on § 506(a), " '[v]alue' does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it imply a full going concern value." *See* H.R.Rep. No. 95–595, at 356 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6311. Rather, Congress envisioned a flexible approach to valuation whereby bankruptcy courts would choose the standard that best fits the circumstances of a particular case. *Id.* ("Courts will have to determine the value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case."). Congress did make at least one thing clear, though: "the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question." *Rash,* 520 U.S. at 962, 117 S.Ct. 1879.

[8] If that language is to be afforded any significance, then, the appropriate standard for valuing collateral must depend upon what is to be done with the property—whether it is to be liquidated, surrendered, or retained by the debtor. In *Rash,* the Supreme Court considered how to value collateral retained by a Chapter 13 debtor exercising the cram down option in § 1325(a)(5)(B) of the Code. The Court distinguished that option from the alternative available to the Chapter 13 debtor—in which its collateral would be surrendered to the objecting