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Welcome to the Jungle: Expert Witness Preparation and Testimony

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Welcome to the Jungle: Expert Witness Preparation and Testimony
Table of Contents

NAVIGATING EXPERT DISCLOSURES UNDER THE FEDERAL RULES
By John Harris and Anthony Pusateri, Quarles & Brady LLP

Federal Rule of Civil Procedure ("FRCP") 26 provides the disclosure requirements relating to expert testimony. Failure to comply with the disclosure requirements of FRCP 26 can result (in a worst-case scenario) in the complete exclusion of proffered expert testimony or in the imposition of material limitations on the scope of testimony that a proffered expert will be allowed to deliver. *See, e.g.,* FRCP 37(c) (failure to disclose information required under FRCP 26 can result in exclusion of proffered testimony or other sanctions).

I. INITIAL EXPERT DISCLOSURE

FRCP 26(a)(2)(A) provides that, in addition to all other pretrial disclosures required under Rule 26, "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." FRCP 26(a)(3)(B) provides that, unless otherwise ordered by the court, such disclosures must be made at least thirty days before trial.

Note that under stipulated pretrial procedure orders used by many courts, these requirements are frequently modified as to the timing of expert disclosures, the sequencing of initial disclosures and service of expert reports, and related matters. Accordingly, in any action, the local rules and any applicable court-specific pretrial disclosure or procedure requirements should always be referenced.

II. "RETAINED" VERSUS "NON-RETAINED" EXPERTS

FRCP 26(a)(2)(B) provides that, unless otherwise stipulated or ordered by the court, a written report must be prepared, signed, and submitted by a proffered expert 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."

FRCP 26(a)(2)(C) provides that, unless otherwise stipulated or ordered by the court, if a proffered expert is not of the type required to file a report under FRCP 26(a)(2)(B), the disclosure rules can be satisfied by a summary disclosure that meets certain stated requirements.

The structure and language of FRCP 26(a)(2) appear to create a bright line rule that expert testimony can be presented without a written report based on the witness's status, *i.e.,* so long as the witness is not "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." However, regardless of the language used in FRCP 26(a)(2)(B), parties are well advised to carefully assess the actual substance and bases for any expert testimony that will be proffered without a report by a "non-retained" expert under FRCP 26(a)(2)(C).

As an initial matter, the disclosure requirements of FRCP 26 do not supplant the substantive evidentiary requirements for admission of expert testimony under the Federal Rules of Evidence. Accordingly, when assessing presentation of expert testimony without a report by non-retained

experts, including people who may be employees of a party, counsel should ensure that the witness has the qualifications required under, and the witness's opinion will satisfy the foundational requirements of, Federal Rules of Evidence 702, 703, and 705, as applicable.

Moreover, courts have published differing opinions regarding which experts are required to file an expert report and the scope of testimony that will be allowed for experts who do not file a report. An increasing number of decisions applies a functional approach based on the expert's relationship to the subject of his or her testimony, rather than making the determination based solely on the status of the expert. Under this functional approach, if an expert witness's opinion is based on his or her personal involvement with or knowledge of the topic at issue, an expert report is generally not required. However, if the expert's opinion goes beyond the scope of his or her personal involvement with the applicable topic, an expert report is required, regardless of whether the expert is "retained" for purposes of the litigation.

Various federal circuit courts have addressed this issue. *See, e.g., Downey v. Bob's Disc. Furniture Holdings, Inc.*, 633 F.3d 1, 5–8 (1st Cir. 2011) (based on the language of the rules and the evolution of the standard to be applied, court finds that as long as an expert was not retained or specially employed in connection with the litigation and his opinion regarding causation is based on personal knowledge and observations made in the course of treatment, no report is required under the terms of FRCP 26(a)(2)(B)); *Timpson by & through Timpson v. Anderson Cnty. Disabilities & Special Needs Bd.*, 31 F.4th 238, 253–54 (4th Cir. 2022) (those designated as "hybrid witnesses" who (a) did not set out a summary of facts to which they would testify, and (b) had no relevant factual evidence pertaining to the claims were required to provide an expert report because their only involvement in the case occurred in the context of having been hired to provide opinions); *Fielden v. CSX Transp., Inc.*, 482 F.3d 866, 870–72 (6th Cir. 2007) (where there was no evidence that opinions of an expert were formed at the request of the party's counsel, but instead were formed at the time of treatment, a treating physician was not required to submit a written report); *Indianapolis Airport Auth. v. Travelers Prop. Cas. Co. of Am.*, 849 F.3d 355, 370–71 (7th Cir. 2017) (hybrid witnesses were not required to submit written reports, but witnesses could be precluded from testifying beyond the scope of facts they learned and opinions formed as a result of their personal knowledge; hybrid witnesses could testify regarding facts that could contradict facts underlying an opposing party's expert opinions and portions of opinions with which they disagreed, as long as that disagreement was factual and arose from their personal knowledge); *Prieto v. Malgor*, 361 F.3d 1313, 1318–20 (11th Cir. 2004) (where an employee who trained police officers on excessive use of force, but did not have personal knowledge of the facts of the case, was to testify, he was required to submit an expert report if an objection was raised to his testimony); *see also Guarantee Tr. Life Ins. Co. v. Am. Med. & Life Ins. Co.*, 291 F.R.D. 234, 237 (N.D. Ill. 2013) ("Non-retained experts must only testify about opinions that were formed during the course of their participation in the relevant events of the case, and only to those opinions which were properly disclosed."); *United States v. Sierra Pac. Indus.*, No. CIV S-09-2445 KJM EF, 2011 WL 2119078, at *4 (E.D. Cal. May 26, 2011) (the difference between retained and non-retained experts is that non-retained experts gain their information through percipient observations, while retained experts gain their information in any other manner).

Accordingly, in instances where a proffered expert will or may present opinions based on matters beyond the witness's personal knowledge or observation, consideration should be given to

submitting a written report regardless of whether the witness's status falls within the specific language of FRCP 26(a)(2)(B).

III. REQUIRED CONTENT FOP EXPERT REPORTS

When a witness is required to submit a written report under FRCP 26(a)(2)(B), the rule provides a specific list of what 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.

FED. R. CIV. P. 26(a)(2)(B).

When preparing the written report, it is imperative to ensure that all opinions are clearly stated and that the basis and reasoning for them are explained in detail. The importance of preparing a clear, well written, and efficient expert report that can be readily understood by the court and/or jury has become even more critical as an increasing number of courts directs that expert testimony must be presented by declaration and the expert report. *See, e.g.,* Ariz. L.R. of Bankr. P. 7016-1(a)(7) (stating that "[u]nless ordered otherwise, the direct testimony of any expert witness must be by written declaration including the expert report").

It is equally imperative to ensure that the written report identifies *all* data, methodologies, and other information reviewed by the witness in forming his or her opinions, even if the data, methodologies, and information were not ultimately used. Failure to ensure complete disclosure of such material can result in the exclusion of the proffered report and testimony. *See, e.g., Jenkins v. Bartlett*, 487 F.3d 482, 488 (7th Cir. 2007) ("A party is barred from using at trial evidence that it failed to disclose 'without substantial justification' as required by Rule 26(a), unless that failure was harmless.") (citing FRCP 37(c)(1)); *Rembrandt Vision Techs., L.P. v. Johnson & Johnson Vision Care, Inc.*, 725 F.3d 1377, 1381 (Fed. Cir. 2013) ("An expert witness may not testify to subject matter beyond the scope of the witness's expert report unless the failure to include that information in the report was 'substantially justified or harmless.'") (citing FRCP 37(c)(1)); *Rodriguez v. Vill. of Port Chester*, 535 F. Supp. 3d 202, 211 (S.D.N.Y. 2021) (expert report must include disclosure of all underlying conclusions on which ultimate expert opinion is based).

The courts have been consistent in requiring disclosure in the written report of *all* facts or data considered or reviewed by the witness, regardless of whether such facts or data are ultimately used by the expert in forming his or her opinion. *See, e.g., Elevate Fed. Credit Union v. Elevations Credit Union*, 67 F.4th 1058, 1068 (10th Cir. 2023) (facts or data that must be disclosed in a report are broadly construed and must include any material considered by the expert, from whatever source, that contains factual information; court found report deficient when expert identified some but not all search terms used by expert in his analysis); *Kim v. Nationwide Mut. Ins. Co.*, 614 F. Supp. 3d 475, 484–85 (N.D. Tex. 2022) (expert report was deficient when expert said that he "may or may not" have reviewed certain estimates, and deposition testimony disclosed that expert reviewed source materials that were not disclosed in his report).

To ensure compliance with the written report requirements, counsel is well advised to have a detailed discussion with the expert witness regarding the report to make sure that the expert is able to point to methodologies, data, documents, or other materials that are identified in the report in responding to questions regarding the expert's analysis, conclusions, or opinions.

IV. REQUIRED CONTENT FOR DISCLOSURES FOR "NON-RETAINED" EXPERTS TESTIFYING UNDER FRCP 26(a)(2)(C)

Although "non-retained" experts testifying under FRCP 26(a)(2)(C) are not required to submit a written report, certain required disclosures must be made regarding such witness's testimony. FRCP 26(a)(2)(C) provides that for witnesses who will present expert testimony under the rule, a disclosure must be made that states:

> (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.

FED. R. CIV. P. 26(a)(2)(C).

While these disclosures are much less onerous than the written report requirements and are usually made by counsel rather than the witness, courts require that the disclosure provide a meaningful statement of the bases for the witness's testimony and the opinions which the witness will present. *See*, *e.g., Anderson v. Bristol, Inc.*, 936 F. Supp. 2d 1039, 1060 (S.D. Iowa 2013) (disclosure that included only witness's name, professional qualifications, and reference to various exhibits produced in the litigation was not sufficient under Rule 26(a)(2)(C); disclosure must include a summary of the specific facts and opinions on which the expert will testify).

V. MULTIPLE EXPERTS

An issue that can arise in litigation involving experts is the number of experts that a party will be allowed to present. Decisions addressing this issue have generally concluded that the court may limit the number of experts that a party will be allowed to present. *See, e.g., Aetna Cas. &*

Sur. Co. v. Guynes, 713 F.2d 1187, 1193 (5th Cir. 1983) (it was within the discretion of the trial court to limit the number of fire investigators that an insurance company could call to testify during trial); *Ruud v. United States*, 256 F.2d 460, 462 (9th Cir. 1958) (it was within the discretion of the trial court to allow the government to call three witnesses and the defendant to call four, as well as for the court to reject two additional proposed experts from the defendant).

The number of experts that will be allowed can become more complex when different methodologies may be applicable to the issue or topic which is the subject of the expert testimony (e.g., different methodologies may be applicable to the valuation of an asset or business). Under these circumstances, courts have applied a flexible analysis that focuses on whether use of multiple experts will help provide a fuller picture of the applicable issue or instead will simply present cumulative or repetitive evidence on a particular topic. *See, e.g., Bowman v. Corr. Corp. of Am.*, 350 F.3d 537, 547 (6th Cir. 2003) (court allowed testimony of four different medical expert witnesses for the defense because they provided testimony as to distinct areas: hematology, pulmonary medicine and critical care, infectious disease, and pathology); *United States v. Charmoli*, No. 20-CR-242, 2022 WL 395169, at *2–4 (E.D. Wis. Feb. 9, 2022) (three experts who opined on the same set of facts and presented nearly identical conclusions were permitted where procedures at issue were evaluated from unique professional perspectives; court discussed that the probative value of the evidence was not substantially outweighed by the danger of delay/presentation of cumulative evidence); *Marquette Transp. Co. Gulf-Inland, LLC v. Navigation Mar. Bulgarea*, 2022 WL 158681, at *2 (E.D. La. Jan. 18, 2022) (three experts were offered, each to provide an opinion on a "distinct category of maritime navigational expertise" and each using different methodologies; notwithstanding the fact that the experts' reports overlapped, offered opinions on the same conduct, relied on the same information, and came to nearly identical conclusions, the court would not limit the number of experts because of the general principal that exclusion of evidence under FRE 403 should be done sparingly); *Bonita Props., LLC v. C & C Marine Maint. Co.*, No. 2:12CV247, 2017 WL 5197990, at *3–4 (W.D. Pa. Jan. 6, 2017) (plaintiff sought to provide testimony from two experts to present "different methodologies" of calculating damages, given the different categories of damage potentially available; because the court had already limited the value that the plaintiff could seek, the court would not allow multiple experts to testify with regard to the same "item of damages," as such testimony would be cumulative and a waste of time).

In light of these authorities, counsel should assess carefully whether different methodologies may bear on a particular issue and, if they do, whether multiple experts should be used to address that issue. In instances where multiple experts are presented on the same issue, counsel should further ensure that the distinct nature of each expert's approach, analysis, and testimony is made clear. Counsel should also articulate to the court why each expert's testimony is helpful and important to the trier of fact and confirm that the multiple experts will not be presenting cumulative testimony.

VI. PROCEDURAL CONSIDERATIONS WHEN DISCLOSURE DISPUTES ARISE

As the above makes clear, a number of potential issues and/or disputes can arise in litigation regarding expert disclosures. How, and when, such issues should be addressed can be complicated by the fact that the expert disclosure requirements are procedural rules arising under the Federal

Rules of Civil Procedure. However, requirements for admission of expert evidence at trial, and grounds for objection to that evidence, are the subject of the separate Federal Rules of Evidence, in particular, FRE 702, 703, and 705. Because the disclosure rules are procedural requirements separate from the rules of evidence, counsel should usually try to address expert disclosure issues through pretrial discovery and motion practice. Attorneys who wait until trial before bringing such issues to the court's attention, in particular if objections to proffered expert testimony will be raised at trial based on inadequate disclosure under FRCP 26, run the risk of the court finding such objections to be waived or limiting the grounds for objection solely to FRE 702, 703, and 705 (which do not contain the substantive disclosure rules).

The primary remedy for failure to make adequate expert disclosures under FRCP 26 is found in FRCP 37. Among other things, FRCP 37(c)(1) provides that "[i]f a party fails to provide information or identify a witness as required by Rule 26(a) or (e), the party is not allowed to use that information or witness to supply evidence on a motion, at a hearing, or at trial, unless the failure was substantially justified or is harmless." However, counsel should not assume this exclusion to be "automatic." FRCP 37 itself contemplates that, if one asserts that its opponent has failed to make adequate disclosures under FRCP 26(a), pretrial motion practice to compel required disclosures will be pursued. *See* FRCP 37(a)(3)(A). If a party asserting inadequate disclosure under FRCP 26(a) fails to pursue the issue through pretrial motion practice, it runs the risk of the court waiving its objections at trial. *See, e.g., Bradshaw v. FFE Transp. Servs., Inc.*, 715 F.3d 1104, 1108 (8th Cir. 2013) (party who did not raise in pretrial discovery proceedings an alleged failure by opposing party to make adequate expert disclosures under FRCP 26(a) was found to have waived its trial objections "by failing to make these objections at the time set in the district court's discovery scheduling order"). *See also Mariscal v. Graco, Inc.*, No. 13-CV-02548-TEH, 2014 WL 4245949 (N.D. Cal. Aug. 27, 2014) (court addressed multiple requests to exclude expert testimony under FRCP 37 for failure to make adequate FRCP 26(a) disclosures through pretrial motions *in limine*); *Momeni-Kuric v. Metro. Prop. & Cas. Ins. Co.*, No. 3:18-CV-00197-RGJ, 2019 WL 3416677 (W.D. Ky. July 29, 2019) (same).

CONSIDERATIONS FOR THE ADMISSIBILITY OF EXPERT TESTIMONY
By Sean B. Davis, Winstead PC[1]

Valuation determinations can be and often are the crux of any successful reorganization. However, given the likelihood that many different constituents have an interest in any asset to be valued—whether the asset is real estate, equipment, inventory, or receivables—it is also likely that these parties will have different perspectives regarding the methodology for valuing and the ultimate value of the particular asset. Indeed, valuation drives several factors crucial to a chapter 11 case, including adequate protection of secured creditors, the best interests of creditors test under section 1129(a)(7) of the Bankruptcy Code, and the extent to which residual value may exist for unsecured creditors. As a result, determining the appropriate expert to opine on asset values and valuation methodology can also be fraught with disagreement.

When assessing the propriety of valuation methods and the fitness of a particular valuation expert, courts employ well-established evidentiary principles. Federal Rule of Evidence 702 governs the admissibility of expert opinions and provides as follows:

> 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:
>
> (1) 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;
>
> (2) the testimony is based on sufficient facts or data;
>
> (3) the testimony is the product of reliable principles and methods; and
>
> (4) the expert has reliably applied the principles and methods to the facts of the case.

FED. R. EVID. 702.

The *Daubert* Standard

The U.S. Supreme Court's seminal *Daubert* opinion added some much needed context to Rule 702. According to the Court, the factors in the rule, taken together, require the proponent of expert testimony to demonstrate that the proffered testimony is both "relevant [and] reliable." *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 589 (1993). Under *Daubert*, the proponent must satisfy a trilogy of proofs: qualification, reliability, and fit. *Schneider ex rel. Est. of Schneider v. Fried*, 320 F.3d 396, 404 (3d Cir. 2003). These requirements apply to all expert testimony. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 147 (1999).

"By means of a so-called '*Daubert* hearing,' the . . . court acts as a gatekeeper, preventing opinion testimony that does not meet the [three] requirements . . . from reaching the [fact finder]. *Fried*, 320 F3d at 404–05 (citing *Daubert*, 509 U.S. at 592 ("Faced with a proffer of expert

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scientific testimony, then, the trial judge must determine at the outset, pursuant to Rule 104(a) [of the Federal Rules of Evidence], whether the expert is proposing to testify to (1) scientific knowledge that (2) will assist the trier of fact to understand or determine a fact in issue.")).

A. Qualification of the Expert

First, "a witness proffered to testify to specialized knowledge must be [qualified as] an expert." *Brown v. Se. Pa. Transp. Auth.* (*In re Paoli R.R. Yard PCB Litig.*), 35 F.3d 717, 741 (3d Cir. 1994). "Qualification refers to the requirement that the witness possess specialized expertise. [Courts] have interpreted this requirement liberally, holding that 'a broad range of knowledge, skills, and training qualify an expert.'" *Fried*, 320 F.3d at 404.

B. Reliability of the Testimony

The second requirement of Rule 702 is that the expert must testify to "scientific, technical, or other specialized knowledge [that] will assist the trier of fact." FED. R. EVID. 702.

> The Supreme Court . . . held that Rule 702 does not incorporate the common law *Frye* rule in which expert testimony is admissible only insofar as it is based on a technique generally accepted in the scientific community. Instead, the Supreme Court . . . [found] that an expert's testimony is admissible so long as the process or technique the expert used in formulating the opinion is reliable. *See Daubert*, 509 U.S. at 589 ("That the *Frye* test was displaced by the Rules of Evidence does not mean, however, that the Rules themselves place no limits on the admissibility of purportedly scientific evidence. Nor is the trial judge disabled from screening such evidence. To the contrary, under the Rules the trial judge must ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable."); *United States v. Downing*, 753 F.2d [1224, 1237 (3d Cir. 1985)]. *Daubert* explains that the language of Rule 702 requiring the expert to testify to *scientific knowledge* means that the expert's opinion must be based on the "methods and procedures of science" rather than on "subjective belief or unsupported speculation"; the expert must have "good grounds" for his or her belief. *Daubert*, 509 U.S. at 590.

Brown, 35 F.3d at 742.

In assessing whether a scientific methodology is reliable (that is, scientifically valid), a court should consider several factors. These include:

> the testability of the expert's hypothesis ("whether it can be (and has been) tested"), whether the methodology has been subjected to peer review and publication, the frequency by which the methodology leads to erroneous results, the existence and maintenance of standards controlling the technique's operation, . . . whether the methodology has been generally accepted in the scientific community[,] . . . whether a method produces testable hypotheses[,] . . . the degree to which the expert testifying is qualified, the relationship of a technique to "more

established modes of scientific analysis," and the "non-judicial uses to which the scientific technique are put."

Id. (internal citations omitted).

As a result of a footnote in the Supreme Court's opinion, practitioners and commentators argued that the *Daubert* standard should be limited to a scientific context and may not be applicable to a more wide-ranging ambit of expertise in non-scientific matters. *See Daubert*, 509 U.S. at 590 n.8. Although that footnote stated that Rule 702 also applies to "technical, or other specialized knowledge," the issue of applying the Daubert analysis to matters requiring that knowledge was left for another day. *See id*. Subsequently, the Supreme Court clarified that the analysis is indeed applicable to "technical or other specialized knowledge"—not merely scientific matters. *See Kumho Tire Co.*, 526 U.S. at 147 (affirming the district court's decision granting summary judgment in favor of defendant tire manufacturer and distributor in products liability suit and finding that the trial court did not abuse its discretion in excluding expert testimony on a manufacturing defect).

In *Kumho Tire Co.*, the Supreme Court also clarified its belief that the trial court's gatekeeper function "ensure[s] the reliability and relevancy of expert testimony." *See id.* at 152 (confirming that the duty to determine the relevance and reliability of expert testimony does not rest with the relevant "community" but rather with the trial court). When assessing the reliability of an opinion, many courts take the position that a single expert's opinion will not be dispositive, but instead a single opinion or competing opinions will simply speak to the weight of the evidence rather than its admissibility. *See Boucher v. U.S. Suzuki Motor Corp.*, 73 F.3d 18, 21 (2d Cir. 1996) ("Although expert testimony should be excluded if it is speculative or conjectural, or if it is based on assumptions that are 'so unrealistic and contradictory as to suggest bad faith,' . . . other contentions that the assumptions are unfounded "go to the weight, not the admissibility, of the testimony.'") (internal citations omitted); *Viterbo v. Dow Chem. Co.*, 826 F.2d 420, 422 (5th Cir. 1987) ("As a general rule, questions relating to the bases and sources of an expert's opinion affect the weight to be assigned that opinion rather than its admissibility"); *In re Com. Fin. Servs., Inc.*, 350 B.R. 520, 529 (Bankr. N.D. Okla. 2005) (flaws in facts assumed by an expert in formulating an opinion do not necessarily render it unreliable because such flaws often go to the weight of the evidence). This bolsters the notion of the trial court's role as gatekeeper.

C. Relevance and Fitness of the Testimony

Finally, "Rule 702 requires that the expert testimony must fit the issues in the case." *Fried*, 320 F.3d at 404. Admissibility depends in part on "the proffered connection between the scientific research or test result to be presented and particular disputed factual issues in the case." *Downing*, 753 F.2d at 1237. Therefore, "even if an expert's proposed testimony constitutes scientific knowledge, his or her testimony will be excluded if it is not scientific knowledge *for purposes of the case*. Rule 702's 'helpfulness' standard requires a valid *scientific* connection to the pertinent inquiry as a precondition to admissibility. Thus, the requirement of reliability, or 'good grounds,' extends to each step in an expert's analysis all the way through the step that connects the work of the expert to the particular case." *Brown*, 35 F.3d at 743 (quotations and internal citation omitted).

Further, the trial court must conduct an in-depth analysis of the helpfulness of the particular expert's testimony. While there is a presumption that expert testimony is or will be helpful, trial courts must balance this presumption against the possibility that the testimony may ultimately be confusing for the fact finder, thereby reducing its helpfulness. *See Downing*, 753 F.2d at 1240–41 ("The trial court must . . . balance its assessment of the reliability of a novel scientific technique against the danger that the evidence, even though reliable, might nonetheless confuse or mislead the finder of fact, and decide whether the evidence should be admitted . . . because the balancing analysis incorporates important policy elements (i.e., the likelihood that a particular type of evidence will mislead the jury) which render the determination something more than a fact-finding."); *see also* 3 J. Weinstein & M. Berger*, Weinstein's Evidence* ¶ 702[03], at 702-14-15 (footnotes omitted) ("Doubts about whether an expert's testimony will be useful should generally be resolved in favor of admissibility unless there are strong factors such as time or surprise favoring exclusions. The jury is intelligent enough, aided by counsel, to ignore what is unhelpful in its deliberations.").

Ultimately, the trial court must use its sound judgment to assess the credibility, propriety, and usefulness of expert testimony when factoring in the weight of the evidence. This is especially true when conducting highly subjective valuation analyses where an efficient market either does not exist or is not readily available. To that end, additional expert evidence, even when conflicting, will probably be helpful, because the more data points that the court has to consider when making its determination, the better informed the final result is likely to be. The court's role as gatekeeper, especially in the chapter 11 context, is therefore of paramount importance and can be the difference between a successful reorganization and a liquidation.

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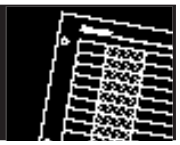
Value & Cents



The *Mirant* Valuation Saga: Epic Battle of Experts

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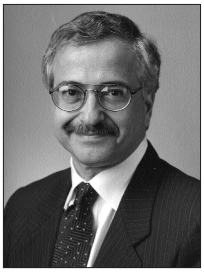
Mirant Corp. filed for chapter 11 protection on July 14, 2003. With claims in excess of $10 billion, it was the largest bankruptcy filing of the year. In April 2005, a hearing for emergence from chapter 11 began in Fort Worth, Texas. The focus of the hearing was the valuation of Mirant's enterprise value to determine the new ownership structure at emergence.

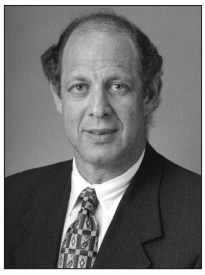


Dr. Allen Michel

The valuation hearing was a bitterly fought battle of experts representing the debtors, creditors, equity-holders and certain convertible security-holders. At least 11 different experts submitted expert reports, and many of these experts testified at the hearing. There were numerous points of contention about the valuation methods employed by the various experts. In fact, the valuation experts differed on nearly every aspect of their valuation methodology. Some differences were minor; however, others could change the value by hundreds of millions of dollars, even billions. Generally, the experts employed two methods to determine Mirant's enterprise value: a comparable company multiple valuation and a discounted cash-flow valuation (DCF).

Comparable Company Multiple Valuation

In performing a comparable company valuation, all of the experts used Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) multiples, as EBITDA is the most widely followed metric in Mirant's industry. The calculation of EBITDA multiples was hotly contested, as experts disagreed on how to calculate the two main components of the multiple: the comparable companies' enterprise value (the numerator) and their EBITDA (the denominator). With Mirant having EBITDA of approximately $1 billion, the multiple used to value its operating assets had a huge impact on value.



Dr. Israel Shaked

Comparable Companies' Enterprise Value. One of the comparable companies, NRG Energy, had a note receivable asset worth over $800 million. One valuation expert believed that the notes were nonoperating assets and reduced enterprise value by this amount, resulting in a lower multiple. Other experts argued that the notes were operating assets and should not be excluded from the enterprise value. This adjustment affected the median multiple used to value Mirant. Specifically, reducing NRG's enterprise value by the notes receivable reduced Mirant's enterprise value by over $500 million.

Comparable Companies' EBITDA. Two of the issues that affected the calculation of the comparable companies' EBITDA had substantial impacts on Mirant's value: mark-to-market gains and losses, and income from unconsolidated investments. While all of the comparable companies comply with FAS 133 (Accounting for Derivative Instruments and Hedging Activities), only one comparable company detailed its gains and losses from marking-to-market its derivative contracts on gas and energy. Its EBITDA, using the numbers in its income statement, was reduced by more than $250 million because of the mark-to-market losses. Certain experts reversed those losses, claiming that they were noncash losses, thereby reducing the multiple. Other experts disagreed, arguing that the remaining comparable companies did not detail similar gains/losses, and therefore the experts were inconsistent in their adjustments.

Another hotly disputed issue was the inclusion of income from minority investments. It is common in the energy industry for companies to take minority stakes in power-producing assets or to develop joint ventures, neither of which is consolidated in the operating income. Instead, income attributable to those investments is included in the income statement but below the operating income line as a separate item.

Certain experts insisted that income from unconsolidated investments needed to be included in EBITDA because it was income from normal operations and it was also the way the comparables reported their EBITDA to analysts and investors. However, these experts failed to include the unconsolidated debt associated with this income in the comparable companies' enterprise value. This inconsistent approach results in a downward biased multiple, thereby reducing Mirant's enterprise value.

Timeliness of Information. The first round of the experts' reports were submitted in February. Rebuttal reports followed in March; the hearing started in mid-April and concluded in late June. During this time period, Mirant continued to operate and forecasts were revised as actual information became available. The comparable companies sold divisions of their businesses, operating agreements expired, Form 10-Ks for the fiscal year ended December 2004 were issued, and then Form 10-Qs for the first quarter ended March were issued. In addition, the comparables and the analysts revised their projections for the 2005 fiscal year and then issued their projections for the 2006 fiscal

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year. All this information had to be considered in the valuation calculations. As a result, throughout this period, the experts had to continuously revise their valuation reports. Some of the experts believed that forward multiples were the only correct multiples to use in valuing Mirant because the market is only concerned with future performance as an indicator of value. They used one- and two-year forward multiples to calculate a range of enterprise values for Mirant. Other experts advocated the use of both forward and historical multiples, arguing that both types are widely accepted in valuation literature and that the market considers both past and future performance when determining value.

Discounted Cash-Flow Valuation

The second method used to value Mirant was a discounted cash-flow valuation. Mirant provided a business plan with detailed projections covering a 10-year period, which mostly eliminated dispute among the experts as to the expected cash flows. However, the other assumptions required to complete the discounted cash-flow valuation varied greatly between valuation experts.

Discount Rate. Cash flows in a DCF model are usually discounted at the company's weighted average cost of capital (WACC). As implied by its name, the WACC is derived as the weighted average of the company's cost of equity and cost of debt based on the company's capital structure. Mirant's after-tax cost of debt was generally agreed upon by the experts to be around 5.4 percent based on Mirant's business plan.

The cost of equity was calculated by experts using a two-step process. The first step was to calculate Mirant's *beta*, based on its expected correlation with the stock market. *Beta* is an element of the cost of equity when using the Capital Asset Pricing Model (CAPM). Mirant's expected *beta* was calculated using the comparable companies. The comparable companies' unlevered (not influenced by capital structure) *betas* were calculated, and the median was applied to Mirant. However, the *betas* varied depending on the methodology being used. In one instance, an expert used a longer time horizon that required him to exclude one of the comps. By doing so, the *beta* was significantly lower than that of some of the other experts.

Once the *beta* was calculated, it was applied to the CAPM formula that considers *beta*, the market-risk premium and the risk-free rate to determine a company's cost of equity. While the experts agreed on the risk-free rate, there was considerable disagreement about the market-risk premium. Certain experts used the long-term equity risk premium of 7.2 percent based on Ibbotson's "Stocks, Bonds, Bills and Inflation" study that covers the period 1926-2004. One expert cited recent studies that indicate a declining risk premium. Rather than 7.2 percent, which is based on data since 1926, the risk premium was estimated to be in the range of 2.55-4.32 percent when looking at much more recent data.

One caveat to the CAPM formula is that whenever warranted, experts add a specific risk premium. The specific risk premium is sometimes calculated using Ibbotson's size premiums, according to the company's size. In this case, Mirant's size warranted a size premium of 0.5 percent. However, some experts felt that an additional premium in excess of 0.5 percent was warranted. One expert applied an additional premium of 1 percent, another expert used 2 percent, and a third expert used 4.2 percent. The additional premiums of 1 and 2 percent were presented without substantiation. The additional premium of 4.2 percent was based on a study of distressed companies. However, following its emergence from bankruptcy, Mirant was not expected to be distressed.

Because Mirant had substantial operations in the Caribbean and Philippines, experts disagreed on the correct application of the WACC for its international cash flows. Some experts felt that the WACC should only be applied to the cash flows from domestic operations. Those experts split the DCF analysis into operations by geographic segment, then used different discount rates for the foreign cash flows based on the country's specific risk and comparable companies in those same areas.

Other experts disagreed with that method. They argued that most of the comparable companies used to calculate Mirant's WACC also have international operations, and therefore Mirant's WACC already reflects foreign operations. Moreover, one expert argued that studies have shown that foreign operations actually decrease rather than increase the risk, therefore the discount rates used for the foreign operations should not be higher than Mirant's WACC. Certain experts discounted all of Mirant's cash flows at the same discount rate, using its WACC.

Terminal Value. The final hotly contested and very significant factor of the DCF valuation was the determination of a terminal value. Because Mirant's own cash-flow projections covered 10 years and its business is expected to operate in perpetuity, an estimate of the value of the business at the end of the 10-year period was a necessary input for the DCF model. The experts all used two methods to calculate a terminal value: an EBTIDA multiple at the end of the 10-year period and an expected perpetual growth rate for Mirant's cash flows.

The terminal EBITDA multiples used by the experts were basically the same as the multiples calculated for the comparable company ("compco") valuation. Most experts took the range of multiples they had previously calculated and applied it to Mirant's expected EBITDA in 10 years. However, one expert who had determined a range of multiples for the compco of 8.0-9.0x used in his DCF analysis terminal multiples of 6.5x-7.5x. No substantiation was provided for lowering the multiple other than a feeling that multiples would be lower in the future. The effect of using the low range was to decrease Mirant's valuation substantially.

The terminal growth rates applied to Mirant's year-10 cash flow also varied among experts. One expert used a perpetual growth rate of 2 percent. Another expert used a range of 1-3 percent. A third expert opined that 3 percent was the absolute minimum growth rate that could be used for the terminal growth. His justification was that based on Mirant's own projections, its free cash flows were projected to grow at an annual compounded rate of 6.11 percent from 2006-14. In addition, he argued that the long-term inflation rate as calculated by Ibbotson was 3 percent. The expert's argument was that based solely on inflation, cash flows should be growing at 3 percent, even before accounting for real GDP growth.

Nonoperating Assets

Once the value of Mirant's operating assets was determined via the compco and DCF valuations, the experts added the value of Mirant's nonoperating assets that were not captured by either of those two methods. The most basic nonoperating asset was cash. Most experts added the value of the cash Mirant expected to have as of the date of emergence from bankruptcy. This methodology was consistent with that used to calculate the compco multiples where total cash was subtracted from the comparable companies' enterprise values. However, one expert added only the "excess cash" he calculated for Mirant as of the date of emergence. Excess cash was calculated by subtracting restricted cash and expected cash payments under the reorganization plan from total cash at emergence. By doing so, he decreased cash and Mirant's value by $800 million.

Another contested issue was the value of Mirant's net operating loss (NOL) that it could use to reduce future tax payments. Generally, experts agreed that Mirant was expected to emerge with large NOLs. However, experts were unsure as to the country of incorporation at emergence and its effect on the NOL. Experts also disagreed on the appropriate discount rate to use for calculating the present value of the expected tax savings resulting

from the NOL's tax shield. Some experts felt that the applicable discount rate was the cost of equity because tax payments are made after debt is serviced and therefore available only to shareholders. Another expert advocated the use of the after-tax cost of debt because the NOL tax shield provided safe, reliable cash flows whose realization was nearly assured in the case of Mirant.

One of the largest differences in experts' opinions was the valuation of excess working capital. Some experts either did not perform any analysis of working capital or did not find any excess. One expert looked solely at accounts receivable to determine whether Mirant had excess accounts receivable outstanding. Based on historical-days sales outstanding, he determined that Mirant's expected excess accounts receivable is $200 million. Another expert looked at Mirant's working capital ratio (current assets/current liabilities). He compared Mirant's working capital ratio to that of the comparable companies and found that Mirant's was considerably higher than those of the comps. Based on the difference between Mirant and its peer group, he determined that $3.1 billion of liquidity was being withheld from creditors in the form of Mirant's excess of current assets.

Because of the broad range of assumptions used in the methodologies for valuing Mirant's operating assets as well as its nonoperating assets, the range in values calculated for Mirant was extremely wide. The lowest value concluded by an expert was $7.4 billion and the highest was $13.5 billion, with a difference of $6.1 billion. While the Mirant valuation hearing illustrates how complex and challenging those hearings can get, it also shows how important it is to have a strong expert to present complex issues in plain English as well as, whenever justified, to credibly impeach the other side's expert. ■

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AMERICAN BANKRUPTCY INSTITUTE
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Bankruptcy Valuation Hearings: As Highly Contested as Ever

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Approximately five years ago, we wrote about the valuation hearing for the emergence from bankruptcy of Mirant Corp.[2] In this case, the focus of the two-month hearing was to calculate Mirant's enterprise value for determining the new ownership structure at emergence. The hearing resulted in a battle of experts, with at least 11 different experts submitting expert reports and many testifying at trial. The valuation experts differed on nearly every aspect of their valuation methodologies, and their opinions differed by more than $6 billion.


Dr. Israel Shaked

Shortly after the emergence, Mirant was acquired for a value far in excess of the claims on the bankrupt estate. This suggested that the valuations prepared on behalf of the equity and preferred equityholders were reasonable, and that the valuations prepared on behalf of the debtors and creditors' committees grossly understated the enterprise value of the company.

Last year, a similar valuation hearing was held in the U.S. Bankruptcy Court for the District of Delaware to determine the value of the assets of Smurfit-Stone Container Corp. (SSCC). At the time, SSCC was a leading integrated manufacturer of paperboard and paper-based packaging in North America. To better understand the valuation issues discussed in this article, it is worthwhile to understand the micro- and macroeconomic background of SSCC.


Brad Orelowitz

Value & Cents

Background

SSCC was one of the industry's largest manufacturers of containerboard and corrugated containers and was also one of the world's largest paper recyclers. Its operations consisted of 12 paper mills, 108 container plants and 29 reclamation plants in various locations across North America. SSCC sold a broad range of paper-based packaging products, including containerboard, corrugated containers, kraft paper and point-of-purchase displays to a broad range of manufacturers of industrial and consumer products. The paper mills were used primarily for the production of containerboard, including unbleached kraft linerboard, white top linerboard and medium. SSCC was North America's second-largest producer of containerboard, which is the principal raw material in the production of corrugated packaging. Linerboard is used as the inner and outer facings, or liners, of corrugated products. Corrugated medium is fluted and laminated to linerboard to produce corrugated sheets that are printed, cut and folded to produce corrugated boxes. As an integrated manufacturer, more than 70 percent of SSCC's containerboard production was used internally by its corrugated container operations. The remainder of SSCC's containerboard production was sold to third parties.

SSCC was also the second-largest producer of corrugated containers in North America. SSCC's container plants were utilized to convert containerboard into corrugated boxes that are used to transport products for manufacturers of consumer and industrial goods. SSCC's principal customers were consumer goods companies, with 54 percent of its packaging sales coming from the food and beverage industry.

The U.S. corrugated products industry is highly cyclical and competitive. The industry is materially affected by changes in regional, national and global economic conditions and is closely related to changes in industrial production and industry capacity. The corrugated products industry is also capital-intensive, leading to high fixed costs for manufacturers as well as substantial price competition and volatility. Over the past

1 This article is for educational purposes only and should not be relied on for future litigation purposes.
2 Shaked, Israel, A. Michel, B. Orelowitz and M. Marcus, "The Mirant Valuation Saga: Epic Battle of Experts," *ABI Journal*, December/January 2006.

decade, the industry has experienced significant consolidation. In 1997, the top five companies in the industry held a 42 percent share of the market. At the time of the valuation hearing, the five largest companies accounted for nearly 75 percent of the market. The leading players included International Paper Co., SSCC, Georgia-Pacific, Temple-Inland Inc. and Packaging Corporation of America.

Given the highly competitive nature of the paperboard and packaging industry, SSCC's performance was highly dependent on the market demand as well as the prices it receives for those products. According to SSCC, the downturn in the global economy resulted in a decline in demand for its products. At the same time, substantial price competition and volatility in the pulp and paper industry resulted in decreased prices for SSCC's products. The decrease in both the demand and prices for SSCC's goods was accompanied by rapid inflation in SSCC's raw material and energy prices. In addition, credit market conditions adversely impacted SSCC's prospects for refinancing its revolving credit and securitization facilities. As a result of these factors, on Jan. 26, 2009, SSCC and its U.S. and Canadian subsidiaries filed a voluntary petition for chapter 11 relief in the U.S. Bankruptcy Court of the District of Delaware. On the same date, SSCC's Canadian subsidiaries filed to reorganize under the Companies' Creditors Arrangement Act in the Ontario Superior Court of Justice in Canada.

While operating in chapter 11, SSCC improved its financial flexibility, as well as its long-term business fundamentals. Specifically, SSCC significantly reduced operating facilities, head count and manufacturing cost structure. Moreover, SSCC was able to outperform its peers, as evidenced by gaining market share through the addition of new national customer accounts. SSCC additionally undertook several key initiatives to improve its overall financial health:

- reduced its net debt by roughly 75 percent upon emergence;
- implemented aggressive cost-saving plan, streamlined operations and aligned capacity with demand;
- invested $1 billion to facilitate long-term growth; and
- reduced the need for new capital investments.

Industry Conditions

The severe downturn in the U.S. economy in the fourth quarter of 2008 that continued into 2009 had a significant impact on the production of corrugated products and containerboard. Industry-wide shipments of corrugated products decreased 7.7 percent in 2009 compared to 2008, while reported 2009 industry containerboard production decreased 7.3 percent. Industry-published prices also declined in 2009. Although the industry experienced declines in sales volume and prices for 2009, industry forecasts were predicting improved conditions for 2010 through 2014.

Valuation Hearing

The valuation hearing took place in spring 2010 and featured experts representing the debtors, creditors, preferred equityholders and equityholders. The two equity groups featured industry and valuation experts. The groups representing the debtors and creditors each had their own valuation expert and relied on SSCC for industry expertise. The valuation experts generally agreed on the valuation methodologies. All four groups computed value using comparable company multiple valuation, comparable transaction multiple valuation and discounted-cash-flow (DCF) methodologies. However, there were numerous points of contention about the assumptions employed by the various experts. The differences in values amounted to billions of dollars. The following are examples of highly contested issues that make valuation hearings complex, financially detailed, tedious and expert-intensive and require bankruptcy lawyers to have a firm grasp of valuation standards.

Unfunded Pension Liabilities

While SSCC utilized the bankruptcy process to substantially reduce its interest-bearing debt by almost $3 billion, SSCC had a material unfunded pension liability. As of Dec. 31, 2009, SSCC's pension plans were underfunded by $1.129 billion. Under U.S. and Canadian laws, following emergence from bankruptcy, SSCC would be required to make contributions to the underfunded pension plans.

SSCC reported the pension plans to be underfunded by $1.129 billion; however, for valuation purposes, the liability is often considered to be much lower because all contributions thereto are fully tax-deductible. The logic of valuing pensions on an after-tax basis for these purposes is that the payments, unlike the principal amount of funded debt, are fully tax-deductible. One of the expert groups did not tax-adjust the unfunded pension liability balance, while three of the groups agreed that the liability should be downwardly adjusted to account for the tax effect. For the DCF methodology, two of the experts reduced the enterprise value by the after-tax unfunded pension liability, whereas the other two experts reduced cash flows by the after-tax pension contributions.

Comparable Company Multiple Valuation

The comparable company multiple valuation analysis determines a firm's value by comparing the firm to comparable publicly traded companies. Multiples of earnings, EBITDA or other financial metrics are derived for each comparable company, and the appropriate multiple is applied to the subject company in order to determine its value.

While the experts disagreed on numerous assumptions made in computing the comparable company multiple valuation, some of the expert groups arrived at multiples that were surprisingly similar. All of the experts agreed that SSCC should be valued based on a multiple of earnings before interest, taxes, depreciation, amortization and pension expense (EBITDAP), given the specific nature of the unfunded pension liabilities and projected irregular pension expenses in this case. Pension expense that is recorded on the financial statements, which is expressed as net periodic benefit costs (NPBC), is a noncash expense. The NPBC is the net sum of a number of items, including the service cost (present value of projected benefits earned by employees in the current year), the interest cost on the pension liability, and amortized gains and losses on plan assets from previous periods, less the expected return on pension plan assets. These components of NPBC are actuarial/accounting amounts, not actual cash flows. Therefore, the pension expense recorded on the income statement does not represent the actual cash contributions to the pension plan made by the plan sponsor. Furthermore, because the NPBC is based in part on gains and losses incurred by the pension plan assets, NPBC can be volatile between different years and different companies, even if contributions to the pension plans are constant, resulting in fluctuations in operating results. This volatility can impair the efficacy of a multiples analysis for industries where pension expenses are substantial.

Two of the experts used the EBITDAP multiple and a revenue multiple, while the other two experts used

the EBITDAP multiple and an EBITDA multiple. One of the experts normalized historical performance to account for the cyclical nature of this industry by taking the average performance over the previous five years, the expected length of the cycle in this industry. Another expert relied only on historical performance (despite the distress of operating under chapter 11), whereas the remaining two experts used projected performance measures multiplied by a forward multiple, a multiple calculated based on projected performance measures of the comparable companies.

Comparable Transaction Multiple Valuation

The comparable transaction multiple valuation analysis determines a firm's value by comparing the firm to acquisitions of comparable companies or assets. Multiples of earnings, or other financial metrics, are derived for each comparable transaction, and the appropriate multiple is applied to the subject company in order to determine its value.

Given the case-specific data limitation, it was generally agreed among the experts that the comparable transaction multiple valuation was less reliable than the other valuation methods due to the lack of comparable transactions. One expert went back 15 years to find a sample of comparable transactions, while the other three experts used ten-, four- and two-year periods. Despite the fact that the experts used different performance measures to apply to the calculated multiples, none of them placed much weight on this methodology. Therefore, the differences in assumptions did not factor materially into the differences in the overall experts' opinions on the value of SSCC.

Discounted Cash Flow Analysis

The DCF analysis is a standard framework used for valuation. The application of the DCF analysis establishes a firm's value by projecting future anticipated benefits, such as cash flow, for a defined period, determining a terminal value at the end of the projection period and discounting those values by a discount or capitalization rate that reflects market rate of return expectations or conditions, as well as the relative risk of the investment.

A typical contentious issue in valuation hearings was neutralized in the case of SSCC in that the discount rates used by the experts were not materially different. There were certain differences in assumptions relating to specific risk, but generally, the weighted average cost of capital calculated by the experts was quite similar.

In a DCF valuation, because the company is expected to operate in perpetuity, the expert needs to calculate the value of the company at the end of the projection period using a constant-growth model (also known as Gordon's Growth Model) or a terminal multiple. The experts generally applied the terminal multiple approach and generally used similar EBITDAP multiples.

The most significant difference in the DCF valuation was due to the differences in cash flows. The company prepared its own forecasted projections; however, two of the experts revised certain of the assumptions to reflect current economic conditions and commodity price projections.

Concluded Value

The experts arrived at distributable values that differed by approximately $2 billion, ranging from a little over $3 billion to a little over $5 billion. The debtors and creditors valued the company at the low end of the range, significantly lower than the company's debt, whereas the equity- and preferred equity-holders valued the company at the high end of the range, above the level of the company's debt. In general, if the court determines that the distributable value is lower than the level of the debt, shareholders are unlikely to participate in the company post-emergence. In contrast, if the distributable value is greater than the level of debt, then upon emergence, shareholders are likely to retain a stake in the company.

Prior to the judge's ruling, the parties agreed to allow the equity and preferred equityholders to participate in the company post-emergence. Seven months after SSCC emerged from chapter 11, an offer was made to acquire the company, with an enterprise value of more than $5 billion. This acquisition was approved in May 2011. Similar to the case of Mirant, the value of SSCC's buyout is more than 50 percent higher than the value determined by the company during the valuation hearings.

In valuation hearings, the focus is on the enterprise value of the firm (*i.e.*, the total assets). In a buyout, the focus shifts to the value of the equity. In addition, even if a buyout occurs soon after a valuation hearing, a significant valuation effort has to be made at the time of the buyout given that the company's value can change due to numerous reasons including restructuring efforts, changing market conditions and macroeconomic factors. ■

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