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Value & Cents

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Are Valuation Disputes Futile?

A common dispute arising in bankruptcy is what value to attribute to a debtor's assets, and the dispute is often litigated. In addition, the litigating parties introduce competing valuations into evidence. The court then usually ascribes a value to the asset after weighing and considering the competing expert valuations and related evidence. In recent litigation in the chapter 11 case of *In re Brickchurch Enterprises Inc.*,² Hon. Alan S. Trust decided not to determine value. Instead, he noted that he would let the market speak for itself, explaining:

As the parties recognized during argument, and including, specifically, in the affidavit of [Geoffrey] Gifkins, market value is determined by the meeting of the minds between [the] seller and buyer. It is not determined by appraisals or real estate agents. The best indication of the value of a real property is what the market will bring forward in the sale process.... So rather than ascribe an artificial value to the property, [the] Court's going to leave that to the marketplace to determine.³

Judge Trust's position on valuation raises the following question: Are many valuation disputes futile? Should bankruptcy courts, in many circumstances, allow unfettered market forces to determine value? This article discusses Adam Smith's invisible hand theory of markets, its application by courts (including one bankruptcy court) and the theory's underpinnings in valuation disputes in bankruptcy.

The "Invisible Hand Theory"

The invisible hand theory of markets is taught in most business schools. The theory originated from 18th century Scottish economist Adam Smith. According to Smith in *Wealth of Nations*, published

in 1776, the economy is led by the invisible hand of each market participant seeking to promote his/her own self-interests:

[E]very individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it ... he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain; and he is in this, as in many other cases, *led by an invisible hand* to promote an end which was no part of his intention.... *What is the species of domestic industry, which his capital can employ, and of which the produce is likely to be of the greatest value, every individual, it is evident, can in his local situation judge much better than any statesman or lawgiver can do for him.*⁴

In lay terms, the invisible hand theory of the market proposes that individual market participants buy and sell goods and services based on self-interest. If market participants are left to their own voluntary unregulated behavior and devices, their unregulated trading of goods and services will also lead to market efficiency and the most accurate pricing of tangible and intangible goods and services.

Courts' Application of the Invisible Hand Theory

Smith's market theory is so popular among many Westerners that numerous courts have cited, mentioned or discussed his theory. Although bankruptcy courts have not extensively cited the invisible hand theory in published decisions, research reveals that close to 30 courts in the U.S. have mentioned this theory. Only two published U.S. bankruptcy



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¹ This article represents the views of the author, and such views should not necessarily be imputed to Simmons Legal PLLC, or its respective affiliates and clients.

² Case No. 22-70914-ast (Bankr. E.D.N.Y. April 30, 2022). Simmons Legal PLLC represents one of the parties in the subject litigation.

³ See *id.* Aug. 31, 2022, Hearing Tr. at 72:9-72:20.

⁴ See Adam Smith, *Wealth of Nations* (1776) (emphasis added).

court decisions mention Smith's invisible hand theory of efficient market operation and pricing.⁵ Only one of those cases, *In re Breitburn Energy Partners LP*, actually described and applied the theory to a valuation dispute.

The *Breitburn Energy* case involved plan-confirmation litigation.⁶ Moreover, the market value of the debtors' assets was the central issue in the plan-confirmation fight.⁷ The debtors in this case were a group of affiliated oil and gas exploration and production (E&P) companies.⁸ The E&P companies owned mature, developed oil and gas assets, including thousands of oil and gas wells and largely undeveloped, unconventional acreage.⁹

To value the companies under any chosen method required the proper estimate of the price of oil and gas.¹⁰ The debtor's valuation expert used the strip price of oil and gas, which "reflects the price at which future contracts for the sale of oil and gas are traded on the New York Mercantile Exchange [NYMEX]."¹¹ In contrast, the equity committee's expert used the consensus price of oil and gas by averaging the sum of 10 forecast prices chosen by the expert.¹²

The court selected the strip price, a price based on Smith's invisible hand theory of markets, as the best estimate of future prices.¹³ Further, the court explained that "[s]trip prices reflect the views of where prices are headed by willing buyers and sellers, each with access to all available information."¹⁴ Other evidence also supported strip pricing as the most accurate reflection of price:¹⁵

- "The Debtors' founder and Chief Executive Officer ... testified that in his 30 years in the oil and gas business, 'all transactions that I have been involved in have been based on strip pricing'";
- the general acceptance of strip pricing in the industry was confirmed by various third-party sources;
- an oil and gas valuation resource "stated that 'if one believes in the invisible hand theory of markets then the NYMEX strip is the best estimate of future prices'"; and
- "strip pricing has been used to value assets in every large, confirmed chapter 11 E&P case since 2015."

As an example of the application of the theory outside of litigation in bankruptcy, the U.S. District Court for the District of Arizona deferred to the invisible hand of the market for the assessment of the reasonableness of an expert's hourly rate:

This rate is determined by the "invisible hand" of the market, and if that market is free from undue influences, it is to a first approximation what one might term "fair." If [Dr. Joseph K. Vaughan, Jr.] tries to charge too much, he will lose business to other experts. If he charges too little, he will have more business than he can handle. All things being equal, the court concludes that Vaughan's hourly rate of \$500 per hour for consultation work is reasonable.¹⁶

In an Aug. 23, 2022, published decision, in the shareholder-initiated securities fraud case of *Allegheny County Employees' Ret. System v. Energy Transfer LP*,¹⁷ the U.S. District Court for the Eastern District of Pennsylvania discussed the invisible hand at play in the pricing of stock that operated through pricing that resulted from a volume of transactions over time, rather than instantaneously. In that case, the court explained:

[T]he security must be subject to a sufficient number of transactions such that, through the push and pull of competing valuations of buyers and sellers, an 'efficient' market clearing price can be established that is understood to reflect all the information available about the security.... The efficient price is not set by an invisible hand that instantly reflects new information in a security's price, but through the dynamic, high-volume exchange of a security over an appropriate window of time.¹⁸

Invisible Hand Theory's Underpinnings in Valuation Disputes in Bankruptcy

The invisible-hand concept of market pricing is also at work in fair market valuation cases in bankruptcy. Courts are often required to consider the fair-market value of assets, including the enterprise or going-concern value of the debtor, in determining various relief, including plan confirmation, stay-relief requests, exemptions and avoidance actions.¹⁹

The phrase "fair market value" is not defined in the Bankruptcy Code. In determining and analyzing value, courts typically adopt and use the classic definition of the "fair market value" of an asset. Under the classic definition, fair market value is considered the price that "a willing seller under no compulsion to sell, and a willing buyer under no compulsion to buy, would agree upon after the property has been exposed to the market for a reasonable amount of time."²⁰

An accurate calculation of fair market value accordingly requires two willing market participants coming together to trade without interference or compulsion from third parties, including regulatory bodies and even the judiciary. As one court noted, "[v]aluation outside the actual market place is inherently inexact."²¹ If that is the case, then the determination of value by a court in a valuation dispute renders an inexact valuation.

However, the circumstances of many cases do not enable a court to allow the parties to test the market to assess a more exact fair market value. In those cases, courts tend

17 No. CV 20-200, 2022 WL 3597200, at *6 (E.D. Pa. Aug. 23, 2022).

18 *Id.* (internal citation omitted).

19 *See, e.g., In re Minkina*, 631 B.R. 544, 555 (Bankr. D. Mass. 2021) (noting that § 522(f)(2)(A) "requires a determination of 'the value that the debtor's interest in the property would have in the absence of any liens.' 11 U.S.C. § 522(f)(2)(A). 'Value' in this section means 'fair market value as of the date of the filing of the petition.'"); *In re Levin*, No. 8-17-77330-LAS, 2020 WL 1987783, at *2-3 (Bankr. E.D.N.Y. April 24, 2020) (determining value for § 522 exemptions); *In re Manning*, 620 B.R. 199, 205 (Bankr. W.D.N.Y. 2020) ("To determine whether debtor has equity in property, in deciding motion for relief from the automatic stay, the court must determine the fair market value of the property, from which the amount of all liens, including those senior and junior to the movant's lien, are subtracted."); *In re Graves*, 19-01345-NPO, 2019 WL 6170789, at *7 (Bankr. S.D. Miss. Nov. 19, 2019) ("[D]etermining the fair market value of the Residence for purposes of § 506(a)(1) and § 1322(b)(2)."); *Breitburn Energy Partners LP*, 582 B.R. at 321 (deciding valuation for plan-confirmation purposes); *In re WRT Energy Corp.*, 282 B.R. 343 (Bankr. W.D. La. 2001) (valuing assets for purpose of determining debtor's solvency at time of alleged fraudulent transfers); *In re Markowitz Bldg. Co.*, 84 B.R. 484, 487 (Bankr. N.D. Ohio 1988) ("For purposes of determining whether Relief from Stay should be granted on property which the Debtor-in-Possession would retain and use, the valuation under 11 U.S.C. § 506(a) should be based on the fair market value.");

20 *See, e.g., Markowitz Bldg. Co.*, 84 B.R. at 487.

21 *See, e.g., Levin*, 2020 WL 1987783, at *2-3 (citations omitted).

5 *See generally In re Breitburn Energy Partners LP*, 582 B.R. 321, 332 (Bankr. S.D.N.Y. 2018); *In re Pillow*, 8 B.R. 404, 416-17 (Bankr. D. Utah 1981).

6 *See Breitburn Energy Partners LP*, 582 B.R. at 332.

7 *Id.* at 330.

8 *Id.* at 325.

9 *Id.*

10 *Id.* at 331 (noting that "[t]he most significant valuation factor was the assumption relating to the price of oil and gas").

11 *Id.*

12 *Id.*

13 *Id.* at 332-33.

14 *Id.* at 332 (citations omitted).

15 *Id.* at 333 (emphasis added).

16 *Jalowsky v. Provident Life and Accident Ins. Co.*, 336 F.R.D. 452, 454 (D. Ariz. 2020) (citation omitted).

to analyze valuation evidence presented by the parties and typically arrive at value using the following broad parameters explained by the U.S. Bankruptcy Court for the Eastern District of New York:

Because of the subjective nature of the appraisal process, courts are given wide latitude in determining value. A court is not bound by the values determined by appraisals but rather may form its own opinion as to the value of the subject property after the consideration of the appraisers' testimony and their appraisals. Moreover, because the valuation process often involves the analysis of conflicting appraisal testimony, a court must necessarily assign weight to the opinion testimony received based on its view of the qualifications and credibility of the parties' expert witnesses.²²

Moreover, although appraisal testimony and appraisal reports are considered, courts will reject as invalid an appraisal method that does not appear to render "an amount that a willing buyer would actually pay to a willing seller."²³ In addition, it is important to note that Smith's idea of valuation, which is embedded in the concept of fair market value utilized by the courts, looks to healthy business transactions rather than distressed transactions for an accurate estimate of value.²⁴

Final Analysis: Should the Market Decide?

Parties do not have the opportunity to let the market determine value in some cases. In those cases, the fact-finder, after considering and weighing the evidence, will have to make a judgment call on the issue. However, when the circumstances of the case allow for market forces to operate unfettered and the market speaks for itself, will bankruptcy courts defer to the market's voice? For example, in many cases, a debtor proposes to market its asset(s) for sale and/or refinancing in bankruptcy. In those cases, the pre-petition creditor that has a lien on the asset(s) may seek stay relief, thus triggering a valuation fight. Faced with competing valuations, should or would the bankruptcy court grant the debtor a grace period and opportunity to test the market to assess the accurate market value for the asset(s) through consummation of a sale or refinancing with a willing buyer and/or lender? We will leave that question for the courts to decide. **abi**

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²² *Id.*

²³ See, e.g., *In re Diamond Beach VP LP*, 506 B.R. 701, 715 (Bankr. S.D. Tex. 2014), *aff'd*, 551 B.R. 590 (S.D. Tex. 2016) ("The goal of the inquiry is always to find the fair market value — an appraisal method is only valid if it produces an amount that a willing buyer would actually pay to a willing seller.") (citation omitted).

²⁴ See, e.g., *In re Glob. Technovations Inc.*, 431 B.R. 739, 772 (Bankr. E.D. Mich. 2010), *aff'd*, No. 10-12781, 2011 WL 1297356 (E.D. Mich. March 31, 2011), *aff'd sub. nom.*, *In re Glob. Technovations Inc.*, 694 F.3d 705 (6th Cir. 2012) ("In the case of a business that qualifies as a 'going concern,' assets are valued at their market rather than distress (i.e., liquidation) value, but the valuation must be done in a 'realistic framework' considering amounts that can be obtained within a reasonable time, by a willing seller from a willing buyer.") (citations omitted); *In re Graves*, 2019 WL 6170789, at *7 (explaining that "because the seller of a foreclosed home is likely to be motivated to sell for a lower price than a sale between a willing seller and a willing buyer, the Court does not consider such sales to provide reliable data of fair market value").