



# SCCAI Summer Conference

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## **Commercial Bankruptcy, Workouts and the Valuation Process**

*Presenters:*

**Robert Miller, Esq.**

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Managing Shareholder

**Winthrop Couchot PC**

*Moderator:*

**Derrick Sinclair, MAI**

**Bob Dietrich, MAI**

Director, Specialty Practice

**Colliers International**

# Bob Miller

BRYAN CAVE

*A Broader Perspective<sup>SM</sup>*



Robert J. Miller, Esq.  
Partner, Phoenix, AZ  
Bryan Cave, LLP

- Mr. Miller is an attorney with Bryan Cave, LLP, an international law firm of 1,100 lawyers practicing from 18 US offices and 14 international offices.
- Mr. Miller regularly represents institutional lenders, companies in distress, fiduciaries (trustees and examiners), other key constituencies in chapter 11 cases, as well as buyers and sellers of distressed debt.
- Since 2007 alone, he has served as legal advisor for lenders on debt obligations of \$4.0+ billion secured by various kinds of commercial real estate. He has served as lead counsel for various chapter 11 debtors, including a number of public reporting companies.
- Mr. Miller has been a speaker at Appraisal Institute National Conferences in Las Vegas and San Diego, and participated in an AI national webinar on bankruptcy valuation.

# Richard Golubow



Richard Golubow, Esq.  
Managing Shareholder  
Winthrop Couchot PC



- Richard Golubow is the Managing Shareholder of Winthrop Couchot PC, California's preeminent boutique insolvency law firm.
- He has extensive experience in the areas of Chapter 11 reorganizations, complex bankruptcy litigation, liquidations, out-of-court workouts, acquisitions and sales of distressed assets, and other areas.
- His client base includes of debtors, creditors, creditor committees, bankruptcy trustees, assignees for the benefit of creditors, receivers and asset purchasers of real and personal property.
- Richard has been honored as the recipient of bankruptcy, insolvency or financial restructuring attorney of the year awards by several leading international financial publications including Corporate INTL Magazine, ACQ (Acquisition Finance) Magazine, Corporate LiveWire, and Finance Monthly. The awards collectively recognize success and excellence, expertise, service, achievement and innovation as chosen by industry peers.

# Bob Dietrich



Robert E. Dietrich, MAI, CRE, CCIM  
Director  
Colliers International



- Mr. Dietrich is the national practice leader of the Specialty Valuation Practice of Colliers International. He is based in the Los Angeles office.
- He has been designated as an expert in real estate valuation, has testified on over 70 occasions in court and has been selected as an independent arbitrator in valuation matters. Bankruptcy experience includes testimony on over 30 occasions regarding property values, plan feasibility, and interest rates.
- He is a past national director of the Appraisal Institute and served as president of the Southern California Chapter of the Appraisal Institute and the Southern California CCIM Chapter.
- Interesting bankruptcy and workout assignments include:
  - Valuation of the Queen Mary ocean-liner hotel in Long Beach, CA
  - Valuation of a 350,000 acre cattle ranch in the Southwest.
  - Valuation of a \$2 billion portfolio of loans secured by mostly high-rise condominiums across the country.

## AGENDA

- Bankruptcy Overview
- Case Study
- Appraisal Issues
- Questions & Answers

# Bankruptcy Overview



## Bankruptcy Overview

What is bankruptcy?

Bankruptcy is a process in which consumers and businesses can eliminate or repay some or all of their debts under the protection of the federal bankruptcy court.

# Bankruptcy Overview



## Who are the players?

- Debtor – Usually a person or entity such as a corporation or partnership. May be a debtor-in-possession.
- Creditor – This can be a single creditor like a bank, or separate committees of secured and unsecured lenders.
- Court – Managed by a federal judge appointed to a 14 year term by the federal district courts.
- Trustee – In some cases, a trustee will be appointed to handle the affairs of the Debtor.

# Bankruptcy Overview



## Types of Bankruptcies

For the most part, bankruptcies can be divided into two types -- liquidation and reorganization. These are covered in several chapters of the Bankruptcy code including:

- Chapter 7
- Chapter 9
- Chapter 12
- Chapter 13
- Chapter 15
- Chapter 11

# Bankruptcy Overview



## Chapter 11 Bankruptcy

Chapter 11 provides for reorganization, usually involving a corporation or partnership. Most large bankruptcies like American Airlines are Chapter 11 cases.

A chapter 11 debtor usually either sells its assets or proposes a plan of reorganization to keep its business alive and pay creditors over time (a plan can be a liquidation (sale) mechanism).

People in business or individuals can also seek relief in chapter 11.

# Bankruptcy Overview



## Bankruptcy Process

The vast majority of real estate valuation issues that arise in bankruptcy cases are in Chapter 11, typically when a property owner becomes delinquent on a loan. In order to avoid foreclosure, a Chapter 11 petition will be filed by debtor's counsel.

In a voluntary case, the debtor automatically assumes an additional identity as the "debtor in possession" and maintains control of the property operations. A debtor remains a debtor in possession until the debtor's plan of reorganization is confirmed, the debtor's case is dismissed or converted to chapter 7, or a chapter 11 trustee is appointed.

# Bankruptcy Overview



## Bankruptcy Process Continued

When a debtor with commercial real estate tries to reorganize, a written *disclosure statement* and a *plan of reorganization* must be filed with the court.

- The *disclosure statement* is a document that must contain information concerning the assets, liabilities, and business affairs of the debtor sufficient to enable a creditor to make an informed judgment about the debtor's plan of reorganization.

# Bankruptcy Overview



## Bankruptcy Process Continued

- The contents of a Chapter 11 plan of reorganization ("Plan") must include a classification of claims and must specify how each class of claims will be treated under the plan. Creditors whose claims are "impaired," i.e., those whose contractual rights are to be modified or who will be paid less than the full value of their claims under the Plan, vote on the plan by ballot.

After the disclosure statement is approved by the court and the ballots are collected and tallied, the court will conduct a confirmation hearing to determine whether to confirm the Plan.

# Bankruptcy Overview



## Single Asset Real Estate In Bankruptcy

Single asset real estate debtors are subject to special provisions of the Bankruptcy Code. The term "single asset real estate" ("SARE") is defined under 11 U.S.C. § 101(51B). A SARE debtor is given less time to reorganize in chapter 11, so the debtor typically has to move fast to survive the chapter 11 process. See 11 U.S.C. § 362(d)(3).

# Bankruptcy Overview



## Valuation Hearings

Valuation hearings are conducted to determine the value of assets in the bankrupt estate. The value is important in establishing the security of creditors and plan feasibility.

Hearings may involve a number of parties, each represented by counsel.

- Debtor
- Secured Creditors
- Unsecured Creditors
- Trustee, if one is appointed

# Bankruptcy Overview



## Valuation Hearings Continued

Hearing operates under federal rules. Daubert, Rule 26, federal fair market value definition, and other federal rules apply.

Valuations and related expert testimony are crucial to stay relief and plan confirmation hearings.

In many courts, your valuation report is likely to be your direct testimony. Other parties are allowed cross examination.

Due to distressed nature of business or properties, the valuation is usually complex. Very seldom is there a simple, slam dunk valuation problem.

# Bankruptcy Overview



## Reorganization Plans

A Plan is required under Chapter 11. A Plan will show the court:

- Classification of all claims.
- A description of how the claims are to be paid and the source of funds.
- If any creditors are impaired, how are they treated.

The valuation of the assets is an important part of most Plans. A great deal of reliance is placed on valuation professionals to set the values. Often times, valuation professionals' opinions will drive whether or not the debtor can emerge from bankruptcy.

## Retention Issues in Bankruptcy

While there are differences in retention and compensation approval in different courts, all have certain requirements.

- Fee agreements must be court-approved.
- Courts have record keeping rules including maintenance of time sheets.
- There are many time constraints by law so make sure these are clearly understood.

# Retention Issues



Appraisers in bankruptcy may be retained at several stages:

- Consulting expert – specific research, valuation report.
- Valuation expert – Discoverable work product which may include appraisal, rebuttal report.
- Feasibility expert – Prepare or rebut a Plan.
- Interest rate expert – Prepare an interest rate report or rebuttal report on interest rates.

# Retention Issues



What professionals are subject to the bankruptcy rules regarding employment in a bankruptcy case?

- Appraisers would be if they are retained by the debtor, trustee, examiner, committee of unsecured creditors, or committee of equity holders.
- They don't apply to an appraiser's retention by an individual creditor or equity holder, but you still may need to track your time towards your fee in case the party wants to seek reimbursement.

# Retention Issues



What is required as part of the employment process by a debtor, trustee, examiner, committee of unsecured creditors, or committee of equity holders?

- A retention (engagement) agreement between the appraiser and those wishing to employ the appraiser in the bankruptcy case.
- Some provisions of a standard retention agreement may not be allowed by a bankruptcy court including indemnifications or excessive retainer amounts
- Disclose all elements of compensation and conflicts.
- Compensation rates should be the same charged outside of bankruptcy for similar clients.

# Retention Issues



An application by the employing party (e.g. trustee, debtor, etc.) to retain you as their appraiser.

- Attorney for employing party will usually draft.
- Make sure it is consistent with your retention agreement and the work you will perform.
- If work assignment changes, it would be appropriate to apply to the court for a change in your retention.

# Retention Issues



Disclosures and court approval are crucial:

- A declaration of appraiser's disinterestedness. Be sure to disclose all connections to all parties in the case.
- The court will authorize your employment by a signed order.
- Applications to employ need to be made promptly.

# Retention Issues



How or where appraisers are retained:

- Plan and stay relief issues
- Use of cash collateral
- Solvency analysis
- Rejection of real property leases
- §363 sale analysis
- Insurance claims
- General litigation claims

# Retention Issues



Examples of how appraisers are used in bankruptcy by a debtor or trustee:

1. Valuation for motion to lift stay for business or real estate.
2. Plan of reorganization.
3. Rebuttal expert.

## Valuation Case Study

### Be Careful What you Ask For: Key Valuation Concepts in a Chapter 11

- Oversecured vs. Undersecured
  - Is collateral value more or less than loan amount? A secured creditor can be undersecured if the collateral value is less than the debt amount.

# Appraisal Issues In Bankruptcy



## Key Valuation Concepts Continued

- If Oversecured
  - The creditor is entitled to
    - Post-petition interest
    - Reasonable professional fees

# Appraisal Issues In Bankruptcy



## Key Valuation Concepts Continued

- If Undersecured
  - The creditor will have an unsecured deficiency claim equal to the amount of the debt over the value of the collateral and a secured claim equal to the value of the collateral
  - The creditor is not entitled to post-petition interest or professional fees
  - The creditor is entitled to a market rate of interest over a market period of time on the secured claim portion

## Key Valuation Concepts Continued

- Market rate of interest over a market time on secured claim
  - In order to confirm a contested plan, debtor must pay:
    - A market rate of interest
    - Over a market time (Usually 5 -7 years)

# Appraisal Issues In Bankruptcy



## Key Valuation Concepts Continued

- Market rate of interest calculation
  - Blended rate
    - Split into three different tranches
      - » 70% LTV = treasury rate equal to duration of debt under the plan + 200 bps (1.75% + 2.00%)
      - » up to 90% of mezzanine debt at 10%
      - » 10% equity at 18%
      - » Equals a weighted average cost of debt of approximately 6.5% for a 100% loan to value loan

## Key Valuation Concepts Continued

- Market rate of interest calculation
  - Build up or Till analysis
    - Start with Prime
      - Add bps for duration, risk, fixed vs. variable rate
      - Completely subjective

# Appraisal Issues In Bankruptcy



## Case Study

- Debtor originally says its property is worth \$25 million and has debt owed to lender/secured creditor of \$30 million. During the case, accrued interest at contract rate is \$6 million. Creditor's attorney fees are \$1.5 million.

## Case Study Continued

- Consequences
  - Creditor is undersecured
  - Creditor has a secured claim of \$25 million and an unsecured claim of \$5 million
  - No post-petition interest or attorney's fees
  - Debtor must pay a market rate on the \$25 million secured claim. Claim is at 100% LTV
  - Market Rate is 6.5% as detailed previously

## Case Study Continued

- After realizing that it cannot afford a 6.5% interest rate, debtor comes up with a new appraisal of \$37.5 million and argues that the loan is now 80% LTV (\$30 million / \$37.5 million) and that the interest rate should be 3.75%

## Case Study Continued

- Consequences of new appraisal
  - Creditor is now fully secured
  - Entitled to post-petition interest of \$6 million
  - Entitled to attorneys fees of \$1.5 million
  - Brings new loan balance to \$37.5 million after allowed items are added back (interest and attorneys fees), which is once again a 100% LTV loan

# Appraisals in Bankruptcy



## Appraising for Bankruptcy Court

- There is always a possibility a report prepared for another purpose may lead you into bankruptcy court.
- Typical scenario:
  - You do a bank appraisal.
  - Something happens (anchor lost, local economy)
  - Retained by bank to update for foreclosure or workout.
  - Borrower files bankruptcy.
  - Your report is submitted on behalf of creditor.

# Appraisals in Bankruptcy



## Bankruptcy Valuation and Reporting Issues:

- Report may be used in more than a single venue.
- Know reporting and valuation requirements of specific potential venues.
- Difference in definition of market value.
- Report format.
- USPAP applicability.
- Report formats.
- Communication

# Appraisals in Bankruptcy



## Bankruptcy Valuation and Reporting Issues - Continued:

- Methodology:
  - Use standard methodology when possible.
  - If a “non-standard” technique is required, make sure it is properly explained.
  - Beware of unsupported adjustments as judges will be suspicious of bias.

# Appraisals in Bankruptcy



## Declarations:

- Rule 26 Disclosure:

- (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 (usually the appraisal report);
- (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.

# Appraisals in Bankruptcy



## Declarations - Continued:

- Valuation rebuttal – SR 3 report
- Non-valuation rebuttal – Complies with USPAP
- Response to critique
- Others – Interest rates, plan feasibility

# Appraisals in Bankruptcy



## How to Get Work From Bankruptcy Lawyers:

- Good source can be current clients like banks including their special assets group.
- Networking Opportunities:
  - Turnaround Management Association (TMA)
  - American Bankruptcy Institute
  - Local groups like Los Angeles Bankruptcy Forum
- Face-to-face meetings with bankruptcy and creditor's rights attorneys.

# Select Cases



## Court Cases:

- Federal Court decisions as guidance for developing appraisals.
- Federal Courts (Tax and Bankruptcy) will almost never “split the difference” on appraisals.
- Federal Judges will weigh evidence to form a final value conclusion. They may use data from one report and use the methodology from another.
- Judges know the meaning of designations and the amount of work needed to obtain the designation. In a recent federal Case, the judge recognizes the importance of the MAI designation. The Court notes that “Within the real estate appraisal community, MAI is viewed as the highest regarded appraisal designation.”

# Select Cases



## Court Cases:

- Hale – Residential property
- Anthem Communities – Multiple residences in a subdivision
- Boltar – Daubert Challenge

# Select Cases



## Hale:

- Residential property in Ramona, California with a loan from PNC Bank.
  - Lender Appraisal: \$400,000 as of September 2010
  - Debtor Appraisal: \$329,000 as of April 2010
- The Court found that both appraisers were credible at their valuation dates.
- The Court looked at areas of disagreement
  - location,
  - condition of the residence, and
  - age of the comparable sales compared to the subject residence.

# Select Cases



## Hale – Continued:

- Court selected 3 best comps from two reports and performed independent analysis.
- Resulting value after adjustments was \$358,000.
- Lessons Learned:
  - Make sure you ask about date of value.
  - Confirm sales.
  - Explain adjustments.
  - If using sales outside of immediate area and not using immediate neighborhood sales, explain thoroughly and disclose sales not used and reasons for excluding.

# Select Cases



## Anthem Communities:

- 11 partly completed homes near Denver, CO
- Value was used to support a motion
- Values were prepared for “As-Is” Condition. Method was:
  - Estimate value if complete
  - Deduct costs to complete
  - Deducted contractor’s fees
  - Deducted cost of capital during construction

# Select Cases



## Anthem Communities – Continued:

- Result: Court denied the motion as the appraisal was flawed and did not address the value of the collateral properly. Valued in bulk instead of individual loans).
- Lessons learned:
  - Make sure you know source of any valuation inputs or adjustments.
  - Make sure you understand issues. If multiple loans, you may need to address each loan rather than an aggregate approach that would be required by most banks.
  - Look at Bankruptcy Court precedent and not FIRREA.

# Select Cases



## Boltar:

- Excluded Expert's Report under Federal Rules of Evidence and Daubert
- Emphasized Court's "Gatekeeper Role"
- The property was a Conservation Easement. However, the lessons learned here are valid in all types of work when dealing with the federal courts.

# Select Cases



## Boltar - Continued:

### What Happened?

- IRS filed a motion in limine to exclude the petitioner's expert report and testimony as neither reliable nor relevant under the Federal Rules of Evidence and Daubert.
- The Tax Court determined that the Taxpayer's expert's report was "so far beyond the realm of usefulness that admission is inappropriate and exclusion" is proper.
- The Taxpayer had no other expert report, and the Court relied only on the IRS valuation. The result was the Taxpayer lost a \$3.0 million dollar deduction from the donation.

# Select Cases



## Boltar - Continued:

### The Property:

- The property was 8.5 acres in Lake County, Indiana.
- Part of the land was wetlands.
- Part was in the City of Hobart and part was in Lake County. The County portion was zoned for low density single family development. The City portion was zoned PUD.
- There were no utilities available to the property.
- The property was land-locked with no legal access.

# Select Cases



## Boltar - Continued:

### The Appraisals:

- The Taxpayer appraiser valued the property at \$3,340,000 under the highest and best use for development of 174 condominiums. This was based on a site plan for a ten acre parcel (Scenario A).
- Scenario B valued the property as vacant development land at \$68,000. The Taxpayer appraiser stated that the value of the easement was the difference between the Scenario A and B values.
- It was not defined as a “Before and After” analysis as required by the regulations. The value estimated for the easement was \$3,245,000 and also reflected mitigation costs.

# Select Cases



## Boltar - Continued:

### The Appraisals:

- The IRS appraiser concluded that the highest and best use was for low density single family development.
- The easement was valued by the IRS appraiser at approximately \$30,000. This was based on a “before” value of approximately \$400,000 and an “after” value of about \$70,000.

# Select Cases



## Boltar - Continued:

### Problems:

- The Appraiser assumed all of the property was in the city of Hobart
- The Court determined that the taxpayer appraiser's opinion of highest and best use was not reasonable.
- In establishing the highest and best use, the Taxpayer appraiser relied on a ten-acre site plan even though the subject property was only 8.5 acres.
- The site plan ignored a 50 foot gas pipeline which crossed the property. The plat map showed that 6 of 29 proposed buildings could not be built.
- The Taxpayer appraiser valued the property before the easement at \$400,000 per acre. The Court noted that nearby land for similar development was selling for \$12,000 per acre.

# Select Cases



## Boltar - Continued:

### Problems - Continued:

- The Court determined that the Taxpayer appraiser's methodology was flawed.
- Finally, the Taxpayer's appraiser was given the chance to change some of the issues like ignoring the easement, or correcting the proper jurisdiction. The appraiser chose not to make any corrections and stood by the faulty report.

# Select Cases



## Boltar - Continued:

### Lessons Learned:

- Make sure facts are correct.
- Court will always look at highest and best use. Make sure it is reasonable and well-supported.
- When valuing a property and you are not preparing a Sales Comparison Approach, look at sales data in the area anyway.
- Make sure you actually state and describe the methodology. The math might be correct, but if it is not described properly, the report may be rejected.

# Select Cases



## Boltar - Continued:

### Court Comment on Daubert:

- The Court stated that a Daubert gate-keeping role for the Court is required because “the cottage industry of experts who function primarily in the market for tax benefits should be discouraged.” The Court notes that all too often, “[t]he problem is created by [expert’s] willingness to use their resumes and their skills to advocate the position of the party who employs them without regard to objective and relevant facts, contrary to their professional obligations.” In this case, the faulty appraisal by a single individual led to a condemnation of all valuation practitioners by a federal judge.

# Select Cases



## Boltar - Continued:

### Closing Comments from Case:

- “[w]e have long recognized that receipt of unreliable evidence is an imposition on the opposing party and on the trial process. We have also frequently stated that an expert loses usefulness to the Court and loses credibility when giving testimony tainted by overzealous advocacy. Expert opinions that disregard relevant facts affecting valuation or exaggerate value to incredible levels are rejected.”
- While “[j]ustice is frequently portrayed as blindfolded to symbolize impartiality, ... we need not blindly admit absurd expert opinions.”

# Helpful Links



## Helpful Links

US Bankruptcy Court:

<http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics.aspx>

TMA - Turnaround Management Association:

<http://www.turnaround.org>

ABI – American Bankruptcy Institute:

<http://www.abiworld.org>

AIRA – Association of Insolvency & Restructuring Advisors

<https://www.aira.org>

Local groups such as:

Los Angeles Bankruptcy Forum:

<http://labankruptcyforum.org>

# Questions?