LESSONS LEARNED FROM CHATZ V. BEARINGPOINT:
How a $20,000 Engagement Led to a $20 Million Lawsuit

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In May of 2006, the U.S. Bankruptcy Court in Chicago, Illinois, issued an 89-page opinion[1] finding that a common stock valuation performed by KPMG (n/k/a BearingPoint) was reasonable and appropriate. The valuation had been performed in September 2000 of high-tech start-up Nanovation Technologies, Inc. After Nanovation filed for bankruptcy in 2001, the bankruptcy trustee sued BearingPoint, alleging that the valuation had been negligently performed and had grossly overvalued the stock. The court's opinion in favor of BearingPoint contained a detailed discussion of the three valuation methodologies used by KPMG (discounted cash flow, market multiples, and third-party transactions), and concluded that KPMG had reached a reasonable conclusion of value. This article will describe some of the lessons learned by the attorneys who defended BearingPoint in this case.

KPMG September 30, 2000 Valuation

Nanovation was a high-tech start-up company founded in 1998, developing nanotechnology for the fiber optic industry. KPMG valued Nanovation's stock for Nanovation's employee stock purchase plan, under which employees could buy Nanovation stock at 85% of the fair market value established by Nanovation's Board. KPMG valued the common stock at

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[1] The opinion is published at 364 B.R. 308.

$9.20/share as of September 30, 2000, and Nanovation's Board subsequently set the fair market value at $10/share for purposes of the stock purchase plan. Nanovation's bankruptcy trustee alleged that the company also used that value to allow five of its directors and officers to repay over $20 million owed to Nanovation with common stock valued at $10/share.

Bankruptcy Trustee Sues BearingPoint for $20 Million

When Nanovation subsequently filed for bankruptcy in July 2001, the bankruptcy trustee sued BearingPoint, alleging that the September 30 valuation had grossly overvalued the stock. The trustee alleged that KPMG's inflated valuation enabled the D&O's to repay their debt with worthless stock that was given a value of $10/share. The trustee hired the author of a well-known valuation textbook, who concluded that Nanovation stock was actually worth only 15 cents/share as of September 30, 2000. The trustee sought recovery of the $20 million of debt that was repaid with allegedly worthless stock.

The primary issue at trial was whether KPMG had properly performed its September 30 valuation. Also at issue was whether KPMG's engagement letter limited KPMG's liability to the $20,000 in fees it had received for the valuation. Ultimately, the court found that the trustee's case was "seriously misguided," and ruled in KPMG's favor on all counts, finding its valuation to have been appropriate and reasonable.

KPMG's Engagement Letter

KPMG obtained a signed engagement letter from Nanovation before conducting its valuation, but many important terms and conditions were in a separate attachment, "Exhibit A." Exhibit A included a provision that limited KPMG's liability to the fees it received. Exhibit A was not attached to the file copy of the engagement letter maintained by either KPMG or Nanovation, and, six years later, no one had a memory of sending or receiving Exhibit A with the engagement letter. The KPMG professionals who worked on the case testified that Exhibit A was always included, but no copy was in the file.

Early in the case, BearingPoint asked the court to rule that BearingPoint could never be liable for more than $20,000, which would have allowed BearingPoint to end the case quickly and cheaply. Because of the ambiguity created by the missing Exhibit A, the court ruled that the case would go forward, and it would be decided, at trial, whether Exhibit A was attached.

Limitations of liability are generally enforceable in Illinois and most other states. However, you must be prepared to prove that the limitation of liability was communicated to and accepted by the client. You must maintain an organized filing system to ensure that the limitation of liability provisions are maintained as part of the engagement letter. Better yet, include critical terms such as limitations of liability in the body of the letter itself. Best of all would be to have the client separately sign or initial the limitation of liability provision. Integrating the limitation of liability in the engagement letter will make it much easier to prove that the client actually agreed to the limitation and will give you a way out of a case early.

KPMG's Discounted Cash Flow Analysis

Regarding KPMG's discounted cash flow analysis, the primary area of disagreement was KPMG's use of a 15% perpetual growth rate. The trustee's expert contended that a 5% perpetual growth rate was appropriate, and that a 15% rate would result in Nanovation soon becoming larger than the entire United States economy. BearingPoint acknowledged that 15% was unusually high, but argued that the rate was justified by the unusual circumstances surrounding Nanovation. The disagreement regarding perpetual growth rate accounted for virtually all the difference between the value calculated by KPMG's and the trustee's expert's DCF.

At the time of KPMG's valuation, Nanovation had less than $1 million in non-core sales, but management believed that Nanovation was close to bringing revolutionary new products to market. Nanovation was projecting enormous sales growth, going from less than $1 million in 2000 to over $150 million by 2003. These high growth rates were consistent with the projections of industry analysts at the time. KPMG added three more years to Nanovation's sales projections, resulting in a discrete period that showed six years of triple-digit and high double-digit growth rates, ending with 40% growth. The trustee's expert did not criticize KPMG's adoption of Nanovation's aggressive projections, or the growth rates used by KPMG during the remainder of the discrete period.

BearingPoint conceded that 15% growth into perpetuity was not possible, but argued that the 15% perpetual growth rate simply represented a gradual decline from 40% to a sustainable perpetual rate of 5%. KPMG's expert performed an analysis showing that dropping from 40% growth into a perpetual growth rate of 15% produced virtually the same value as reducing the 40% growth by 5% per year until it reached a 5% perpetual growth rate. The court accepted this analysis, and held that "KPMG's selection of a 15% growth rate was reasonable and consistent with generally accepted valuation practices."

The trustee's theme that a 15% perpetual growth rate would result in Nanovation becoming larger than the United States economy had only superficial appeal. By demonstrating that an immediate drop into a 15% perpetual growth rate was no different than a more gradual drop into a 5% perpetual growth rate, KPMG convinced the court that 15% was reasonable under the circumstances. Given the extremely high growth rates that Nanovation was projecting, the court was convinced that using a 15% perpetual growth rate was an appropriate way to approximate a gradual decline in growth from the high rates of the discrete period to a more sustainable perpetual growth rate.

KPMG's Market Approach

KPMG's comparable companies included both start ups and some very mature companies, including Corning, PerkinElmer and JDS Uniphase. The trustee's expert only used start up companies, and argued that mature companies were too different from Nanovation to be used. "Corning," the trustee's lawyers crowed, "has been around so long that it made the glass for [Thomas] Edison's light bulb!"

The trustee's logic was flawed, however. The pricing fundamentals generated by the more mature companies were generally lower than those generated by start ups, so KPMG's use of those mature companies actually lowered the ultimate conclusion of value. This certainly did not support the trustee's argument that KPMG had *overvalued* Nanovation. More importantly, KPMG was able to show that, throughout 2000, stock prices of KPMG's companies moved in sync with the trustee's expert's companies. All the companies were subject to the same market forces and risk factors, and their multiples changed similarly.

Next, the trustee's expert attacked KPMG's use of four pricing fundamentals: BEV to total assets, BEV to book BEV, BEV to LTM Revenue, and BEV to 2001 projected revenue. KPMG assigned 15% weight to each of the first two fundamentals, and 35% weight to each of the latter two. KPMG selected a multiple within the range of multiples shown by its nine comparable companies for each of these pricing fundamentals.

The trustee's expert criticized KPMG for using a fundamental related to projected future revenue, which he considered too uncertain to be a reliable indicator of value. The trustee's expert used only one pricing fundamental: BEV to LTM Revenue, and he used the lowest multiple of the four comparable companies he selected. In effect, he applied a single multiple derived from only one company—the company that generated the lowest multiple.

BearingPoint argued that the trustee's expert's position that future sales were too uncertain was inconsistent with his use of a discounted cash flow that utilized the same projected sales. Moreover, projected future sales was what drove investment in start-ups like Nanovation. Investors did not purchase stock in companies like Nanovation because of their past sales (which were minimal for Nanovation), but because of the sales that Nanovation believed it would make in the future.

The trustee's expert's approach appeared designed to drive the value of Nanovation as low as possible. He selected only one pricing fundamental and used only one company—both of which produced the lowest possible value of Nanovation. KPMG's decision to weigh four pricing fundamentals, and to select a multiple from a range of multiples generated by nine companies, seemed far more reasonable, and less results-oriented, than the trustee's expert.

Real World Transactions

As the court noted:

> "Actual transactions in the securities being valued are the best source of evidence of the value of those securities."

Fifty percent of the weight in KPMG's valuation study came from actual transactions in Nanovation stock. The trustee gave such transactions no weight. More than anything else, this led the court to conclude that the Trustee's expert had simply closed his eyes to reality.

Preferred Stock Sales

Eleven days prior to September 30, 2000, a group of four investors purchased $20 million of Nanovation preferred stock at $15/share. Thirty days earlier, Motorola purchased $10 million of Nanovation preferred stock at $15/share. KPMG acknowledged that preferred stock is different from common stock, but believed that these differences were minimal, and therefore accorded the transactions 50% of the overall weight in its valuation. The trustee's expert argued that the preferred stock sales said nothing about common stock value.

At trial, BearingPoint analyzed the features of the preferred stock and argued that most of those features added no significant value. The preferred stock was convertible to common stock at a 1 to 1 ratio, and enjoyed no dividend preference or superior voting rights. The preferred stock included the right to appoint one member of Nanovation's Board, but one group of investors never even exercised that right until reminded to do so months later, demonstrating that this feature had little value to them. The preferred stock also had a liquidation preference over the common, but BearingPoint's expert believed the value to be negligible because this was a high tech start up. If the company declared bankruptcy, shareholders would not get anything whether they enjoyed a preference or not. This is exactly what happened in Nanovation's bankruptcy.

A right of redemption, which allowed the shareholders to redeem the stock for the purchase price after five years, had some value. BearingPoint's expert argued that the feature was essentially a put option (i.e., an option to put the stock back to the company at a certain price), and that there are generally accepted methods for valuing put options. BearingPoint's expert used Black-Scholes and a Monte Carlo simulation to value the redemption feature, which produced a value of between about 50 cents and $3 per share. Subtracting this value from the price of the preferred stock meant that the rest of the security (i.e., a share of common stock) was worth between $12 and $14.50. Although the trustee's expert acknowledged that Black-Scholes and Monte Carlo are generally-accepted valuation tools, he contended that they were not appropriate for valuing preferred stock benefits.

Common Stock Transactions

BearingPoint learned through discovery that there was an active market for Nanovation common stock, even though the company was privately-held. Nanovation's stock register revealed hundreds of transactions during 2000, and interviews revealed that people paid between $15 and $45 per share, both before and after the September 30 valuation. Depositions revealed additional sales during 2000 for between $50 and $75 per share. There was no evidence that anyone had paid less than $15/share for Nanovation common stock at any point during 2000, and Nanovation common stock continued to sell for $7 per share as late as March 2001. These sales all involved hundreds or thousands of shares. Although KPMG had been aware of transactions in Nanovation's common stock when it performed its valuation, it did not consider them because it lacked information about them. BearingPoint argued that these transactions corroborated KPMG's value of $9.20/share.

The trustee's expert refused to consider these transactions, claiming he lacked sufficient information to consider them in forming his opinions. In a devastating blow to the trustee's credibility, when asked why he did nothing to inquire about these transactions, such as interview the purchasers or issue subpoenas to gather additional information, he testified that he had been instructed by the trustee's lawyers not to do so.

Stamford International

Approximately 40% of the outstanding common stock of Nanovation was owned by a Canadian company called Stamford International, Inc. Stamford was a true shell that owned no assets and no business other than its stake in Nanovation. Stamford was publicly traded in Canada and on an over the counter market in the United States. Stamford was well-known in the investor community as a vehicle to acquire an indirect interest in Nanovation.

KPMG was not aware of, and did not consider, Stamford during its valuation. At trial, though, BearingPoint used the publicly-traded prices at which Stamford traded around the September 30 valuation to calculate an implied value of Nanovation stock. BearingPoint argued that because Stamford owned no other assets, the only reason an investor would purchase Stamford stock would be to acquire an indirect ownership interest in Nanovation. Thus, what an investor paid for Stamford showed how the investor valued Nanovation. By considering the number of shares of Nanovation owned by Stamford, and the number of shares of Stamford outstanding, BearingPoint's expert was able to devise a simple formula that converted a price of Stamford stock into an implied value of Nanovation. Applying this formula to the price at which Stamford traded yielded an implied value of Nanovation as of September 30 of $10.80/share. BearingPoint argued that this was further corroboration that its value of $9.20/share was not excessive.

Once again, the trustee's expert refused to consider evidence regarding Stamford, testifying that the price of Stamford revealed nothing about the fair market value of Nanovation. The trustee's expert argued that Stamford experienced wide price swings, but the price swings were no more volatile than the publicly-traded start ups the trustee's expert used as comparable publicly traded companies. He argued that Stamford did not trade in sufficient volume to be reliable, but thousands of shares were traded nearly every day, with over 75,000 shares traded during the week of September 30 alone. He argued that disparities in Stamford's price on the U.S. market and the Canadian markets made the price unreliable, but there was a correlation of greater than .99 between the two markets.

The court agreed with BearingPoint that the three types of real-world transactions—preferred stock, common stock, and Stamford—corroborated the reasonableness of KPMG's conclusions. The court was also highly critical of the trustee's expert for failing to reconcile his value of 15 cents/share with the real-world transactions showing values 75 to 100 times higher. The court ultimately concluded that "there is no way to reconcile his theoretical 15 cent valuation" with the numerous actual transactions in Nanovation stock.

Lessons Learned

Over one year after the trial ended, the bankruptcy judge issued an 89-page opinion excoriating the trustee and his expert, and completely vindicating the valuation performed by KPMG. The court's conclusion was best summarized in the following passage:

> After careful consideration of all the evidence, this court firmly believes that KPMG's work was neither negligent nor in breach of its contract with Nanovation. Moreover, KPMG's valuation was performed in a manner that was decidedly more reasonable than the analysis completed by the trustee's expert for this litigation. It was not enough for the trustee to promote [the trustee's expert's] authorship of widely-accepted valuation textbook over careful analysis and reasoning. At the end of the day, the trustee's hyperbole did not prevail over logic.

What lessons should valuation consultants take away from this experience?

- Reputation and expertise are not sufficient to carry the day in court. The analysis must make sense and must not appear results-oriented.

- Include critical terms of the engagement in the body of the engagement letter.

- In a discounted cash flow analysis, even an unusually high perpetual growth rate is defensible if, under the circumstances, it can be explained.

- More comparable companies, and more pricing fundamentals, are generally preferable to fewer when applying the market approach, and use of only one company or pricing fundamental will likely be viewed as unreasonable.

- The selection of appropriate pricing fundamentals must make sense. Looking at historical revenue in the case of a start-up is not likely to be considered reasonable.

- Actual transactions in a company's securities cannot simply be ignored. While there may be insufficient information to include them in a quantitative analysis, they can serve as a "red flag" if there is a significant disparity between such actual transactions and a theoretical analysis.

Conclusion

The 89-page opinion in *Chatz v. Bearingpoint* is unique in the detail with which it examines the work of a valuation consultant accused of error. The case involved interesting and novel issues, and serves as a cautionary tale for valuation professionals. Even the most routine engagement can, under certain circumstances, lead to massive potential exposure.