Valuation in **Bankruptcy**

BY GREGORY R. MARSH

ON FEB. 27, 2008, the Financial Accounting Standards Board (FASB) issued proposed FASB Staff Position 90-7, an Amendment of AICPA Statement of Position 90-7. The proposed amendment would remove the requirement in AICPA Statement of Position 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code (SOP 90-7), that an entity applying fresh-start reporting must early adopt authoritative accounting standards that will be applicable to the emerging entity's financial statements within 12 months following emergence.

SOP 90-7 was issued in 1990 to provide guidance on financial reporting for entities that file petitions with the bankruptcy court and expect to reorganize as a going concern under Chapter 11 of Title 11 of the U.S. Code. It has remained the primary guidance for financial reporting by entities in reorganization since that time.

Under SOP 90-7, entities meeting certain criteria are required to adopt Fresh-Start Accounting (FSA), under the assertion that the emerging company is a new and different successor entity, and since historical costs and accounts of the predecessor company are no longer representative of contracts that have been renegotiated, all assets (and now liabilities) should therefore be reported at their current fair value. Paragraph 38 of SOP 90-7 requires, in part, that the reorganization value of the emerging entity be allocated to the entity's assets in conformity with the procedures specified by FASB Statement No. 141, Business Combinations (FAS 141).

In recent years, the FASB has moved from encouraging early adoption to prohibiting early adoption of its new pronouncements. This is true of two new standards scheduled to take effect this year that will require significant changes in the way asset and liability values are determined and reported following an acquisition. One of them is a comprehensive revision of FAS 141, which will require major changes in the way the fair value of acquired assets is reported beginning Dec. 15 of this year.

FASB Statement No. 141

FASB Statement No. 141 (revised 2007) Business Combinations, (FAS 141R), nullifies or replaces five other existing FASB pronouncements, and makes significant amendments to 80 others. One of those affected is SOP 90-7, in which two key paragraphs were modified to read as follows (additions underlined; deletions italicized):

1. Paragraph .38:
Entities that adopt fresh-start reporting in conformity with paragraph .36 should apply the following principles:

• The reorganization value of the entity should be assigned to the entity's assets <u>and liabilities</u> in conformity with the procedures specified by FASB Statement No. 141 (<u>revised 2007</u>), Business Combinations. If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts should be reported as goodwill in accordance with paragraph 6 of FASB Statement No. 142, Goodwill and Other Intangible Assets.

• *Each liability existing at the plan confirmation date, other than deferred taxes, should be stated at present values of amounts to be paid determined at appropriate current interest rates.*

2. Paragraph .64:
A general restructuring of liabilities involves negotiation between the parties in interest. The negotiation and distribution under the confirmed plan constitutes an exchange of resources and obligations. By analogy, the guidance provided by *APB Opinion 16* <u>FASB Statement 141(R)</u> for recording liabilities assumed in a business combination *accounted for as a purchase* should be applied in reporting liabilities by an entity emerging from Chapter 11.

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ART BY NEWSCOM

New fair value standard set to change the corporate reorganization game.

These seemingly minor changes to SOP 90-7 create a link to existing and new FASB fair value accounting standards that will become effective on Dec. 15 of this year. The effect is not minor, however, and it will change how reorganization value and intangible asset values of distressed companies are determined and reported.

This is particularly relevant in a bankruptcy setting, because the values reported in accordance with SOP 90-7 are the very same ones that appear in the disclosure statement, plan of reorganization, and are submitted as evidence to support or defend against various motions that ultimately determine claimholder recoveries.

Bankruptcy and the 2005 Act

To the extent that the values determined under generally accepted accounting principles (GAAP) will continue to be used and accepted by bankruptcy courts and creditors in negotiating asset values in relation to adequate protection, fraudulent transfers, avoidable preferences, equitable subordination and confirmation of a plan, a claimholder's command of the new valuation requirements and acceptable methodologies will be a critical determinant of a successful recovery. This is even more important since the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which limits a debtor's ability to obtain extensions of the exclusive period to file and solicit acceptance of its own plan of reorganization.

The changes introduced by the 2005 revisions in bankruptcy law have often been described as "sweeping," and while that may be true for consumers and their creditors, the effect on businesses filing for Chapter 11 protection has been less apparent.

The 2005 Act modified the time periods used to define preferences and reclamations, and further reduced the time allowed for lease rejection and tax payments. The obvious practical result of these provisions is that more pre-petition planning is now required in order to comply with the new law. The broader effect of the 2005 Act's additional creditor protections seem to have had the most influence outside the bankruptcy arena, in that corporate bankruptcy filings declined precipitously in 2006 to the lowest number seen in over 20 years.

Powerful Tool for Claimholders

The greatest impact on claimholders will result from the new time restrictions on the debtor's exclusive right to file and solicit acceptance of a plan. The previous law imposed no limit for extensions of the exclusive right beyond the initial 120 days. While any claimholder is free to vote against a reorganization plan, the new 18 month exclusivity period will present more opportunities for claimholders to propose their own plan and more effectively promote a particular reorganization value. Combined with the proper application of the new fair value accounting rules, this can become claimholders' most powerful negotiation tool, as it directly changes the bargaining range within which reorganization value is determined.

While any person who holds any of the debtor's claims is entitled to submit a reorganization plan, the success of such a strategy is in part dependent on the claimholder's credibility with the judge, who must approve the plan before it can be put to a vote.[1]

As claimholders are presented with this option more frequently, the range of proposed reorganization values is likely to increase, and with it the unpredictability of payouts and recoveries. A total of five plans were filed in Revco's 1991 Chapter 11 bankruptcy, and two of those included proposed acquisitions submitted by competitors Rite-Aid and Eckerd.

Although analysts had valued Revco at between $800 million and $900 million, Rite-Aid's plan amounted to a proposed buyout for $730 million in cash and stock. In the surprising conclusion of a four year battle, a creditor group gained acceptance of its own plan to keep Revco independent, which included an unexpected cash investment to fund higher payouts to secured creditors, and gave the stockholders nothing.

As they are presented, the FASB pronouncements and bankruptcy laws appear to be determinative of the value of creditor and shareholder claims. In practice however, minimum legal standards such as the absolute priority rule and cramdown provisions are routinely violated by agreement in favor of an expedient confirmation, the continued services of owner/managers, or other settlements negotiated in an effort to preserve the remaining value of assets.

While an estimate of reorganization value must be presented to creditors and the court during various stages of the bankruptcy process, this value may be revised multiple times in response to one or more claimholder's opinion or knowledge that certain assets have been undervalued or perhaps have gone unrecognized.[2]

Similarly, the true realizable value of the debtor's assets often turns out to be quite different than the negotiated reorganization value used to determine payouts in bankruptcy situations or out of court restructurings. This is because various parties are motivated to promote vastly different asset and reorganization values in an effort to realize a higher payout to their class.

Senior claimholders benefit from a lower reorganization value because they then receive a greater portion of the consideration available for distribution, especially when it includes stock or warrants. Unsecured creditors are last in line to be paid, and therefore prefer a higher reorganization value to avoid getting squeezed out by the priority claims.

A well publicized example of this phenomenon is the confirmation, on March 9, 1993, of the reorganization plan of National Gypsum over opposition by the junior bondholders committee, which alleged that Gypsum management had intentionally manipulated financial data and operating projections to lower the valuation. Gypsum's reorganization value implied that the common stock was worth $12 per share, and one year later it was trading at $40.

New Rules Change the Outcome

Intended to benefit the users of financial statements generally, the increased rigor of the valuation methodology mandated by the recent FASB pronouncements can be expected, through their application to fresh start accounting rules, to increase the importance of actively participating in the valuation process in a bankruptcy or out of court restructuring.

To understand why this is so, it is helpful to understand some of the major provisions of FAS 141R and FAS 157, and how they might interact with SOP 90-7 in a reorganization setting.

FAS 141R turns one of the oldest generally accepted accounting principles on its head. The conservatism principle essentially mandates that estimates of asset value should be the lower of two traditional reference points, cost or market value. For acquired companies (and now companies emerging from Chapter 11), however, FAS 141R will require asset and liability values to consist of estimates that reflect the fair value standard as defined by FASB Statement No. 157, Fair Value Measurement (FAS 157). The two statements are coordinated: FAS 141R specifies what assets and liabilities must be identified and valued in an acquisition scenario, and then directs us to FAS 157 for guidance on how those value estimates should be made.

The result is that asset values will be reported at fair value, even if the sum of the parts is different than the cost paid by the acquirer. FAS 141R requires immediate recognition of this difference in the form of a gain or loss reported on the new or emerging entity's opening income statement. Some of the other significant changes introduced by FAS 141R are:

• Transaction costs must be expensed, and not capitalized as part of the purchase price.

• Contingent consideration (e.g., earnout payments) must be estimated and booked on the balance sheet as an assumed liability, which will increase the amount of goodwill.

• The value of potential impairments of assets and contingent liabilities must be quantified and recognized.

• Future restructuring costs will no longer be recognized as an accrued liability, and instead must be expensed in the period they are incurred.

Arriving at these estimates will be challenging for any acquirer, and to the extent they will determine reorganization value, obtaining agreement among claimholders will be particularly difficult.

For example, to predict the amount for which a lawsuit against the company will be settled, FASB's Concepts Statement 7 points to the use of a probability matrix as an acceptable methodology, but it does not specify how the probabilities of total victory, partial settlement, or total loss are to be determined. In contrast, the known restructuring costs to be incurred as part of a reorganization will not be reported on the balance sheet, although they will surely enter into the reorganization value analysis as a predictable and quantifiable reduction in cash flow.

The effect of any inaccuracies in the estimates made under FAS 141R will extend to future years because periodic fair value adjustments to the assets and liabilities must be reported on the income statement as gains, losses, expenses and income.

The New Fair Value Standard

Already effective for fiscal years beginning after Dec. 15, 2007, for financial assets and liabilities, the effective date of FAS 157 for nonfinancial assets and liabilities is deferred to fiscal years and interim periods beginning after Dec. 15, 2008.

One of the major themes of FAS 157 is that fair value is an exit price for which an asset could theoretically be sold to a market participant who would employ it at the highest and best use. What the acquirer actually paid for the asset or how it will actually be used is, with limited exceptions, ignored under FAS 157.

An extreme, yet fairly common, example is a brand or trade name that an acquirer intends to retire permanently and replace with its own. Under the old accounting rules, the buyer would write the value down to zero, but since such an asset qualifies as identifiable under FAS 141R, it must be recognized and booked on the balance sheet at a value that reflects what a competitor would pay for it in accordance with FAS 157.

FAS 157 requires the reported values of both assets and liabilities to reflect realizable market prices, whether or

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Appraising Overseas Residence

it possessed all of the important attributes of the property being appraised; and

• Reconcile the opinions into an estimate of market value for the subject.

American or Foreign Appraiser?

In selecting an appraiser to value foreign residential property, it is necessary to consider whether the appraiser should be an American appraiser or a foreign appraiser. While many U.S.-based appraisers have been asked to value properties in other countries, the task is generally considered "somewhat akin to valuations in other areas of the United States outside a particular appraiser's normal market experience, but…far more difficult because of the complexities of property ownership systems, laws, customs, and local markets in other countries."[21]

James Casson, a member of the Appraisal Institute, and managing director of Albert Valuation Group, says: "The trick is getting the market data, i.e., comparables, when you do not speak the language or are not familiar with the local customs and culture. It is that simple and that complicated."

Indeed, some U.S.-based appraisers will not even undertake the assignment to appraise foreign property due to the very issues raised by Mr. Casson. For example, Jonathan J. Miller, CRP (Certified Relocation Professional), President/CEO of Miller Samuel Inc., said that it is "far too complex and not realistic" for an American appraiser to independently appraise a foreign property and that "in the end, the reliability of the final product may be questionable."

The barriers to collecting market data by an American appraiser include the language barrier, unfamiliarity with local laws, customs, nuances and market trends, as well as the lack of connection to the local bureaucracies.

Mr. Casson says that the most difficult aspect of preparing a foreign appraisal is the "language barrier" and "reluctance on the part of the local bureaucrats to share data with outsiders." Mr. Casson encountered particular difficulties when conducting a recent appraisal in Normandy due to the fact that "sales and confirmation data [were] considered by most market participants to be extremely confidential and of a non-public nature." Mr. Casson claims that he relied on his "abundance of patience and a touch of personality" to overcome these hurdles.

An American appraiser must quickly familiarize himself with the pace and style of the local people, which may include recognizing that few bureaucrats work in the mid-afternoon in Spain, or that certain countries, such as France, go on vacation for the entire month of August.

Finally, the cost can be very high as it requires not only the base project fee, travel expenses and extra time involved for an American appraiser to acclimate and learn the culture and market nuances, but also, according to Mr. Casson, the extraordinary research fees which include the hiring and "wining and dining" of local contacts to secure the required property information.

There are, however, certain benefits to hiring an American-based appraiser. Specifically, an American appraiser will be licensed and accredited pursuant to the state and federal requirements, as well as have the recognized accreditations. He will also be able to employ accepted appraisal methodology recognized in the New York courts and appreciated by New York judges, so the process of qualifying the appraiser as an expert and having the report admitted into evidence can be accomplished without much difficulty. In addition, an American appraiser is more likely to be available to later testify in court without undue delay or language barrier.

On the other hand, using a local foreign appraiser provides the benefit of utilizing first-hand, comparable, local market information, and knowledge of the local real estate market, trends and property nuances. In addition, there is an added benefit of saving significant time and money.

There are also significant disadvantages to using a local foreign appraiser. Specifically, while there are several initiatives to create a universal standard for real estate appraisals, currently there are none accepted worldwide.[22] As such, the methodology and standards employed by foreign appraisers vary greatly. For example, Mr. Miller explains that in England an appraiser is called a "surveyor," and that in most cases a surveyor is also a broker. As such, there is an implied bias in the appraisal provided. While this bias is recognized in England and thus offset by the finder of fact, presenting the appraisal to a New York court would be a challenge. Accordingly, due to the varying standards and qualifications of foreign appraisers, a New York practitioner may encounter significant difficulty in qualifying the witness as an expert and having the appraisal admitted into evidence.

Another difficulty when selecting a local foreign appraiser is the real potential for a language barrier, even if the appraiser speaks English. Translators can certainly be used to overcome the burden of communicating and translating the final written product; however, even with a translator, certain language nuances may be missed, and important information lost in translation.

Finally, there is also the question of the foreign appraiser's availability to testify in the event that it becomes necessary at trial.

A Good Compromise. While hiring an American or local foreign appraiser each has its benefits and burdens, a good compromise, to render arguably the most accurate and reliable work product, is hiring an American-based appraiser who in turn hires and relies on a local foreign appraiser for his day-to-day market research and analysis.[23] The American appraiser would then evaluate the findings and present the information, with full disclosure of his sources and the potential biases, by utilizing the methods and standards accepted by New York courts. Mr. Miller states that "in this way, the American appraiser can review the materials to make sure that the numbers support the results and thereby offset any implied biases of a foreign appraiser." This method also significantly reduces the time and cost of having an American conduct the appraisal solo, and insures that the report comports with the methodology and standards expected by New York courts.

While hiring an American or local foreign appraiser each has its benefits and burdens, a good compromise is hiring an American-based appraiser who in turn hires and relies on a local foreign appraiser for his day-to-day market research and analysis.

Finding Qualified Appraisers

Although this may seem an easy matter, many have found it particularly challenging to locate either an American appraiser who will undertake the appraisal of a foreign property, or a local foreign appraiser.

To locate an American appraiser, a New York practitioner should contact reputable real estate appraisers they have worked with in the past. Other American sources include the Appraisal Institute, AQB, The Appraisal Foundation, and the New York Board of Real Estate Appraisers. A practitioner should also explore international real estate brokerage companies, such as Sotheby's and Christie's.

To research appraisers globally, some resources include: International Valuation Standards Committee (www.IVSC.org); The Royal Institution of Chartered Surveyors (RICS) (www.RICS.org); International Real Estate Federation (www.FIABCI.org); German Association of Mortgage Banks (www.HypZert.com); The European Group of Valuers' Associations (www.tegova.org); International Federation of Surveyors (www.fig.net); Union of Pan-American Valuation Organizations (www.upav.be); Brazilian Appraisal Institute; Korea Appraisal Board (www.ibape.org); Korea Association of Property Appraisers (www.kapanet.or.kr/eng); Japan Real Estate Institute (www.reinet.or.jp); China Institute of Real Estate Appraisers and Agents (www.anevar.ro); Ukrainian Society of Appraisers (www.uto.com.ua); National Association of Romanian Valuers; and Mexican Federation of Valuation Colleges (www.fecisvalmexico.org).

In sum, when the issue of residential real property in a foreign country presents itself in the context of a matrimonial action, special care and attention must be given to select the appropriate appraiser to value the property. Whether the appraiser is American or foreign must be determined in the context of the overall situation, taking into consideration the location of the property, the cost and time involved and various language and cultural constraints. The pitfalls are many, but can be properly addressed with appropriate research and planning.

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1. *Vogel v. Vogel*, 156 AD2d 671, 549 NYS2d 438 (2d Dept. 1989); *Niles v. Niles*, 126 AD2d 874, 510 NYS2d 970 (3d Dept. 1987).
2. See *Xikis v. Xikis*, 43 AD3d 1040, 841 NYS2d 692 (2d Dept. 2007) (wife was not entitled to an award of any appreciation in value in husband's separate property where there was no nexus between her activities and the property's appreciation); *Hartog v. Hartog*, 85 NY2d 36, 48, 647 NE2d 749, 623 NYS2d 537 (1995) (although marital residence was "separate property," trial court awarded 50 percent of appreciation of value of residence where defendant established that subsequent appreciation value was attributable to both parties' efforts).
3. 19 Carmody-Wait 2d §118:197 (March 2008) (citations omitted).
4. Id. (Citing *Eli v. Eli*, 123 AD2d 819, 507 NYS2d 435 (2d Dept. 1986) (holding that the court did not err in distributing to the wife 100 percent of all marital property available for disposal, where the determination was largely in favor of husband with respect to the wife's major property claims to assets and property in Iran which was precluded from distribution by diplomatic and political relations between Iran and the United States)).
5. 48A N.Y. Jur.2d Domestic Relations §2630 (citations omitted).
6. Id. (Citations omitted).
7. Id. (Citations omitted).
8. See id.
9. See, e.g., *Vainchenker v. Vainchenker*, 242 AD2d 620, 662 NYS2d 545 (2d Dept. 1997); *Amisson v. Amisson*, 251 AD2d 274, 672 NYS2d 801 (2d Dept. 1998); *Harris v. Harris*, 242 AD2d 558, 662 NYS2d 532 (2d Dept. 1997); *Iwahara v. Iwahara*, 226 AD2d 346, 640 NYS2d 217 (2d Dept.1996); *Kaye v. Kaye*, 192 AD2d 365, 596 NYS2d 33 (1st Dept. 1993); *Vogel v. Vogel*, 156 AD2d 671, 549, NYS2d 438 (2d Dept. 1989).
10. See Advisory Committee Notes to Fed. Rule Evid. R. 706.
11. Id.; 11 N.Y. Prac., New York Law of Domestic Relations §14:86.
12. DRL §237; see also 48A N.Y. Jur.2d Domestic Relations §§2576 and 2659.
13. 11 N.Y. Prac., New York Law of Domestic Relations §14:86.
14. Id.
15. 3 New York Matrimonial Law and Practice §19:4.
16. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999); *Daubert v. Merrell Dow Pharms.*, 509 U.S. 579 (1993); *Frye v. U.S.*, 293 F. 1013 (D.C. Cir. 1923).
17. *Meiselman v. Crown Heights Hospital*, 285 NY 389, 398-399, 34 NE2d 367 (1941); *Tallowe v. Metropolitan Ski Slopes Inc.*, 28 NY2d 410, 414, 322 NYS2d 665, 271 NE2d 515 (1971); see also 3 New York Matrimonial Lawyer and Practice §19:4 (citations omitted).
18. See www.appraisalfoundation.org.
19. See www.AppraisalInstitute.org/profession/appraiser.
20. See www.appraisalinstitute.org.
21. John D. Dorchester, Jr. and Joseph J. Vella, "Valuation and the Appraisal Institute in a Global Economy: The European Initiative," The Appraisal Journal (January 2000), at 72.
22. John D. Dorchester, Jr. and Joseph J. Vella, "Valuation and the Appraisal Institute in a Global Economy: The European Initiative," The Appraisal Journal (January 2000), at 72.
23. Expert testimony can be based on hearsay evidence if the hearsay is a type commonly relied upon by experts in the field. See 2 Equit. Distrib. of Property 3rd, §7:5 (citing *Tumminello v. Tumminello*, 234 AD2d 448, 651 NYS2d 66 (2d Dept. 1996) (citation omitted)); see also *Hinlicky v. Dreyfuss*, 6 NY3d 636, 648, 848 NE2d 1285, 815 NYS2d 908 (2006); *Greene v. Xerox*, 244 AD2d 877, 877-878, 665 NYS2d 137 (1997), lv denied 91 NY2d 809 (1998).

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Personal Property Appraisals

It is the appraiser who, once hired, generates a contract expressing the terms and conditions of the appraisal.

Procedure After Appraiser Hired

The contract will be signed by both parties and should include provisions that cover:

• the identification of the appraiser and the client,
• the purpose of the appraisal,
• the services that will be provided,
• fees and out of pocket costs,
• the time frame,
• access to the personal property,
• indemnity,
• impossibility of performance,
• modification to the agreement,
• remedies in case of an event of default that impacts on expenses,
• inability to complete the appraisal, and
• a clause to be held harmless from all liability.

An appraiser requires a partial payment before starting. Contracts are not standardized because of the many aspects of each appraisal.

The appraiser arranges the first visit to the client's home, office or storage facility; everything should be available for the appraiser's physical examination.

The client or the client's authorized representative and the appraiser spend the first visit together. At that time the appraiser examines the items, requests available materials such as copies of receipts, bills of sale, artist's biography, manufacturer's certificate of authenticity, dates of purchase, cost of purchase, knowledge of the history of the item (inherited, purchased, bought at an estate sale) and all other relevant materials.

The appraiser photographs all items as proof that they exist, particularly if it is an insurance appraisal, and for documentation purposes. Digital photographs are easily e-mailed to other experts for their opinion of value.

The appraiser will measure each item, check the condition, which is categorized as excellent, good or poor, find markings or signatures, identify the item by artist or manufacturer, and describe the item with title for an artwork or type of furnishing, material or medium, provenance if available.

The final appraisal report will include the research findings, comparable items used to establish value, how the values were arrived at, and the value stated as a dollar amount, not an estimate. Labeled digital photographs will identify all items in the appraisal. Sources and experts will be listed in a bibliography along with the qualifications of the appraiser.

There are three approaches to determining value that are explained in the final appraisal report. The one most commonly used in personal property appraisals is the sales comparison approach. This method compares the subject property to others that have sold at auction or retail. The appraiser will refer to comparables that show like items that sell in the primary and secondary markets.

The other two valuation approaches are the cost and the income approach. The cost approach is for a damage or loss appraisal when an item needs to be replaced with another of similar qualities. For example, the damaged item is a painting. A similar painting by the same artist of a similar theme, size, medium, condition, date, value, replaces the previous painting and the value is established based on other sales.

The income approach is one that analyzes future income from an item. An example: the estate of American architect Frank Lloyd Wright decides to replicate one of his wooden chairs at a greatly reduced price. The chair is marketed to the general public and fetches a stream of revenue.

Once the appraiser finishes the research and completes the valuation process, the appraisal report is composed and organized in an explicitly readable fashion. The appraiser's findings and valuations are based on the appraiser's expert knowledge and research. Valuations are not contestable. The Appraisers Association of America, under "Elements of a Correctly Prepared Appraisal," communicates the components of a professionally prepared appraisal with writing guidelines; see www.appraisersassoc.org.

Finally, the appraisal report and the original notes from which it was prepared are confidential. The appraiser will not allow access to them without the permission of the client, or the client's authorized representative(s).

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The New Fair Value Standard

not a real market exists. Its effects will soon appear in the financial statements of companies that experienced a revaluation event, merger, or reorganization in the first quarter of 2008. One of the most anticipated effects is the requirement that the face value of a liability be adjusted to fair value in the event a re-allocation of value is necessary under FAS 142, FAS 141, SOP-90, or one of many other FASB pronouncements.

This would mean, for example, that a financially distressed company recognizing a goodwill impairment charge under FAS 142 will also have to write down its unsecured debt to the extent the fair value of the promissory note has declined due to increased default risk. The surprising offsetting entry specified by FAS 157 is to record a gain on the income statement, which has been pointed out by many to be counterintuitive and perhaps even a bad faith representation, in light of the fact that the bank indenture is still in force for the full amount of the loan.

Conclusions

The far-reaching effects of the new FASB pronouncements will be most apparent in an acquisition or reorganization scenario, because that is where the fair value determination reflects an immediate and explicit exchange of value between and among buyers, creditors and stockholders.

This contrasts with the gradual, delayed adoption of the new fair value standard and valuation methodologies most companies will experience under generally accepted accounting principles, which require a real event or adoption of a change in accounting method to trigger a revaluation of assets or liabilities. Even then, under FAS 133 or FAS 159 for example, only affected or selected assets are revalued and the effect on the company balance sheet may be insignificant or materialize over many years.

Since the value exchanged between claimholders has in the past been influenced as much by negotiation and court approval as it has by regulation and statute, valuation analyses can be expected to play a greater role in the process because the new standards will require

1) less speculation and more objective evidence in determining reorganization value,

2) identification of previously unrecognized or undervalued intangible assets that can be associated with specific income streams, comparable market transactions, or reproduction costs, and

3) application of the fair value standard, which recognizes incremental value resulting from potential synergies with other assets, even if unrealizable by the subject company itself.

The proposed FASB amendment to SOP 90-7 may appear on its surface to be only a technical clarification, but in reorganizations already underway, it could significantly change the prospects for recovery of some claimholders by delaying the adoption of the new fair value accounting rules that will change how reorganization value is determined. In any case, companies emerging from Chapter 11 on or after Dec. 15 that are required to adopt the Fresh Start Accounting rules under SOP 90-7 will also be required to adopt the new fair value accounting standards.

The full effect of these changes on the reorganization and restructuring process remains to be seen, but they will increase the focus on the valuation analysis and its power as a negotiating tool. This should present significant opportunities for well-informed claimholders to identify undervalued or overvalued assets, and to improve their prospects for recovery.

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1. This is now also true of pre-confirmation modifications under §1127(f), which was added by the 2005 Act.
2. Section 321 of the 2005 Act formalizes preconfirmation plan modifications by requiring adequate notice and opportunity for a hearing.

Qualified Appraisals and Donation of Artwork

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Donor Penalties. For purposes of the federal income tax, a valuation misstatement is considered "substantial" when the donor values the donation at 150 percent of the correct value as determined by the IRS, or, if the matter is litigated, by a court of competent jurisdiction. For example, if the donor values a gift at $150,000, but the correct value is only $100,000, a 20 percent penalty will be imposed on the amount of the underpayment due to the IRS. With respect to a "gross" valuation misstatement, the 40 percent penalty on the amount of underpayment will be triggered where the misstatement is at least 200 percent of the correct value as determined by the IRS or a court of competent jurisdiction. Therefore, if the donation was reported as having a value of $200,000 but the correct value is $100,000, then the 40 percent penalty will be triggered.

Appraiser Penalties. An appraiser is subject to a penalty if the appraiser knew or reasonably should have known that the appraisal would be used in connection with a tax return and the claimed value of the property would result in a substantial or gross valuation misstatement. The penalty to which an appraiser is subject is the greater of (i) $1,000 or (ii) 10 percent of the amount of tax attributable to a substantial or gross valuation misstatement (capped at 125 percent of the gross income received by the appraiser for the valuation). Furthermore, appraisers should be aware that they can be barred from practicing before the Treasury or the IRS for valuation misstatements. The IRS will not penalize an appraiser, however, if it is determined that the value established in the appraisal is "more likely than not" the correct value.

Conclusion

There are significant areas of concern when seeking a deduction for any kind of charitable contribution. The donor faces possible consequences that range from the complete loss of the donation to the imposition of stiff penalties if a required appraisal is not appropriately and accurately prepared. Appraisers themselves can also face penalties. With donations of artworks, the need for careful attention to the appraisal process can be significantly increased. Care must be taken to find an appraiser with expertise in the particular type of artwork donated. In addition, there are indications that donations of artworks could be subject to greater scrutiny by the IRS in coming years.

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1. See Appraisal Standards Board, "Ethics Rule," Uniform Standards of Professional Appraisal Practice (2008-2009) at U-8.
2. See, IRS Publication 561, "Determining the Value of Donated Property" (Rev. April 2007).
3. Jason Felch and Doug Smith, "Inflated Art Appraisals Cost U.S. Government Untold Millions," Los Angeles Times, March 2, 2008.