

U.S. Bank National Association v. Verizon Communications, Inc.: What Was the Value of Idearc?

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The focus of this discussion is the U.S. Bank National Association v. Verizon Communications, Inc., decision as it relates to the spin-off of the Verizon Communications, Inc. ("Verizon") directories business, Idearc, Inc., ("Idearc"). Idearc filed for bankruptcy 28 months following its spin-off from Verizon. Amidst reorganization, Idearc filed an action against Verizon, contending that Idearc was loaded with so much debt in the spin-off that it was insolvent and destined to collapse. The Verizon decision highlights various factors a valuation analyst should consider in the application of (1) the guideline publicly traded company method, (2) the guideline merged and acquired company method, and (3) the discounted cash flow method. The Verizon decision also highlights factors and procedures a valuation analyst should consider when reconciling the values estimated using the selected valuation methods.

INTRODUCTION

The increase in business bankruptcies during the recent economic period has resulted in an increased demand for bankruptcy valuation and financial advisory services. This discussion of the *Verizon* decision highlights some of the factors that a valuation analyst should consider when performing a bankruptcy valuation analysis.

In *U.S. Bank National Association v. Verizon Communications Inc.* ("Verizon") the U.S. District Court ruled on the value of Idearc, Inc. ("Idearc"), an incumbent printing business, at the time of its spin-off from Verizon in November of 2006.¹

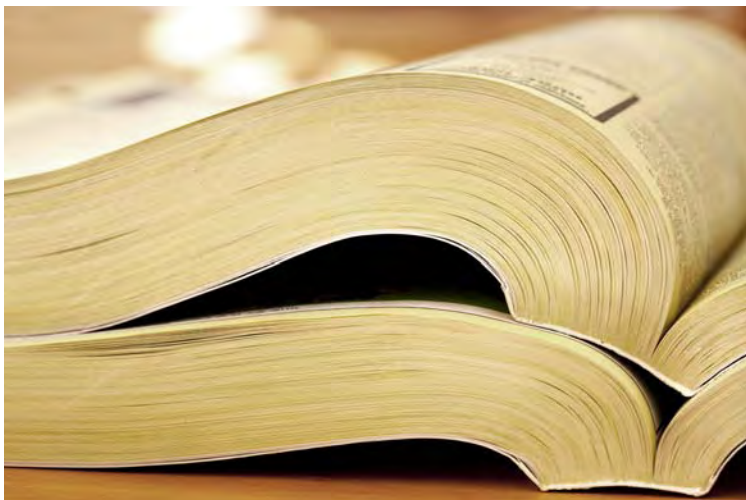
The U.S. District Court for the North District of Texas ("district court") opined on the value of Idearc and on the application of various valuation procedures performed by the analysts for the plaintiff and the defendants. The valuation procedures included (1) the market approach, guideline publicly traded company method and guideline merged and acquired company method, and (2) the income approach, discounted cash flow method.

The district court ruled that the valuation analysis presented by the plaintiff was flawed. This was due to certain incorrect or unsupported assumptions and considerations made in the analysis.

THE FACTS OF THE CASE

In the context of reorganization following bankruptcy, the plaintiff, U.S. Bank National Association, as Litigation Trustee of the Idearc, Inc., Litigation Trust (the "trustee"), filed an action against the defendants, Verizon Communications, Inc., Verizon Financial Services, LLC, GTE Corporation, and John Dierksen (collectively "Verizon"). The plaintiff alleged a variety of claims arising out of Idearc's spin-off from Verizon in 2006. The primary allegations were that (1) the transaction was a fraudulent conveyance and (2) the defendants misrepresented Idearc's value to the market.

The district court issued an order bifurcating the trial, limiting the first phase of the trial to the determination of Idearc's enterprise value at the time it



was spun off from Verizon in November 2006. All the remaining factual questions were reserved for a potential second phase of the trial.

The district court dismissed the trustee's fraudulent conveyance claims related to \$7.1 billion in debt and the shares of stock that Idearc issued to Verizon in exchange for Verizon's domestic directories business at the time of the spin-off. Further, the district court dismissed the trustee's claim for unjust enrichment and for alter ego to the extent it was pled as a separate case of action.

The district court dismissed the trustee's fraudulent conveyance claims related to Idearc's transfer to Verizon of approximately \$2.5 billion in cash at the time of the spin-off on the grounds that such claims were barred by Bankruptcy Code Section 546.

About the Parties

Idearc was a wholly owned subsidiary of Verizon engaged in the directories business prior to the November 17, 2006, spin-off. Idearc operated as an independent New York Stock Exchange-traded company for two years following the spin-off. However, in March 2009, 28 months after the spin-off and during the recent economic recession, Idearc filed a petition for reorganization under Chapter 11.

As part of the reorganization claim to pursue potential claims against the defendants, Idearc created the litigation trust, with U.S. Bank National Association as the trustee.

The defendant, Verizon, is a publicly traded company. Verizon Financial Services, LLC, and GTE Corporation were entities owned by Verizon. Dierksen was an officer of Verizon and served as the sole director of Verizon Directories Disposition Corporation (which became Idearc) from its formation in June 2006 through November 16, 2006.

Verizon's directories business was a mature and stable business, capable of generating significant cash flow and attractive to investors for this reason. At the time of the spin-off, Verizon's Information Services division was the second-largest directories business in the United States. This division published more than 1,200 directories in 35 states and the District of Columbia.

Idearc was the incumbent publisher in 316 markets in the legacy GTE/Bell Atlantic regions and an independent publisher in 42 markets. Idearc had a presence in 81 of the top 100 telecommunications markets across the United States.

Historically, Verizon's directories business produced revenue of more than \$3.4 billion annually. Revenue for the latest 12 months ended June 30, 2006, totaled \$3.3 billion. Its earnings before interest, taxes, depreciation, and amortization (EBITDA) margin was approximately 50 percent. Verizon's electronic business and independent print "achieved high-10% margin and low-20% margin, respectively."² Adjusted EBITDA totaled approximately \$1.7 billion in 2005.

The Verizon filings with the U.S. Securities and Exchange Commission (SEC) indicated decreasing revenue generated by its directories business between 2001 and 2006. Additionally, Verizon provided private-side investors with management-prepared forecasts that showed a flat projected EBITDA and decreasing projected free cash flow between 2006 and 2010.

Due to significant investor interest in directories companies, stand-alone directories companies traded at as much as 10 times EBITDA. By comparison, Verizon's directories business was trading at only around 5.0 to 5.5 times its EBITDA.

Investment bankers advising Verizon suggested that investors may have viewed Verizon's directories business as less valuable because Verizon owned it. They opined that Verizon and its directories business would be more valuable if investors could hold them as two separate stocks.

The Transaction

Verizon completed the Idearc spin-off on November 17, 2006. Verizon contributed its domestic print and electronic directories business to Idearc in exchange for approximately \$7.115 billion in Idearc debt, \$2.5 billion in cash, and 146 million shares of Idearc common stock.

In connection with the spin-off, Idearc incurred \$9.115 billion in debt and received commitments from financial institutions to lend it up to an additional \$250 million through a revolving credit facility. The debt was comprised of the following:

1. \$1.515 billion secured term loan A
2. \$250 million revolving credit facility
3. \$4.75 billion secured term loan B
4. \$2.85 billion in senior notes (“unsecured notes”)

The Idearc spin-off generated significant demand for its debt securities.

The parties structured the transaction as a tax-free event and entered into a tax sharing agreement (TSA). The TSA allocated liability between the parties should the Internal Revenue Service (the “Service”) later determine that the event did not qualify as a tax-free event. The TSA was filed with the SEC on November 21, 2006.

Valuations Prior to the Transaction

In the summer of 2005, an internal Verizon document indicated an enterprise value of \$6.5 billion for its directories business, which was a result of a “downside case” discounted cash flow analysis evaluating a worst-case scenario for the stand-alone print business.

In Verizon’s “strategic update” to the board of directors in November 2005, the enterprise value of its directories business ranged from \$10.5 billion to \$15.0 billion. This analysis was subsequently refined and the final concluded enterprise value was \$12.8 billion.

Around 2006, several private-side investors, including Morgan Stanley, Citibank, JP Morgan Chase & Co., and Goldman Sachs Group Inc., performed their own valuations of Verizon’s directories business, which would become Idearc. Each of the companies prepared its own projections for revenue, EBITDA, and cash flow.

Morgan Stanley estimated a decrease in EBITDA and cash flow between 2006 and 2013. Morgan Stanley concluded that Idearc’s enterprise value was \$12.5 billion and its equity value was \$3.4 billion around the date of the spin-off.

Citibank projected year-over-year decreases in revenue and EBITDA margins for Idearc, which resulted in estimated enterprise values ranging from \$11.7 billion to \$14.4 billion. JP Morgan Chase & Co., created a downside case scenario estimating annual decreases in revenue and adjusted EBITDA.

Goldman Sachs also prepared a downside projection, which reflected annual decreases in EBITDA and cash flow between 2006 and 2014. Goldman Sachs concluded an enterprise value of \$12.5 billion and equity value of \$3.5 billion for Idearc around the date of the spin-off.

Houlihan Lokey, Inc. (“Houlihan”) performed a valuation analysis in connection with a solvency opinion prepared for Idearc in the fall of 2006.

THE PLAINTIFF’S POSITION IN THE DISPUTE

The plaintiff argued that (1) the transaction was a fraudulent conveyance and (2) the defendants had misrepresented the value of the Verizon’s directories business to the market. According to the plaintiff, Verizon portrayed its directories business as having significant potential for growth, while secretly considering it a “dying harvest business” undergoing a “secular change” that needed to be sold.

Idearc’s creditors contended that the spin-off was designed to generate \$9.5 billion for Verizon, leaving Idearc with a significant amount of debt, thus making Idearc insolvent and slated for bankruptcy.

The plaintiff presented evidence of Idearc’s value in the form of a valuation report and valuation expert testimony.

Valuation Methodology: Plaintiff’s Analyst

The plaintiff’s analyst estimated the enterprise value of Idearc as of November 17, 2006 (the “valuation date”), using the following:

1. The guideline publicly traded company method of the market approach
2. The guideline merged and acquired company method of the market approach
3. The discounted cash flow (DCF) method of the income approach

The Market Approach—Guideline Publicly Traded Company Method

In the guideline publicly traded company method, the plaintiff’s analyst estimated the enterprise value of Idearc based on EBITDA multiples of five selected guideline publicly traded companies.

The plaintiff’s analyst used the same guideline publicly traded companies and used the same multiples that Houlihan used when it performed a valuation in connection with a solvency opinion prepared for Idearc in the fall of 2006. These guideline companies included (1) Eniro AB, a Nordic company; (2) Seat Pagine Gialle SpA, an Italian company with subsidiaries in the United Kingdom; (3) Yellow Pages Income Fund, a Canadian company; (4) Yell Group plc, a United Kingdom company with operations in

the United States, Spain, and a number of countries in Latin America; and (5) RH Donnelley Company.

Of the five guideline companies, only one company, RH Donnelley Company, was an incumbent print company operating in the United States, like Idearc.

Using the guideline publicly traded company method, the plaintiff's analyst estimated Idearc values from \$11.7 billion to \$13.2 billion.

The Market Approach—Guideline Merged and Acquired Method

In the guideline merged and acquired company method, the plaintiff's analyst estimated the enterprise value of Idearc based on EBITDA multiples implied by transactions involving comparable acquired companies that were similar to Idearc.

The plaintiff's analyst used a list of 17 transactions compiled by Houlihan when it prepared its solvency opinion for Idearc in 2006. The plaintiff's analyst examined information regarding each of the transactions and determined the extent to which those transactions were appropriate to use for valuing Idearc.

Using the guideline merged and acquired company method, the plaintiff's analyst estimated Idearc values from \$13.4 billion to \$15.8 billion.

The Income Approach

Using the DCF method, the plaintiff's analyst estimated the enterprise value of Idearc based on three different cash flow projections.

For the first projection, the plaintiff's analyst made downward adjustments to the "base case" projection that Verizon prepared in 2006. For the second projection, the plaintiff's analyst used the "stress-test" projection prepared by Houlihan for its solvency opinion in 2006. For the third projection, the plaintiff's analyst used an extrapolation of the actual historical performance trend of Verizon's directories business between 2003 and 2006.

The plaintiff's analyst estimated the terminal growth rate based on the Gordon Growth Model. The plaintiff's analyst used the same terminal growth rate as the growth rate that was used for the five-year projection period between 2006 and 2010. The terminal growth rate assumed an annual rate of EBITDA decrease in perpetuity.

The plaintiff's analyst estimated a weighted average cost of capital discount rate of 9.75 percent. In calculating Idearc's cost of equity, the plaintiff's analyst incorporated a 2 percent company-specific risk premium. The plaintiff's analyst argued that this

adjustment was appropriate given certain disadvantages specific to Idearc, including the following:

1. Lower projected growth for Idearc
2. Operations concentrated in highly competitive markets
3. Lagging behind competitors in performance
4. Inexperienced management
5. Restricted strategic and financial options due to the TSA

The cost of capital assumed a capital structure of 44 percent debt and 56 percent equity.

Based on the DCF method, the Idearc enterprise value ranged from \$5.4 billion to \$6.3 billion as of the valuation date. The plaintiff's analyst concluded that the midpoint of \$5.85 billion reasonably reflected the Idearc enterprise value as of the valuation date.

The trading multiple implied by the plaintiff's analyst DCF method ranged from 3.5 to 4.2 times the Idearc 2006 EBITDA. No competitor of Idearc at the time had a market value approaching such low multiples.

Concluded Value

According to the plaintiff's analyst, Verizon's directories business performed worse than the guideline companies. The guideline companies reported recent revenue growth, while Verizon's directories business reported revenue decreases. As a result, the plaintiff's analyst opined that the companies were not comparable enough to Idearc to warrant significant weighting of the indication of value from the guideline publicly traded company method.

The plaintiff's analyst also argued that the guideline companies selected by Houlihan were not truly comparable in terms of their operations and location, given that only one company was an incumbent print company in the United States. Additionally, this particular guideline company received significant income tax benefits in connection with its purchase of Dex directories company.

These income tax benefits would not be available to Idearc after the spin-off. Based on these considerations, the plaintiff's analyst weighted the value indication from the guideline publicly traded company method 15 percent.

The plaintiff's analyst also allocated 15 percent weight to the indication of value from the guideline merged and acquired company method. In doing so, the plaintiff's analyst argued that (1) the transactions selected by Houlihan did not involve

sufficiently comparable companies and (2) the TSA prevented Idearc from accessing the transactions market. The plaintiff's analyst believed that this conflicted with the premise of the merged and acquired method—that the subject is able to access the market.

By applying a 15 percent weighting to the value indication from the guideline publicly traded company method, 15 percent to the value indication from the guideline merged and acquired company method, and 70 percent to the value indication from the DCF method, the plaintiff's analyst estimated a range of Idearc values of \$7.5 billion to \$8.8 billion.

Using the midpoint of this range, the plaintiff's analyst concluded that the Idearc value as of the valuation date was \$8.15 billion. Considering the spin-off debt of \$9.115 billion, this would mean that Idearc was insolvent following the spin-off.

The plaintiff's analyst allocated no weight to the price at which Idearc's common stock traded on the NYSE and did not include any determination of what total enterprise value for Idearc was implied by the trading price. The plaintiff's analyst argued that the price was unreliable and inflated due to Verizon's misrepresentations to the market and omissions to investors.

The plaintiff's analyst concluded that Verizon:

1. did not disclose significant differences in EBITDA margins from the incumbent print and electronic businesses,
2. concealed annual decreases in revenue in specific northeastern urban markets, and
3. failed to disclose missed management projections and pessimistic projections for the directories business.

THE DEFENDANTS' POSITION IN THE DISPUTE

The defendants presented a rebuttal to the plaintiff's analyst report and expert testimony. The defendant's analyst focused the rebuttal analysis primarily on the DCF analysis in the plaintiff's analyst expert report.

Projections

The defendant's analyst testified that the financial projections, or the cash flow, calculated by the plaintiff's analyst in the DCF method were unreliable. The analyst testified that, under generally accepted valuation principles, it was incorrect to use a purely historical average for a projection, as was done in the third projection. The analyst testified that it was

incorrect to use the stress-test projection prepared by Houlihan because it was originally prepared for a sensitivity analysis, and not for valuation purposes.

The defendant's analyst also testified that the adjustments made by the plaintiff's analyst to Verizon's "base case" projections were inappropriate. The defendant's analyst argued that Verizon's projections were conservative and more pessimistic than industry reports indicated.

A downward adjustment to Verizon's projection of independent market growth was unjustified. This is because the company historically reported strong growth in this segment of its revenue and the projections were already more conservative than industry expectations.

Additionally, the defendant's analyst alleged that the plaintiff's analyst misinterpreted and rejected some of the electronic commerce data, which resulted in a lower projection for Verizon's electronic commerce revenue. Further, the defendant's analyst did not agree with the plaintiff's analyst opinion that Idearc would be unable to reduce its bad debt expense by as much as Verizon projected.

Terminal Value

The defendant's analyst alleged that the plaintiff's analyst assumption of an annual rate of EBITDA decline in perpetuity in estimating the terminal value of Idearc in the DCF method was commercially unreasonable and inappropriate in a DCF valuation.

The defendant's analyst further explained that in performing a contemporaneous valuation, an analyst would not assume such a perpetual annual decrease in Idearc's EBITDA. The analyst would consider that management would take steps to assure that such EBITDA decreases did not occur. For example, Idearc could withdraw its planned annual \$200 million dividend if projected revenues didn't meet their targets.

Discount Rate

The defendant's analyst argued that the capital structure assumed by the plaintiff's analyst in the estimation of the discount rate was not appropriate for a U.S. company like Idearc. Additionally, the guideline company most comparable to Idearc was significantly more leveraged.

The defendant's analyst also stated that an additional company-specific risk premium of 2 percent constituted a kind of "double counting," which violated standard valuation practice. The plaintiff's analyst assumed significantly lower cash flow than contemporaneous analysts due to the downward

adjustments she made to Verizon's projections. Therefore, she already accounted for the company-specific risks Idearc faced.

Simply correcting for the errors in the discount rate and terminal value calculations increased the value indication from the DCF method by \$4.3 billion, resulting in an adjusted value range from the DCF method of \$9.7 billion to \$10.6 billion.

Instances of Double Counting

The district court agreed with the defendant's analyst testimony that there were multiple instances of double counting that affected the plaintiff's analyst's DCF analysis and overall conclusions. Some of the reasons that led the plaintiff's analyst to apply a company-specific risk premium in the DCF method, (such as negative growth in revenue relative to Idearc's competitors and the fact that the TSA supposedly prevented Idearc from accessing the transactions market) also led her to weigh the conclusions from the market approach at 15 percent each.

Additionally, one of the reasons the plaintiff's analyst gave little weight to the guideline publicly traded company method was because the selected guideline companies were not adequately comparable to Idearc. In the guideline publicly traded company method, the plaintiff's analyst applied the same multiples used by Houlihan in its solvency analysis for Verizon in 2006.

However, Houlihan applied a multiple discount to account for the dissimilarity between Idearc and the guideline companies. Therefore, by applying Houlihan's discounted multiples and then weighting the guideline publicly traded company method only 15 percent, the plaintiff's analyst double counted the impact of the guideline publicly traded company comparability issue.

Outlier DCF Value Indication

The plaintiff's analyst selected inputs that lowered Idearc's value, including (1) pessimistic projections of Idearc's future performance, (2) reliance on a terminal value that considered a perpetual decrease in EBITDA, and (3) a higher discount rate, including a company-specific risk premium.

The defendant's analyst asserted that just correcting the errors in the discount rate and terminal value calculations would yield a value from the DCF method \$4.3 billion higher than the plaintiff's analyst concluded.

The plaintiff's analyst indication of value from the DCF method resulted in an outlier in relation to her value indications under each of the market approach methods used. The defendant's analyst

testified that typical valuation practice would be to (1) exclude the outlier, (2) give less weight to the outlier, or (3) inquire further into the model that generated an outlier.

The plaintiff's analyst testified that she looked deeply at any potential flaws in her DCF analysis. The defendant's analyst found this statement not credible in light of unsupportable methods and inputs, or unsupportable combinations of methods and inputs used by the plaintiff's analyst.

Market Misrepresentations

The plaintiff's analyst asserted that she did not consider Idearc's stock price at the time of the spin-off. This was because material information regarding risks Idearc faced, Idearc's expected performance, and future industry outlook was believed to have been withheld from the market.

The defendants provided evidence regarding information Idearc disclosed in its Form 10 and Offering Memorandum for its unsecured notes filed with the SEC. These documents contained comprehensive risk disclosures modeled after disclosures made by other public directories companies. The disclosures included the following:

1. Risks Idearc would face following the spin-off
2. Generally declining usage of print directories
3. Changing technologies and user preferences and the uncertainty surrounding Idearc's ability to respond adequately to these changes
4. Increased competition
5. Idearc's reliance on small and medium-sized businesses
6. The economic downturn and other events
7. Disruptions or turnover in sales representatives

Additionally, the defendants presented evidence about the effects of the TSA on Idearc's ability to access the merger and acquisition market. The defendant's tax expert stated that TSAs were typically used in spin-offs to provide an incentive for the spun-off company to use diligence before entering into post-spin transactions that may undermine the tax-tree status of the earlier event.

The TSA permitted Idearc to engage in merger and acquisition activity. Idearc could engage in some acquisition activity without triggering any tax liability. Idearc could also engage in debt prepayment or refinancing upon providing Verizon a tax opinion from counsel or a new ruling from the Service that such a transaction would not affect the

tax-free status of the spin-off. Further, the TSA was publicly filed with the SEC.

THE DISTRICT COURT'S DECISION

The district court reviewed a record that the Trustee compiled in order to determine if material information was withheld from the market or if material misrepresentations were made to the market, which would render the stock price irrelevant and unreliable.

The district court found that each piece of material information that the Trustee argued was not disclosed to the market was in fact available to the market. Additionally, the information apparently withheld from the market, which the trustee argued was material, was found by the district court to be immaterial to Idearc's value.

The district court did not find the plaintiff's analyst report and testimony persuasive and did not accept the plaintiff's analyst's conclusion that the value of Idearc was \$8.15 billion on the date of the spin-off. The district court was not persuaded that the plaintiff's analyst's DCF analysis was more reliable than the other methods used, which showed that Idearc was solvent as of the valuation date.

The district court was persuaded by the rebuttal of the defendant's analyst, which showed that the plaintiff's expert's DCF analysis was significantly flawed with respect to its most important inputs. The district court agreed that the plaintiff's analyst selected inputs that forced Idearc's value lower, thereby producing a valuation that implied a very low trading multiple for Idearc.

The district court also agreed that there were numerous instances of double counting in the plaintiff's analyst's DCF analysis and the overall conclusions. The district court had no evidence to conclude that Idearc was insolvent on November 17, 2006. Credible evidence of Idearc's value found in the plaintiff's analyst report and other available evidence showed that it was solvent on this date.

The market value of Idearc's equity, based on its common stock price as quoted on the NYSE, was \$3.8 billion on November 17, 2006. Given Idearc's \$9.15 billion outstanding debt and after subtracting \$100 million in cash on hand, the total enterprise value of Idearc implied by trading on the NYSE was no less than \$12.8 billion.

The district court found it likely that this figure accurately represented the value of Idearc on November 17, 2006. The district court found it clear that Idearc's value was at least \$12 billion on the date of the spin off.

SUMMARY AND CONCLUSION

The *Verizon* decision highlights the relationship between (1) the assumptions, considerations, and procedures used when performing a bankruptcy valuation analysis and (2) the reliability or persuasiveness of the resulting completed bankruptcy valuation analysis.

The district court ultimately found the rebuttal report provided by the defendant to be more persuasive than the expert report from the plaintiff. The district court concluded that several of the inputs and the rationale/assumptions supporting the use of such inputs in the plaintiff's analyst valuation analysis were flawed.

The flaws included faults in the assumptions underlying (1) the adjustments made to Idearc's projections, (2) the selection of market multiples, and (3) the selection of weightings assigned to the concluded values. The district court also found missteps in the calculation of the terminal value and discount rate in the DCF analysis.

Further, the district court found multiple instances of double counting and that information the plaintiff claimed was withheld from the market or misrepresented to the market was disclosed by Verizon and available to investors.

The district court determined that the market value of Idearc's equity, based on its common stock price as quoted on the NYSE, accurately represented the value of Idearc at the time of the spin-off and should have been considered in the plaintiff's analyst valuation.

The *Verizon* decision illustrates how flawed (1) valuation inputs and assumptions and (2) execution of valuation procedures can undermine the reliability of a bankruptcy valuation analysis.

Analysts should strive to ensure that the methods and assumptions used in a bankruptcy valuation analysis are (1) supported by relevant data and the facts of the case and (2) reflective of generally accepted valuation principles.

Notes:

1. U.S. Bank National Association v. Verizon Communications Inc., No. 3:10-CV-1842-G, 2013 WL 230329 (N.D. Texas, Jan. 22, 2013).
2. *Id.* at *19.

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