Valuations of Distressed Companies
Best Practices for Valuing Businesses Before, During and After Bankruptcy or Reorganization

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today’s panel features:
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Thursday, September 2, 2010

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Today’s Program

Pre-Bankruptcy Scenarios
*(Mark Kanaly, Jim Alerding, Michael Foreman)*

In-Bankruptcy Scenarios
*(Michael Foreman, Jim Alerding, Mark Kanaly)*

Business Restructurings Outside Of Bankruptcy
*(Jim Alerding)*

Slides 6-53

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Slides 110-130
Pre-Bankruptcy Scenarios

Mark Kanaly, Alston & Bird
Jim Alerding, Clifton Gunderson
Michael Foreman, Hayes and Boone LLP
Options

- Sale of part of the company
- Acquisitions by the company
- New equity investments in the company
- Tender offer for debt
- Recapitalization of the business
- Interim forbearance
- Exchange offers
Bankruptcy And Remedies

• Surrender assets to its secured creditors

• Cease operations, liquidate assets, satisfy debts

• If foreclosure is only option, file a Chap. 7 bankruptcy case and allow liquidation to be handled by a court-appointed trustee.

• If the company’s financial distress can be addressed through the reorganization provisions of the Bankruptcy Code, then Chap. 11 may be filed.
Valuation Analyses Before Bankruptcy

• Providing corporate transaction opinions
  – Advising the boards of both financially troubled and financially sound companies
  – Analyzing proposed merger/acquisition, dividend, executive bonus, financing and restructuring transactions
  – Performing fairness opinions
    • Absolute fairness of the transaction price and terms
    • Relative fairness of the transaction price and terms
    • Both from a financial point of view
Valuation Analyses Before Bankruptcy (Cont.)

- Performing solvency opinions
- Debtor company can meet its debt service obligations
- Debtor company has adequate short-term liquidity
- Advising the debtor company board/management regarding “zone of insolvency” asset and equity values
- These transaction analyses provide a defense against fraudulent conveyance, preferential debt payment, preferential transfer and other allegations.
Necessary Valuations During The Bankruptcy Process

- In connection with a motion to lift the automatic stay
- To obtain adequate protection
- To seek or oppose confirmation of a plan of reorganization
- To prosecute or defend actions to recover preferential transfers
- To recover fraudulent transfers
Standard Of Value

• Fair market value
• Investment value
• Fair value (state rights/financial reporting)
• Intrinsic value
• Investment value
• Sect. 506 of the Bankruptcy Code provides that “value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.”
Distressed And Impaired

• Distressed
  – Having been foreclosed and offered for sale, usually at a price below market value
  – Of, relating to, or experiencing economic decline or difficulty

• Impaired
  – Functioning poorly or incompetently
  – Disabled or functionally defective
Special Issues In Distressed Or Impaired Company Valuation

- Liquidity
- Contractual defaults (bank covenants)
- Greater emphasis on cash flow
- Short-term solvency issues
- Effects:
  - Asset-based lending is likely more available than cash flow lending
  - The liquidation value of the company may become more important than the going concern value.
Additional Considerations

• Outlook for the company
  – Consistent with the industry
  – Ability of current management to keep the company afloat
  – The outlook given a replacement management

• Feasibility of the forecasts and reasonableness of assumptions

• What is the optimal capital structure for the company?
  – What is the attainable capital structure given the stress and impairment?

• Facts and circumstances that led to the distress or impairment

• What is the permanent loss of business or relationships as a result of the impairment?
• The premise of value is the overriding valuation assumption about the likely set of circumstances that apply to the subject company being valued.

• Two types: Going-concern value and liquidation value.
Determining Premise Of Value

- Market conditions and outlook
- Competitive environment
- Financial history
- Historical operations
- Management’s track record
- Ability to secure adequate capital to move forward
Valuation Approaches

• Asset approach: Estimates value of equity by examining assets and liabilities at a point in time

• Income approach: Value is based on expected future cash flow

• Market approach: Assesses value by comparing the company to the current market prices of similar companies or the historical sales of similar companies
Income Approach = Best Approach

• Bankruptcy courts and valuation treatises agree that valuations should be based on the expectation of future earnings, as stated in a leading bankruptcy case by the U.S. Supreme Court, Consolidated Rock Products Co. v. DuBois.

• The Supreme Court criticized methods of valuation used by the lower court and pointed to the income approach.

• The income approach is generally considered the best approach because it is based on cash flows inherent to a company and the riskiness of those cash flows.
Two Methods

There are two generally accepted methods to value a company under the income approach:

- Discounted cash flow (DCF)
- Capitalized cash flow (CFC)

Because the capitalized cash flow method has limitations, it is seldom used in complex valuation assignments.
Strengths Of DCF

• Less influenced by extrinsic factors (market volatility or macro-economic factors)

• Flexible, forward-looking method that can incorporate expected changes to a company’s operating strategy and key variables (growth rates, operating margins, required operating working capital, and expected capital expenditures)

• Allows the valuation analyst to consider many variables and assumptions
Weaknesses Of DCF

• May be based on overly optimistic/pessimistic financial projections, based on motivations and perspectives of the party seeking the valuation opinion and the expected use of the opinion

• Highly sensitive to assumptions used to derive cash flows, discount rate and terminal value
Elements Of The DCF

• Free cash flows: Represents cash flows from operations, independent of leverage and non-operating investments

• Terminal value: Represents the estimated value of a company from the end of the discrete projection period into perpetuity

• Weighted average cost of capital: Represents the weighted average cost of all forms of capital used by a company to finance the operations, including debt and equity
Valuations and Bankruptcy Cases

Valuations are at the heart of many aspects of a bankruptcy case, including:

- Use of collateral
- Granting of priority liens in one creditor’s collateral to secure a DIP loan from another lender
- Relief from the automatic stay
- Sales of assets
- Recovery of preferences
- Recovery of fraudulent transfers
- Confirmation of a plan - best interest of creditor’s test
- Confirmation of a plan - cram down
Marketplace Conditions

• The volume of corporate bankruptcy filings has increased materially during the recent economic downturn. However, valuation analysts should be mindful of bankruptcy considerations in the valuation of both financially troubled and financially sound companies.
Valuation Analyses Performed Before The Bankruptcy Filing

- Providing corporate transaction opinions
  - Advising the boards of both financially troubled and financially sound companies
  - Analyzing proposed merger/acquisition, dividend, executive bonus, financing and restructuring transactions
  - Performing fairness opinions
    - Absolute fairness of the transaction price and terms
Valuation Analyses Performed Before The Bankruptcy Filing (Cont.)

- Relative fairness of the transaction price and terms
- From a financial point of view
  - Performing solvency opinions
    - Assets exceed liabilities on a fair value basis
    - Debtor company can meets its debt service obligations
    - Debtor company has adequate short-term liquidity
Valuation Analyses Performed Before The Bankruptcy Filing (Cont.)

• Advising the debtor company board/management regarding “zone of insolvency” asset and equity values

• These transaction analyses provide a defense against fraudulent conveyance, preferential debt payment, preferential transfer and other allegations.
Determining Debtor Company
Solvency Or Insolvency

• Related to preference item and/or fraudulent conveyance claims

• Valuation considerations
  – Similar to the “zone of insolvency,” the solvency/insolvency analysis may be performed over a period of time, during which the transfers or preferences are alleged to have been made.
Determining Debtor Company Solvency Of Insolvency (Cont.)

− All assets and all liabilities should be valued to determine whether the debtor company was solvent or insolvent at a specific point in time.
− Solvency/insolvency analyses include all recorded assets and liabilities and all unrecorded intangible assets and (typically) contingent liabilities.
− The solvency/insolvency analyses typically will rely principally on an income approach analysis, and, therefore, on cash flow projections.
Advising Debtor Entity Board Of Directors Regarding “Zone of Insolvency”

• Related to financially sound companies
  – In a troubled economy, even a financially sound debtor company can approach insolvency quickly and without warning.
  – The “best practice” that can be performed in such a situation is for the attorney and the valuation analyst to conduct client training on:
Advising Debtor Entity Board Of Directors Regarding “Zone of Insolvency” (Cont.)

- (1) The meaning of the “zone of insolvency,” and
- (2) The meaning of “insolvent” from a valuation/bankruptcy perspective
  - A financially troubled debtor company could be slipping in and out of insolvency on a daily – or even an hourly – basis.
  - The debtor company board should be well versed from the lawyer and the valuation analyst on what the “zone of insolvency” means.
Advising Debtor Entity Board Of Directors Regarding “Zone of Insolvency” (Cont.)

- There should be mechanisms set up at the debtor company to monitor the solvency situation.

- The board should be educated as to other “constituencies” who should be considered (e.g., creditors), if the company enters the “zone of insolvency.”
Advising Debtor Entity Board Of Directors Regarding “Zone of Insolvency” (Cont.)

• Legal considerations regarding zone of insolvency analyses
  – Setting up a mechanism to track the debtor company “zone of insolvency”
  – Developing a debtor company policy on the due care of the various “constituencies” when the zone of insolvency is entered
  – Balancing of the “business judgment rule” to the interest of the various debtor company constituencies (e.g., equity owners, creditors, employees)
Advising Debtor Entity Board Of Directors Regarding “Zone of Insolvency” (Cont.)

• Valuation considerations regarding the “zone of insolvency”
  – A valuation is performed as of a specific point in time
  – How do you monitor the almost infinite points in time related to an insolvency?
  – Setting up a system for monitoring debtor company value on an ongoing basis
Advising Debtor Entity Board Of Directors Regarding “Zone of Insolvency” (Cont.)

– What is a reasonable expectation of monitoring debtor company value in an insolvency environment?

– Which asset balance and values change quickly – and which do not?
Defining Value

Standards Of Value
• Fair market value
• Fair value (state rights/financial reporting?)
• Intrinsic value
• Investment value

Premises Of Value
• Going concern
• Liquidation (orderly/forced)
Definitions: Distressed And Impaired

- Distressed
  - Having been foreclosed and offered for sale, usually at a price below market value
  - Of, relating to, or experiencing economic decline or difficulty

- Impaired
  - Functioning poorly or incompetently
  - Disabled or functionally defective
Special Issues In Distressed Or Impaired Company Valuation

- Liquidity
- Contractual defaults (such as bank covenants)
- Greater emphasis on cash flow (as opposed to “earnings”)
Special Issues In Distressed Or Impaired Company Valuation (Cont.)

- Short-term solvency issues, i.e. can the company create “cash flow” in the short term?
  - Stabilizing the company is most important (if that is a reasonable assumption).
Special Issues In Distressed Or Impaired Company Valuation (Cont.)

• Effects:
  – Asset-based lending is likely more available than cash flow lending.
  – The liquidation value of the company may become more important than the going concern value.
Additional Considerations

• Outlook for the company
  – Consistent with the industry
  – The ability of current management to keep the company afloat
  – The outlook given a replacement management

• Feasibility of the forecasts and the reasonableness of the assumptions
Additional Considerations (Cont.)

• What is the optimal capital structure for the company?
  – Perhaps more important, what is the attainable capital structure, given the stress and impairment of the company?

• Facts and circumstances that led to the distress or impairment

• What are the permanent losses of business or relationships (e.g. suppliers) as a result of the impairment, if any?
Approaches To Value

- **Income approach**: It is likely that the discounted benefits method will be used, as opposed to the capitalization of benefits.
- **Market approach**: The approach should focus on locating similar, distressed or impaired, companies under both the guideline publicly traded company method and the guideline company transaction method.
- **Asset approach**: Very little changes in the application of the asset approach. However, if the premise of value changes midstream from going concern to liquidation value, the determined value of the underlying assets is likely to be affected.
Consideration Of Risk In Distressed Or Impaired Company Valuation

• Domestic economic factors affecting value
  – Real economic growth
  – Inflation
  – Interest rate risk
  – Default risk
  – Investor risk aversion
  – The risk-free rate into perpetuity?
Consideration Of Risk In Distressed Or Impaired Company Valuation (Cont.)

- The industry
  - Challenging environment across all industries
  - Where is the industry/company in its life cycle?
    - Start-up – high failure rates
    - Growth phase
    - Mature
    - Decline – increasing/high failure rates
  - Concentration
Consideration Of Risk In Distressed Or Impaired Company Valuation (Cont.)

• The industry (Cont.)
  – Substitute products
  – Threat of new entrants
  – Growth outlook
  – Is the industry cyclical?
    • Commodities
    • Housing
Consideration Of Risk In Distressed Or Impaired Company Valuation (Cont.)

- The company
  - Determine the cause(s) of distress or impairment
    - General economic contraction and industry decline (previously discussed)
    - High leverage
    - Bank covenant default
    - Operating inefficiencies/mismanagement
    - Perceived risk of suppliers and customers
Consideration Of Risk In Distressed Or Impaired Company Valuation (Cont.)

• The company (Cont.)
  – Evaluate management’s action plan
    • What is the basis for management’s assumptions?
      – Macroeconomic and industry factors
      – Internal adjustments
    • Are the assumptions reasonable?
    • Are the financial projections attainable?
    • Does the plan rely on existing assets or growth assets?
Consideration Of Risk In Distressed Or Impaired Company Valuation (Cont.)

- The company (Cont.)
  - Determine the premise of value (though quite subjective, there can be a good case for a unique strategic value if the company were to be sold)
Premise Of Value Considerations

- What is the purpose of the valuation?

- Upon whose judgment does it rely?
  - Clarify the premise of value beforehand
  - Understand the purpose of the valuation

Premise Of Value Considerations (Cont.)

• At what point does the premise of value change?
  – Moving from going concern to liquidation
• Default risk and projections
  – Bond ratings
  – Decision tree analysis
  – Monte Carlo simulation
  – Scenario analysis
  – Altman Z score
    » No clear strategy to fund either in or out of bankruptcy
    » No identified strategic corporate buyer fit

The Impact Of Special Issues On Valuation Approaches

- Asset approach becomes paramount, at least as a fall-back value.

- The liquidation premise to determine asset values is of the most interest to the owner/buyers/creditors.
In-Bankruptcy Scenarios

Michael Foreman, Hayes and Boone LLP
Jim Alerding, Clifton Gunderson
Mark Kanaly, Alston & Bird
Valuation Scenarios In Bankruptcy

• At or before filing - Solvency or insolvency?
• Determination of secured claims
  – Under- or over-secured
  – Inter-creditor disputes between senior and junior lien holders
  – DIP financing, use of cash collateral and adequate protection
• Sect. 363(b) auction sales
  – Stalking horses and higher and better bidding
  – “Apples vs. oranges.
  – Emergency sales
  – Secured creditor’s ability to credit bid
• Preference avoidance – Debtor’s insolvency during 90 days prior to bankruptcy
• Constructive fraudulent transfer avoidance – Exchange of reasonably equivalent value at time of transaction
• Plan confirmation
  – New value exception to absolute priority rule
  – Cram-down and determination of indubitable equivalent
  – Enterprise valuation, unfair discrimination and the “fair and equitable” test
  – Present value determination
Key Valuation Concepts And Methods

• Different values are determined for different purposes:
  – Asset value: Pursuant to Supreme Court’s *Rash* decision (discussed later under heading “Determination of Secured Claims”), valuation must be consistent with proposed use of asset (e.g., going concern v. liquidation).
  – Enterprise value: Determination of debtor’s assets as an ongoing business enterprise
  – Distributable value: Determination of enterprise value plus sources of additional value available for distribution to creditors (i.e., may include assets to be liquidated and causes of action)

• Market valuation: Review of empirical market data at or about the time of valuation
  – Is this the best indicator of value under all circumstances? The more thinly traded the securities, the less reliable the market will be as an indicator of value.
  – Use of a trading average over a single day’s quote is preferred, especially where trading was volatile.
  – Is it ever appropriate for the court to factor in a control premium?

• Comparable companies or transactions: Review of available public data for companies or transactions comparable with the valuation subject, as of the time of valuation
  – Market multiples used as a proxy for risk assessment
  – Circumstances determine factor against which multiple is applied (e.g, EBITDA vs. revenue)
  – May provide a reality check to one of the other valuation methods
Key Valuation Concepts And Methods (Cont.)

- Discounted cash flow (DCF): Measures value by forecasting a company's ability to generate cash, by adding (i) the present value of the company's distributable cash flows (i.e., cash flows available to all investors) during the forecast period and (ii) the present value of the company's terminal value (i.e., its value at the end of the forecast period).
  - Discount rate (a/k/a weighted average cost of capital): Based upon a combined rate of the costs of debt capital and the cost of equity capital
  - Terminal value: An assessment of the company's long-term business value
  - Length of forecast period: While there is no specific rule, the goal is to forecast the company's performance through a complete business cycle until a steady state of growth or maturity is reached.

- Four-step analysis: (1) Determine the projected distributable cash flow of a company within a forecast period of time; (2) Determine the company's terminal value by the end of a forecast period, by applying a selected metric of value (usually the company’s EBITDA) to an appropriate multiple, (3) Determine the present value of both free cash flow and terminal value of the company by applying an appropriate discount rate, and (4) Calculate the sum of the present value of cash flow and present value of terminal value, which represents the total enterprise value.

- The lower the discount rate, the higher the value.
- Subject to judicial criticism and caution, due to the flexibility and subjectivity of the different DCF variables.
Key Players: The Court And The Experts

- Bankruptcy court (sometimes, the district court) is the trier of fact.
  - Legal determinations are subject to *de novo* review, but findings of fact are not to be set aside unless found to be clearly erroneous.
  - Inherent irony that judges, who would not qualify as an expert witnesses themselves in a valuation trial, regularly determine the worth of assets and businesses.
  - The valuation of a business is a mixed question of fact and law. The proper method of valuation in a particular factual context is a legal question.

- Expert witnesses are advocates, far from impartial.
  - Expert impartiality is neither startling nor a reason to disregard testimony, but rather means the court must be cautious.
  - Risk that expert will disregard or fail to adequately consider valuation methods that do not support client’s position.

- The *Daubert* principle: Court must determine whether the proponent of the expert testimony demonstrates that his or her testimony is both reliable and relevant. *Daubert v. Merrill Dow Pharm., Inc.* 509 U.S. 579,589 (1993).
  - *Daubert* principle applies to admissibility, weight, and credibility.
  - Court must undertake a rigorous examination of the facts on which the expert relies, the method used by the expert as the basis for the opinion, and how the expert applies the facts and method to the particular case.
  - Expert testimony should be excluded if it is speculative or conjectural.
At Or Before Bankruptcy Filing

- Different definitions of insolvency:
  - Balance sheet assets vs. liabilities, usually determined in accordance with GAAP
  - Pursuant to Bankruptcy Code Sect. 101(32), the term “insolvent” means a financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, \textit{at a fair valuation}.

- Delaware courts have made it clear that directors have no duty to creditors, unless the company is insolvent.
  - In the past, Delaware courts recognized the existence of expanded fiduciary duties to creditors when the company entered the “zone of insolvency.”
  - In 2007, Delaware Supreme Court rejected such an expansion of fiduciary duties until the company is actually insolvent.
At Or Before Bankruptcy Filing (Cont.)

- As a result, breach of fiduciary duty cases implicate valuation issues regarding the financial situation of the company at some time prior to the bankruptcy, and often arise in connection with determining insolvency and reasonably equivalent value in fraudulent transfer actions.
  - In *VFB, LLC v. Campbell Soup Company*, where plaintiffs alleged breach of fiduciary duty claims in constructive fraudulent transfer action, court found that debtor was solvent at the time of the transaction and, therefore, no fiduciary duties were owed to creditors. *VFB LLC v. Campbell Soup Co.,* 482 F.2d 624 (3d Circuit 2007).
  - In *Asarco LLC*, court found company’s directors owed fiduciary duties to creditors because the company was insolvent at the time of the transfer, and that fiduciary duties were breached by the debtor and its parent arising out of transaction entered into with actual intent to hinder or defraud creditors. *In re Asarco LLC (Asarco LLC v. Americas Mining Corp.)*, 396 B.R. 278 (S.D. Tx. 2008).

- Zone of insolvency continues to be relevant to directors and others because of valuation difficulties in determining insolvency prior to bankruptcy.
- “Deepening Insolvency” cannot constitute a cause of action for breach of fiduciary duty but may be relevant as a measure of damages.
- Company does not need to be insolvent or undertake solvency analysis to file for Chap. 11 bankruptcy.
  - Company only needs a legitimate business purpose for filing
  - Company does not need to conduct solvency analysis prior to filing
Determination Of Secured Claims

- Bankruptcy Code Sect. 506(a) bifurcates claims into secured and unsecured claims based on judicial valuation of the collateral securing the claim.

- “Such value shall be determined in light of:
  - The purpose of the valuation, and
  - The proposed disposition or use of such property, and
  - In conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.

- Either fair market value, going concern value or liquidation value may be appropriate valuation method, depending on the proposed use of the property.

- Timing of valuation determined by the status of the case (i.e., at the commencement of the case, if plan or sale motion has been filed).
• The Supreme Court’s *Rash* Decision: Where debtor intending to retain collateral sought to satisfy Chap. 13 cram-down requirements for confirmation of Chap. 13 plan confirmation, debtor was required to pay the secured creditor the full value of its collateral with interest. *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997).
  - Debtor argued that court should adopt a “foreclosure value” for the property, i.e. the net amount that would have been realized in a foreclosure sale of the property.
  - Secured creditor argued that court should use “replacement value,” i.e. cost to purchase similar collateral.
  - The Supreme Court, reversing the Fifth Circuit, held that the proper valuation of the collateral for purposes of Chap. 13 cram-down is the replacement value to the debtor.
Determination Of Secured Claims (Cont.)

• The *Rash* Court relied on the Bankruptcy Code Sect. 506(a) requirement that the court value property according to the “proposed disposition or use.”

• Since debtor proposed to continue to use the collateral (a car), the replacement value was the appropriate method under the circumstances.

• Replacement value defined as the price a willing buyer in the debtor’s trade, business or situation would pay a willing seller to obtain property of like age and condition.

• Bankruptcy court is charged with finding the best way to determine replacement value under a particular set of circumstances.

• Court rejected the “split the difference” method.
Determination Of Secured Claims (Cont.)

• Other than where the collateral is to be sold pursuant to Bankruptcy Code Sect. 363(b) or under a Chap. 11 plan, the bankruptcy court will be required to assess competing expert witness testimony unless some other compelling evidence of value exists.
  – Valuation issues also arise if sale is challenged on the basis that the company has greater value to creditors if ownership is transferred to them.
• However, actual sales are the best evidence of value. If the collateral is to be sold pursuant to Bankruptcy Code Sect. 363(b), the court is not required to conduct separate valuation hearing.
• Adequate protection protects secured creditor against a decrease in value of its interest in the debtor’s property.
  – Periodic cash payments or replacement liens
  – Indubitable equivalent of creditor’s interest in the debtor’s property
Determination Of Secured Claims (Cont.)

• An oversecured creditor is entitled to include accrued interest, fees and charges in its claim up to the value of the collateral.

• An under-secured creditor may have Sect. 1111(b) election to protect itself against post-bankruptcy appreciation in value of collateral, and may exercise credit bid rights in connection with a Sect. 363 sale.

• A secured creditor’s motion for relief from the automatic stay requires valuation by bankruptcy court to determine whether the debtor has any equity in the collateral.

• Inter-creditor disputes raise an issue of whether the collateral has sufficient value to afford junior lien holders a secured claim.
Bankruptcy Code Sect. 363(b) sales of assets outside of the ordinary course of business generally are conducted through an auction process, where an initial “stalking horse” bid is subjected to higher and better bidding.

• The highest and best standard may result in a bid being approved by the bankruptcy court that does not offer the highest value for the assets, if another bid is determined to be better.

• A stalking horse bid is usually preferred to commence the Sect. 363(b) auction process, except when time does not permit a stalking horse offer to be presented, or initial indications of interest are lower than the perceived value of assets.
Sect. 363(b) Auction Sales (Cont.)

- Valuation issues may arise where bids are submitted on different “apples vs. oranges” terms (e.g., all-cash bid compared with cash plus notes and/or equity, single bid for entire business compared with multiple bids for parts of business)

- Determination of bidding procedures, including through negotiations with stalking horse and/or other interested parties and unilaterally by the debtor at the actual auction, affects the nature of the auction process and may be a factor in determining auction outcome.

- Timing pressures of the bankruptcy case, such as deadlines imposed by secured creditors in connection with DIP financing or agreements on use of cash collateral or debtor’s liquidity, also may be a factor in determining the auction outcome.
Sect. 363(b) Auction Sales (Cont.)

- A successful credit bid need not generate the cash proceeds equal to the indicative market value of a debtor’s assets
  - Secured creditors may bid up to the full amount of their allowed claim (regardless of collateral value) to acquire the assets to which their lien is attached, in exchange for cancelling the indebtedness in the amount of the bid.
  - A credit bid need not include any payment of value to the debtor.
  - A credit bid may be mixed, including cash and a credit bid of a portion of the creditor’s claim.
  - A higher credit bid in the full amount of the claim or a mixed credit bid can therefore beat an all-cash bid of a competing purchaser.

- However, the Third Circuit determined in *Philadelphia Newspapers* that, while a secured creditor has a right to credit bid pursuant to Sect. 363(k) in connection with a Sect. 363(b) sale, the secured creditor does not have the right to credit bid where the debtor was being sold pursuant to a Chap. 11 plan. In re Philadelphia Newspapers, LLC, 599 F.3d 298 (3d Cir. 2010).
Sect. 363(b) Auction Sales (Cont.)

- Debtor’s ability or desire to conduct a 363(b) auction may be impeded by need for an expedited sale to preserve the value of the debtor’s assets.
  - For example, in the Chrysler and General Motors Chap. 11 cases, pre-arranged sale transactions were approved on an expedited basis where the bankruptcy court found that the proposed transaction was the only available option, the transaction was conducted in good faith and at arm’s length, and the transaction was necessary to preserve a portion of each company’s going concern business and to maximize the value of each debtor’s estate. In re Chrysler, LLC, 405 B.R. 84 (Bankr. S.D.N.Y. 2009, aff’d by Ind. State Police Pension Trust v/ Chrysler, 576 F.3d 108 (2d Cir. 2009).

- Bankruptcy Code Sect. 363(e) precludes a Sect. 363(b) sale where interests sought to be removed by a sale free and clear of such interests could not be valued and, thus, adequately protected
  - For example, in the Phoenix Coyotes case, the bankruptcy court found that certain rights and interests of the National Hockey League – a membership selection right, the right to control where member teams played home games and the right to a relocation fee from a team that changes its location – could not have been afforded adequate protection if the sale were approved to a buyer not supported by the NHL. (In re Dewey Ranch Hockey, LLC, 414 B.R. 577 (Bankr. D. Az. 2009))
Preference Avoidance

• Pursuant to Bankruptcy Code Sect. 547(b), a trustee or DIP may avoid any transfer of an interest of property of the debtor:
  – (1) To or for the benefit of a creditor
  – (2) For or on account of an antecedent debt owed by the debtor before such transfer were made
  – (3) Made while the debtor was insolvent
  – (4) Made:
    • (A) On or within 90 days before the date of the filing of the petition, or
    • (B) Between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
  – (5) That enables such creditor to receive more than such creditor would receive if:
    • (A) The case were a case under Chap. 7 of the Bankruptcy Code,
    • (B) The transfer had not been made, and
    • (C) Such creditor received payment of such debt to the extent provided by the provisions of the Bankruptcy Code
Preference Avoidance (Cont.)

• Bankruptcy Code Sect. 547(f) provides that, for the purposes of Sect. 547, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the debtor’s petition.

• A valuation of debtor’s assets and liabilities as of the date of the alleged preference is required, if the creditor seeks to rebut the insolvency presumption.

• In *American Classic Voyages*, bankruptcy court determined that the debtor was solvent approximately two months prior to the bankruptcy filing, and, accordingly, ruled that payments made to lenders could not be recovered. In re *American Classic Voyages Co., Inc.*, 367 B.R. 500 (Bankr. D. Del. 2007).
  
  – Banks’ expert prevailed over plaintiff’s, where bank expert’s valuation of debtor on a going concern basis was found to be appropriate, and plaintiff’s expert valued the debtor on a liquidation basis (because the debtor ended up liquidating under Chap. 11) and had less experience in providing expert valuation testimony.
  
  – After payments were made to banks, Sept. 11 occurred, and that event was found to have had a devastating affect in the debtor’s tourist-based business, resulting in debtor’s insolvency.
Constructive Fraudulent Transfer Avoidance

• Bankruptcy Code Sect. 548(f)(a)(1)(B) provides that a trustee or DIP may avoid any transfer made or obligation incurred by the debtor within two years before the date of the filing of the bankruptcy petition, if the debtor voluntarily or involuntarily:
  – (i) Received less than a reasonably equivalent value in exchange for such transfer or obligation, and
  – (ii) (I) Was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer of obligation
  – (II) Was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital
  – (III) Intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor’s ability to pay as such debts matured; or
  – (IV) Made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business
Constructive Fraudulent Transfer Avoidance (Cont.)

• Defense to a constructive fraudulent transfer claim typically includes a defense based on attacking the insolvency-related elements, requiring a fair valuation of the debtor’s assets and liabilities as of the time of the transfer or obligation.

• Valuation issues also arise with respect to the “reasonably equivalent value” element, comparing what the debtor transfer or incurred against the value or benefit the debtor received.
  – Court looks at value as of the time of the transfer from the perspective of the company’s unsecured creditors.
  – Reasonably equivalent value is viewed as “roughly the same value” being given on each side of the transaction.
  – Court seeks to determine what a willing buyer would pay to a willing seller in an arm’s-length transaction.
  – While a majority of the courts conduct a “totality of the circumstances” analysis, some courts use a “percentage of property value” test, finding reasonable equivalent value if the value the debtor received was at least 70% of the value of the assets involved, as determined at trial.
Constructive Fraudulent Transfer Avoidance (Cont.)

- TOUSA, Inc.: Official unsecured creditors committee brought an adversary proceeding against new term lenders, who were granted liens in the assets of the debtor subsidiaries, and against prior lenders of the parent company debtor who received a portion of the new loan proceeds, seeking to avoid the new lenders’ liens, the settlement payment to the prior lenders, and the grant of a security interest in favor of the new lenders in a tax refund as a preference. In re TOUSA, Inc. (Official Comm. of Unsecured Creditors of TOUSA, Inc. v. Citicorp North America, Inc.), 422 B.R. 783 (Bankr. S.D. Fla. 2009)
  - Prior lenders were ordered to disgorge $403 million to the debtor’s estate, and new term lenders’ liens on TOUSA’s subsidiaries’ assets were voided.
  - The new term lenders have appealed, seeking to have their liens reinstated. The prior lenders have appealed to the extent that they were required to repay funds in excess of those required to make the subsidiaries whole to the term lenders.

- The TOUSA bankruptcy court found that:
  - Parent debtor had caused the subsidiary debtors to obtain loans from the transferees and grant the transferees liens in the subsidiary debtors’ assets.
  - Loan proceeds were used to settle an action by lenders against parent.
  - Subsidiary debtors did not receive reasonably equivalent value for liens, since loan proceeds paid an antecedent debt of parent only, the subsidiary debtors were insolvent both before and after the transaction, and they were left with unreasonably small operating capital.
Constructive Fraudulent Transfer Avoidance (Cont.)

• The TOUSA bankruptcy court also found that:
  – Both lender groups had more than sufficient notice of the debtors’ insolvency based on objective, publicly available information to preclude a good faith defense, and the transfers provided no direct or indirect benefit to the subsidiary debtors.
  – The grant of the liens to the new lenders was for the benefit of the prior lenders, the settlement provided no value to the subsidiary debtors, and the committee could prevail against both lenders groups.

• In determining insolvency at the time of the transfer, the court found the committee’s expert testimony, based on his DCF analysis, to be more credible and reliable than the criticisms and forecasts of defendants’ experts based on market data, among other things.
  – Forecasts of future housing sales and pace were based on realistic and supported view of the likely trajectory of the housing market after July 31, 2007.
  – Conclusions regarding future sales and sales pace were based on a thorough and competent analysis of market information.
  – The costs inputs used in the expert’s DCF analysis were reasonable predictions of future costs.
Expert’s discount rates were reasonable and consistent with prevailing market rates.

Determination that expert’s valuation of undeveloped land was problematic, but defendant experts’ criticisms were unpersuasive.

The observable market value and comparable companies tests supported the results of the expert’s DCF analysis.

• The TOUSA court’s insolvency determination, in turn, supported its determination that the subsidiary debtors did not receive reasonably equivalent value.

• However, to what extent was the court’s view of the experts an extension of, and influenced by, his finding that neither lender group acted in good faith, and each was grossly negligent?
Constructive Fraudulent Transfer Avoidance (Cont.)

• In the *Asarco* case, the court found the experts’ DCF analyses to be the most reliable means of valuing the stock of a third company transferred by the debtor to its parent for value prior to bankruptcy.
  – However, while the court found that reasonably equivalent value was given to the debtor by its parent, the court found that the transfer was made with the actual intent to hinder or defraud debtor’s creditors, and ruled in favor of plaintiff debtor.

• In contrast to the use of DCF analyses by the *TOUSA* and *Asarco* courts, the courts in *VFB, LLC v. Campbell Soup Company* and *Iridium LLC* found in favor of defendants on issues of insolvency and reasonably equivalent value, based on determination that market data are a more reliable measure of value than expert witness testimony.
  – *VFB*: Since equity markets allow participants to voluntarily take on or transfer among themselves the risks that a company’s projections will be inaccurate, the stock price of a company established in the equity market portrays the most accurate picture of value.
  – *Iridium*: The public trading market constitutes an impartial gauge of investor confidence and remains the best and most unbiased measure of fair market value and, when available to the court, is the preferred standard of valuation … However, the court … has broad discretion to find that the markets somehow were distorted and did not fairly represent the debtor’s enterprise value, but the court needs a substantial reason to justify departing from that standard and finding that value implied by an efficient market is not a trustworthy benchmark.
Constructive Fraudulent Transfer Avoidance (Cont.)

- **VFB, LLC v. Campbell Soup Company**: Third Circuit affirmed district court judgment for parent company, finding that the food companies transferred to the plaintiff subsidiary were worth well in excess of the amount the subsidiary paid for them, where court relied primarily on the price of the subsidiary’s stock after disclosures that the parent company had manipulated the earnings of the transferred businesses before the transfer.
  - “DCF analyses are imprecise and have value only in certain limited circumstances.” In this case, plaintiff expert’s DCF analysis was flawed, primarily due to “hindsight bias.”
  - The court had no basis for second-guessing the value that was fairly established in open and informed trading, even if the market was suffering from “irrational exuberance” in establishing plaintiff’s stock price.

- **Iridium, LLC**: Bankruptcy court ruled against debtor and found that the debtor had a positive enterprise value at the time of the transactions in question, even though the market information at the time of the transactions subsequently proved to have been a poor indicator of the debtor’s future value. In re Iridium LLC, 373 B.R. 283 (Bankr. S.D.N.Y. 2007)
  - Due to the sheer volume of contemporaneous market evidence, the committee’s expert needed to reconcile his DCF analysis with the market data and through a comparable companies analysis to be effective, credible and reliable.
  - In this case, the court was given no reason to disregard efficient market as a trustworthy benchmark of value.
Plan Confirmation

• Bankruptcy Code Sect. 1129(b): A Chap. 11 plan shall be confirmed if “it does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.”

• Absolute priority rule: A senior creditor is entitled to be paid or allocated all value from the debtor before any of that value is paid or allocated to a junior class. Accordingly, if all of the debtor’s reorganization value is allocated to senior classes, and they are still not paid in full, absolute priority is not violated so long as no junior class participates on account of its junior interest.
  – A senior class of creditors may consent, as a class, to junior classes receiving value, even if that senior class is not paid in full or allocated all of the debtor’s reorganization value.

• Three key elements of the absolute priority rule:
  – What “property” of the debtor’s estate will the junior class receive?
  – Is the junior class receiving value “on account of” a prior interest?
  – How is the property being valued?
Plan Confirmation (Cont.)

• New value exception, restated: Junior classes of creditors or equity owners may participate in a plan, without full payment to the dissenting senior creditors, if they make a new contribution:
  – In money or money’s worth – release of pre-petition claims likely not sufficient;
  – That is reasonably equivalent to the value of the new equity interests in the reorganized debtor – valuation litigation, with varying tests and standards applied by court; and
  – That is necessary for implementation of a feasible reorganization plan – new value is the most feasible source of new capital, and the reorganization of the debtor must be feasible.
  – The contribution must be substantial. This requirement is not applied by all courts and has been viewed as subsumed within the three other tests.

• Debt-for-equity and “gift” plans implicate valuation.

• Bankruptcy court valuation of new value arises in a number of different contexts:
  – Exit financing
  – Asset acquisition
  – Rights offering
  – Allocation of equity in reorganized debtor among creditors or shareholders, providing new value and creditors receiving less than the amount of their claims
Plan Confirmation (Cont.)

- Where the debtor is insolvent, the stockholder’s participation must be based on a contribution in money or money’s worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder.” Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 60 S. Ct. 1, 84 L.Ed. 110 (1939).

- “LaSalle” market test:
  - Must every new value plan be tested by a competing plan or bids?
  - What is the role of Sect. 363(b) auction process in determining confirmation of a new value plan?
  - Should reorganization value be tested against liquidation value?

  - Degree of causation between prior claims or interests and opportunity to provide new value in exchange for interest in reorganized debtor
  - The exclusive ability of a debtor’s equity holders to proposed a plan is a form of “property,” similar to an option.
  - The adequacy of an old equity holder’s proposed new value should be tested against some form of market valuation.
Plan Confirmation (Cont.)

• “Cram down” refers to the power of the bankruptcy court to force confirmation of a Chap. 11 plan, notwithstanding the dissent of one or more classes of creditors or ownership interests.

• Difficult policy issue: Does the Bankruptcy Code’s principle of debtor rehabilitation justify the imposition of substantial valuation risks on secured creditors?

• Common cram down methods:
  – Abandonment of collateral
  – Giving secured creditor “indubitable equivalent”
  – Secured creditor retains a lien on its collateral to secure its allowed secured claim, and receives on account of its claim deferred cash payments totaling at least the allowed amount of the claim with a present value of at least the value of the creditor’s “interest in the estate's interest in such property”
Plan Confirmation (Cont.)

• “Present value” reflects the time value of money.
  – $10 today is worth more than $10 paid a year from today.
  – Calculation of present value is determined by commonly accepted practices and formulas.

• Present value analysis calculates the value of property or cash to received in the future.
  – Assumes that the payments or distributions or property will be made as promised
  – Compensation for the risk that the promised payments or distributions will be made is reflected in components of the analysis, such as the interest or discount rates used.

• Market conditions and feasibility considerations are significant in selecting a rate at which an amount today could be invested to yield the promised amount when it is promised to be paid.

• Four components of a present value calculation:
  – The amount of each payment (including any accrued and payable interest)
  – The timing of each payment
  – The number of payments
  – The effective discount rate
Plan Confirmation (Cont.)

• The bankruptcy court must determine an appropriate rate to serve as the measuring standard.
  – Court’s determination is based on the facts of a given case.
  – Courts have used many different rates and formulas.
• The Supreme Court determined that an appropriate interest rate to be used in discounting to present value in the cram down context is best determined by use of a formula approach based upon the prime rate of interest. Till v. SCS Credit Corporation, 541 U.S. 465; 124 S. Ct. 1951; 158 L. Ed. 2d 787 (2004).
• The plan proponent bears the burden of proof on all confirmation issues, and must establish the applicable discount rate and entity valuation.
  – If the plan proponent does not carry its burden, confirmation should be denied, regardless of whether opponents to the plan have introduced contrary evidence.
  – Once the plan proponent satisfies its burden, opponents must make their own presentation on each issue.
Plan Confirmation (Cont.)

• Chap. 11 cram down rate may bear relation to the rate an efficient market would produce.
  – Debtor in possession (DIP) and exit financing rates may not be relevant to the cram down rate.
• Three common present value methods:
  – Creditor’s cost analysis: Looks at costs incurred by the creditor in being treated as provided for in the plan
  – Coerced loan analysis: Treats any deferred payment of an obligation under a plan as a coerced loan, such that the rates used in the analysis would correspond to the rate that would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral and risk
  – Specifically crafted discount-rate analysis: Adds to the interest rate paid for Treasury notes – i.e., a riskless cost of money, a premium based on a number of factors, including:
    • The term
    • Physical, financial and personal quality of security
    • Risk of repayment, future default or financial condition of the borrower
    • Profit component, which reasonably could be expected to be provided to the creditor forced by the plan into lender/borrower relationship
Plan Confirmation (Cont.)

• Since the plan must be fair and equitable as to each dissenting class, where a class of claims or equity is to be eliminated (thus, assumed to be a dissenting class), holders in the impaired class can force a valuation of the reorganized debtor to ensure that whoever does receive the equity interests in that entity will not be overcompensated.

• “Value is a word of many meanings. It may suggest actual or original cost, replacement cost, book value, fair market value, liquidation value, scrap value and a host of other concepts. The term, however, gathers its meaning in a particular situation from the purpose for which a valuation is being made.” Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Ry. Co., 318 U.S. 523, 540, 63 S. Ct. 727, 738, 87 L.Ed. 959, 994 (1943).

• An alternative to a DCF analysis is the “capitalized earnings valuation method.”
  – Analyzes the capitalization of average annual income, determined based on average prospective earnings and an appropriate capitalization rate
  – Tends to be backward-looking, to rely on accounting earnings and to select discount rates for the debtor's income by analogy

• Discounted cash flow analyses are designed to be forward-looking, to rely on actual earnings generated and to calculate discount rates for the specific debtor.
Plan Confirmation (Cont.)

- **Mirant**: In determining total enterprise value of debtor for plan confirmation purposes, court found, among other things, that the debtor’s value depended, in part, on the economic characteristics of the debt and equity assumed under the DCF method, the required return on debt and equity being a necessary element in calculating enterprise value. In re Mirant Corp., 334 B.R. 800 (Bankr. N.D. Tx. 2005).
  - Because *Till* instructs what return a secured creditor is entitled to for cram down purposes, *Till* effectively determines what cash flow is necessary to satisfy that creditor. The value of the obligation, “naturally dependent on the interest it bears,” is *not* determined by the market but rather through court’s objective inquiry as to appropriate interest rate.
  - *Till* then instructs on how to value the required return; the formula for determining the present value of secured debt or equity securities under a plan will be a risk-free rate plus an adjustment for risk based on the specific risks shown in evidence.
  - According to *Till*, the market does not properly measure the value of an obligation undertaken in a plan.
  - Thus, a debtor’s value, creditworthiness and attractiveness as an investment can be objectively assessed as of the proposed plan effective date.
Plan Confirmation (Cont.)

- **Granite Broadcasting**: Bankruptcy court overruled objection of preferred equity holders to confirmation of the plan, which had argued that the plan undervalued the debtors and paid the secured creditors more than the full amount of their claims, thereby depriving the preferred equity holders of their appropriate value.
  - The court found that the evidence supported the debtor’s projections of future performance, and the preferred holders were unable to offer a selling price supporting a different market value.
  - In this case, there was no risk that a market test would undervalue the debtors, since the preferred holders had the information necessary to make an informed offer and the ready ability to pay the price, as well as an interest in acquiring the debtors.
  - The expert valuations and the proposal made by the preferred holders confirmed that there was no value of the debtors beyond the debt, where the preferred holders’ proposal refused to pay any pre-payment penalty asserted by the secured lenders under the loan agreement, which would have been payable in a transaction between a willing buyer and willing seller when neither is under any compulsion to act.
Plan Confirmation (Cont.)

• **Young Broadcasting**: Bankruptcy court denied confirmation to competing plan proposed by unsecured creditors committee, which provided for reinstatement of the secured lenders’ loan. Court found the committee’s plan was not feasible in proposing payment of loan debt when it matured through a sale of the reorganized entity, since projections of the company’s growth were unrealistic and not supported by any reasonable analysis. In re Young Broadcasting Corp., 430 B.R. 99 (Bankr. S.D.N.Y. 2010).
  
  – Where the committee’s plan proposed to reinstate the lenders’ debt but would have avoided compliance with the loan agreement change of control provisions, court found the plan’s proposed corporate governance structure precluded compliance with the credit agreement such that the loan could not be reinstated.
  
  – Expert’s used of a “levered DCF” valuation was inadmissible because the court determined that it was not a reliable method of valuation, by failing to meet any of the Daubert factors: (i) It included multiple novel assumptions that do not exist in the generally accepted DCF analysis, (ii) is not a method that has been tested or relied upon by other experts, (iii) Had never been subjected to peer review or discussed in any publication, (iv) The potential rate of error was unknown, and (v) There was no evidence that the method was ever employed or generally accepted in any academic or professional community.
  
  – The committee’s plan was not feasible, since it was based on purely speculative assumptions regarding the reorganized debtor’s ability to satisfy the debt at the restated date of maturity.
Plan Confirmation (Cont.)

- *Spansion Inc.*: Bankruptcy court found debtor’s plan was fair and equitable to the one dissenting class based on the court’s analysis of the debtors' net distributable value, but denied confirmation on other grounds. In re Spansion, Inc. (U.S. Bank Nat’l Assoc. v. Wilmington Trust Co.), 426 B.R. 114 (Bankr. D. Del. 2010).
  - The court found that the evidence supported the debtor’s projections of future performance, and the preferred holders were unable to offer a selling price supporting a different market value.
  - The more reliable comparable company analyses used an EBITDA multiple rather than using a combination of EBITDA and revenue multiples, since the combination approach produced a variance in valuation ranges more than twice the range using only the EBITDA multiple.
  - The more reliable DCF valuations used both base case and contingency case projections, rather than only the base case projections as advocated by the objecting parties, and the experts justifiably accorded less weight to the contingency case projections than the base case projections.
  - Compared with the analyses by plan proponents’ experts, objecting parties expert’s DCF analysis was found to have used a lower discount rate, which resulted in a higher value, a higher perpetuity growth rate which resulted in a higher terminal value, and out-year projections inconsistent with the reasonable assumptions of the debtors’ management.
  - Pre-confirmation claims trading was found to not be an accurate measure of a debtor’s value.
Valuation Analyses Performed During Bankruptcy Filing – Valuation Of A Secured Creditor’s Collateral

- Valuation of assets, properties or business interests that serve as creditor’s collateral for purposes of:
  - Adequate protection of any creditor security interests
  - Splitting under-secured creditor claims
  - Relief from any court-ordered stay
Valuation Analyses Performed During Bankruptcy Filing – Valuation Of A Secured Creditor’s Collateral (Cont.)

• Valuation issues
  – Does the debtor entity have no equity value?
  – Is the collateral property needed by the debtor entity?
  – What is the appropriate standard of value and premise of value?
Valuation Analyses Performed During Bankruptcy Filing – Fairness Of Corporate Transactions During Bankruptcy

- Debtor in possession (DIP) transactions that may occur during bankruptcy:
  - Purchase or sale of a DIP business unit (e.g., subsidiary, line of business)
  - Sale or license of a DIP intellectual property
  - Transfer of assets or business units to/from a related party (e.g., shareholders, managers, directors)
Valuation Analyses Performed During Bankruptcy Filing – Fairness Of Corporate Transactions During Bankruptcy (Cont.)

• Fairness of the proposed DIP transaction to:
  – Individual creditors
  – All creditors
  – Other parties

• Valuation issues:
  – Fairness to whom?
  – What are the appropriate standard of value and premise of value?
  – What is the highest and best use (HABU) of the transaction property?
Valuation Analyses Performed During Bankruptcy Filing – Valuation Of Reorganized Debtor Securities

- The debtor entity may be a C corporation, S corporation, LLC, LLP, etc.

- The debtor securities may include equity securities (common, preferred, convertible) and debt securities (straight, convertible).

- The debtor securities may be issued to:
  - A creditor or creditor class as part of the reorganization
  - The DIP employees as part of a key employee compensation plan
Valuation Analyses Performed During Bankruptcy Filing – Valuation Of Reorganized Debtor Securities (Cont.)

- The debtor securities valuation considerations
  - What are all the rights and features of the DIP securities?
  - What is the appropriate standard of value and premise of value?
  - What is the appropriate DIP HABU?
  - The analyses should consider both the bankruptcy period and the post-bankruptcy results of operations.
  - The analysis may include fairness considerations.
Determining Debtor Company Insolvency
(E.g., Related To Preference Items And/Or Fraudulent Conveyance)

- Valuation considerations
  - Similar to the situation in the “zone of insolvency”, an analysis likely may be performed for a range of time during which the transfer or preferences are alleged to have been made.
  - All assets and all liabilities should be valued to determine whether the debtor company was insolvent at a point in time.
  - Includes all “recorded” assets and liabilities and all assets and liabilities that are not recorded for GAAP reporting purposes
Feasibility Of Reorganization Plan

- Evaluation of projections
- Ability to obtain financing for the plan
- Value perceptions of investors, lenders and marketplace
Assessing Proposed Plan Of Reorganization
(E.g., Is It Fair And Equitable To Creditors, And Reasonable?)

• Valuation considerations
  – The analysis most likely will be based on a set of cash flow projections/
  – Instead of arriving at a value of the reorganized business, the analyst is really giving an opinion on whether the elements of the proposed reorganization plan, represented by the cash flow projections, can be reasonably attained.
  – Therefore, the cash flow projection assumptions are extremely important, and the analyst should be assured that they are reasonably supported.
Assessing Proposed Plan Of Reorganization (E.g., Is It Fair And Equitable To Creditors, And Reasonable?), Cont.

- The analyst should take into account all aspects of the proposed reorganization plan.
- Income tax issues (including the use of NOLs, asset basis adjustments, future income taxes, etc.) are often important.
- Since the cash flow projections are not discounted in the reorganization plan assessment, it is not possible to take into account non-attainment risk in the selected discount rate. So, once again, an assessment of the cash flow projection assumptions is important.
Financial Reporting Vs. Bankruptcy

- Is it represented on the financial statements?

- Should it be?

- How do we value it?
Financial Reporting Vs. Bankruptcy (Cont.)

- Assets
  - Tangible vs. intangible
    - Accounts receivable
    - Inventory
    - Machinery and equipment
Financial Reporting Vs. Bankruptcy -
Assets

- Patents
- Customer relationships/customer lists
- Distributor relationships
- Trade name/trademarks
- Existing technology
- In-process R&D
- Non-compete agreements
- Supplier lists
- Goodwill
- Net operating losses
Financial Reporting Vs. Bankruptcy - Liabilities

- Liabilities
  - Booked vs. contingent
    - Accounts payable
    - Accrued expenses (wages)
    - Warranties
    - Deferred taxes (change in ownership)
    - Guarantees
    - Indemnifications
    - Litigation
    - Pollutants (real estate)
Valuation Analyst Caveats In Bankruptcy Environment

• There may be no market for the subject debtor company assets or securities.

• Therefore, the analyst may have to conceptualize a market for the subject debtor company assets or securities.

• There are often technical legal issues involved in bankruptcy matters. Don’t hesitate to ask the client’s legal counsel for legal instructions.
Valuation Analyst Caveats In Bankruptcy Environment (Cont.)

- Don’t reach legal conclusions as part of the valuation, fairness or solvency analyses. That is the lawyer’s job.

- Most bankruptcy valuation and insolvency analyses rely principally on financial projections. The DIP/reorganized company financial projections should be subject to rigorous due diligence.
Valuation Analyst Caveats In Bankruptcy Environment (Cont.)

- Parties in interest typically have adverse interests. Therefore, the valuation analyst may receive biased or incomplete data – including from the client and the client’s legal counsel.

- The debtor company operations will be different after the bankruptcy, compared with during the bankruptcy. That fact may affect the reorganized company asset and equity values.
Valuation Analyst Caveats In Bankruptcy Environment (Cont.)

• The selected standard of value and premise of value (and the related HABU conclusion) can significantly affect the asset and equity value conclusions.

• Be aware of the differing roles of the valuation analyst/financial advisor as (1) a valuation analyst (with SSVS compliance) vs. a financial advisor (exempt from SSVS), and as (2) a consulting expert vs. a testifying expert.
Valuation Analyst Caveats In Bankruptcy Environment (Cont.)

- Income tax considerations can materially affect both the DIP and the reorganized company asset values and equity values. Don’t hesitate to ask for income tax advice or income tax instructions from bankruptcy and/or tax legal counsel.

- From the bankruptcy perspective, there is more to the valuation analyst’s role than just providing value opinions. The valuation analyst is often a financial adviser, opining on transactional fairness and/or debtor company solvency/insolvency issues.
Business Restructurings Outside Of Bankruptcy

Jim Alerding, Clifton Gunderson
Restructuring Issues Outside Of Bankruptcy

• Quality and adequacy of information provided by management

• Lack of due diligence by stakeholders

• No formal committees

• Questionable financial projections prepared by management
Restructuring Issues Outside Of Bankruptcy (Cont.)

• The income approach becomes important as the primary line of value (given the “floor” value of the asset approach).
  – Cash flows are paramount in this approach.
  – Historical cash flows are likely of little value.
  – A DCF method is the only reasonable income method in this situation.
  – Forecasts are critical, as assumptions are difficult when valuing a distressed company.
  – If the situation allows, consider a “real options” approach to the DCF.
Impact Of Special Issues On Valuation Approaches

- The market approach is of value only if there is a truly comparable market for the target company.
  - Query: Is the market comparable if the “market” companies are not distressed?
  - The guideline company method is difficult in a non-distress situation. It is probably not useful in the case of a distressed or impaired company.
  - Particular intangible assets might make the company valuable, whether impaired or not. In such a case, a market transaction method might be appropriate.
Normalization In A Distressed Valuation

- Standard normalization adjustments
  - Non-recurring items
  - Non-operating assets
  - Accounting method differences
Normalization In A Distressed Valuation (Cont.)

• Additional considerations
  – Normalized revenue
    • Is the company’s industry cyclical?
    • Is the industry currently in a trough?
  – Operating costs that can be or are being eliminated
  – Future investments/divestments
  – Restructuring costs
Normalization In A Distressed Valuation (Cont.)

- Extra legal expense
- Extra accounting expense
- Bank covenant violations
- Cost of refinancing
Discount For Distress?

“Distressed entities generally have higher risk profiles and lower profitability levels compared to their healthy competitors, and a proper discount for distress, usually at least 20%, therefore must be built into the valuation.” *

Development Of An Appropriate Discount Rate

• Selection of the discount rate
  + Risk-free rate (shorter time horizon)
    • Long-term risk free rate?
    • Match the cash flow with the corresponding risk free rate?
  + ERP
  + Size premium
  + Default spread
  + Company-specific risk

Risk-adjusted discount rate
Always Consider

- What is the condition of the industry in which the company participates?
- How much of a company’s distress is related to mismanagement?
- Does the business have access to capital?
Always Consider (Cont.)

- Has risk been appropriately account for?
  - Project cash flow
  - The discount rate
  - Both (be careful not to double-count)

- Have valuation multiples been developed using comparable companies?

- What is the probability of bankruptcy?
Common Valuation Services After The Bankruptcy

- ASC Sect. 852-10, * fresh-start accounting valuations
  - ASC Sect. 852-10 established criteria allowing for an emerging company to use “fresh start accounting” under certain circumstances.
  - First, there should be a change in control in the voting shares immediately after the reorganization plan confirmation. This means that existing shareholders prior to confirmation should receive less than 50% of the voting shares after confirmation.
  - Second, the valuation analyst should calculate the reorganization value of the assets and compare that value to the total of their post-petition liabilities and allowed claims. If the reorganization value of the assets is less than the total value of the post-petition liabilities, then the debtor company qualifies for fresh start accounting.

* ASC Sect. 852-10 used to be AICPA SOP 90-7
Source: Association of Insolvency & Restructuring Advisors, SOP 90-7: The Basics written by Sean Raquet, CPA, CFE, October/November 2008.
Common Valuation Services After The Bankruptcy (Cont.)

- ASC Sect. 852-10,* fresh-start accounting valuations (Cont.)
  - In theory, fresh start accounting provides the emerging entity with the opportunity to reflect its assets at fair value upon the reorganization plan confirmation. This fair value presentation is more meaningful to financial statement users than the presentation of assets and liabilities at historical cost. By allowing the emerging entity to state its assets and liabilities at fair value, its post-bankruptcy financial position is presented more fairly.

* ASC Sect. 852-10 used to be AICPA SOP 90-7

Common Valuation Services After The Bankruptcy (Cont.)

- ASC Sect. 852-10,* fresh-start accounting valuations (Cont.)
  - The valuation analyst can be an integral and necessary part of the team to estimate the fair value of the reorganized company assets under ASC Sect. 852-10 “fresh start” accounting.

* ASC Sect. 852-10 used to be AICPA SOP 90-7

Source: Association of Insolvency & Restructuring Advisors, SOP 90-7: The Basics written by Sean Raquet, CPA, CFE, October/November 2008.
Internal Revenue Code Sect. 382

Tax Attribute Considerations

• IRS Sect. 382 limits the amount of the net operating loss (NOL) that can be used after an entity ownership change occurs.
  – This is a complicated IRC section to plan for and comply with
  – Sect. 382 applies after a 50% change in ownership.
  – Sect. 382 limits the NOL tax attribute use to the product of (1) the taxpayer company value multiplied by (2) the statutory tax exempt interest rate.

• IRC Sect. 393 provides the same post-ownership change use limitation for most income tax credits (e.g., the R&D tax credit).
IRC Sect. 392 Planning Considerations

- Sect. 382 (I)(5) allows for the election out of Sect. 382 treatment within a Chap. 11 bankruptcy filing
  - The ownership change of 50% or more must be due to the Chap. 11 restructuring.
  - The reorganized company must continue the taxpayer business enterprise operations for two years after the election.
  - The reorganized company must not have another Sect. 382 ownership change for two years after the election.
  - The taxpayer company must “recapture” all of the interest expense that was deducted for the past three years (which effectively lowers the amount of the NOL that is carried forward).
IRC Sect. 392 Planning Considerations (Cont.)

• If there is (1) no two-year continuity of taxpayer, business enterprise operations or (2) another change in ownership of the reorganized taxpayer company within two years, then:
  – The Sect. 382 limitation effectively becomes zero, and the utilization of the NOL tax attribute is lost.
  – Accordingly, post-bankruptcy income tax planning regarding the carryover of tax attributes is important.
  – Any potential DIP/reorganized company acquirer must be comfortable with (1) the two-year reorganized company holding period, and (2) the two-year extended exit strategy.
Built-In Gains Tax Considerations

- In the case of a Sect. 382 election, the valuation of the debtor corporation enterprise is encouraged (remember, the NOL use limit is the company value times the tax exempt interest rate).
  - It is important to identify any built-in gains against which the NOL tax attribute can be used.
  - This identification will increase the amount of the Sect. 382 limitation.
# Orderly Liquidation Value

<table>
<thead>
<tr>
<th>Asset</th>
<th>Valuation Convention</th>
<th>Items Affecting Valuation/Realization</th>
<th>Current Environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and marketable securities</td>
<td>• Gross book value</td>
<td>• Nature of asset. Cash may be restricted or earmarked for a counterparty.</td>
<td>• Lower cash balances with potentially higher float levels than historically</td>
</tr>
<tr>
<td>Accounts and notes receivable</td>
<td>• Gross book value multiplied by historical collection percentage</td>
<td>• Receivables aging • Customer and industry concentration. Eligible vs. Ineligible, from ABL perspective</td>
<td>• Higher than normal past due concentration, due to customer “stretch”</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Customer programs including feasibility of customer returns/credits</td>
<td>• Higher component of receivables from bankrupt or distressed customers, creating incremental likelihood of write-off</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Consider costs to collect • In time, most receivables are collected upon; litigation used as a safety valve</td>
<td></td>
</tr>
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</tr>
</tbody>
</table>
| Inventory     | • Recent appraisals made for current gross inventory position (amt./type/status) | • Seasonality (high vs. low selling season)  
• Cost-benefit analysis for in-process inventory completion  
• Existing orders against specific inventory  
• Advanced payments against inventory, which may dilute recoveries  
• Costs to dispose  
• Litigation may be used as a safety valve | • Deeper discounts as a result of:  
– Lower ordinary course volumes and margins  
– Excess inventory in current channels (perhaps from similar liquidations) |
| Prepaid expenses | • Net book value with a factor applied depending on the determined collection prospects | | • Dependant on specific case |
**Orderly Liquidation Value (Cont.)**

<table>
<thead>
<tr>
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<th>Valuation Convention</th>
<th>Items Affecting Valuation/Realization</th>
<th>Current Environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intangible assets/ intellectual property</td>
<td>• Recent appraisals, or if unavailable, management input/valuation discretion</td>
<td>• Proprietary nature of products/services • Patents/trademarks/copyrights held and associated terms • Potential future cash flow from assets</td>
<td>• Generally lower appetite for intangibles, if any to begin with</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>• Recent appraisals • If appraisals are unavailable, analysis may be used taking account book values and/or original cost multiplied by factor</td>
<td>• Standard characteristics (size, location, age) • Utility or transferability of assets across products/industry • Costs to dispose</td>
<td>• Unprecedented value deterioration due to reduced demand, significant supply (from similar liquidations), limited financing options • Significantly longer marketing period, in some cases two-plus years</td>
</tr>
</tbody>
</table>