Bankruptcy Litigation Valuation Guidelines

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Valuation opinions are often required as part of the bankruptcy process. Therefore, bankruptcy counsel often seek the professional services of a valuation analyst to provide assistance in developing an acceptable plan of reorganization. This discussion identifies ten guidelines that contribute to a successful bankruptcy engagement.

Introduction

Valuation issues influence many of the legal matters that arise within a bankruptcy proceeding. Therefore, bankruptcy counsel often have to retain, work with, rely on, examine, or defend valuation analysts within a bankruptcy environment.

This discussion presents a top ten list of guidelines for bankruptcy counsel who work with valuation analysts. This list encompasses the principal considerations related to a bankruptcy valuation.

This list of ten guidelines is not presented in order of importance. However, this list does summarize some of the more important considerations for both the valuation analyst and the legal counsel who are involved in a bankruptcy-related dispute.

Bankruptcy Valuation Analyst Guidelines

1. There is an extensive scope of services that valuation analysts can provide to legal counsel within the bankruptcy discipline

As bankruptcies have become more complex and bankruptcy proceedings have become more contentious, the scope of valuation analyst professional services has expanded.

These valuation services include the valuation of debtor businesses, business ownership interests, securities, and intangible assets. These services include forensic analysis, such as forensic accounting, financial investigations, litigation support services, and expert witness testimony.

These valuation services also include independent financial advisory opinions, such as transaction fairness opinions, adequate consideration opinions, reasonably equivalent value opinions, reasonableness of plan of reorganization opinions, and other financial opinions.

Valuation analysts assess if and when debtor companies enter the zone of insolvency. Valuation analysts perform solvency and insolvency analyses for purposes of proving fraudulent transfer, preference payment, and other claims. Valuation analysts estimate the value of creditors' collateral, including the value of debtor company tangible assets, intangible assets, and securities.

Valuation analysts may help identify cash generating business or asset sale opportunities. Analysts opine on the fairness of the proposed sale price and sale structure of Bankruptcy Code Section 363 asset sale transactions. Debtor company business and asset valuations are an important component of securing debtor-in-possession (DIP) financing. Valuation analyses also opine as to whether various transactions involving the debtor assets or securities protect the interests of the debt holders or the equity holders.

And, valuation analysts may help the DIP management and/or the bankruptcy counsel develop the plan of reorganization, assess the reasonableness of a plan of reorganization, and quantify the income tax and financial accounting implications of a plan of reorganization.

2. The valuation analyst should understand and document all of the elements of the bankruptcy valuation assignment

The elements of the valuation assignment are typically described in the statement of the purpose and objective of the bankruptcy valuation. Before starting the engagement, bankruptcy counsel should ensure that the analyst understands the following elements of the bankruptcy valuation:

a. The valuation subject (what debtor business, assets, or securities are the subject of the analysis)
b. The subject ownership interest (this is typically, but not always, a fee simple ownership interest)
c. The appropriate standard of value (this is typically, but not always, fair market value)
d. The appropriate premise of value (this is typically, but not always, value in continued use as a going concern)
e. The appropriate valuation date (and the analyst should understand why the selected date is relevant to the bankruptcy proceeding)

These elements of the valuation are usually provided to the analyst by the client (or by the client's legal counsel). And, these elements of the valuation are typically documented in the analyst's engagement letter.

3. The valuation analyst should perform the appropriate due diligence in all aspects of the bankruptcy valuation assignment

Valuation analysts typically perform reasonable data gathering and due diligence procedures before performing any quantitative or qualitative analyses. Analysts typically perform due diligence procedures related to various categories of documents considered in the valuation, including the following:

a. Historical financial documents regarding the debtor business or assets
b. Historical operational documents regarding the debtor business or assets
c. Historical legal documents regarding the debtor business or assets
d. Historical ownership documents regarding the debtor business or assets
e. Documents regarding the historical or proposed transaction
f. Legal documents regarding the bankruptcy proceeding
g. Prospective financial information regarding the debtor business or assets
h. Publicly available information regarding the debtor industry
i. Publicly available information regarding guideline public companies
j. Publicly available information regarding guideline sale transactions

Before relying on any documents or data, the analyst will typically consider if the document is complete, a draft or a final document, one document within a chain of documents, etc. The analyst may consider if (a) the document was prepared contemporaneously to the subject transaction or valuation date or (b) the document was prepared after litigation was filed.

The analyst may consider if the document was contemporaneously relied on by any parties not related to the bankruptcy. And, the analyst may consider if the document was ever reviewed by an auditor, regulator, or other independent third party.

The analyst typically performs reasonable due diligence procedures related to any debtor company prospective financial information (PFI). This type of information includes any debtor business plans, operating budgets, strategic forecasts, or financial projections.

The analyst will often assess such PFI with regard to the following:

a. The debtor company's historical ability to project financial results
b. The debtor company's current results of operations
c. The debtor company's current plant and other capacity constraints
d. The debtor company's current position in the industry
e. Security analyst projections for guideline public companies
f. Industry projections from financial reporting agencies, trade associations, etc.

The valuation analyst will typically have a reasonable basis for relying on selected documents or data (and of not relying on rejected documents or data).

4. There are generally accepted valuation approaches, methods, and procedures

These generally accepted approaches, methods, and procedures are promulgated by various valuation professional organizations. The generally accepted methods are documented in the valuation professional literature. The generally accepted methods are commonly used by professional valuation analysts. In fact, what makes a valuation method generally accepted is the fact that it is commonly used in the valuation profession.

Bankruptcy valuation analysts are aware of the generally accepted methods. Bankruptcy valuation analysts should be able to describe the generally accepted methods to the legal counsel and the finder of fact. And, experienced valuation analysts consistently apply the generally accepted methods. The valuation analyst who uses an "other" valuation method should be able to explain the reason for (and the rationale behind) the departure for the generally accepted methods.

Valuation analysts do not use the generally accepted methods simply because the methods are documented in promulgated standards and professional literature. Rather, valuation analysts rely on the generally accepted methods because these methods are based on fundamental economic principles and established valuation theory.

5. There is a generally accepted vocabulary that is used in the valuation profession

Most professions use technical jargon that is specific to that profession. The purpose of such technical jargon is not to obfuscate complex issues. Rather, the purpose of such jargon is to clarify complex issues. The valuation profession has its own technical jargon. Valuation analysts use that jargon as a shorthand means of communicating with each other, with bankruptcy counsel, and with the non-valuation parties to a bankruptcy.

The technical valuation jargon terms typically have a specific meaning. And, these terms relate to specific components of the generally accepted valuation approaches, methods, and procedures.

The *International Glossary of Business Valuation Terms* has been adopted by four professional business valuation organizations in the United States. To demonstrate their experience and expertise, bankruptcy valuation analysts typically comply with the terminology adopted in that glossary.

Experienced valuation analysts are careful in their selection and application of technical jargon. This precise language allows for the effective communication of valuation analyses and conclusions to bankruptcy counsel, finders of fact, and other parties to the bankruptcy.

Inexperienced valuation analysts are less than careful in their selection and application of technical jargon. This imprecise language allows for the ineffective communication of valuation analyses and conclusions to bankruptcy counsel, finders of fact, and other parties to the bankruptcy.

Further Reading

Dr. Israel Shaked and Robert F. Reilly, *A Practical Guide to Bankruptcy Valuation* (New York: American Bankruptcy Institute, 2013).

6. There are generally accepted valuation professional standards and practices

Many bankruptcy valuation analysts are members of one or more of the following professional organizations: the American Institute of Certified Public Accountants, the American Society of Appraisers, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts.

Each of these organizations has training and testing programs that lead to business valuation credentials. And, each of these organizations has a code of ethics and a set of professional standards that its credentialed valuation analysts subscribe to.

There is no statutory, regulatory, or judicial requirement that a bankruptcy valuation analyst be credentialed by any professional organization. However, credentialed analysts have demonstrated their professional experience, expertise, and dedication by obtaining a valuation credential. And, such analysts subscribe to a documented set of professional standards.

The trend in the bankruptcy discipline appears to be that (a) more valuation analysts are obtaining some type of a professional credential and (b) more analysts are performing their valuations in compliance with some set of recognized professional standards.

7. There are complex income tax and financial accounting implications to most bankruptcy-related valuations

Not all valuation analysts are income tax specialists or financial accounting experts. However, there are taxation and accounting implications to bankruptcy filings, bankruptcy transactions, and bankruptcy emergences.

Debtor companies consider the taxation and accounting implications of almost all bankruptcy related decisions. Creditors consider the taxation and accounting implications of almost all bankruptcy-related decisions. Finders of fact consider the taxation and accounting implications of almost all bankruptcy-related decisions.

Therefore, valuation analysts should be aware of these taxation and accounting implications. And, analysts should include such implications in the bankruptcy valuation.

The income tax implications of bankruptcy can be very complex. Such tax implications can affect the value of a debtor company's stock and assets. Such tax implications can affect the value of completed or proposed bankruptcy transactions. And, such tax implications can affect the reasonableness of a proposed plan of reorganization.

Valuation analysts routinely rely on debtor company financial statements during the valuation process. Therefore, valuation analysts should understand the financial accounting principles upon which the debtor company financial statements are prepared. And, valuation analysts should understand any financial accounting effects on the transaction they are analyzing or the valuation they are preparing.

Valuation analysts without the appropriate tax accounting or financial accounting expertise may consult with either appropriately qualified colleagues or third-party accounting specialists.

8. Valuation analysts should be sufficiently familiar with all of the intangible asset considerations of the bankruptcy valuation

Valuation analysts are often asked to value debtor company intangible assets, either as an independent business interest or as part of the analysis of a going- concern business. These intangible asset valuation analyses may be a component of a debtor company solvency analysis, fair market value analysis, transaction fairness analysis, collateral value analysis, reasonably equivalent value analysis, or other bankruptcy-related analyses.

Intangible assets may be a component of a Bankruptcy Code Section 363 asset sale transaction. And, intangible asset licenses or sale/license-back transactions are sometimes used as a source of cash flow generation for the DIP.

The debtor company intangible assets are often grouped into the following four categories:

a. Financial intangible assets, such as cash, notes receivable, and marketable securities
b. Intellectual property, including patents, copyrights, trademarks, and trade secrets
c. Identifiable commercial intangible assets, such as contracts, permits, franchises, computer software, engineering drawings and technical documentation, customer relationships, supplier relationships, employee relationships, and others
d. Goodwill and going concern value

Experienced analysts know that there are generally accepted intangible asset valuation approaches, methods, and procedures. Of course, the generally accepted valuation approaches are the cost approach, the market approach, and the income approach.

Each valuation approach typically includes several generally accepted valuation methods. And, there are generally accepted standards and practices related to reporting the results of the intangible asset valuation.

Valuation analysts who do not have sufficient intangible asset valuation experience or expertise may either work with a more qualified colleague or confer with an independent valuation specialist.

9. Valuation analysts should be sufficiently familiar with all of the real estate and tangible personal property considerations of the bankruptcy valuation

Many valuation analysts are not experienced real estate or tangible personal property appraisers. Nonetheless, the value of the debtor company real estate and personal property may be an important component of the bankruptcy valuation analysis. For example, the value of the debtor company tangible assets could affect a solvency analysis, fair market value valuation, collateral value analysis, transaction fairness opinion, or reasonably equivalent value opinion.

The value of the debtor tangible assets could affect the availability of (a) DIP financing (including sale/leaseback) opportunities, (b) cash-generating asset or business spinoff opportunities, and (c) the plant resources to implement a proposed plan of reorganization.

The analyst should be aware that there are generally accepted tangible asset valuation approaches, methods, and procedures. The analyst should be aware that there are generally accepted standards and practices related to reporting the results of the tangible asset value conclusion.

The analyst should be aware of how different standards of value (e.g., fair market value vs. market value) may affect the tangible asset value conclusion. And, the analyst should be aware of how different premises of value (e.g., value in continued use vs. value in exchange) may affect the tangible asset value conclusion.

The analyst should be familiar enough with tangible asset appraisal principles and procedures for the following reasons:

a. To know when and how to rely on these value conclusions of such appraisals
b. To be able to distinguish between a professionally prepared and appropriately supported appraisal and an appraisal that is less credible
c. To be able to explain the appraisal analyses and conclusion to the client and the client's legal counsel
d. To be able to interpret the appraisal results for a bankruptcy proceeding finder of fact

Valuation analysts who do not have sufficient familiarity with tangible asset appraisals may either work with a more qualified colleague or confer with an independent valuation specialist.

10. Valuation analysts should be familiar with generally accepted valuation reporting standards

Valuation analysts have to communicate the results of their analyses to the bankruptcy counsel and to the finder of fact. This communication may involve a written report, an oral report, expert testimony, or some combination of these three mediums.

There are generally accepted standards and practices with respect to the preparation of a written valuation report. These standards are promulgated by various valuation professional organizations. And, these standards become generally accepted because they have become common practice within the community of professional valuation analysts. Valuation analysts who practice in the bankruptcy discipline should be familiar with these standards.

Likewise, there are generally accepted standards and practices with respect to oral valuation reports, including expert testimony. Valuation analysts who practice in the bankruptcy discipline should also be familiar with these standards.

Often, expert witnesses have to comply with specific statutory and administrative requirements related to expert reports. These requirements may include the Federal Rules of Evidence. The valuation analyst may confer with legal counsel with regard to the application of specific expert testimony rules.

In addition, legal counsel should instruct the analyst as to the appropriate reporting requirements with respect to expert reports and expert testimony. Ultimately, it is the counsel's responsibility to instruct the analyst with regard to the law. The analyst is not a lawyer; the analyst should expect legal instructions from bankruptcy counsel.

"There are generally accepted standards and practices with respect to the preparation of a written valuation report."

Summary and Conclusion

Bankruptcy counsel often retain, work with, and rely on valuation analysts during a bankruptcy proceeding. This discussion presented guidelines for bankruptcy counsel who work with valuation analysts.

The past decade or so has witnessed increased professionalism among valuation analysts who practice in the bankruptcy discipline. This increase in professionalism may have occurred in response to increased expectations from clients and client's legal counsel. And, this increase in professionalism may have occurred in response to the increased sophistication of courts, opposing legal counsel, and opposing valuation analysts.

Bankruptcy valuation analysts apply generally accepted valuation approaches, methods, and procedures in their related valuations. Bankruptcy valuation analysts apply generally accepted reporting standards and practices in their valuations.

The use of generally accepted approaches, methods, and procedures should result in a bankruptcy valuation that is transparent and replicable. The use of generally accepted reporting standards and practices should result in a valuation report that is clear, consistent, and cogent.

Clients, legal counsel, and courts expect valuation analysts to be able to support their bankruptcy valuation analyses, conclusion, and report. And, clients, legal counsel, and courts expect valuation analysts to be able to dispassionately assess the strengths and weaknesses of the opposing analyst's bankruptcy valuation analyses, conclusion, and report.

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