Valuation Analyses and the Commercial Bankruptcy

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There are valuation issues involved in most commercial bankruptcy matters. These valuation issues are often important to the debtor in possession, the various classes of creditors, the various contract counterparties and other interested parties, and the legal counsel for all of the above. First, this discussion summarizes many of the reasons to conduct a valuation within a bankruptcy environment. Second, this discussion considers many of the issues the valuation analyst typically encounters within a bankruptcy context. And, third, this discussion presents numerous caveats for the analyst who is performing a bankruptcy-related valuation.

Introduction

Many factors may cause an industrial or commercial company to consider filing for bankruptcy protection. Certainly, the 2008 financial crisis and the ensuing slow economic recovery have caused financial distress in many industries and for many debtor companies.

Issues related to the valuation of businesses, securities, and operating assets are commonplace within a commercial bankruptcy. Related financial issues (e.g., corporate solvency, transactional fairness, reasonableness of a business plan, reasonably equivalent value in a property transfer) are also common within the commercial bankruptcy.

Valuation analysts who practice in this discipline should be familiar with both of the following:

1. The reasons to conduct a bankruptcy valuation
2. The analytical issues that are specific to a bankruptcy valuation

Valuation analysts are often called on to perform valuation or related financial advisory services within a commercial bankruptcy. This discussion summarizes many of the reasons why valuation analysts are retained within a bankruptcy matter.

This discussion summarizes many of the issues that valuation analysts commonly encounter when performing a bankruptcy-related analysis. And, this discussion presents practical caveats that valuation analysts may consider when preparing bankruptcy-related analyses.

Reasons to Conduct a Bankruptcy Valuation

The following list presents some reasons why valuation analysts are retained in a commercial bankruptcy. The section citations refer to the United States Bankruptcy Code. The rule citations refer to the United States Bankruptcy Rules.

1. Preference actions solvency analysis (Section 547)
2. Fraudulent transfers solvency analysis (Section 548)
3. Asset sale prices and creditor adequate protection (Section 363)
4. Adequate protection of creditor's interest (Section 361)
5. Value of secured creditor's claim as fully secured (Rules 3012 and 3018)

6. Confirmation of the reorganization plan (Section 1129)
7. Cram down of the reorganization plan (Section 1129)
8. Secured creditor relief from the automatic stay (Section 362)
9. Collateral value for debtor-in-possession (DIP) financing
10. Director duties and the zone of insolvency

Each of these reasons to perform a commercial bankruptcy valuation is summarized below.

Section 547 – Preference Claims and Debtor Solvency

In a Chapter 11 bankruptcy, the appointed trustee may seek to avoid (i.e., reverse) any transfers of cash or property out of the bankruptcy estate. That avoidance brings more property and more cash back into the bankruptcy estate—to allow the trustee to settle more of the debtor's liabilities. Section 547 allows the trustee to avoid certain so-called preference payments under certain circumstances.

The relevant subsections of Section 547 follow:

> (b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property –
>
> 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 was made;
> 3. made while the debtor was insolvent; . . .
>
> (f) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

Of course, the creditor recipients of the debtor's property or cash may not be so willing to return the transaction proceeds to the bankruptcy estate. Therefore, the creditors' counsel may retain a valuation analyst to assess the debtor's solvency prior to the date of the bankruptcy filing. The creditors typically want to claim that:

1. the debtor was in fact solvent prior to the bankruptcy filing and
2. therefore, their receipt of either property or cash from the debtor was not an avoidable preference payment.

Section 548 – Fraudulent Transfers and Debtor Solvency

In the Chapter 11 bankruptcy, the trustee can avoid (or reverse) either transfers made by the debtor corporation or liabilities assumed by the debtor corporation under certain circumstances. An important factor in determining if the debtor's transfer was fraudulent (and, therefore, if the transfer may be avoided) is whether the debtor corporation was insolvent at the date of the transfer.

Often, counsel for the trustee retains a valuation analyst to opine that the debtor corporation was insolvent on the pre-bankruptcy transfer dates. Alternatively, the affected creditors often retain a valuation analyst to opine that the debtor corporation was solvent on the pre-bankruptcy transfer dates.

The relevant subsections of Section 548 related to fraudulent transfers and debtor solvency are presented below:

> (a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (B)(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 or 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.

With regard to the above-described conditions related to a fraudulent transfer, Section 548 lists three separate fraudulent transfer tests that are performed as of the transfer date. These three fraudulent transfer tests are typically performed by a valuation analyst or other financial adviser. These three fraudulent transfer tests determine:

1. whether the debtor corporation was insolvent—i.e., whether the debtor company liabilities exceeded the debtor company assets at fair valuation;
2. whether the debtor corporation was expected to be able to pay its debts (including principal and interest payments) as such debts matured; and
3. whether the debtor corporation had an unreasonably small amount of capital to continue to be able to operate as a going concern.

The trustee may claim that a fraudulent transfer occurred if the valuation analyst concludes that the debtor corporation fails any of these three tests as of the transfer date. And, each of these tests is based on a financial analysis that is typically conducted by a valuation analyst (or other financial adviser).

Section 101 – Definition of "Insolvent"

The previously mentioned claims of preference payments and fraudulent transfers are made, in part, based on the allegation that the debtor corporation was insolvent as of a particular point in time (i.e., a point in time related to a specific pre-bankruptcy transaction). As presented in the subsection below, Section 101 provides the relevant definition for the term "insolvent":

(32) The term "insolvent" means—

(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—

(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and

(ii) property that may be exempted from property of the estate under section 522 of this title;

(B) with reference to a partnership, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation—

(i) all of such partnership's property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and

(ii) the sum of the excess of the value of each general partner's nonpartnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner's nonpartnership debts; and

(C) with reference to a municipality, financial condition such that the municipality is—

(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or

(ii) unable to pay its debts as they become due.

The principal provision of this insolvency definition can be summarized as: Are the debtor company's debts greater than the value of the debtor company's assets, at fair valuation? The answer to that question is based on a valuation analysis. If the answer is yes (i.e., the company liabilities exceed the fair value of the company assets), then the debtor company is insolvent. If the answer is no (i.e., the fair value of the company assets exceeds the company liabilities), then the debtor company is solvent.

Section 363 – Asset Sales and Adequate Protection

During a prolonged bankruptcy proceeding, it is common for a DIP to sell off some of the debtor corporation assets included in the bankruptcy estate. Those DIP assets subject to sale may be a subsidiary, division, or other business unit of the debtor corporation. In particular, the DIP may be able to sell off

some nonperforming business assets. And, the DIP may be able to sell off any nonoperating assets that are not part of the debtor company's core business. Such asset sales (often referred to as "363 asset sales") are typically intended to both:

1. eliminate or reduce any DIP operating losses and
2. generate cash that would become available to pay off some of the debtor company's liabilities.

However, in a bankruptcy proceeding, the trustee has to make sure that such 363 asset sales are fair to the stakeholders of the bankruptcy estate. Such stakeholders are primarily the debt holders. The following subsection of Section 363 relates to asset sales from the bankruptcy estate:

> (b)(1) The trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate
>
> (c)(1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.
>
> (p) In any hearing under this section—
>
> (1) the trustee has the burden of proof on the issue of adequate protection; and
>
> (2) the entity asserting an interest in property has the burden of proof on the issue of the validity, priority, or extent of such interest.

Accordingly, the trustee will often retain a valuation analyst to opine that the price of the proposed 363 asset sale is fair, thereby providing adequate protection to the creditors. If the proposed asset sale transaction is controversial, then the creditors may also retain a valuation analyst to opine that the price of the proposed 363 asset sale is not fair (and does not provide adequate protection to the creditors)—and that the court should not approve the proposed asset sale.

Section 361 – Decrease in the Value of a Creditor's Interest

The Bankruptcy Code provides protection for a creditor's interest in the debtor's property. Sometimes events occur during the bankruptcy proceeding that reduce the creditor's interest in the debtor's property (such as a 363 asset sale of that collateral property).

In such an instance, Section 361 basically provides that the creditor should be made whole. The creditor could be made whole by receiving either:

1. cash from the trustee or
2. an additional lien on other debtor corporation property.

The relevant subsections of Bankruptcy Code Section 361 are presented below:

> When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—
>
> (1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;
>
> (2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or
>
> (3) granting such other relief, other than entitling such entity to compensation allowable under section 503 (b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

In these instances, the important questions often include the following:

1. By how much was the value of the creditor's interest (in the debtor's collateral property) reduced?
2. What is the value of the additional interest that the creditor should receive in order to obtain the "indubitable equivalent" of the value of the lost security?

These value of a creditor's interest questions are important to the secured creditors. And, these questions are typically answered by the results of a valuation analysis.

Bankruptcy Rules Regarding a Secured Creditor's Interest

In a Chapter 11 bankruptcy, the value of a secured creditor's security interest is important for a number of reasons. For example, the value of the creditor's security affects the creditor's influence with regard to the approval (or disapproval) of the proposed plan of reorganization.

When there is a question about the value of a creditor's security interest, the court may hold a valuation hearing and hear testimony from valuation analysts.

Sections of two relevant Bankruptcy Rules regarding the value of a secured creditor's interest are presented below:

> **Rule 3012 Valuation of Security**
>
> The court may determine the value of a claim secured by a lien on property in which the estate has an interest on motion of any party in interest and after a hearing on notice to the holder of the secured claim and any other entity as the court may direct.
>
> **Rule 3018 Acceptance or Rejection of Plan in a Chapter 9 Municipality or a Chapter 11 Reorganization Case**
>
> (a) *Entities Entitled To Accept or Reject Plan; Time for Acceptance or Rejection*. A plan may be accepted or rejected in accordance with §1126 of the Code within the time fixed by the court pursuant to Rule 3017.
>
> (d) *Acceptance or Rejection by Partially Secured Creditor.* A creditor whose claim has been allowed in part as a secured claim and in part as an unsecured claim shall be entitled to accept or reject a plan in both capacities.

A creditor typically wants to prove that it is a secured (versus an unsecured) creditor. And, a creditor wants to prove particularly that it is a fully secured (and not a partially secured) creditor.

The determination of the value of the creditor's security interest in the debtor's collateral property is often the result of a valuation analysis.

Section 560 – Determination of a Secured Creditor's Status

"The recurring question of the value of the creditor's security interest in the debtor's property is typically answered by a valuation analysis."

Creditors, of course, are interested in determining whether their security interest in the debtor property is greater (or lesser) than the debtor's liability to them. This relationship between (1) the value of the creditor's security and (2) the amount of the debtor's liability may affect the secured creditor's status throughout the bankruptcy proceeding.

The relevant subsections of Section 560 related to a secured creditor's status are presented below:

> (a) (1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to set off is less than the amount of such allowed claim. Such 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.
>
> (b) To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.

As mentioned above, to the extent that the value of the creditor's security interest exceeds the amount of the debtor's liability, then the secured creditor can claim interest on that difference during the bankruptcy proceeding.

The recurring question of the value of the creditor's security interest in the debtor's property is typically answered by a valuation analysis.

Section 1129 – Reorganization Plan Confirmation

Valuation analysts (and other financial advisers) are often called on to analyze and opine on the proposed plan of reorganization in a bankruptcy. The valuation analyst can perform this reorganization plan analysis on behalf of the DIP or on behalf of any group of secured or unsecured creditors.

The relevant subsections of Section 1129 are presented below:

> (a) The court shall confirm a plan only if all of the following requirements are met: . . .
>
> (7) With respect to each impaired class of claims or interests—
>
> (A) each holder of a claim or interest of such class—
>
> (i) has accepted the plan; or
>
> (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; . . .
>
> (11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan. . . .
>
> (16) All transfers of property of the plan shall be made in accordance with any applicable provisions of nonbankruptcy law that govern the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.
>
> (b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan 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.
>
> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:
>
> (A) With respect to a class of secured claims, the plan provides—
>
> (i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and
>
> (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

A valuation analyst is commonly asked by legal counsel to review the proposed reorganization plan. The analyst is asked by counsel to assess (and to opine on) whether the proposed reorganization plan is "reasonable." Also, the analyst is asked by counsel to opine as to whether the proposed reorganization plan is "fair and equitable" to the various classes of creditors and to other stakeholders in the bankruptcy estate.

Section 1129 – Cram Down of the Reorganization Plan

Ideally, all parties to the bankruptcy will accept the proposed reorganization plan. However, that general acceptance by all parties does not always happen. Often, one or more of the creditor groups is not satisfied with the reorganization plan.

However, the court can still confirm the reorganization plan over the creditors' objections. Even if the reorganization plan impairs the interests of one or more of the creditor groups, the court may confirm the proposed plan if the plan is "fair and equitable" with regard to all groups of creditors that are impaired.

Valuation analysts often testify in such bankruptcy hearings regarding their analyses of the reorganization plan and, particularly, regarding their opinions of whether the proposed plan is "fair and equitable" to all impaired creditor groups.

This judicial confirmation of such a reorganization plan is called a "cram down," and such a cram down is allowed in Bankruptcy Code Section 1125. The following discussion summarizes the provision of Section 1129:

> Another requirement for reorganization plan confirmation is that, with respect to each class of claims, (1) such class has accepted the plan, or (2) such class is not impaired under the plan. If all the requirements for plan confirmation are met except for this one, the plan can still be confirmed *if* the plan 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. This is known as a *cram down*.

Section 362 – Secured Creditor Relief from the Automatic Stay

After a bankruptcy filing, there is an automatic stay with regard to the creditors' ability to collect the debtor's prepetition debts. This automatic stay can be lifted by the court in certain instances.

Section 362 allows for a secured creditor to receive relief from this automatic stay of collection efforts if two certain conditions are met. First, related to the secured property, the debtor corporation must have no equity in the property (i.e., the amount of the specific liability exceeds the value of the specific collateral asset). Second, the secured property must not be a necessary part of the debtor company's core business.

A valuation analyst is often called on by counsel to provide expert testimony related to both of these questions with regard to a Section 362 motion. The relevant subsections of Section 362 are presented below:

> On request of a party in interest and after notice and a hearing, the court shall grant relief from the [automatic] stay . . ., such as by terminating, annulling, modifying, or conditioning such stay—
>
> (1) for cause, including the lack of adequate protection of an interest in property of such party in interest;
>
> (2) with respect to a stay of an act against property . . . , if—
>
> (A) the debtor does not have an equity in such property; and
>
> (B) such property is not necessary to an effective reorganization. . .

Valuation and DIP Financing

A debtor company's ability to borrow is limited during a Chapter 11 proceeding. Without the court's authorization, the debtor company can only incur ordinary course of business trade debt that will be allowed as an administrative expense in the bankruptcy case.

However, the court can authorize the debtor's obtaining of credit secured by a senior or equal lien on encumbered property of the bankruptcy estate. The court can authorize such debt only if (1) the debtor company is unable to obtain credit otherwise and (2) there is adequate protection of the interest of the holder of the lien on the property on which such senior or equal lien is proposed to be granted. This type of new debt is usually referred to as DIP financing.

So, in order to obtain DIP financing, the debtor company has to prove that the value of its collateral property is greater than the amount of the new DIP liability. A valuation analyst is often asked to value the proposed collateral intellectual property and to opine that the intellectual property's value is greater than the amount of the proposed financing.

Section 101 – Definition of "Intellectual Property"

The financially distressed DIP usually doesn't have a lot of property left to pledge for DIP financing collateral. Often, the debtor company has already pledged all of its receivables, inventory, real estate, tangible personal property, and equity in subsidiaries and joint ventures.

However, the debtor company may not have previously pledged its intellectual property as secured debt collateral. Therefore, the DIP financing may involve the pledge of the debtor company's intellectual property assets as the DIP financing collateral.

Therefore, a valuation analyst is often asked to value the debtor company's intellectual property for DIP financing collateral purposes. Section 101, subsection 35A, provides the following definition of intellectual property:

> (35A) The term "intellectual property" means—
>
> (A) trade secret;
>
> (B) invention, process, design, or plant protected under title 35;
>
> (C) patent application;
>
> (D) plant variety;
>
> (E) work of authorship protected under title 17; or

(F) mask work protected under chapter 9 of title 17;

to the extent protected by applicable nonbankruptcy law.

The Zone of Insolvency and the Debtor Corporation Director Duties

Directors of a debtor corporation typically owe a duty of loyalty, care, and good faith to the corporation and to its shareholders. But when a debtor corporation approaches the zone of insolvency, under the laws of most states, the directors owe those duties to creditors too. In such a case, creditors (and not just shareholders) have standing to assert breach of fiduciary duty claims on the company's behalf.

Before a bankruptcy filing, valuation analysts are often asked to assess the financial condition of a financially distressed company. Before approving any major dividend, financing, capital expenditure, or other corporate decision, the corporation's directors (and the corporation's counsel) may want the valuation analyst to opine as to whether the debtor corporation is operating near (or in) the zone of insolvency.

Analytical Issues in Bankruptcy Valuations

Valuation analysts who practice in the commercial bankruptcy discipline should be familiar with the following common analytical issues:

1. There is no Bankruptcy Code definition (or standard) for the term "value." Valuation analysts who practice in this discipline sometimes use fair value, fair market value, market value, or other standards of value. Section 506 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." However, this statutory guidance does not provide an actual standard of value.
2. The analyst's use of hindsight in the bankruptcy valuation is discouraged. The courts seem to adopt the so-called "known or knowable principle" with regard to the analyst only using information that was knowable as of the defined valuation date. Of course, in many bankruptcy matters, there is usually a controversy among the opposing valuation analysts over when actual events (favorable or unfavorable) would have been known or knowable as of the defined valuation date.
3. The analyst's reliance on (and due diligence regarding) the company management-prepared financial projections should be justified. The questions that the analyst typically considers with regard to the use of management-prepared financial projections in the bankruptcy valuation may include the following:
   - How contemporaneous are the projections to the valuation date?
   - Were the projections prepared after the valuation date but, if so, were they still prepared based on assumptions that were known or knowable as of the valuation date?
   - Were there various unreconciled versions of the management-prepared projections?
   - What was the purpose for which the management projections were prepared?
   - How accurate has company management historically been related to preparing financial projections?
   - How reliable is the selected set of management-prepared projections?
   - Should the analyst consider various projection scenarios?
   - Were the financial projections ever relied on by an independent party (e.g., auditors, regulators, financing source)?
4. The analyst should document a replicable and transparent selection of valuation variables. The questions that the analyst typically considers with regard to the use of valuation variables in the bankruptcy valuation may include the following:
   - Should the valuation variables reflect the current financial state of the debtor corporation?
   - Should the valuation variables reflect reorganized financial state of the debtor corporation?
   - Should the valuation variables reflect a willing buyer/willing seller or an industry average set of assumptions?
   - How does the assumed financial condition of the debtor corporation affect

the selected cost of capital components (e.g., the cost of debt, cost of equity, the debt/equity ratio) and the concluded weighted average cost of capital (WACC)?

- How does the assumed financial condition of the debtor corporation affect the terminal value expected long-term growth rate?
- Should the selected discount rate relate to the operating risk of the debtor company or to the performance risk of the specific financial projections?

5. The analyst should consider the fact that current interest rates are still at historically low levels. The questions that the analyst typically considers with regard to the selected interest rate in the bankruptcy valuation cost of capital analysis may include the following:
   - How should the currently low risk-free rate of return affect the selection of the cost of debt capital?
   - How should the currently low corporate bond interest rates affect the selection of the cost of debt capital?
   - Can the debtor corporation actually realize such low capital costs?
   - Does an understated WACC calculation overstate the debtor corporation business value?
6. The analyst should be prepared to explain and defend the reasonableness of the analyst's due diligence procedures. The questions that the analyst typically considers in the due diligence process of the bankruptcy valuation may include the following:
   - Does the bankruptcy assignment involve a contemporaneous valuation or a retrospective valuation?
   - Did the analyst have access to the debtor corporation management and/or to other relevant parties?
   - Did the analyst consider that the parties' memories and perceptions of prepetition events and conditions often change over time?
   - Did the analyst recognize the fact that only a limited amount of debtor corporation documents may be available?
   - Could the analyst's industry research be subject to various interpretations?
   - Did the analyst appreciate the fact that hindsight is always "20/20" when performing a retrospective valuation analysis?
7. The analyst should consider all of the income tax effects on the debtor corporation value. The questions that the analyst typically considers in the income tax deliberations during the bankruptcy valuation may include the following:
   - What is the debtor's effective income tax rate?
   - What is the amount of the debtor's cash income tax expense?
   - What is the value of the debtor corporation deferred tax assets or tax liabilities?
   - What is the debtor's expected use of NOLs and other income tax attributes?
   - How will a possible change of ownership affect the debtor corporation's income tax attributes?
   - How will a possible change of ownership affect the debtor corporation's asset tax basis?
8. The analyst should avoid the use of industry so-called valuation rules of thumb as a specific valuation method. The questions that analysts typically consider with regard to the interpretation of industry valuation rules of thumb may include the following:
   - Are there any industry rules of thumb with regard to financial metric pricing multiples?
   - Are there any industry rules of thumb with regard to operational metric pricing multiples?
   - Are there any industry rules of thumb that may imply values of debtor company intangible assets/contingent liabilities (e.g., capitalization of the debtor corporation's operating leases)?
   - Are there any industry rules of thumb for consideration with regard to any of the individual financial projection variables?
   - Do the industry rules of thumb assume the average company in the subject industry?
   - If they are valid, how are the industry rules of thumb supported by any empirical transaction data?

9. The analyst will typically perform a cash flow test within a solvency analysis, and such a solvency analysis may be prepared for many bankruptcy purposes. The questions that the analyst typically considers with regard to the solvency analysis cash flow may include the following:
   - Should the analyst include the raising of either new debt capital or new equity capital during the cash flow test projection period?
   - Should the analyst consider the debtor's current credit availability during the cash flow test projection period?
   - Should the analyst consider any debtor corporation asset sales during the cash flow test projection period?
   - Did the analyst adequately consider the longest term debtor corporation debt outstanding in the cash flow test projection period?
   - Did the analyst adequately consider any debtor corporation debt balloon payments later in the cash flow test projection period?
10. The analyst should consider the appropriateness of applying a market approach in an inactive transaction market. The questions that the analyst typically considers with regard to the use of the market approach in an inactive market may include the following:
   - Are there any sufficiently comparable public companies available for consideration in the market approach analysis?
   - Are there any sufficiently comparable merger and acquisition (M&A) transactions available for consideration in the market approach analysis?
   - Is there a sufficiently active current market for the debtor company assets or securities?
   - How reliable are any "backsolve" valuation method sale transactions of the debtor company securities with regard to providing meaningful valuation guidance?

Analyst Caveats in Performing Bankruptcy Valuations

Valuation analysts may consider the following practical caveats with regard to the preparation of valuations within a bankruptcy context:

1. The analyst should accept legal counsel's advice and instructions; the analyst should also:
   - document all of the legal counsel's instructions,
   - document all of the legal counsel's definitions of technical legal terms,
   - not practice law without a license, and
   - let the legal counsel take responsibility for all legal issues related to the bankruptcy.
2. Legal counsel may not be totally forthcoming with the valuation analyst; the analyst, therefore, should also:
   - be aware of any "creeping commitments" (or unintended expansions) regarding the scope of the analyst's work in the bankruptcy engagement and
   - be aware of any legal-counsel-imposed limitations on the analyst regarding access to all of the documents in the case.
3. The analyst should document, document, document—both in the valuation workpapers and in the valuation report; in particular, the analyst may:
   - document all debtor corporation management and other party interviews;
   - document all due diligence procedures performed;
   - document why the analyst selected or rejected each valuation method that was considered in the analysis;
   - document why the analyst selected or rejected each valuation variable that was considered in the analysis;
   - document why the analyst selected or rejected each set of financial projections that was relied on (or not relied on) in the analysis; and
   - use contemporaneously prepared financial projections relied on by others (including management), if possible, and not use financial projections prepared after litigation (if possible)
4. The analyst should use generally accepted valuation approaches, methods, and procedures in the bankruptcy valuation; in particular, the analyst typically should not:
   - use de novo valuation methods (or use de novo valuation method naming conventions) or

- rely on "rules of thumb" pricing methods to achieve specific value indications to include in the final value conclusion.

5. The analyst should use confirmatory valuation approaches and methods in the bankruptcy analysis; in particular, the analyst may:
   - explain the valuation synthesis and conclusion process and
   - explain the quantitative (or qualitative) value conclusion process so that it is replicable, transparent, and auditable.
6. The analyst should use confirmatory source documents, if possible; in particular, the analyst may:
   - look for confirmatory source documents;
   - look for contradictory source documents;
   - explain the process and reasoning for selecting the specific source documents relied on;
   - look at and consider all source documents that are made available to the analyst in discovery or otherwise; and
   - avoid wearing "hindsight blinders"—i.e., the process of excluding post-valuation date documents that contain pre-valuation date information
7. The analyst should consider all debtor corporation intangible assets in the bankruptcy valuation analysis; in addition, the analyst should consider all debtor corporation contingent liabilities in the bankruptcy valuation analysis
8. The analyst should consider the expected income tax effects in all of the bankruptcy valuation (and solvency, fairness, and related opinion) analyses; in that consideration, the analyst may:
   - consult with an independent income tax expert, if one is needed, and
   - consult with an income tax expert colleague, if one is available.
9. In bankruptcy-related litigation, the valuation analyst should be mindful that "your expert report is your best friend"; the analyst should be mindful that:
   - the valuation expert's report should be clear, convincing, and cogent;
   - the valuation expert's report should be replicable and transparent;
   - the valuation expert's report should be adequately supported with source documents; and
   - the valuation analyst should also be mindful of the expert report caution that: "If it's not in the report, you didn't do it."
10. The analyst should know his or her own technical limitations in performing the valuation; that is, the analyst should rely on third-party specialists for input into the valuation, when needed; such third-party specialists may include:
    - industry experts,
    - tax accounting experts,
    - financing accounting experts,
    - real estate appraisal experts,
    - personal property appraisal experts, and
    - other experts.

"The analyst should consider all debtor corporation intangible assets in the bankruptcy valuation analysis."

Summary and Conclusion

Many industrial and commercial companies are still experiencing financial distress in this slow growth economic recovery. Accordingly, many debtor corporations still need the protection of (or the final resolution of) a bankruptcy filing.

Valuation issues frequently arise in commercial bankruptcy proceedings. Therefore, valuation analysts are often called on to assist the many parties to the commercial bankruptcy, including the debtor in possession and/or the trustee, the management or directors of the pre-filing debtor corporation, the secured creditors committee, the unsecured creditors committee, and other parties in interest to the proceeding (e.g., contract counterparties, unions, joint ventures, etc.).

This discussion summarized many (but not all) of the reasons why valuations are performed within a bankruptcy context. This discussion summarized many (but not all) of the issues that analysts commonly encounter when preparing bankruptcy valuations. And, this discussion presented several practical caveats and cautions for valuation analysts who practice in the bankruptcy discipline.

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