

# Business Valuation Issues in Bankruptcy

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# Discussion Outline

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- Introduction
- Ten common bankruptcy business valuation services
- Ten common bankruptcy valuation issues
- Ten analyst caveats for performing bankruptcy valuations
- Summary and conclusion – questions and discussion



# Ten Common Bankruptcy Valuation Services

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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 fully secured? (Rules 3012 and 3018)
6. Confirmation of reorganization plan (Section 1129)
7. Cram down of the reorganization plan (Section 1129)
8. Secured creditor relief from automatic stay (Section 362)
9. Collateral value for DIP financing
10. Director duties and the zone of insolvency



# Section 547

## Preference Claims and Debtor Solvency

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(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.



# Bankruptcy Code Section 548—Fraudulent Transfers and Debtor Solvency

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(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;



# Bankruptcy Code Section 548—Fraudulent Transfers and Debtor Solvency (cont.)

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(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.



# Bankruptcy Code Section 101

## Definition of "Insolvent"

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(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;



# Bankruptcy Code Section 101

## Definition of “Insolvent” (cont.)

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(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.





# Bankruptcy Code Section 363

## Asset Sales and Adequate Protection

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(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.



# Bankruptcy Code Section 363

## Asset Sales and Adequate Protection (cont.)

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(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.



# Bankruptcy Code Section 361

## Decrease in Value of Creditor's Interest

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### **Section 361**

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



# Bankruptcy Code Section 361

## Decrease in Value of Creditor's Interest (cont.)

(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.



# Bankruptcy Rules Regarding Secured Creditor's Interest

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## **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.



# Bankruptcy Rules Regarding Secured Creditor's Interest (cont.)

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## **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.



# Bankruptcy Code Section 560

## Determination of Secured Creditor Status

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(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.



# Bankruptcy Code Section 560 Determination of Secured Creditor Status (cont.)

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(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.





# Bankruptcy Code Section 1129

## Reorganization Plan Confirmation

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(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. . .



# Bankruptcy Code Section 1129

## Reorganization Plan Confirmation (cont.)

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(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.



# Bankruptcy Code Section 1129

## Reorganization Plan Confirmation (cont.)

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(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;



# Bankruptcy Code Section 1129

## Cram Down of the Reorganization Plan

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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*.



# Bankruptcy Code Section 362 Secured Creditor Relief from Automatic Stay

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## Section 362(d)(1) and (2)

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. . .



# DIP Financing

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

The court can authorize the obtaining of credit secured by a senior or equal lien on encumbered property of the estate only if (1) the debtor 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 is usually referred to as DIP financing.



# Bankruptcy Code Section 101

## Definition of “Intellectual Property”

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(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 Debtor Corporation Director Duties

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Directors of a debtor corporation owe a duty of loyalty, care, and good faith to the corporation and its shareholders. But when a 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.





# Common Issues in Bankruptcy Valuations

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1. There is no Bankruptcy Code definition (or standard) of the term "value"
  - Use of fair value, fair market value, market value, other standard of value
  - Bankruptcy Code 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."
  
2. The use of hindsight in the valuation is discouraged
  - The courts seem to adopt the so-called known or knowable rule
  - There is usually a controversy over when actual events (favorable or unfavorable) would have been known or knowable



# Common Issues in Bankruptcy Valuations (cont.)

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3. The analyst's reliance on management-prepared financial projections
  - How contemporaneous are the projections to the valuation date
  - Projections prepared after the valuation date but still known or knowable
  - Various versions of management projections
  - What was the purpose for which the management projection's were prepared
  - How skilled is management in preparing projections
  - How reliable is the selected set of management projections
  - Should the analyst use various projection scenarios



# Common Issues in Bankruptcy Valuations (cont.)

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## 4. Analysts selection of valuation variables

- Should variables reflect current state of the debtor
- Should variables reflect reorganized state of the debtor
- Should variables reflect a willing buyer or industry average assumptions
- Assumed condition of the debtor affects  $k_d$ ,  $k_e$ , debt/equity ratio, WACC
- Assumed condition of the debtor affects the expected LT growth rate
- Should selected discount rate relate to the debtor company or to the performance risk of the projections

## 5. Current interest rates are unreasonably low

- Low risk-free rate affects  $k_e$
- Low corporate bond interest rates affect  $k_d$
- Can the debtor actually realize such low capital costs
- Does an understated WACC overstate the debtor value



# Common Issues in Bankruptcy Valuations (cont.)

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6. The reasonableness of the analyst's due diligence
  - Contemporaneous valuation versus retrospective valuation
  - Access to debtor management and other parties
  - Parties' memories and perceptions often change over time
  - Limited debtor documents may be available
  - Industry research is subject to various interpretations
  - Hindsight is always 20/20
  
7. Consider all of the income tax effects on the debtor value
  - Effective income tax rate
  - Cash income tax expense
  - Value of deferred tax assets or liabilities
  - Use of NOLs and other income tax attributes
  - Change of ownership affect on debtor tax attributes
  - Change of ownership affect on debtor asset tax basis



# Common Issues in Bankruptcy Valuations (cont.)

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8. Use of industry valuation rules of thumb
  - Rule of thumb financial pricing multiples
  - Rule of thumb operational pricing multiples
  - Rule of thumb values of intangible assets/contingent liabilities (e.g., capitalization of debtor operating leases)
  - Rules of thumb for individual financial projection variables
  - Rules of thumb assume the average company
  - If valid, rules of thumb should be supported by empirical data
  
9. Cash flow test within a solvency analysis
  - Inclusion of new debt or new equity capital during the cash flow projection period
  - Consideration of debtor's current credit availability during projection period
  - Consideration of any asset sales during the projection period
  - Consider longest term debt outstanding in projection period
  - Consider debt balloon payments later in the projection period



# Common Issues in Bankruptcy Valuations (cont.)

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## 10. Use of the market approach in an inactive market

- There are no sufficiently comparable public companies
- There are no sufficiently comparable M&A transactions
- There is no current market for the debtor company (assets or securities)
- How reliable are backsolve method transactions in the debtor company securities



# Analyst Caveats in Performing Bankruptcy Valuations

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1. Accept legal counsel advice and instructions
  - Document all legal instructions
  - Document all legal definitions
  - Don't practice law without a license
  - Let legal counsel take responsibility for legal issues
  
2. Lawyers lie
  - Be aware of creeping commitments regarding the scope of the engagement
  - Be aware of any limitations regarding access to all of the documents in the case



# Analyst Caveats in Performing Bankruptcy Valuations (cont.)

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3. Document, document, document
  - Document all management and other party interviews
  - Document all due diligence procedures
  - Document why you selected/rejected valuation methods
  - Document why you selected/rejected valuation variables
  - Document why you selected/rejected financial projections
  - Use contemporaneously prepared financial projections relied on by others, if possible
4. Use generally accepted valuation approaches, methods, and procedures
  - Don't use de novo methods (or naming conventions)
  - Don't rely on rules of thumb as value indications
5. Use confirmatory valuation approaches and methods
  - Explain your valuation synthesis and conclusion process





# Analyst Caveats in Performing Bankruptcy Valuations (cont.)

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6. Use confirmatory documents, if possible
  - Look for confirmatory documents
  - Look for contradictory documents
  - Explain your selection of documents
  - Look at all documents that are available to you
  - Don't wear hindsight blinders
7. Consider all debtor intangible assets in the valuation  
Consider all debtor contingent liabilities in the valuation
8. Consider the expected income tax affects in all valuation (and other solvency) analyses
  - Consult a tax expert, if needed



# Analyst Caveats in Performing Bankruptcy Valuations (cont.)

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9. In bankruptcy litigation, your expert report is your best friend
  - Report should be clear, convincing, and cogent
  - Report should be replicable and transparent
  - Report should be supported with source documents
  - If it's not in the report, you didn't do it
  
10. Know your limitations, rely on specialists when needed
  - Industry experts
  - Tax accounting experts
  - Financing accounting experts
  - Real estate appraisal experts
  - Personal property appraisal experts
  - Other experts



# Summary and Conclusion

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- Common bankruptcy valuation services
- Common bankruptcy valuation issues
- Bankruptcy valuation analyst caveats
- Questions and discussion

