Bankruptcy Valuation Analyst Guidelines

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Valuation analysts (analysts), forensic accountants, financial advisers, and related professionals are often called on to provide valuation and other financial opinions within a commercial bankruptcy context. These opinions often involve analyzing when a debtor company enters the zone of insolvency, assessing the debtor company solvency or insolvency, determining the value of a creditor's security interest, concluding the fairness of a proposed sale or financing transaction while the debtor is in bankruptcy protection, determining whether a proposed plan of reorganization is fair and equitable, or providing the fresh-start accounting asset and liability values for a reorganized debtor company that is exiting bankruptcy protection.

Introduction

Valuation analysts (analysts) and related financial professionals are often called on to value a debtor company business, business ownership interest, securities, or intangible assets within a commercial bankruptcy context. These valuations and transactional opinions are prepared for a number of bankruptcy-related purposes.

This discussion summarizes many of the topical issues facing the experienced analyst who practices in the bankruptcy discipline. This discussion suggests practical guidance for analysts who provide bankruptcy-related analyses and opinions.

Bankruptcy Valuation Analyst Guidance

1. There Is an Extensive Scope of Services that Analysts Can Provide within the Bankruptcy Discipline

As commercial bankruptcies have become more complex and bankruptcy proceedings have become more contentious, the scope of the analyst's professional services has expanded. These services include the valuation of the debtor company business, business ownership interests, debt and equity securities, and intangible assets.

These services also include forensic analysis, such as forensic accounting, financial investigations, litigation support services, and expert witness testimony.

Finally, these services include independent financial advisory opinions, such as transactional fairness opinions, adequate consideration opinions, reasonably equivalent value opinions, reasonableness of the plan reorganization opinions, and other financial opinions.

Analysts routinely assess if and when the debtor company enters into the zone of insolvency. Analysts also perform solvency and insolvency analyses for purposes of proving fraudulent transfer, preference payment, and other claims. In addition, analysts estimate the value of creditors' collateral, including debtor company tangible assets, intangible assets, and debt and equity securities.

Analysts may help to identify cash-generation debtor in possession (DIP) business or asset sale opportunities, and they opine on the fairness of the proposed sale price and sale transaction structure.

Debtor company business and asset valuations are an important component of securing DIP financing. Analyses opine as to whether various transactions involving debtor assets or securities protect the interests of the company creditors or equity holders.

Analysts may also help develop the plan of reorganization, assess the reasonableness of the plan of reorganization, and quantify the post-bankrutpcy income tax and financial accounting implications of the plan of reorganization.

2. The 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 the start of the engagement, the analyst should understand the following elements of the bankruptcy valuation:

1. The valuation subject (which debtor businesses, business ownership interest, securities, or intangible assets are the subject of the analysis)
2. The subject ownership interest (this is typically, but not always, a fee simple ownership interest)
3. The appropriate standard of value (this is typically, but not always, fair market value)
4. The appropriate premise of value (this is typically, but not always, value in continued use as a going concern)
5. The appropriate valuation date (unless purely determined by law(s), 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 legal counsel) and are typically documented in the analyst's engagement letter.

3. The Analyst Should Perform the Appropriate Due Diligence in All Aspects of the Bankruptcy Valuation Assignment

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:

1. Historical financial documents regarding the debtor company business or assets
2. Historical operational documents regarding the debtor company business or assets
3. Historical legal documents regarding the debtor company business or assets
4. Historical ownership documents regarding the debtor company business or assets
5. Documents regarding the historical or proposed transaction
6. Legal documents regarding the bankruptcy proceeding
7. Prospective financial information regarding the debtor company business or assets
8. Publicly available information regarding the industry in which the debtor company operates
9. Publicly available information regarding guideline public companies
10. Publicly available information regarding guideline merger and acquisition transactions

Before relying on any documents or data, the analyst typically considers whether the document is complete, a draft or a final document, one document within a chain of documents, and the like. The analyst may also consider whether

1. the document was prepared contemporaneously to the subject transaction or valuation date or
2. the document was prepared after litigation was filed.

The analyst may further consider whether the document was contemporaneously relied on by any parties not related to the bankruptcy, and whether 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 company business plans, operating budgets, strategic forecasts or financial projections.

The analyst often assesses such PFI with regard to the following:

1. The debtor company's historical ability to project financial results
2. The debtor company's current results of operations
3. The debtor company's current plant and other capacity constraints

4. The debtor company's current position in the industry
5. Security analyst projections for guideline public companies
6. Industry projections from financial reporting agencies, securities brokerage firms, industry trade associations, and so forth

The analyst should have a reasonable basis for relying on documents or data selected for the valuation analysis.

4. There Are Generally Accepted Valuation Approaches, Methods, and Procedures

There are generally accepted approaches, methods, and procedures with regard to the valuation of businesses, business ownership interests, securities, and intangible assets. These generally accepted approaches, methods, and procedures are promulgated by various valuation professional organizations.

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

Analysts should be aware of the generally accepted methods and should be able to describe them to counsel, the finders of fact, and others. Experienced analysts consistently apply the generally accepted approaches and methods. The analyst who uses another valuation method should be able to explain the reason for (and the rationale behind) the departure from the generally accepted approaches and methods.

Analysts do not use the generally accepted methods simply because the methods are documented in promulgated standards and professional literature. Rather, 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, but rather to clarify them. Consequently, the valuation profession has its own technical jargon, and valuation analysts use that jargon as a shorthand means of communicating with each other and with the nonvaluation parties to a bankruptcy.

The technical valuation jargon terms typically have specific meanings and relate to specific components of the generally accepted valuation approaches, methods and procedures. *The International Glossary of Business Valuation Terms* has been adopted by the four professional business valuation organizations in the United States. Bankruptcy valuation analysts typically attempt to comply with the terminology adopted in that glossary.

However, in practice, there may be a wide range of terms (used by professionals) referring to the same valuation concept. Similarly, business schools, which train numerous future investment bankers and finance professionals, also use a wide, nonstandardized range of terminology.

6. There Are Generally Accepted Valuation Professional Standards and Practices

Some bankruptcy analysts are members of one or more of the following professional organizations: the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuators and Analysts (NACVA).

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

However, there is no statutory, regulatory or judicial requirement that a bankruptcy valuation analyst be credentialed by any professional organization.

7. There Are Income Tax and Financial Accounting Implications to Most Bankruptcy-Related Valuations

Not all 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, creditors and finders of fact all consider the taxation and accounting implications of almost all bankruptcy-related decisions.

Therefore, analysts should be aware of these taxation and accounting implications, and, whenever relevant, analysts should include such implications in their bankruptcy valuations.

The income tax implications of bankruptcy can be complex. They can affect the value of a debtor company's stock and assets, and they can impact the value of completed or proposed bankruptcy transactions. In addition, such income tax implications can affect the reasonableness of a proposed plan of reorganization.

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

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

8. Analysts Should Be Sufficiently Familiar with All of the Intangible Asset Considerations of the Bankruptcy Valuation

Analysts are often asked to value debtor company intangible assets, either (1) as an independent business interest or (2) as part of the analysis of the debtor 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 and/or other bankruptcy-related analyses.

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

In addition, debtors often have to analyze whether or not they should reject any intellectual property (IP) license agreements. And, the IP licenses have to analyze the financial consequences of the debtor's rejection of those IP licenses.

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

1. Financial intangible assets, such as cash, notes receivable and marketable securities
2. Intellectual property, including patents, copyrights, trade secrets, and (for many purposes) trademarks
3. Identifiable commercial intangible assets, such as contracts, permits, franchises, computer software, engineering drawings and technical documentation, customer relationships, supplier relationships, employee relationships and others
4. Goodwill and going-concern value

"[A]nalysts should understand the financial accounting principles upon which the debtor company financial statements are prepared."

The generally accepted approaches applied to the valuation of intangible assets are the cost approach, the market approach and the income approach. Each approach includes several valuation methods and each method includes several procedures. In addition, there are professional standards related to reporting the results of the intangible asset valuation. Analysts who do not have sufficient intangible asset valuation experience or expertise may either work with a more qualified colleague or confer with a third party valuation specialist.

9. Analysts Should Be Sufficiently Familiar with Any Real Estate and Tangible Personal Property Appraisal Considerations of the Bankruptcy Valuation

Most 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 company tangible assets could affect the availability of:

1. DIP financing (including sale/leaseback) opportunities,
2. cash-generating asset or business spin-off opportunities, and

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3. the plant and equipment resources needed to implement a proposed plan of reorganization.

The analyst should be aware that there are various tangible asset appraisal approaches, methods, and procedures related to the development of the tangible asset value conclusion. In addition, there are professional standards related to the reporting of the results of the real estate and tangible personal property appraisals.

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

The analyst should be familiar enough with tangible asset appraisal principles and procedures to:

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

Analysts who do not have sufficient familiarity with tangible asset appraisals may either work with a more qualified colleague or confer with a third party appraisal specialist.

10. Analysts Should Be Familiar with Generally Accepted Valuation Reporting Standards

Analysts have to communicate the results of their valuations of the debtor company business, business ownership interest, securities, or intangible assets. This communication may involve a written report, oral report, expert testimony, or some combination of these three mediums.

There are standards and practices that are promulgated by various valuation professional organizations. Likewise, there are also standards and practices with respect to oral valuation reports, including expert testimony. However, these standards are mandatory only for the members of these organizations.

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 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, and the analyst should expect to receive and rely on legal instructions from bankruptcy counsel.

Summary and Conclusion

The past decade or so has witnessed increased professionalism among valuation analysts, forensic accountants, financial advisers, and other financial professionals 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, as well as the increased sophistication of courts, opposing legal counsel, and contrarian analysts.

Clients, legal counsel, and judicial finders of fact expect bankruptcy analysts to be able to support their valuation analyses, conclusions and reports. And, they also expect bankruptcy analysts to be able to dispassionately assess the relative strengths and weaknesses of the opposing analyst valuation analyses, conclusions, and reports.

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