

Bankruptcy Valuation Insights

BANKRUPTCY-RELATED VALUATION AND FINANCIAL ADVISORY SERVICES

Nguyen "Wen" Ho and Scott Cobb

When a debtor corporation files for bankruptcy protection, there are a variety of reasons why the debtor in possession, the creditors, and their respective legal advisors may seek bankruptcy-related valuations. These reasons range from solvency and insolvency issues to planning a corporate transaction during the bankruptcy to valuing the reorganized debtor corporation equity interest given to a creditor class as part of the proposed plan of reorganization. There are a unique set of regulatory, accounting, and market-related issues to consider when a debtor corporation is involved in a bankruptcy proceeding. This discussion summarizes ten common reasons to conduct a valuation analysis within a bankruptcy context.

INTRODUCTION

The number of business bankruptcies is reaching record levels. And, the number of business bankruptcy filings is expected to increase in the second half of 2009. The reasons for this expected increase in business bankruptcy filings are obvious:

- the recessionary national economy causing reductions in both business and consumer expenditures
- increased foreign competition in many industries (due to stagnant economies in foreign countries)
- unavailability—and increased cost—of debt capital
- unavailability—and increased cost—of equity capital
- unwillingness (and regulatory inability) of financial institutions to renegotiate credit terms or forgive minor debt covenant violations

This increase in business bankruptcies has resulted in an increased demand for bankruptcy-related valuation and financial advisory services. Various parties to the bankruptcy action may be interested in these valuation and finan-

cial adviser opinions, including: the debtor-in-possession (DIP) management, the debtor corporation equityholders, unsecured creditors, secured creditors, DIP financing sources, legal counsel for all of the above parties, and the bankruptcy court.

The bankruptcy of an industrial or commercial company often involves the valuation of the assets, properties, and business interests included in the bankruptcy estate. This discussion summarizes many of the reasons for con-

ducting a valuation of the business or assets of the debtor corporation seeking bankruptcy protection. However, the discussion is not intended to provide a comprehensive listing of all of the reasons to conduct a bankruptcy-related valuation.

This discussion also summarizes many of the factors that the valuation analyst should consider in the typical bankruptcy-related valuation.

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TYPICAL REASONS TO CONDUCT A BANKRUPTCY-RELATED VALUATION

Valuation analysts and other independent financial advisers are often called on to conduct bankruptcy-related valuations for the following ten reasons:

1. Determining Debtor Corporation Insolvency for Avoidable Actions

The debtor corporation insolvency is a required condition for certain actions under the Bankruptcy Code. For example, in order for certain payments to creditors to be considered either preference items or fraudulent transfers (and, therefore, to be voidable transfers), the debtor corporation must be insolvent at the time of the transaction.

Bankruptcy Code Section 547 covers claims related to preference items. Claims related to a fraudulent conveyance are covered by the Bankruptcy Code Section 548.

Under the Bankruptcy Code, the term “insolvent” means that the debtor corporation’s liabilities exceed the debtor corporation’s assets, at fair value. This one condition of debtor corporation insolvency is the only requirement for a claim of voidable preference payments. The measure of debtor corporation insolvency related to a claim of preference items is determined by the “balance sheet test.”

Claims of fraudulent conveyance (or a fraudulent transfer from the debtor to the creditor) involve a multiple-component insolvency analysis. According to the Bankruptcy Code, a fraudulent conveyance has occurred if the debtor corporation fails any one of the following three tests:

1. The balance sheet test—that is, do debtor corporation assets exceed the debtor corporation liabilities, based on a fair valuation?
2. The cash flow test—that is, can the debtor corporation meet its expected debt service obligations as they mature?
3. The capital adequacy test—that is, does the debtor corporation have an unreasonably small amount of capital?

However, under the recently enacted Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “2005 Act”), a debtor corporation will not be able to avoid a transfer if it was made:

1. in the ordinary course of business of the debtor corporation and the transferee or
2. in accordance with ordinary business terms.

2. Adequate Protection of Creditor Security Interests

Under the Bankruptcy Code, a secured creditor with a secured claim is entitled to adequate protection of the

subject property interests when the creditor requests relief from the automatic stay. Adequate protection for the creditor property interest is also required before either the debtor-in-possession or the bankruptcy trustee can use, sell, or lease certain kinds of collateral.

One of the provisions related to a creditor’s adequate protection specifically relates to the value of the creditor’s collateral interest. If the value of the creditor’s collateral property decreases during the bankruptcy proceedings, then the bankruptcy trustee may be required to make payments to the creditor. These payments are made to the creditor in order to provide for that adequate protection.

However, with regard to the valuation of the creditor collateral, the Bankruptcy Code does not specify either:

1. which business/asset valuation methods are to be used or
2. which is the appropriate valuation date to be used.

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For purposes of ensuring adequate creditor protection, some courts have allowed various premises of value with regard to the valuation of the creditor’s secured claim. For example, various courts have allowed going-concern value, a wholesale price, and a sale price at a court-ordered sale as acceptable premises of value with regard to the valuation of a creditor’s collateral.

The appropriate premise of value generally relates to:

1. the highest and best use of the collateral or
2. the actual/current use of the collateral.

A number of courts have looked to the proposed use of the collateral when deciding which premise of value to be used. Within the going-concern premise of value, the courts have generally accepted the income approach/discounted cash flow method in the valuation of a creditor’s security interest.

3. Fraudulent Transfer Avoidance Actions

A transfer by a debtor corporation may be avoided as a fraudulent conveyance if the assets are transferred for less than their reasonably equivalent value. A fraudulent transfer occurs if the debtor corporation:

1. was insolvent or becomes insolvent due to the transfer
2. was engaged after the transfer in a business with an unreasonably small amount of capital, or

- intended to incur debts that would be beyond the debtor corporation's ability to repay.

In addition to avoiding a fraudulent transfer under the Bankruptcy Code provisions, a debtor corporation may also avoid a fraudulent transfer under individual state statutes.

The 2005 Bankruptcy Act extended the period during which a debtor corporation transfer may be considered fraudulent from one year to two years. In addition, a transfer to an insider of the debtor corporation will be considered fraudulent/voidable if:

- the debtor corporation received less than reasonably equivalent value and
- the transfer was made under an employment contract and not in the ordinary course of business (for example, an extraordinary bonus payment to the debtor corporation management or directors).

In assessing a fraudulent conveyance transfer, the "reasonably equivalent value" may consist of property, satisfaction, or the securing of either a present or antecedent debt. Accordingly, the determination of a fraudulent transfer may require both:

- valuation of the property transferred by the debtor corporation and
- valuation of the property received by the debtor corporation.

4. Determining the Feasibility of the Proposed Plan of Reorganization

The feasibility of the proposed plan of reorganization relates to:

- the soundness of the proposed capital structure of the debtor corporation and
- the attainability of the projected cash flow.

The feasibility of the proposed reorganization plan also relates to whether the debtor corporation has a reasonable prospect for a financial recovery.

The confirmation of the proposed plan may not be approved by the court if the reorganization plan is likely to be followed by:

- the debtor corporation's liquidation or
- the need for further financial reorganization of the debtor corporation.

Accordingly, a debtor corporation business valuation may be required to demonstrate to the court the feasibility (or reasonableness) of the proposed plan of reorganization.

5. Determining the Best Interest of a Creditor Under Chapter 11

Under the Bankruptcy Code, a creditor must either (1) accept a plan of reorganization or (2) receive or retain property under a plan of reorganization that is not less than the amount the creditor would receive or retain if the debtor corporation was liquidated. The appropriate valuation date for this purpose is the effective date of the plan of reorganization.

With regard to determining the best interest of the creditor, the debtor corporation valuation is typically performed under the premise of value in exchange on an orderly disposition basis and not under the premise of value in exchange on a forced liquidation basis.

For this purpose, the premise of value in exchange on a forced liquidation basis is usually used to determine whether the plan of reorganization (as opposed to a plan of liquidation) is in the best interest of the creditors. However, the valuation premise of value in continued use, as a going concern is usually used to determine whether a creditor class should accept or reject the proposed plan of reorganization.

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6. "Splitting" Under-Secured Creditor Claims

The claim "splitting" procedure occurs when a secured creditor claim has a market value that is less than the face amount of the creditor claim. In that event, the creditor claim is divided into two parts, namely:

- a secured claim to the extent of the actual collateral market value and
- an unsecured claim to the extent of the collateral value deficiency.

This valuation of the creditor's collateral property should typically consider both (1) the current use and (2) the proposed disposition or use of the collateral property.

Under the Bankruptcy Code, the determination of the factors that affect collateral value should be made in conjunction with a judicial hearing:

1. on the disposition or use of the subject collateral assets or
2. on a plan of reorganization affecting the creditor security interest.

The valuation of the creditor's collateral may affect the secured creditor's voting power to accept or reject the proposed plan of reorganization. And, the collateral valuation may affect the amount of distributions made to the secured creditor under the plan of reorganization.

7. Determining Whether a Plan of Reorganization Is Fair and Equitable to a Dissenting Creditor Class in Chapter 11

To determine whether the proposed plan of reorganization is fair and equitable to a dissenting creditor class, valuations are typically performed on the creditor's collateral. In addition, the present value of the expected future payments under the proposed plan of reorganization is typically quantified.

The present value of the expected future payment is usually determined by discounting the dollar amounts expected to be received under the proposed reorganization plan to a present value. However, for this purpose, the Bankruptcy Code does not define the acceptable procedures for quantifying the appropriate present value discount rate.

If the debtor corporation existing shareholders are to receive nothing under the proposed plan of reorganization, then a valuation of the subject debtor business equity may be required. This business valuation is used to demonstrate that the existing shareholders have no equity value left in the subject debtor corporation.

Alternatively, let's assume that the existing shareholders will have control of the reorganized debtor corporation after the corporation emerges from bankruptcy. In that case, the existing shareholders must either:

1. demonstrate that the unsecured creditors will retain or receive property with a present value equal to the amount of their unsecured claims (in order to satisfy the absolute priority rule) or

2. contribute sufficient "new value" to repurchase control of the debtor corporation (sometimes called the "new value exception" to the "absolute priority rule").

It is noteworthy that some courts have not recognized this so-called "new value exception."

In addition, the valuation of the debtor corporation business equity is typically an important issue in determining whether the proposed plan of reorganization is eligible for a cramdown.

8. Securities Given to a Creditor Class as Part of a Proposed Plan of Reorganization

The consideration or compensation distributed under a plan of reorganization in a Chapter 11 proceeding may consist primarily of securities of the reorganized debtor corporation. The value of these distributed securities, which determines the amount of compensation given to a creditor class, depends on the valuation of the reorganized debtor corporation.

Accordingly, a valuation is typically required for both:

1. the debtor corporation business enterprise under the plan of reorganization and
2. the particular debtor corporation securities subject to distribution to a creditor class under the reorganization plan.

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9. Planning a Corporate Transaction During the Bankruptcy

A debtor corporation business valuation is typically needed in situations where the debtor-in-possession (or the bankruptcy trustee) is planning a significant corporate transaction, such as a merger or acquisition.

Such a debtor corporation business valuation is intended to ensure that the bankruptcy estate:

1. receives a fair price for the business unit that is sold off or
2. pay a fair price for the business unit that is acquired.

Similarly, when assets of the bankruptcy estate are to be transferred in other than an arm's-length transaction, a valuation of the debtor corporation assets is typically necessary. Such a valuation is intended to ensure that the bankruptcy estate:

1. receives no less than a fair price for the assets that are transferred to a related party or
2. pays no more than a fair price for assets that are purchased from a related party.

In either case, the ultimate purpose of the debtor corporation valuation is to ensure that the bankruptcy estate assets are not dissipated as a result of the proposed corporate transaction.

10. Bankruptcy Estate Property of Inconsequential Value

The concept of “inconsequential value” is important in several bankruptcy-related instances. The secured creditor will lose its election to forego the unsecured deficiency claim in exchange for considering all of the claims secured in a Chapter 11 proceeding (the so-called “Section 1111(b)(2) election”). This statement is true if the secured debtor’s collateral interest in the debtor’s property is of an “inconsequential value.”

As another example, the bankruptcy trustee may abandon (or be required to abandon) property of the bankruptcy estate that is of inconsequential value to the estate. Accordingly, a valuation of the debtor corporation assets may be required to demonstrate to the trustee which bankruptcy estate assets are of inconsequential value.

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INDUSTRY-SPECIFIC VALUATION CONSIDERATIONS

In a valuation of the debtor corporation enterprise, securities, or assets, the valuation analyst may consider any industry-specific valuation factors. Some of the common industry-specific factors include the following:

- federal and state regulations that affect the subject debtor corporation entity (including, for example, the Stark laws, Medicare, and other program reimbursement requirements, and particular regulations affecting not-for-profit health care entities)
- the types of business enterprise buyers and sellers that participate in the subject debtor corporation industry, which may include both for-profit entities that price transactions based on an after-tax cost of capital and not-for-profit entities that price transactions based on a pretax cost of capital
- the unique intangible assets that exist within the subject debtor corporation and the effect of industry regulation on the value of any identified intangible assets
- antitrust considerations with regard to debtor industry mergers and consolidations
- the impact of governmental regulation with regard to the development, commercialization, and transfer of industry products and services
- the economic effects of:
 1. the product/service life cycle development phase
 2. required R&D and capital expenditure requirements
 3. intellectual property protection

Valuation analysts may consider these—and other—industry-specific factors in the bankruptcy valuation of any industrial or commercial debtor corporation.

When an industrial or commercial debtor corporation files for bankruptcy protection, there are numerous reasons to perform a valuation of the bankruptcy estate assets, properties, or business interests. This discussion presented a listing of the common reasons to perform a bankruptcy-related valuation. It should be noted, however, that this list is not intended to be a comprehensive list, and this list is not presented in order of importance or priority.

SUMMARY AND CONCLUSION

When one of these reasons for a valuation arises within a bankruptcy proceeding, parties to the bankruptcy, including the DIP, the secured and unsecured creditors, and their respective

legal counsel, should retain a valuation analyst who is experienced in bankruptcy-related issues.

Valuation analysts are not bankruptcy lawyers, of course. However, the valuation analyst performing bankruptcy-related financial advisory services should be generally familiar with the related statutory authority, judicial precedent, and administrative procedures with regard to a bankruptcy proceeding.

In addition, the parties to the bankruptcy proceeding should be aware of any unique regulatory, accounting, taxation, and competitive issues that may affect the valuation of business entities in the subject industry. Therefore, the valuation analyst should have industry-specific experience and expertise with regard to the valuation of debtor corporation businesses, business securities, and tangible and intangible assets.

Nguyen “Wen” Ho is a senior associate in our Washington, D.C.-area office. She can be reached at (703) 235-4612 or nho@willamette.com.

Scott Cobb is a senior manager in our Washington, D.C.-area office. Scott can be reached at (703) 235-4608 or sscobb@willamette.com.