

## VALUATION-RELATED FINANCIAL ADVISORY SERVICES FOR BANKRUPTCY PURPOSES

Robert F. Reilly and Ashley L. Reilly

*Although the number of business bankruptcy filings has decreased somewhat since the mid-1990s, there continues to be a significant number of industrial and commercial companies for all sizes filing for bankruptcy protection. This article describes ten common reasons why financial advisers may have to perform valuation services related to an industrial or commercial company debtor in bankruptcy. And, this article describes seven common factors that a financial adviser should consider when performing a bankruptcy-related valuation.*

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### INTRODUCTION

The 2004 and the 2005 year-to-date numbers of business bankruptcy filings were somewhat lower than the "record" number of filings in the mid-1990s. However, there is still a significant number of business bankruptcy filings each year. These business bankruptcy filings relate to companies across virtually all industrial and commercial sectors. A number of factors have contributed to this continuation in the number of business bankruptcy filings. These factors include the following:

1. a generally stagnant national economy,
2. a general increase in foreign competition,
3. overcapacity (and the related product/service price competition) in the domestic market segments,
4. continually increasing R&D expenditure requirements, and
5. the increasing costs of debt and equity capital financing for facilities and equipment.

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 article summarizes many of the common reasons for conducting a valuation of industrial or commercial company businesses or assets for bankruptcy purposes. However, this article is not intended to provide a comprehensive listing of all of the reasons to conduct a bankruptcy-related valuation analysis.

This article will also summarize some of the general factors that the financial adviser should consider in the bankruptcy valuation of a typical industrial or commercial company.

### REASONS TO CONDUCT A BANKRUPTCY VALUATION

#### 1. Adequate Protection of Creditor Security Interests

Under the Bankruptcy Code, a creditor with a secured claim is entitled to adequate protection of the property interests when that creditor requests relief from the automatic stay. Adequate protection for the secured 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 the creditor "adequate protection" specifically concerns the value of the creditor's collateral property. If the value of the creditor's collateral property will decrease during the bankruptcy proceedings, then the bankruptcy trustee may be required to make payments to the creditor in order to provide for that adequate protection.

However, with regard to this creditor collateral valuation, the Bankruptcy Code does not specify either (1) what business/asset valuation methods are to be used or (2) what is the appropriate valuation date to be used.

For purposes of ensuring adequate protection, the courts have allowed various premises of value with regard to the valuation of the creditor's secured claim. For example, various courts have alternatively allowed (1) going concern value, (2) a wholesale price value, and (3) a sale price at a court-ordered sale—all as acceptable premises of value with regard to the valuation of a creditor's collateral.

Within the going concern premise of value, the courts have generally accepted the income approach, and specifically the discounted cash flow method, to value the creditor's security interest.

## 2. “Splitting” of the Under-Secured Creditor Claims

This “splitting” of the secured creditor's claim procedure occurs when a creditor claim has a market value that is less than the face amount of the claim. In that event, the secured creditor claim is divided into two parts: (1) a secured claim to the extent of the actual collateral market value and (2) an unsecured claim to the extent of the collateral value deficiency.

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

Under the Bankruptcy Code, the determination of the factors that affect the value of the collateral property 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 collateral property valuation may affect the creditor's voting power to accept or reject a proposed reorganization plan. And, the collateral property valuation may affect the amount of distributions made to the creditor under a reorganization plan.

## 3. Determining Debtor Insolvency Related to Avoidance Actions

The corporate debtor's insolvency is a required condition for certain avoidance actions allowed under the Bankruptcy Code. For example, for certain payments to creditors to be considered preference items or fraudulent transfers (and, therefore, to be considered voidable), the corporate debtor must be insolvent at the time of the transfer.

Under the Bankruptcy Code, the term “insolvent” means that the value of the debtor's liabilities exceed the value of the debtor's assets, estimated at fair value. This is the only test of insolvency (i.e., the balance sheet test) that is needed to classify payments to creditors as preference items.

Accordingly, the determination of insolvency requires a valuation of both (1) the corporate debtor's assets (both tangible and intangible) and (2) the corporate debtor's liabilities (both short term and long term). This solvency “balance sheet” valuation is typically performed as of the date of the transfers from the debtor to the creditor.

However, the Bankruptcy Code does not specify what are the appropriate valuation approaches, methods, or procedures to use with regard to the valuation of the debtor's assets and liabilities.

For claims of fraudulent conveyance, the debtor corporation has to fail any one of the following three solvency tests: (1) the balance sheet test (i.e., does the fair value of

the debtor assets—both tangible and intangible—exceed the value of the debtor liabilities?), (2) the cash flow test (i.e., will the debtor be able to pay its debt service obligations as they mature?), and (3) the adequate capital test (does the debtor have an unreasonably small level of capital?).

## 4. Determining the Best Interest of a Creditor under Chapter 11

Under the Bankruptcy Code, a creditor must (1) accept a plan of reorganization or (2) receive/retain property under a plan of reorganization that is not less than the amount the creditor would receive/retain if the debtor were in liquidation. 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 valuations are 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 liquidation basis is usually used to determine if 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 in determining whether a creditor class should accept or reject the plan of reorganization.

## 5. Determining if a Plan of Reorganization Is Fair and Equitable to a Dissenting Creditor Class in Chapter 11

To determine whether a proposed plan of reorganization is fair and equitable to a dissenting creditor class, values are typically determined for those creditors' property collateral. In addition, the present value of the expected future payments under the proposed plan of reorganization are typically quantified.

The present value of the expected future payments is typically determined by discounting the dollar amounts expected to be received under the reorganization plan to a present value. However, for this purpose, the Bankruptcy Code does not define the basis or methodology for determining the appropriate present value discount rate.

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

Alternatively, let's assume that the existing shareholders will have control of the debtor after the bankruptcy. In that case, the 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 (to satisfy the “absolute priority rule”) or
2. contribute sufficient “new value” to repurchase control of the debtor (sometimes called the “new value exception” to the “absolute priority rule”).

It is noteworthy that some courts have not recognized the so-called “new value exception.”

In addition, the debtor business equity valuation is typically important to the determination of whether the proposed plan of reorganization is eligible for the accounting “cramdown” procedure.

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

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

1. the debtor’s liquidation or
2. the need for further financial reorganization of the debtor.

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

## 7. Debtor Property of Inconsequential Value

The concept of inconsequential value is important in several bankruptcy-related instances. For example, a 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 is true if the secured creditor’s collateral interest in the debtor’s property is of an “inconsequential value.”

As another example, the bankruptcy trustee may abandon (or may be required to abandon) property of the bankruptcy estate that is of “inconsequential value” to the estate.

Accordingly, a valuation of the debtor entity assets may be required to demonstrate which assets are of “inconsequential value.”

## 8. Planning Corporate Transactions During the Bankruptcy

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

Similarly, when assets of the bankruptcy estate are to be transferred in other than an arm’s-length transaction, a valuation of the debtor entity assets is typically necessary.

## 9. Fraudulent Conveyance Transfers

Transfers by a debtor may be avoided as fraudulent 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
3. intended to incur debts that would be beyond the debtor’s ability to repay.

In assessing a fraudulent/voidable creditor transfer, the “reasonably equivalent value” may consist of (1) property, (2) satisfaction, or (3) the securing of either a present or antecedent debt. Accordingly, the determination of a voidable fraudulent transfer may require both:

1. a valuation of the property transferred by the debtor corporation, and
2. a valuation of the property received by the debtor corporation.

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

Consideration or compensation distributed under a plan of reorganization in a Chapter 11 proceeding may consist primarily of securities of the reorganized debtor. 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, valuations are typically required for both:

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

## GENERAL CONSIDERATIONS RELATED TO A BANKRUPTCY VALUATION

In a valuation of the debtor business enterprise, securities, or assets, the financial adviser should consider a number of general valuation factors. Some of these general valuation factors include:

1. any federal or state regulations that affect companies operating in the debtor corporation's subject industry;
2. the costs of capital components for (a) the subject debtor corporation, (b) the most likely population of typical buyers for the subject debtor corporation, and (c) the industry in which the subject corporation operates;
3. any unique intangible assets that may exist within the subject debtor corporation—and the effect of any industry-specific regulations on the value of the subject intangible assets;
4. the debtor corporation strategic strengths, weaknesses, opportunities, and threats vis-à-vis the subject debtor's competitor companies;
5. the cost/volume/profit relationships in the subject industry that affect (a) economies of scale, (b) economies of scope, and (c) any other factors that may influence consolidation trends;
6. antitrust considerations with regard to mergers and consolidations in the industry in which the subject debtor corporation operates;
7. the impact of (a) governmental regulation with regard to the development and commercialization, (b) domestic competition, and (c) foreign competition transfer of products and services; and
8. the economic effects of (a) an industry-specific product life cycle development phase, (b) industry-specific R&D expenditure and capital expenditure requirements, and (c) industry-specific intellectual property protections.

Financial advisers should consider these (and any other appropriate) general factors in the bankruptcy valuation of an industrial or commercial company.

## SUMMARY AND CONCLUSION

When an industrial or commercial company files for bankruptcy protection, there are numerous reasons to perform a valuation of the bankruptcy estate assets, properties, or business interests. This article presented a “top 10” listing of the common reasons to perform bankruptcy-related valuations. However, it should be noted that this “top 10” list (1) is not intended to be a comprehensive list and (2) is not presented in any particular order of importance or priority.

When one of these “top 10” valuation reasons arises in a bankruptcy proceeding, the parties to the bankruptcy (including the debtor in possession, the various secured and unsecured creditor committees, and their respective legal counsel) should retain a financial adviser who is experienced:

1. in bankruptcy-related valuation issues and
2. in providing financial advisory services to participants of the subject industry.

Financial advisers should not attempt to be bankruptcy lawyers, of course. However, a financial adviser who performs bankruptcy-related valuation services should be generally familiar with the related statutory authority and administrative procedures with regard to a bankruptcy proceeding.

In addition, all parties to the bankruptcy should be aware of the regulatory, accounting, and competitive issues that are unique to the subject industry. Therefore, the financial adviser should have specific experience and expertise with regard to the valuation of businesses, securities, and tangible and intangible assets in the particular industry in which the debtor company operates.

*Robert Reilly is a managing director of our firm, and he is resident in our Chicago office. Robert can be reached at (773) 399-4318 or rfreilly@willamette.com.*

*Ashley Reilly is an intern of the firm and is also resident in the Chicago office. Ashley can be reached at alreilly@willamette.com.*

We are pleased to announce that

**Lynn H. Whang**

has joined the firm as an associate  
in our Washington, D.C., office

Lynn has joined the valuation consulting practice of the office. She specializes in the valuation of businesses, business interests, debt and equity securities, and intellectual properties, for purposes of: transaction opinions, financings, taxation, bankruptcy, litigation, and strategic planning.

Prior to joining the firm, Lynn was a budget analyst with the International Trade Association in Washington, D.C., Before that, she was an assistant branch manager for the Farmers Bank of Maryland.

Lynn holds a BA degree in economics (with honors) from Boston College, and she holds an MBA degree in international finance from George Washington University.