Willamette Management Associates

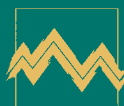
Insights

Issue 123

Winter 2020

Business Valuation, Forensic Analysis, and Financial Opinion Insights

Thought Leadership in Valuation for Bankruptcy Purposes



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Insights, the thought leadership journal of applied microeconomics, is published on a quarterly basis, with periodic special interest issues. *Insights* is distributed to the friends and clients of Willamette Management Associates.

Insights is intended to provide a thought leadership forum for issues related to the Willamette Management Associates business valuation, forensic analysis, and financial opinion services.

Insights is not intended to provide legal, accounting, or taxation advice. Appropriate professional advisers should be consulted with regard to such matters. Due to the wide range of the topics presented herein, the *Insights* thought leadership discussions are intended to be general in nature. These discussions are not intended to address the specific facts and circumstances of any particular client situation.

The views and opinions presented in *Insights* are those of the individual authors. They are not necessarily the positions of Willamette Management Associates or its employees.

We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to thought leadership topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from legal counsel, accountants, bankers, and other thought leaders involved in the valuation and forensic services community. Please address your comments or suggestions to the editor.

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Editors for This Issue: Nathan P. Novak and Jeffrey A. Jensen, CPA

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Forethoughts

As our firm moves beyond its 50th anniversary, we look forward to providing another 50 years of professional thought leadership. This *Insights* issue focuses on discussions of the valuation considerations related to bankruptcy and solvency purposes.

The bankruptcy process often requires input from—and decisions by—a wide range of professionals, including company executives, attorneys, accountants, and other advisers. Sometimes overlooked are the valuation-related aspects of bankruptcy. There are many times throughout a bankruptcy process in which a valuation analyst may provide valuable advice to any number of the parties involved. The discussions presented in this *Insights* issue are intended to provide those decision makers with an understanding of current topics related to valuation issues in a bankruptcy context.

Willamette Management Associates has over 50 years of experience in providing valuation analyses for application in the bankruptcy process. Our analysts routinely provide bankruptcy counsel, company executives, and other parties with solvency analyses for fraudulent conveyance purposes, asset valuations for corporate reorganizations, and expert testimony in federal and state courts.

This *Insights* issue provides perspectives from both the valuation profession and the legal community. We are pleased to include discussions from bankruptcy attorneys Andrea Levin Kim and Cory Kandestin, who provide insights on insolvency considerations in commercial litigation and on the application of the balance sheet test for fraudulent transfer analyses. This *Insights* issue also presents thought leadership discussions on developments in bankruptcy law in the Kingdom of Saudi Arabia and how these may impact U.S. and international investors in the area. Other discussions explore such topics as the trend in retail bankruptcies and the use of the asset-based approach to value debtor companies in bankruptcy.

Finally, this *Insights* issue provides a discussion of the recent *Estate of Aaron U. Jones v. Commissioner of Internal Revenue* U.S. Tax Court case. Willamette Management Associates managing director Robert Reilly provided testifying expert services in that case, which ultimately resulted in a major win for the taxpayer and a shift in the court's view on tax-affecting a tax pass-through entity.

We thank all of our contributors, colleagues, clients, and friends for their ongoing support, and we are proud to present this issue of *Insights*.

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The Balance Sheet Test in Fraudulent Transfer Cases: Is It Appropriate to Fair Value Liabilities?

Cory D. Kandestin, Esq.

Proving insolvency is an important element of a fraudulent transfer claim. Therefore, it is surprising that courts diverge on how they interpret the most basic of the solvency tests, the balance sheet test. Some courts hold that the balance sheet test compares the recorded amount of liabilities to the fair value of assets. Other courts hold that the balance sheet test compares the fair value of liabilities to the fair value of assets. This discussion examines these differing interpretations of the balance sheet test and recommends a unifying principle to reconcile these differing interpretations.

Introduction

In fraudulent transfer law, insolvency often is an important contested issue. It is an affirmative element of a "constructive" fraudulent transfer claim, meaning that a plaintiff *must* prove the transferor's insolvency to win (or prove a similar financial condition like unreasonably small capital). From a defendant's perspective, proving solvency could afford a defense to the fraudulent transfer claim. Because insolvency is such a significant question, fraudulent transfer cases frequently involve a "battle of the experts" offering competing valuations of the transferor entity.

It is surprising, then, that courts diverge on how they describe the most basic of the fraudulent transfer solvency tests, known as the "balance sheet test." At its simplest, the balance sheet test asks whether a transferor's liabilities exceed the transferor's assets: if yes, then the transferor is insolvent; if no, then the transferor is solvent. The test is more complicated in practice. This is because both the Bankruptcy Code and state law say to compare balance sheet accounts at "fair valuation."[1]

Most balance sheets are prepared under generally accepted accounting principles ("GAAP"), which do not necessarily reflect a "fair valuation."[2] So before comparing assets and liabilities, a solvency analyst may need to adjust each balance sheet account from a GAAP-based balance to a "fair valuation."

Nonetheless, courts disagree on exactly which accounts on the balance sheet should receive a "fair valuation." Some courts, particularly in bankruptcy, say that only assets should be stated at "fair valuation."[3] But other courts, particularly those applying state law, say that liabilities should be stated at fair valuation as well.[4]

This judicial divergence is particularly baffling, because both the Bankruptcy Code and state law define the balance sheet test using nearly identical language.[5] In fact, most state fraudulent transfer statutes borrow their insolvency language directly from the Bankruptcy Code.[6]

To muddy the waters even more, courts often do not literally follow either of the two tests. Courts in the "do not value liabilities" category in fact *do* value certain types of liabilities, like

contingent liabilities, thus acknowledging that liability valuation is sometimes appropriate. Courts in the "do value liabilities" category *do not* perform certain types of liability valuation procedures, like discounting liabilities to reflect default risk, thus recognizing that some aspects of liabilities should not be stated at fair valuation. In short, neither formulation fully reflects how courts apply the balance sheet test in practice.

This discussion examines these two interpretations of the balance sheet test. Although the two interpretations appear radically different if applied literally, courts have deviated from literal applications in favor of a fairly consistent balance sheet test. In that test, some aspects of liabilities are valued but other aspects are not. This discussion provides a principle that more fully reflects how courts apply the test in practice.

The principle is this: the only liability valuations that should be performed in the balance sheet test are those that would be relevant to a *hypothetical buyer of the debtor's entire package of assets and liabilities*. From a buyer's perspective, certain types of liability valuation, such as adjusting contingent liabilities to their expected value, are appropriate, because they affect the price that the buyer would be willing to pay for the debtor. Other types of liability valuation, such as discounting to reflect a debtor's default risk, are irrelevant to price and, therefore, have no place in the balance sheet test.

Not only does this principle more accurately describe how courts apply the balance sheet test, it also offers a consistent method to evaluate which types of liabilities—such as contingent liabilities, unliquidated liabilities, non-interest-bearing debts, and below-market-rate debts—are good candidates for fair valuation when conducting the balance sheet test.

The Two Prevailing Interpretations of the Balance Sheet Test

Courts have interpreted the federal and state balance sheet tests differently, giving rise to two general interpretations of the test.

In federal court, the prevailing view is that the balance sheet test requires a "fair valuation" of assets only, comparing the fair value of assets to the face value of liabilities.[7] For example, the Delaware Bankruptcy Court has held on several occasions that "debts are measured at their face value and not their market value."[8]

The bankruptcy court based this conclusion primarily on the text of the Bankruptcy Code, which defines insolvency as the "financial condition such that the sum of [an] entity's debts is greater than all of such entity's property, *at a fair valuation*."[9] The bankruptcy court interpreted the phrase "at a fair valuation," which appears at the very end of the definition, to modify the immediately preceding language only ("all of such entity's property")—in other words, the asset-side of the balance sheet only. Numerous bankruptcy courts have agreed with this interpretation.[10]

Under this interpretation of the balance sheet test, if a transferor has $1,000 in bond debt, a $1,000 court judgment entered against it, or $1,000 in accounts payable, then in each case the transferor has a $1,000 liability, no fair valuation required.

State law follows a seemingly opposite interpretation. Although each state has its own fraudulent transfer statute, most states have adopted the Uniform Fraudulent Transfer Act or its successor, the Uniform Voidable Transactions Act.[11]

Both of these uniform acts include a balance sheet test that compares fair value of assets to the *fair value* of liabilities. For example, the drafters of the Uniform Fraudulent Transfer Act wrote in their official commentary that the insolvency test "contemplate[s] a fair valuation *of the debts* as well as the assets of the debtor."[12]

The drafters of the more recent Uniform Voidable Transactions Act went even further and altered the definition of insolvency to "make *clearer* that 'fair valuation' applies to debts as well as to assets."[13] The Uniform Voidable Transactions Act's updated balance sheet test now provides that a transferor is insolvent "if, at a fair valuation, the sum of the debtor's debts is greater than the sum of the debtor's assets."[14]

By moving the phrase "at a fair valuation" from the end of the sentence to the beginning, the drafters took direct aim at bankruptcy court decisions interpreting the phrase "at a fair valuation" as applying to assets only.

This split in federal and state law is problematic. This is because plaintiffs frequently assert federal and state fraudulent transfer claims together in one action. A debtor in bankruptcy has the exclusive standing to assert fraudulent transfer claims, both federal and state.[15]

As a result, bankruptcy courts often must resolve both claims in the same case. But if the claims apply different balance sheet tests, then the bankruptcy court potentially could reach inconsistent results. In theory, a debtor could be solvent and insolvent at the same time, depending on which law applied. Not only would this result be impractical, it also would be bad policy: as a number of courts have noted, federal and state fraudulent transfer law stems from the same roots and should be interpreted consistently.[16] There should be only one balance sheet test.

Courts Do Not Literally Follow Either of the Two Interpretations of the Balance Sheet Test

A deep dive into the case law reveals that neither interpretation of the balance sheet test is a fully accurate description of what courts do in practice.

Although many federal courts say to not value liabilities, these same courts in fact do value certain types of liabilities when conducting the balance sheet test. For example, even federal courts reduce "contingent liabilities" to their expected value.[17]

> **"Because the [contingent] liability is uncertain to occur, valuing it at face would overestimate the debtor's exposure."**

A liability is contingent if it is uncertain to occur, such as a pending lawsuit against a debtor that could lead to a money judgment. Because the liability is uncertain to occur, valuing it at face would overestimate the debtor's exposure.[18]

For instance, if a lawsuit asserted a $1 million claim against the debtor, but the plaintiff had only a 5 percent probability of success, then treating the judgment as a $1 million liability for purposes of the balance sheet test would be inappropriate. A court instead would value the judgment by multiplying its face amount against the probability of occurrence ($1 million × 5 percent), ultimately valuing the contingent liability at $50,000.[19] In other words, the court would engage in a form of liability fair valuation.

But as even state law recognizes, not every type of liability valuation is appropriate under the balance sheet test.[20] For example, a court should not discount a liability to reflect a debtor's risk of nonperformance.[21]

To understand why, consider a company that issues public bonds at a face value of $1,000. If the company is financially troubled and at risk of defaulting on the bonds, then the market price of those bonds may fall below face to reflect this risk of nonperformance. For instance, if the company has only $500 in assets with which to pay the bonds, then the market may value the bonds at not more than $500 notwithstanding their $1,000 face amount.

Although this type of valuation may occur in the market, it has no place in the balance sheet test, because it would skew the test in favor of solvency. A well-informed creditor would never value a liability at greater than the debtor's ability to pay—in other words, at greater than the value of the debtor's assets.[22]

Likewise, a well-informed debtor would never value a debt at a greater amount than what creditors would accept.[23] Liabilities would never exceed

assets, and solvency under the balance sheet test would be a foregone conclusion. Thus, even if liabilities must receive a "fair valuation," certain types of valuation procedures are not appropriate for the balance sheet test.

As these examples demonstrate, a liability fair valuation sometimes, but not always, is appropriate under the balance sheet test. But the two prevailing formulations of the test speak in absolutes ("do" or "do not" value liabilities) and, therefore, do not fully capture this nuance.

Reconciling the Law: Liabilities Should Be Valued from the Perspective of a Hypothetical Buyer

Because the fair valuation of liabilities sometimes is appropriate under the balance sheet test, the question becomes, when? Based on how courts apply the test in practice, a common principle emerges: liabilities should receive only a "fair valuation" that is relevant from the perspective of a hypothetical solvent buyer pricing the debtor's collective assets and liabilities.

Judging solvency from the perspective of a buyer is not new or unique in bankruptcy. As the Seventh Circuit held nearly 30 years ago, "[t]o decide whether a firm is insolvent within the meaning of [fraudulent transfer law], a court should ask: What would a buyer be willing to pay for the debtor's entire package of assets and liabilities?"[24]

If the overall amount is positive, then the debtor is solvent. And, if negative, then the debtor is insolvent.[25] Approaching the balance sheet from this perspective helps reconcile some of the inconsistencies in the case law.

For example, let's consider contingent liabilities, which courts reduce to their expected value (even those courts belonging to the "do not value" group). From the perspective of a hypothetical buyer, valuing contingent liabilities is appropriate: to determine a price for the debtor's package of assets and liabilities, the buyer must reduce contingent liabilities to their expected values. Because this type of valuation is relevant to determining what a buyer would pay for the debtor, it is an appropriate type of valuation to perform in the balance sheet test.

Now let's consider valuing liabilities for default risk—a practice disfavored even by those courts in the "do value" group. From the perspective of a hypothetical buyer, this is not an appropriate type of valuation procedure. A debtor's default risk may matter to creditors, but not to a buyer. The buyer will be assuming the debtor's liabilities.

Therefore, the debtor's ability to pay those liabilities going forward becomes irrelevant. Conducting the balance sheet test from the perspective of a hypothetical buyer thus confirms that a "fair valuation" of liabilities does not include valuation for default risk.

What Other Types of Liabilities Should Be Valued under the Balance Sheet Test?

Outside of contingent liabilities, at least three other categories of liabilities—unliquidated liabilities, non-interest-bearing debts, and below-market-rate debts—are candidates for fair valuation.

Unliquidated Liabilities

Liabilities are "unliquidated" if their amounts are undetermined. Examples include environmental liabilities or mass tort liabilities where the underlying wrongdoing already has occurred but the amount of the damages is not yet known.

Courts generally value unliquidated liabilities by estimating their amount and then reducing that amount to present value.[26]

Valuation in the form of discounting to present value is appropriate from a buyer's perspective. This is because a buyer assigning a price to a future liability would take into account the time-value of money.

Although discounting to present value is not controversial, parties have disagreed over the appropriate discount rate. Here again, the rate should be one relevant to a hypothetical buyer. For example, in the *Tronox* bankruptcy case, the parties disagreed about the appropriate discount rate that the court should use to reduce the debtor's environmental liabilities to present value.[27]

The plaintiff advocated for a risk-free discount rate based on U.S. Treasury bond yields (2.5 percent), while the defendant advocated for a 5 percent discount rate that incorporated a risk premium to reflect the chance that the debtor would default on its environmental liabilities. The court selected the risk-free rate, finding that the debtor's ability to pay its liabilities was irrelevant for purposes of determining solvency.[28]

By rejecting a discount rate that incorporated default risk, the court valued the debtor's

environmental liabilities from the viewpoint of a hypothetical buyer—without expressly saying so.

Non-Interest-Bearing Debts

Like unliquidated debts, non-interest-bearing debts that are due in the future are candidates for valuation under the balance sheet test by reducing them to present value.[29] Because a hypothetical buyer acquiring the liability would have no obligation to make interim interest or coupon payments, valuing the debt to reflect the time-value of money is appropriate.

Debts with Below-Market Interest Rates

Debts bearing some of the characteristics of unliquidated or non-interest-bearing liabilities may also be candidates for fair valuation. One such example is a debt with a below-market interest rate.

Let's consider a debt that is not quite non-interest-bearing, but that is almost there: for example, a debt bearing a 0.5 percent rate for a long term. The same reasons for valuing a non-interest-bearing debt at present value also could apply to this low-rate debt. A hypothetical buyer could assume the debt (and acquire the company's associated assets) more cheaply than originating new debt at a market price to acquire the same assets.

Discounting the debt to reflect its below-market rate, therefore, could be appropriate under the balance sheet test, particularly if the debt is long term. This is a true gray area in the law, as little-to-no court guidance exists.

However, if a court accepts that a "fair valuation" of liabilities should be conducted from the viewpoint of a hypothetical buyer, then the court should also accept that debts with below-market rates may be given a "fair valuation" in the balance sheet test.

Conclusion

Although courts do not apply the balance sheet test in a consistent manner, conducting the test from the perspective of a hypothetical buyer helps reconcile the differences between the two prevailing iterations of the test, and captures how courts apply it in practice. Because the case law in this area is so sparse, this principle also provides a consistent method to evaluate whether to—and how to—value any unusual liabilities in future cases.

Notes:

1. *See* 11 U.S.C. § 101(32) (defining insolvency as the "financial condition such that the sum of [an] entity's debts is greater than all of such entity's property, *at a fair valuation*.") (emphasis added); Uniform Fraudulent Transfer Act ("UFTA") § 2 ("A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets *at a fair valuation*.") (emphasis added); see also Uniform Voidable Transactions Act ("UVTA") § 2 ("A debtor is insolvent if, *at a fair valuation*, the sum of the debtor's debts is greater than the sum of the debtor's assets.") (emphasis added).
2. *See, e.g.*, Lids Corp. v. Marathon Inv. Ptrs., L.P. (In re Lids Corp.), 281 B.R. 535, 540 (Bankr. D. Del. 2002) ("[T]he Balance Sheet Test is based on a fair valuation and not based on Generally Accepted Accounting Principles ('GAAP'), which are used to prepare a typical balance sheet.").
3. *See, e.g.*, In re Lids Corp., 281 B.R. at 545–46.
4. *See, e.g.*, Waller v. Pidgeon, 2008 WL 2338217, at *4–7 & n.8 (N.D. Tex. June 5, 2008), *aff'd* 324 F. App'x 431 (5th Cir. 2009).
5. *See* n.1, *supra*.

6. *See* UFTA § 2 cmt 1 ("Subsection (a) is derived from the definition of "insolvent" in . . . the Bankruptcy Code. . . ."); UVTA § 2 cmt 1 (same).

7. *See, e.g.*, In re Lids Corp., 281 B.R. at 545–46; Hanna v. Crenshaw (In re ORBCOMM Global, L.P.), 2003 WL 21362192, at *2 (Bankr. D. Del. June 12, 2003); Faulkner v. Kornman (In re Heritage Org., L.L.C.), 413 B.R. 438, 503 n. 53 (Bankr. N.D. Tex. 2009); Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A., Ltd. (In re Payless Cashways, Inc.), 290 B.R. 689, 700 n.28 (Bankr. W.D. Mo. 2003).

8. In re Lids Corp., 281 B.R. at 545–46 (citing Travellers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.), 134 F.3d 188, 196 (3d Cir. 1998)); In re ORBCOMM Global, L.P.), 2003 WL 21362192, at *2.

9. 11 U.S.C. § 101(32) (emphasis added).

10. *See, e.g.*, In re Heritage Org., L.L.C., 413 B.R. at 503 n. 53; Hoffinger Indus., Inc. v. Leesa Bunch & McMasker Enters., Inc. (In re Hoffinger Indus., Inc.), 313 B.R. 812, 819–20 n.4 (Bankr. E.D. Ark. 2004); In re Payless Cashways, Inc., 290 B.R. at 700 n.28.

11. According to the Uniform Law Commission's statistics that are published on its website, 45 states adopted the Uniform Fraudulent Transfer Act after it was published in 1984, and 20 have since adopted the updated Uniform Voidable Transactions Act, which was published in 2014. As of October 1, 2019, four more states, including New York, currently have pending legislation to enact the UVTA.

12. UFTA § 2 cmt 1 (emphasis added).

13. UVTA § 2 cmt 1 (emphasis added).

14. *Id*. § 2; *compare with* 11 U.S.C. § 101(32) (an entity is insolvent if "the sum of [the] entity's debts is greater than all of such entity's property, at a fair valuation.").

15. Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.), 818 F.3d 98, 111 (2d Cir. 2016) ("Once Tribune entered bankruptcy, the creditors' avoidance claims were vested in the federally appointed trustee [under] 11 U.S.C. § 544(b)(1)"); *see also* Ahcom, Ltd. v. Smeding, 623 F.3d 1248, 1250 (9th Cir. 2010) ("When the trustee does have standing to assert a debtor's claim, that standing is exclusive and divests all creditors of the power to bring the claim"); In re PWS Holding Corp., 303 F.3d 308, 314 (3d Cir. 2002) ("§ 544(b) places the debtor in possession in the shoes of its creditors, giving it the right to prosecute individual creditors' fraudulent transfer claims for the benefit of the bankruptcy estate").

16. *See, e.g.*, Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1068 (3d Cir. 1992) (citing U.S. v. Tabor Court Realty Corp., 803 F.2d 1288, 1299 (3d Cir. 1986) (consistent treatment of the two is "essential to promote commerce nationally."); Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 60–61 (1989) (noting that the Bankruptcy Code merely codified existing law and did not create a new fraudulent transfer cause of action).

17. *See, e.g.*, In re Xonics Photochemical, Inc., 841 F.2d 198, 199–200 (7th Cir. 1988).

18. *Id*. at 200 (the uncertainty of the liability is "a compelling reason not to value contingent liabilities on the balance sheet at their face amounts").

19. *Id*.; *see also* WRT Creditors Liquidation Trust v. WRT Bankruptcy Litigation Master File Defendants (In re WRT Energy Corp.), 282 B.R. 343, 400 (Bankr. W.D. La. 2001) ("The court concludes that the fair value of a contingent liability is properly determined by multiplying total debt guaranteed by the probability that the debtor would be required to make good on the guarantee.").

20. *See, e.g.*, UVTA § 2 cmt 1 (discussing instances where valuation is not appropriate).

21. *See, e.g.*, UVTA § 2 cmt 1 (noting that although liabilities should be valued, they should not be valued for risk of nonperformance); see also Travellers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.), 134 F.3d 188, 196–97 (3d Cir. 1998).

22. *See, e.g.*, *id*. (adopting the bankruptcy court's reasoning that discounting for risk of default would be circular and lead to solvency).

23. *Id*.

24. *See, e.g.*, Covey v. Commercial Nat'l Bank of Peoria, 960 F.2d 657, 660 (7th Cir. 1992).

25. *Id*.

26. *See, e.g.*, Tronox Inc. v. Kerr McGee Corp. (In re Tronox Inc.), 503 B.R. 239, 313–14 (Bankr. S.D.N.Y. 2013) (estimating the debtor's massive environmental liabilities and then discounting that amount to present value).

27. *Id*. at 314–15.

28. *Id*.

29. *See, e.g.*, UVTA § 2 cmt. 1 (discounting appropriate "for non-interest-bearing debt that is due in the future in order to reduce the debt to its present value").

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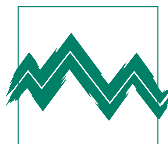

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Solvency Opinions and Concerns about Fraudulent Conveyance in Leveraged Transactions

C. Ryan Stewart

The many considerations related to solvency opinions can be quite complicated. Yet these analyses are often required as a condition for consummating sizeable recapitalizations and other risky corporate transactions. A solvency opinion may serve as the means (1) to address the possibility that the transaction could be alleged to be a fraudulent conveyance at some point in the future and (2) to provide comfort to fiduciaries responsible for approving such transactions. This discussion describes each of the three financial tests that are the components of the fraudulent transfer analysis. And, this discussion presents considerations and procedures that (1) enhance the analytical support for the solvency opinion and (2) bolster its usefulness to the intended user.

Introduction

Independent financial advisers are often asked to issue solvency opinions in order to provide an assessment of a debtor company's solvency as of the date of a proposed leveraged transaction.

For instance, a debtor company board of directors may often request that a solvency opinion be procured as part of its due diligence process for certain corporate transactions. Should the board of directors approve a proposed transaction, the solvency opinion (1) provides support for the decision and (2) provides evidence of actions taken in order to fulfil the board's fiduciary duty of care should the transaction be challenged in a fraudulent conveyance claim.

Examples of corporate transactions that may benefit from the preparation of a solvency opinion include, but are not limited to, the following:

1. Leveraged dividend recapitalizations
2. Equity security redemptions
3. Leveraged asset purchases
4. Substantial liability payments

When financial advisers refer to a solvency opinion, they are typically referring to the performance of several tests to determine whether the conditions indicative of a fraudulent conveyance as presented in Bankruptcy Code Section 548 exist as of a specified date. Therefore, the solvency opinion, in this context, is essentially a preemptive fraudulent conveyance analysis.

The three generally accepted tests—and the associated conditions—for fraudulent conveyance and for the related solvency opinions include the following:

1. The *balance sheet test* considers whether the total fair value of the debtor company assets is greater than the total amount of the debtor company liabilities.
2. The *cash flow test* evaluates whether the debtor company will be able to pay its debts and other financial obligations as they become due. The period analyzed is generally from the transaction date through the maturity date of any transaction related debt.
3. The *capital adequacy test* considers whether the debtor company has the capital needed to meet its operating expenses, capital expenditure requirements, and debt repayment obligations during the first few quarters after the proposed transaction.

The analysis of reasonably equivalent value is typically included when analyzing a transaction for fraudulent conveyance purposes. However, it is not typically included as a separate analysis when conducting a pretransaction solvency opinion. This subject is beyond the scope of this discussion.

In a bankruptcy context, the notion of solvency is limited to an analysis of assets and liabilities. However, in the context of this discussion, the terms "solvency opinion" and "solvency analysis" will refer to an analysis of a debtor company that is performed prior to a proposed transaction and includes the performance of the three aforementioned fraudulent transfer tests.

The Balance Sheet Test

The balance sheet test indicates whether, at the time of the transaction, the total fair value of the debtor company assets is greater than the total amount of debtor company liabilities.

First, the analyst typically considers the highest and best use of the debtor company assets. The highest and best use analysis indicates the appropriate premise of value for the valuation aspects of the analysis. A typical premise of value conclusion is value in continued use, as part of a going-concern business enterprise.

Second, the analyst typically estimates the fair value of the debtor company assets, including (1) financial assets, (2) real estate and tangible personal property, and (3) intangible assets.

Third, the analyst estimates the amount of debtor company liabilities including all (1) current liabilities, (2) long-term liabilities, (3) contingent liabilities, (4) disputed claims, and (5) any liabilities attributable to the proposed transaction (i.e., transaction debt).

Fourth, the analyst compares the fair value of the debtor company total assets to the amount of the debtor company total liabilities. The debtor company is considered to "pass" the balance sheet test if the fair value of the total assets exceeds the amount of the total liabilities.

Contingent Liabilities and Disputed Claims

Disputed claims and contingent liabilities can be particularly tricky in a balance sheet test analysis. This is because these liabilities are not usually readily identifiable and may or may not be disclosed in debtor company financial statements or other information provided by the company management.

A contingent liability is an obligation that requires a triggering event to occur before the debtor company is required to pay a specified amount to a creditor. However, a disputed claim involves a dispute about the amount associated with a claim after the events spawning the claim have already occurred.

These types of liabilities are not always obvious. Therefore, a financial adviser should conduct appropriate due diligence to ensure that contingent liabilities and disputes claims are accurately reflected in the analysis.

A significant factor in estimating the amount of a contingent liability or disputed claim—and its impact on the debtor company—is the uncertainty surrounding:

1. the occurrence of a triggering event in the case of a contingent liability or
2. the outcome of a dispute in the case of a disputed claim.

In both instances, financial advisers may typically apply a probability weighting that is reflective of the chances of a certain outcome occurring.

The Cash Flow Test

The cash flow test is designed to consider the debtor company's ability to pay its financial obligations (including any new debt related to the proposed transaction) as they mature.

The starting point for the cash flow test analysis is typically a set of earnings or cash flow projections developed by the company management. The length of the projection period should typically be equal to the repayment period for any new debt related to the proposed transaction.

The financial adviser may use the financial projection to estimate the debtor company's net cash flow, after taking into account the financing and operating obligations as well as capital investment and working capital needs of the company.

The cash flow test is considered "passed" if the debtor company is expected to have the ability to meet its financial obligations and remain in compliance with any debt covenants in each year of the projection period.

The Capital Adequacy Test

The capital adequacy test (sometimes called the "reasonable capital test") indicates whether the debtor company is engaged in a business or transaction for which it has an adequate amount of capital. The capital adequacy test evaluates the debtor company's ability to meet its (1) operating expenses, (2) capital expenditure requirements, and (3) debt repayment obligations.

The goal of the test is to evaluate the likelihood that the company will survive potential business fluctuations over several quarters following the closing of the proposed transaction.

The capital adequacy test involves an analysis of short-term sources and uses of funds, typically for the next four to six quarters following the transaction date.

Typically, the capital adequacy will have an appearance very similar to the cash flow test and should also include the same or similar scenario and sensitivity analyses as well as stress testing.

The capital adequacy test is "passed" if the analysis indicates that the company is expected to have sufficient cash on hand to pay its:

1. operating expenses,
2. capital expenditures, and
3. debt repayment obligations.

As part of the cash flow test and capital adequacy test, the financial adviser generally performs scenario analyses, which may include sensitivity and stress testing, in order to more rigorously assess risks associated with the proposed transaction. This can also be used as a tool to give fiduciaries and managers insight into how the proposed transaction could affect the company under various operating conditions.

Scenario Analyses

The terms "scenario analysis" and "sensitivity analysis" are sometimes used interchangeably. However, for purposes of this discussion, a distinction can be made. While a scenario represents a possible future environment or set of circumstances within which the debtor company could find itself operating, the sensitivity analysis is related to the observed outcomes achieved by changing the financial variables of the scenario.

Often, a scenario analysis is deterministic in nature. That is to say that it has single point estimates for key inputs and outcomes determined by the parameter values.[1]

However, scenario analyses can be stochastic in nature with one or more random variables, and be used to estimate the probability of outcomes within a forecast. An example of a stochastic analysis is a Monte Carlo simulation. While certain elements of this discussion may be applicable to deterministic and stochastic scenario analyses, the focus of this discussion is on deterministic scenarios.

> "No matter the type of scenario, care should be taken to consider and understand the types of operational disturbances, both internal and external, that could cause such scenarios."

A very basic deterministic scenario analysis will include the base case scenario and a sensitivity analysis of the base case. However, certain situations may call for a more rigorous analysis, which could include sensitivity analyses and stress tests related to several types of scenarios.

Scenarios can be grouped into several broad categories, including the following:[2]

- Single event scenarios are relatively straightforward and are usually not the types of events that would result in a chain of successive events.
- Multi-event scenarios are the result of multiple factors that cause a chain of successive events due to causal linkages between various factors.
- Reverse scenarios are developed by determining what set of conditions will lead to a specified financial result. This type of analysis can be especially challenging because such an analysis involves a comprehensive understanding of the risk dynamics of the subject debtor company.
- Historical scenarios are based on actual historical events. The advantage of the historical scenarios is that the short-, medium-, and long-term effects of the event can be observed. Further, the effect of the event on specified risk factors and the relationships between risk factors can be studied. Based on this study, the financial adviser can make proper adjustments when developing scenarios that assume similar events occur in the future.
- Synthetic scenarios involve hypothetical circumstances that have not been observed, but could occur at some point in the future. An example of a synthetic scenario would be the development of a breakthrough technology.

No matter the type of scenario, care should be taken to consider and understand the types of operational disturbances, both internal and external, that could cause such scenarios. Internal and external factors can be grouped into economic, industry, and company-specific categories. Any combination of factors can be used as the event catalyst or the basis for a scenario.

Scenario Development Considerations

Management-prepared financial projections are typically the starting point of a scenario analysis in the context of a solvency opinion. It is the financial adviser's responsibility to assess the reasonableness of the financial projection starting point.

The financial adviser should understand the narrative behind the financial projections and the relationships between the assumptions and variables that drive the projections. When developing scenarios, the financial adviser applies this knowledge to ensure that changes to the financial variables:

1. correctly flow through the model and
2. accurately reflect the relationships between cash flow drivers.

The due diligence related to the financial projections also helps the financial adviser to be able to recognize additional scenarios that should be analyzed in order to provide a robustly supported solvency opinion.

The following illustrative questions are financial-projection-specific inquiries that may provide perspective and may aid the financial adviser in identifying aggressive or conservative bias within the financial projections:

1. What is the functional use or purpose of the financial projections?
2. How experienced is the company management team in preparing financial projections?
3. When were the financial projections prepared?
4. How does the current projection reconcile with historical projections?
5. Who prepared the financial projections and what was the process?
6. How comprehensive are the projections and the supporting documentation?

The reasonableness analysis encompasses the evaluation of many factors and requires the understanding of the interrelationships of these factors, while also considering the impact of outside influences on the company-specific risk elements.

The financial adviser should typically develop a thorough understanding of the mechanics of the company's projection model—as well as the story supporting the projection—before moving forward with the scenario analysis.

The financial adviser can then develop one or several scenarios based on economic, industry, or company-specific factors identified during the due diligence process. While general economic and industry data are typically readily available, a financial adviser should consult the company management in order to understand how and what data was used to develop the projection.

There are many company-specific risk factors that can be informative when included in scenarios for the cash flow test and capital adequacy test. Debtor company management may be a valuable resource for assistance in identifying the company's unique areas of risk and the potential impact on financial performance.

Debtor company management can alert financial advisers to the implications surrounding areas of company-specific risk such as the following:

1. Geographic concentration
2. Customer concentration
3. Key person dependence
4. Supplier concentration
5. Technology or other intellectual property obsolescence
6. Lack of product diversification
7. Unique exposure to changes in laws or regulations
8. Potential or existing litigation
9. Strained supplier relations
10. Strained employee relations
11. Plant and physical capacity constraints

Sensitivity Analysis

After developing several scenarios, the financial adviser may run sensitivities of all or certain scenarios to observe the outcomes resulting from incremental changes in the financial variables. A sensitivity is the effect of a set of alternative assumptions regarding a future environment or scenario.[3]

For example, when a financial adviser uses the company management projections as a starting point and then adjusts the variables to reflect small changes in the execution of management's plan, then they have created a sensitivity analysis.

By reviewing the outcomes to various sensitivities, the financial adviser should be able to observe the responsiveness of the cash flow to relatively small changes in the financial variables within the framework of a given scenario.

Stress Testing

A stress test is a projection of the financial condition of a company under a specific set of severely adverse circumstances that may be the result of one or several risk factors resulting in severe consequences that can extend over months or years. The likelihood of the stress test condition is typically not likely, yet plausible.[4]

Examples of stress tests scenarios include, but are not limited to, natural disasters, terrorist attacks, political instability (revolution, regime change, expropriation), regulatory changes, economic depression, company fraud, and war.

Summary and Conclusion

Solvency opinions are typically prepared in the context of a proposed transaction when a corporate board of directors or other intended user requires:

1. evidence of actions taken to fulfil their fiduciary duty and
2. comfort that a proposed transaction is not expected to directly cause the insolvency of the company.

A financial adviser should be sure to conduct proper due diligence and apply the appropriate analytical procedures in order to develop a defensible solvency opinion.

Notes:

1. *Stress Testing and Scenario Analysis* (Ottawa, Canada: International Actuarial Association, July 2013), 3.
2. Ibid., 12–16.
3. Ibid., 4.
4. Ibid.

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Insolvency Considerations in Commercial Litigation

Andrea Levin Kim, Esq.

Whether as a company's general counsel or as a client's litigation counsel, it may be foreign to your daily practice to think about the law that governs insolvency and the tools of that practice. However, when a client's company discovers a corporate fraud or theft or it finds itself headed into a bet-your-company dispute, it is worth thinking outside the box. This discussion describes how the law defines insolvency, the way the tools of insolvency law work in these unexpected circumstances, and some areas to think about when determining the strategic importance of insolvency considerations.

Introduction

It is nothing new for companies facing insolvency or financial distress regarding creditors to consider bankruptcy and the tools of the Bankruptcy Code and state statutes. It is also typical for such companies to plan and analyze their payments of debt and their payments to equity holders very carefully in light of the potential for payments to be unraveled later under Chapter 5 of the Bankruptcy Code and similar state statutes.

However, the circumstances that should trigger such considerations are not always so straight forward. Frequently, commercial litigators are in the midst of a perfect storm of circumstances that merit consideration of the more sophisticated application of—and consequences of—fraudulent transfer law and insolvency planning. These considerations are not only relevant for tactical use *in* the course of litigation, they are also relevant for addressing potential liability related to the company's change in circumstances that uniquely arise in periods of insolvency.

This discussion explores two circumstances in which commercial litigation *should* be married with considerations of insolvency and fraudulent transfer law, but often is not. This may be because the insolvency implications are not at the fore, or it may be that the litigator does not have sufficient expertise in insolvency litigation and consequences in order to spot the issue.

Specifically, this discussion looks at the following two contexts:

1. A corporate defalcation (e.g., embezzlement or fraudulent financial reporting) discovered by the company and investigated
2. A company facing litigation that could, if successful, shut down the company or cause it to have to wind down

When addressing a theft or a potential judgment—two events that are unforeseen and which can dramatically shift the fortunes of a business—it is important to understand that the implications of these events on the company's solvency may necessitate tactical planning beyond simply handling the primary crisis.

In each circumstance, the certainty of the entity's insolvency is not yet realized, and the company may not even appreciate the legal definition

of solvency, thinking that concept only belongs in a bankruptcy proceeding. Nonetheless, any strategy or approach to the litigation at issue would be remiss if insolvency-related legal issues are not timely explored.

Put simply, a failure to consider consequences of insolvency periods (past, present, or future) could translate into directors and officers facing lawsuits that could have been avoided, business owners facing lawsuits well after they are lulled into believing the worst of the litigation is over, and creditors failing to recognize the potential for recovery from using the lever of an insolvency-related claim.

Insolvency Considerations in Corporate Defalcations

As a certified fraud examiner and trial counsel, my engagements often start with a company's fledgling discovery that a trusted employee (usually a CFO, controller, or other financial professional or C-suite member) has been systematically embezzling, misrepresenting the state of the company's affairs, or otherwise creating confusion around the source of the company's altered or less than steady performance.

In those circumstances, so much needs to be handled well: issues surrounding the employee's termination, bank account and company data access issues, marshalling witness testimony carefully, identifying repositories of stolen funds and/or tracing assets purchased with embezzled funds, forensic accounting issues, alerting fidelity policy carriers, bringing in replacement help to the role of the removed embezzler(s), providing potential criminal referrals, investigating potential co-conspirators and persons with knowledge, and the list goes on.

The scope of the investigation could be a matter of days, months, or even years depending upon the complexity and depth of the defalcation at issue.

Unless the discovery also led to an immediate recognition of the company's insolvency, however, insolvency issues are not usually among the primary or immediate concerns. In the midst of the investigation or pursuit of litigation or resolution against the wrongdoer(s), the investigator and the litigators can help the company become aware of and think through those insolvency issues. This discussion explores a few of those issues.

Misrepresentations and Loan Defaults

If the defalcation was material enough such that creditors, particularly lenders, have been misled and/or financial statements that affect the company's creditors (e.g., borrowing base reports, inventory reports, sales numbers, reserves, profitability) were misstated (unbeknownst to the rest of management), that impact should be evaluated as soon as possible.

A technical loan default or other covenant default may put the company in a precarious situation, where it is unable to pay its debts as they come due (one of the three potential indications of insolvency recognized under the U.S. Bankruptcy Code and most states' statutes[1]).

The very complaint or criminal referral the litigation team prepared to assist the company in pursuing the bad actors may be exhibit A to a creditor's or creditors' notice of default.

Newly Discovered Periods of Insolvency

When the defalcation is fully investigated and corrections are made to the company's financial statements, it may be that prior periods, as restated, contain periods of previously undiscovered balance sheet insolvency. During periods of insolvency, the company's management owes fiduciary duties to *creditors*, including a duty to preserve the assets of the company for the sake of creditors.[2]

During those periods of time, dividends paid to equity holders could be considered constructive fraudulent transfers (transfers during a period of insolvency for which the company did not receive reasonably equivalent value) because, during periods of insolvency, equity holders' interest has negative value.

If in light of the defalcations it later becomes clear that the company may default in paying certain creditors, not only the current default but these prior periods of insolvency may become fertile ground for those creditors to file fraudulent transfer claims to claw back company payments to equity holders in order to put more money in the kitty to pay creditors.

Fraudulent Transfer Claims against the Perpetrator

If the embezzler transferred company funds to himself or entities he controls or owns, creditors or a bankruptcy trustee or receiver may consider bringing claw back actions against the embezzler rather than the sometimes more-difficult-to-prove, fact-intensive fraud or theft claims.

Some schemes are more subtle such that the path to proving intentional misconduct is expensive and time consuming and/or may not come with a means of recovering attorneys' fees.

In such circumstances, the cleaner, more straightforward claim may be a claim for fraudulent transfer.

Section 7 of the Uniform Fraudulent Transfers Act ("UFTA") allows the court to award a creditor "any other relief the circumstances may require," which can sometimes include attorney fees and even punitive damages.

Consider the Insurance

As much as fraudulent transfer law can provide a means for creditor recovery against corporate malfeasants who enriched themselves, it should be noted that there is, practically speaking, no insurance that covers fraudulent transfer claims per se. To be more direct: to win such a fraudulent transfer claim is only valuable if you can collect against the perpetrator.

If the embezzler was a covered director or officer or employee with liability coverage, however, the creditor or creditor representative (bankruptcy trustee, receiver, asset assignee) may have a covered claim if they allege that company directors or officers breached their fiduciary duty when making the fraudulent transfer.

For that reason, when investigating an internal defalcation, if the scope of the fraud or scheme could eventually prove to have damaged company finances to the point of insolvency, the company's governance may also become a target of a director and officer liability suit on the theory that management breached its duty of care in allowing or not preventing such transfers to wrongdoers.

These considerations are important to the strategic approach to recovery and for tactical considerations of all constituents: management, creditors, other operating fiduciaries, and the litigators that assist them.

Squash Your Company Litigation

The company has vowed to fight the suit to the death, and it is perfectly capable of paying for its defense. The company's defense counsel assesses the risk of losing the $20 million lawsuit at 60 percent. It is a tough case, but everyone is committed to winning.

Whether the litigator knows it or not, the potential liability assessment may have everything to do with a later determination of insolvency. And the insolvency considerations should not start at the conclusion of the lawsuit, but immediately. Counsel may or may not have a good idea of what the impact of losing that lawsuit may be, but the impact on the company matters not only on the courthouse steps, but on day one of the litigation.

The U.S. Bankruptcy Code's assessment of insolvency, and parallel state statutes, includes not only assets and liabilities recorded on the organization's books, but also the value of *contingent* liabilities.

Just the fact of the lawsuit being filed and assessed at having a greater than 50/50 chance of resulting in that hypothetical $20 million damage amount means that a court in the future may deem the company to have been insolvent at the point back when the $20 million lawsuit was filed. Counsel may be defending a company that a court later will say was insolvent the whole time the defense was ongoing.

A more realistic scenario is that on day one of the lawsuit, management is confident (and so is counsel) in their defense, but the case gets worse as more facts come to light in the discovery process. For example, six months into the case, the company may have to consider the possibility of a judgment award; but, of course, for the last six months it has not been operating as if that judgment was a potential reality.

In the meantime, for the whole pendency of the case, the company was, from a bankruptcy law perspective, *insolvent*. So, all its payments to equity holders, all its payments to creditors that were in some way unusual (in timing or amount), and any transaction it has entered into during the pendency of the case may be walked back by fraudulent transfer claims should the company lose the suit.

The time the company should be concerned about the consequences of losing the suit is the moment the suit is received. The company directors should be concerned not only for the sake of aggressively defending the claims, but they also should consider company affairs post-filing through the lens of potential insolvency-related legal issues.

Important issues to consider include the following:

- How the company will be funded
- How investments will be made in the company during the pendency of the lawsuit

Those issues are examined in the next sections of this discussion.

Panic Distributions

The instinct of owners, particularly of closely held companies, when a large, potential company-squashing suit is filed may be to distribute the money and run. After all, the shareholders or owners see a currently healthy business, and they want to be sure that they do not leave that value there just to be taken by the purveyors of the lawsuit.

The commercial litigator defending the suit is likely to not even ask about, let alone advise, on the company's distributions during the pendency of the case, as that may seem it has nothing to do with the case.

But equity distributions made at a time when the business would be balance sheet insolvent if the expected liability from the lawsuit were treated as a current liability may well be a good way to buy two lawsuits for the price of one. If a judgment is obtained against the company, the holder of that judgment will then seek to collect.

If the company cannot pay the judgment, one avenue available to the judgment creditors is to sue the equity holders (and anyone else who arguably received company assets for less than reasonably equivalent value) for having received constructively fraudulent transfers from the company.

All that judgment creditor will have to prove is that the company was insolvent at the time distributions were made to equity holders; dividends paid when a company is considered insolvent are routinely the subject of claw back or fraudulent transfer claims. This is because the value of the equity holders' interest in the company is eliminated when the company is considered insolvent.

Make It a Loan

A company's equity holders looking down the barrel of a large potential judgment may struggle with the decision to infuse more invested funds into the company at a time when the lawsuit may result in a judgment entitling the holder to all the remaining unencumbered assets of the company. They may be stuck having to make that investment to stay in business (or to pay their counsel's legal bills).

As the company may still prevail in the lawsuit, leadership may be hesitant to pull the bankruptcy cord, but again, if equity investment is infused, it may very well become the subject of a claw back or fraudulent transfer action by the judgment creditor later.

The solution that company owners land on frequently when there are concerns that they will not have much equity interest left if or when the a judgment is awarded is to make a loan to the company. The owners effectively put themselves in line with other creditors of the company.

While there is nothing wrong with making a loan, if it is not a really a loan—it does not look, quack, and act like a loan—a court in a later fraudulent transfer suit may not be fooled. A creditor can argue that the loan should be recharacterized as an equity investment if it does not have the indicia of debt.

Typical factors that courts look to in deciding whether the debt is really a debt or an equity investment in disguise are as follows:

1. Names given to the instruments, if any, evidencing the indebtedness
2. Presence or absence of a fixed maturity date and a schedule of payments

3. No fixed rate of interest or interest payments
4. Whether repayment depended on success of the business
5. Inadequacy of the company's capitalization
6. Identity of interests between creditor and stockholder
7. Security, if any, for the advances
8. Ability to obtain financing from outside lending institutions (on the theory that if no one else would lend to the company, the stockholder probably did not)
9. The extent to which the advances were used to acquire capital assets (if the money was just for day to day operations, it is more likely debt, whereas increasing the assets of the business leans in favor of treating the inflow as capital investment)
10. Whether there is a sinking fund (if the company has to put aside money periodically to ultimately pay off the debt, it is more likely debt)
11. Whether voting rights were changed or given with the investment of funds[3]

If a court or jury finds that the debt should be treated as equity and recharacterized as such based on these factors, any payment to equity holders during the period in which the company is insolvent may be clawed back as a fraudulent transfer.

A Real Life Example[4]

Let's consider a real-life small business example: Widget Installer Co. ("Widget") installs widget-parts in industrial plants. One of its widget suppliers sues for $800,000 in allegedly unpaid invoices. Widget hires trial counsel to defend the suit.

Management knows the suit is unfounded; after all, the company pays all of its bills and the negotiated terms allowed for discounts on the widgets it ordered. But a recent data-loss disaster destroyed the company's accounting records and the documents showing the agreed discounts promised.

Counsel is concerned that the testimony of management without more evidence will not win the day, but then again, it may.

Widget does not carry a lot of assets on hand. Widget is primarily an installer and service provider. As a result, the Widget assets at the time the suit is filed are limited to the following:

1. Leftover inventory of widget parts with an approximate liquidation value of $180,000
2. A certificate of deposit of approximately $100,000 in value that is currently securing a bond required by a contract that Widget has in place for a client
3. An additional $150,000 of receivables

"If a court or jury finds that the debt should be treated as equity and recharacterized as such based on these factors, any payment to equity holders during the period in which the company is insolvent may be clawed back as a fraudulent transfer."

In terms of liabilities, (1) the company has a promissory note due to its bank of $200,000 not yet matured and (2) the company's largest shareholder has a loan to the company committing Widget to repay the debt owed directly to him. However, there is no documentation, no stated interest rate or definite repayment date. The amount of this debt fluctuates, but it hovers around $100,000.

If the supplier is awarded a judgment for $800,000, there is no doubt that the company cannot pay the judgment—at least not without some form of longer-term payment terms.

The business is profitable and the largest, controlling shareholder regularly receives dividend payments. He wants to continue making investments in the business and receiving dividend payments during the pendency of the suit.

Given a strong likelihood that a judgment in excess of the company's net assets will be entered, Widget was insolvent the moment the suit was filed from a fraudulent transfer analysis perspective. The contingent liability was likely to be greater than the net assets. Therefore, any dividend payment made to the controlling shareholder or to other shareholders may very well be the subject of a fraudulent transfer or preference suit by the judgment creditor when it cannot collect from the company.

The controlling shareholder could still invest money through a loan mechanism. However, the loan agreement that exists is highly susceptible to being recharacterized as equity because it does not have the definite terms, form, or strictures of debt.

> **"The law generally expects the management of a company in the vicinity of insolvency to prioritize preservation of the assets for all creditors."**

Even if the controlling shareholder papers a loan to the company with all the definite terms, a judgment creditor may seek to recharacterize that loan as an equity infusion. If that occurs, a court will be able to look behind the paper to see whether any other lender would have made such loans and whether the loan was not for purchasing capital assets, like a new truck that the shareholder may drive off into the sunset with if a judgment is awarded.

Although it may be difficult for a closely held company's largest shareholder to understand how he or she cannot simply run the business as usual until the lawsuit is resolved, in most jurisdictions, when the company goes into the "zone of insolvency"—generally a position where the company owes more than it owns or when debts exceed assets—the duties of the company's officers and directors are to the creditors of the company and, specifically, to preserve corporate assets for the creditors' benefit.

The law generally expects the management of a company in the vicinity of insolvency to prioritize preservation of the assets for all creditors.

As a general matter, any monies that leave the company may be the subject of fraudulent transfer or preference claims if they do not provide equal value to the company. Such claims can be made against the recipient of those transfers for value received that did not provide the company/debtor with equal value.

Specifically, loan repayments to equity owners and any direct benefits to company owners are viewed skeptically by courts. If those expenditures cannot be tied to value received by the company, they may be pursued by the judgment creditor.

In effect, Widget is being run for the benefit of the supplier that is suing it, an important point for the owners and management of the company to understand when gauging how, what, and whether to re-invest in the company and when planning how to manage the defense of the lawsuit.

Conclusion

The subtleties and factual considerations surrounding fraudulent transfer and preference laws; fiduciary duties shifting during periods of insolvency; and corporate representations to lenders, trade creditors, and other third parties require careful, skillful, and strategic thought and planning when a company is contemplating bankruptcy options and when unexpected or uncontrolled circumstances arise.

It is when businesses and their constituents are *not* thinking about bankruptcy, but experiencing unexpected potential or yet-unquantified losses, that these issues may go unnoticed and unevaluated. Having litigators with experience in the insolvency arena can be invaluable in these contexts.

Notes:

1. Insolvency is defined in the Bankruptcy Code and in many states' laws as (a) not being able to pay debts as they come due, (b) being undercapitalized, or (c) balance sheet insolvency (the test for which includes reasonably certain contingent liabilities as well as booked liabilities). *See e.g.*, Peltz v. Hatten, 279 B.R. 710, 742 (D. Del. 2002), *aff'd sub nom*. In re USN Commc'ns, Inc., 60 F. App'x 401 (3d Cir. 2003) ("To succeed on his fraudulent transfer claim . . . the Liquidating Trustee must also prove, by a preponderance of the evidence, that USN was either rendered insolvent by the CT Tel acquisition or insolvent as of the Closing date of February 20, 1998, under one or more of the three insolvency tests set forth in 11 U.S.C. § 548(a)(1)(B)(ii)—the balance sheet test, the unreasonably small capital test, or the ability to pay debts as they come due test.").
2. *See, e.g.*, In re Scott Acquisition Corp., 344 B.R. 283, 288 (Bankr. D. Del. 2006). (Under Delaware law, creditors of an insolvent corporation are owed fiduciary duties.)
3. Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.), 269 F.3d 726, 747-50 (6th Cir. 2001); Cohen v. KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.), 432 F.3d 448, 455 n.8 (3d Cir. 2006).
4. The names have been changed to maintain anonymity.

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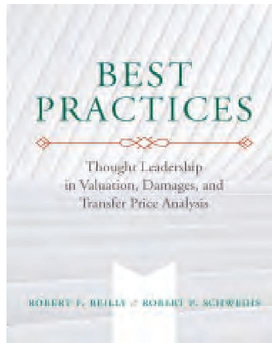
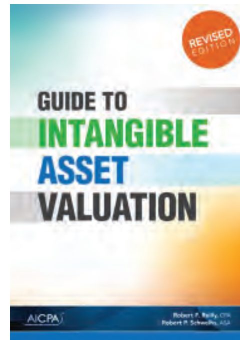
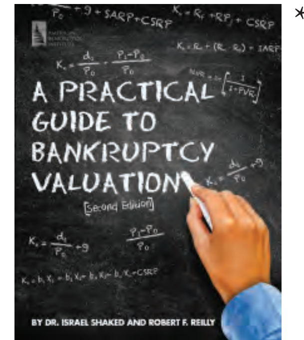
Valuation Textbooks Authored by Robert Reilly and Robert Schweihs







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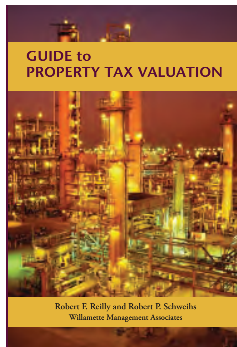

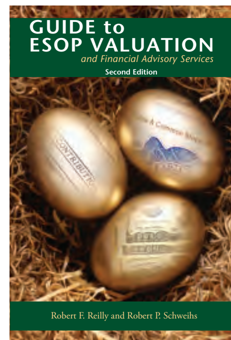

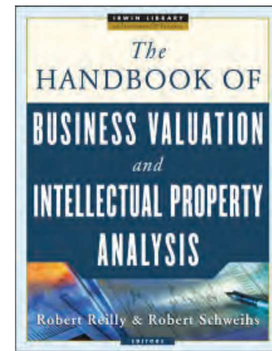

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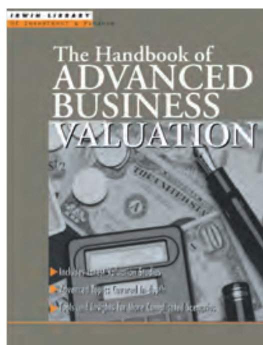

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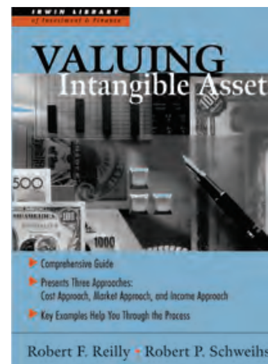

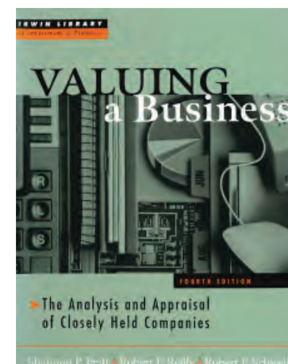

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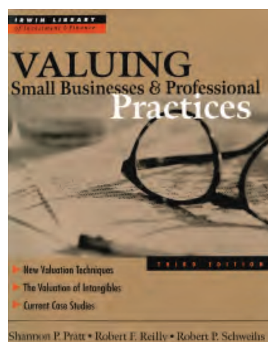

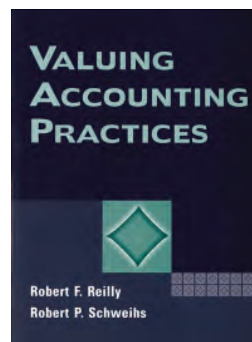

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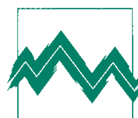

Willamette Management Associates

A Primer on Valuation Considerations in Bankruptcy

Fady F. Bebawy

This discussion summarizes some of the fundamental elements that go into valuations performed with regard to a bankruptcy proceeding. This discussion is important because bankruptcy law is complex and valuation is also complex. Moreover, conducting a business valuation of a distressed company in the many stages of a bankruptcy proceeding may be a complex process. Understanding the inherent challenges of a bankruptcy valuation analysis and how these challenges affect the valuation conclusions is important. This discussion clarifies some of the complexities of bankruptcy valuation. This discussion provides considerations and observations that (1) aid in the valuation analysis itself and (2) assist the many constituents to the bankruptcy proceeding to better evaluate, understand, and apply valuations.

Introduction

This discussion of valuations conducted in a bankruptcy context is guided primarily by chapter 11 of the U.S. Bankruptcy Code (the "Bankruptcy Code") relating to reorganization. In other words, let's assume that the company filing a petition for bankruptcy protection intends to continue as a going concern with the aid of bankruptcy law and emerge from bankruptcy to once again operate as a going-concern company. This process or proceeding is referred to as "Chapter 11" or "reorganization."

The company that has filed a petition under Chapter 11 is typically referred to as the "debtor" and the debtor's business and net assets are referred to as the "estate." The debtor in Chapter 11 may be operated by current management (debtor-in-possession or "DIP") or a court appointed "trustee."

Trustees may be appointed when current management is found to have participated in fraud, dishonesty, or some form of criminal conduct.

The provisions in Chapter 11 offer temporary relief to companies undergoing some form of financial distress. Without this relief, these otherwise healthy and viable companies would likely fail to meet their debt obligations and be forced to discontinue their operations, sell off their assets, and pay down as much of their debts as they can.

In such cases, not only are the interests of public security holders unmet, but other repercussions are felt in (1) the markets in which the company provided its products and services, (2) the employment of the debtor's personnel, (3) the credit markets which funded its operations, and (4) the other factors of economic and public interest.

Therefore, successfully reorganizing debtor companies through Chapter 11 bankruptcy protection offers a significant public interest benefit.

While providing temporary relief to distressed companies, reorganization provisions seek to meet the interests of three constituents:

1. Public security holders, in the case of publicly traded companies
2. Parties in interest
3. Public needs related to the economy

Chapter 11 provides each of these constituents the right to "raise and appear and be heard on any issue in a case under chapter 11."[1]

The third constituent, the general public, is represented by the Securities and Exchange Commission ("SEC") in an advisory role.[2]

Both the second constituent and the third constituent are specifically enabled to raise and appear and be heard under Section 1109.[3]

"Parties in interest" is a broad term which refers to creditors, equity security holders, indenture trustees, or any committee representing creditors or equity security holders.[4] All of these constituents are directly involved with, and have an economic interest in, the business of the debtor.

Involving all these constituents in the bankruptcy process, "will enable the bankruptcy court to evaluate all sides of a position and to determine the public interest."[5]

With respect to the public benefit:

> The advisory role of the Securities and Exchange Commission will enable the court to balance the needs of public security holders against equally important public needs relating to the economy, such as employment and production, and other factors such as the public health and safety of the people or protection of the national interest.[6]

Some General Elements of a Corporate Reorganization

One often misunderstood element of companies filing petitions for reorganization is that the debtor company need not be insolvent in order to file the petition. The filing company—that is the "debtor"—should simply have what its Chapter 11 title implies: debt.

The second general element of a corporate reorganization is the remedy of an automatic stay. This means that once a reorganization petition is approved, the debtor will immediately receive an automatic stay of any actions against it that may otherwise be taken by creditors.

Specifically, Section 362 lists eight actions creditors may take against a company in default which are halted by the automatic stay.[7]

This section also lists certain exceptions to the automatic stay remedy. These exceptions include actions such as criminal actions against the debtor, tax-related actions, and the enforcement of governmental policy and regulatory actions.[8]

The third general element of a corporate reorganization is known as the absolute priority doctrine. This element is the classification and priority of claims and interests against the debtor. All the claims should be paid in full in a class before any claims can be paid to the next class. Furthermore, if the debtor's assets, or their value, fall short of completely satisfying all the claims in a particular class, then the assets are distributed to all the members in the class on a pro rata basis.

The order in which claims are settled is as follows:

- Collateralized claims to the extent they are secured against the pledged property—if the value of the pledged property is not greater than the claim, this shortfall is unsecured
- Priority claims
- Unsecured claims that were filed in a timely manner—this would include any collateralized claim in which there was a shortfall in the value of the pledged property
- Unsecured claims that were filed last
- Equity interests

One general principle that creditors typically maintain throughout the Chapter 11 proceeding, and one that the debtor or trustee should keep in mind, is that creditors will not accept a plan of reorganization unless the creditors' position after the settlement is at least as favorable as it would have been as a result of a liquidation outcome. This liquidation outcome represents a low watermark below which creditors will not accept.

The fourth general element of a corporate reorganization relates to provisions that demonstrate a sense of practicality, expedience, and efficiency, while promoting standards of fairness and equity.[9]

One such provision is the so-called "cramdown" provision that involves confirmation of a plan of reorganization despite the objections and dissents of some classes of claims. Section 1129 contains the cramdown provision.[10]

On the one hand, equitable and fairness standards safeguard the interests of the dissenting creditors and dissenting equity security holders, while on the other hand, these dissenting claim holders may essentially be compelled (or forced) to accept the terms of the plan of reorganization, despite their disapproval.

The Topic of This Discussion

Two main actors play a role in the typical Chapter 11 reorganization proceeding. These main actors

“[B]ankruptcy law in Chapter 11 reorganization affords, and even champions, the notion of fairness—fairness to the debtor.”

are the DIP or the trustee on the debtor’s side and the bankruptcy court on the other side. While many other professional service providers also play a role in the proceedings, the essence of achieving a successful corporate reorganization very much involves the accurate estimation of fair value or fair market value.

The remaining sections of this discussion cover the many intersections that take place in nearly any Chapter 11 reorganization proceeding between:

1. the activities and actions involved in carrying out a corporate reorganization and
2. the role of business valuation and of property valuation.

While the valuation analyst certainly does not lead the Chapter 11 initiatives, the role of business value and property value determinations is nevertheless very important.

The following sections of this discussion highlight important areas of challenges, and improvements, related to the role of valuation in reorganization proceedings. The two main actors playing the important roles in Chapter 11 reorganization proceedings—the DIP/trustee and the bankruptcy court—would be well served to understand these intersections, challenges, and areas of improvement.

Also, the many professional service providers to a reorganization would also do well to be aware of these intersections, challenges, and areas of improvement.

On the debtor side, the professional service providers may include legal counsel, turnaround restructuring advisers, investment banking advisers, and, of course, analysts.

On the creditor side and the equity holder side, the professional service providers may include legal counsel to each creditor and equity committee, potentially some turnaround restructuring advisers, and, of course, valuation analysts.

The next sections of this discussion consider the following topics:

1. The principle of fairness in bankruptcy law and valuation
2. Bankruptcy governance and the role of expert opinions
3. Recovery remedies and limitations in bankruptcy
4. Valuation analysis
5. Challenges in bankruptcy valuation
6. Considerations and observations in bankruptcy valuation

The Principle of Fairness in Bankruptcy Law

The fundamental goal of bankruptcy law protection, and particularly Chapter 11 reorganization, is premised on the notion of the principle of fairness. The introduction of this discussion mentioned that reorganization provisions seek to meet the interests of three constituents affected by a distressed company. This is the fairness principle.

In addition to these three constituents, there is, of course, a fourth constituent without which considerations of the three constituents would not exist. This fourth constituent is the debtor itself.

Here, bankruptcy law in Chapter 11 reorganization affords, and even champions, the notion of fairness—fairness to the debtor. If the Chapter 11 provisions could speak, they would simply say that it is not fair that an otherwise good and healthy company, which provides a service to the community, would be destroyed because it fell on some financial and economic bad times.

To be fair to the debtor company, and to its three constituents, the Chapter 11 provisions give them temporary relief to restructure and reorganize so that the company can meet the obligations of its creditors and resume contributing to the community as a going concern.

This is the overarching principle of fairness in bankruptcy law. And, the Chapter 11 bankruptcy protection process proceeds to discharge the duties under its provisions in order to fulfill the mandate of this important principle.

We also find fairness even in the way in which bankruptcy courts are structured. Within the U.S. civil court system,[11] two discrete types of civil courts have historically existed: courts of law and courts of equity. Courts of law adjudicate disputes in accordance with federal and state law by awarding remedies (relief) based on pecuniary damages.

On the other hand, courts of equity adjudicate disputes in accordance with a set of principles based on fairness, equality, moral rights, and natural law, rather than on a strict interpretation of the law. Moreover, courts of equity award remedies in the form of an action, rather than a monetary payment.[12]

This “remedy of action” is carried out in a Chapter 11 bankruptcy law proceeding by providing

a chance for a temporarily troubled company to reorganize and continue to operate. Given this "equitable remedy of action," it makes sense, and should come as no surprise, that bankruptcy courts are courts of equity in which the court is able to tailor a resolution based on what is fair and equitable to the parties.

A court of law provides remedies in the form of pecuniary damages. A court of equity provides remedies of actions to make things right.

There are specific mentions of fairness and equity in Chapter 11 of the Bankruptcy Code. While the provisions in Chapter 11 mention fairness six times, only one section provides an explanation of how fairness is to be understood and applied.[13]

This section is Section 1129(b)(1),[14] and it is interestingly referred to as the so-called "cramdown." Ironically, the term cramdown suggests something opposite from the notion of fairness.

This section states, "the court, on request of the proponent of the plan, shall confirm the plan . . . 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."[15]

Although some classes do not accept the plan, the court may nevertheless accept the plan and essentially "cram it down" the dissenting classes. This cramdown feature addresses the fourth general element of a corporate reorganization mentioned in the introduction of this discussion relating to practicality, expedience, and efficiency. Achieving consensus among all the constituents to a bankruptcy proceeding is an impractical expectation that rarely happens. This is especially true in bankruptcy where so many positions of the parties are intrinsically adversarial.

The principle of fairness is provided in the two mutually inclusive conditions laid out in Section 1129(b)(1) where a plan (1) "does not discriminate unfairly" and (2) "is fair and equitable."

Fair and equitable is elaborated in subsection (b) with the provision of certain requirements. These requirements are detailed with respect to each class of claims: secured claims, unsecured claims, and a class of interests.[16]

The lawmakers in the House of Representatives who amended Section 1129(b) provide further context regarding this cramdown provision.

> This subsection contains the so-called cramdown. It requires simply that the plan meet certain standards of fairness to dissenting creditors or equity security holders. The general principle of the subsection permits confirmation notwithstanding nonacceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. The dissenting class must be paid in full before any junior class may share under the plan. If it is paid in full, then junior classes may share. Treatment of classes of secured creditors is slightly different because they do not fall in the priority ladder, but the principle is the same.[17]

Finally, Section 101 of the Bankruptcy Code provides 55 paragraphs in which bankruptcy terms are defined.[18] However, while the term "fair" appears only two times under this section, this word is not included as one of the 55 definitions nor does the two appearances of the term include any definition.

Analysts may also search for other important terms that are helpful for valuation purposes, such as value, standard of value, premise of value, and liquidation. However, none of these terms are defined in Section 101.

The Principle of Fairness in Valuation

Interestingly, the notion of fairness does not arise in the discipline of valuation in a way that attempts to provide for dealing among constituents in some equitable way. But the absence of equitable dealing in valuation is neither surprising nor pejorative. It is simply not the duty nor responsibility of the valuation industry. It is, on the other hand, the duty and responsibility of the law.

The notion of fairness in the discipline of valuation arises in assigning values to properties, whether tangible assets, intangible assets, or ownership interests in business entities (whether controlling or noncontrolling) that provide an accurate measure of worth. This "accurate measure of worth" is what underpins the principle of fairness in valuation.

The valuation profession has evolved over the past half century, whereby an extensive compendium of principles, standards, and definitions have developed that provide a framework to which valuation practitioners may adhere when performing business and/or property valuations.

Four valuation professional organizations ("VPOs") have adopted valuation terms and definitions to ensure the quality of valuations for the benefit of the valuation profession and its clients.[19]

Each of these VPOs confer professional valuation credentials and professional standards with which

its members must comply in order to be in good standing with each VPO.[20]

Two general principles guide analysts in performing any business valuation, whether the valuation is of a financially healthy company or of a financially distressed company.

The first principle is determining the appropriate standard of value related to the subject valuation. The standard of value is usually guided by statute, whether it is a federal statute or a state statute. The typical standards of value include (1) fair market value, (2) fair value, and (3) investment value.[21]

Of course, in the context of a bankruptcy, another common standard of value would be liquidation value. As stated previously, bankruptcy law does not specify what standard of value should be applied in performing valuations in bankruptcy. Since federal bankruptcy law generally prevails, standard of value guidance for bankruptcies may also not exist at the state level.

The second principle is determining the appropriate premise of value. The premise of value refers to assumptions about the subject business that is being valued. If the business is expected to continue to operate into the future, its premise of value is a going-concern premise.

On the other hand, if the business is not expected to continue to operate into the future, in this case its premise of value is a liquidation premise. Liquidation can either be orderly or forced. The difference between the two generally relate to how quickly the liquidation is performed.

The standards of value that are typically applied in most valuations of businesses include fair value and fair market value.

Fair Value Standard of Value

The fair value standard of value is often applied in valuations where state law is applicable. This standard of value is applied in instances such as shareholder dispute cases and shareholder oppression cases.

The fair value standard of value is also applied in shareholder appraisal rights cases. In these cases, each state will typically have both statutory laws and case laws that specifically identify the appropriate standard of value, depending on the nature of the case, as well as guidance on how the specific standard of value is defined and applied.

In addition to state law, the fair value standard of value is also applied for purposes of financial accounting compliance. In this instance, an understanding of fair value is promulgated by the Financial Accounting Standards Board ("FASB"), which is a private sector body that the SEC has delegated the responsibility of setting accounting standards, and codifying these standards in Accounting Standards Codification ("ASC") topics.

The FASB is responsible for establishing U.S. generally accepted accounting standards ("GAAP"), and the ASC is the codification system for organizing GAAP rules.

In ASC Topic 820, the term fair value is defined as, "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of a measurement date."[22]

Fair Market Value Standard of Value

The fair market value standard of value is often applied in valuations that are required for income taxation purposes where provisions in the Internal Revenue Code are applicable. This standard of value is applied in instances such as federal gift tax returns, federal estate tax returns, acquisitions of nonprofit organizations by for-profit entities, certain types of solvency analyses, and so forth.

While fairness opinions are typically performed by applying the fair market value standard of value, this is not always the case, and state statutory laws are not always clear on this type of valuation.

Valuation analyses for bankruptcy often apply the fair market value standard of value. However, as mentioned previously, the Bankruptcy Code does not currently provide specified guidance with respect to which standard of value valuation analysts should apply.

One definition of fair market value is provided in Revenue Ruling 59-60. In this Revenue Ruling, fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[23]

Bankruptcy Governance and the Role of Expert Opinions

The bankruptcy proceeding is governed by the DIP or trustee and the court, from which the DIP/trustee must receive approval to perform many of the activities for the debtor during bankruptcy. The dynamics between the DIP/trustee and the court provide enough checks and balances to ensure, or attempt to ensure, the bankruptcy proceeding progresses properly.

Because of the complexity of Chapter 11 bankruptcy proceedings, many financial advisory service providers play a role in reorganizations. Among other service offerings, these financial advisory service providers are regularly called on to provide expert opinions and testify to those opinions in bankruptcy court.

This discussion segregates expert services into three groups: bankruptcy expert services, valuation expert services, and accounting expert services.

Bankruptcy Expert Services

Bankruptcy experts often play a significant financial advisory services role among all the financial advisory service providers who touch a Chapter 11 bankruptcy proceeding. These services are typically undertaken by turnaround/restructuring consultants.

Bankruptcy experts often get involved in every facet of the bankruptcy proceeding. Bankruptcy experts will get involved in the business operations, manage and monitor cash flow, examine preference payments and fraudulent transfer payments, and develop the plan of reorganization.

In addition, such bankruptcy experts oftentimes assume executive positions such as interim (1) chief restructuring officer, (2) chief executive officer, (3) chief financial officer, or (4) chief operating officer. These are all areas within the bankruptcy expert's area of expertise.

Given the extensive reach of turnaround consultants in the bankruptcy proceedings, in many instances they may also provide some of the required valuation expert services.

Accordingly, turnaround consultants are expected to have deep expertise in many areas of bankruptcy, reorganization, and restructuring. However, providing expert services in another area, like valuation, which is a very technical area, may present some challenges.

Therefore, caution is advisable when bankruptcy professionals consider providing expert services outside of their primary area of expertise. This is particularly important if the expert testimony should be provided by an independent, third-party provider, which is often the case for business valuation analysts.

Valuation Expert Services

The need for business valuations and asset valuations is extensive in most every stage of a bankruptcy proceeding and even pre-petition.

Solvency opinions and valuation opinions may be requested by (1) the distressed company, pre-petition; (2) the debtor at the time of the petition filing and after; (3) the debtor and creditor(s) for suspected fraudulent transfers; (4) the debtor and creditor(s) for asset collateral purposes; and (5) the debtor and creditor(s) for confirming the plan of reorganization.

> **"[T]the importance of the valuation analyst preparing an analysis that is thoughtful, accurate, robust, and supportable cannot be overstated."**

In the instances where both the debtor and the creditor require a valuation or a solvency opinion, these constituents are likely to be very adversarial. This also means that the valuation experts retained to provide these valuation opinions are also likely to be adversarial. Retaining valuation professionals, and even ones who have experience in litigation matters, is especially important in adversarial environments.

For example, the debtor seeking fraudulent transfer recovery remedies will retain a valuation analyst to perform a solvency analysis in order to demonstrate that the debtor is insolvent and recovering fraudulent transfers is imperative to the successful reorganization of the debtor.

The creditor (or transferee, that is, the recipient of the fraudulent transfer), on the other hand, will seek to refute this remedy by retaining a valuation analyst to demonstrate that the debtor is solvent and recovering fraudulent transfers is, therefore, not important, nor allowable, for the debtor.

In all of these instances, the importance of the valuation analyst preparing an analysis that is thoughtful, accurate, robust, and supportable cannot be overstated.

Let's consider a final note related to valuation analyses for distressed companies. Care should be taken in relying on the financial statements of distressed companies. The debtor's historical financial statements may not be useful to rely on for the purposes of the requested valuation analysis. The valuation analyst may have to adjust (or "normalize") the financial statements by making extensive normalizing adjustments.

The same word of caution mentioned above for bankruptcy experts providing valuation expert services is also relevant here. In instances where the historical financial statements are not suitable for the requested valuation analysis, the valuation analyst may recommend to the debtor to retain accounting experts to render the financial statements appropriate to the direction of the bankruptcy reorganization.

Accounting Expert Services

Based on the specific properties needing to be valued, the information must be segregated and accumulated accordingly. This may be challenging because the accounting and financial information based on the structure of the debtor before the petition may be very different than the new structure of the estate in the proposed plan of reorganization.

Therefore, the valuation analyst, who will typically require the financial statement information pro forma according to the new structure of the estate, may be involved in developing this information. However, this type of forensic accounting work may be better provided by an accounting expert.

Similarly, if fraud was committed within the debtor, the misstated financial statements will typically need to be reconstructed in order to provide useful input for the valuation analysis. The efforts involved in reconstructing the financial statements are usually quite intensive.

Once again, this financial statement reconstruction service may be better suited for accounting experts to provide. Valuation analysts typically do not provide accounting opinions, nor will the valuation analyst render opinions that involve legal or taxation advice.

Recovery Remedies and Limitations in Bankruptcy

Recovery remedy provisions in Chapter 11 reorganization provide one thing and one thing only—a mechanism to bring back much needed money and assets to the estate in order to bolster the chances, and expedite the debtor's time line, to exit bankruptcy and emerge as a viable going-concern business.

While bankruptcy law includes a number of recovery remedy provisions, limitations are also placed on some of these recovery provisions, and other provisions, due to (and in accordance with) the bankruptcy law principle of fairness.

The following discussion considers some of the recovery remedies and certain limitations imposed on recovery actions.

Recovery Remedies

Recovery actions could potentially represent very significant assets of the estate. Recovery actions are initiated after the petition and during the debtor reorganization.

Whether the recoveries are related to preference payments, fraudulent transfer payments, or due to some other avoidable transactions, the recovery actions are usually vigorously litigated by the transferees since the outcome of the bankruptcy proceeding can either:

1. result in less than the full debt payment they received pre-petition or
2. result in a deferral of the full debt payment over a lengthy future time horizon.

There are many relief remedies that can be pursued in Chapter 11 proceedings. This discussion will focus on some, but not all, of these remedies. These remedies are Section 362 automatic stay, Section 547 preference payment recovery, Section 548 fraudulent transfer avoidance, Section 544 state fraudulent conveyance/avoidance recovery, and Section 363 asset sales relief.

Section 362 Automatic Stay

This automatic stay provision was previously described in the "Introduction" section of this discussion as the second element of a corporate reorganization under the subsection of "Some General Elements of a Corporate Reorganization."

Section 547 Preference Payment Recovery

As the title suggests, preference payments are payments made to one "preferred" creditor at the expense of payments to other "less preferred" creditors. These favorable payments are made to some creditors to preserve business relationships, to protect insiders from losses, and to establish goodwill with certain creditors considered important in order to preserve working relationships during and after the bankruptcy.

While preference payments are not fraudulent per se, the element of certain creditors being "favored" over others suggests the unequitable nature of preference payments. In other words, preference payments violate the bankruptcy law fair and equitable principle.

It is likely that many healthy companies regularly make preference payments to certain creditors over others. However, in the case of healthy companies, all the creditors get paid and the preference is usually based on the timing of the payments with the preferred creditors getting paid earlier than the other creditors.

Under the Section 547 recovery remedy provisions, the trustee[24] may avoid preference transfers

under four conditions. The first two conditions relate to payments made to a creditor and for an antecedent debt.

The third condition relates to making the preference payment while the company was insolvent. This is a discrete milestone and can directly be demonstrated by the trustee by retaining a valuation analyst to perform a solvency analysis.

Conversely, the transferee challenging the recovery action may also retain a valuation analyst to perform a solvency analysis to demonstrate that the company was solvent at the time of the preference transfer.

The fourth condition allows a time frame for avoiding preference payments. The preference payments that are eligible to be avoided should have been made within 90 days before the filing date of the Chapter 11 petition. If the preference payment was made to an insider, then these payments may be avoided if they were made within one year before the petition filing date.[25]

In addition to a time window to recover preference payments, Section 547 spells out three exceptions that the transferee may argue. The first exception relates to an exchange for new value. In other words, if the payment was made for new goods and services received, the court will not view this as a preference payment.[26]

The second exception relates to transfers made in the ordinary course of business or made according to ordinary business terms.[27]

The third exception relates to security interests. If the transfer was made that resulted in a security interest in property acquired for new value, then this transfer may not be recovered as an avoidable preference transfer.[28]

Section 547 also imposes the burden of proof on each constituent regarding whether or not the preference payment is avoidable. "[T]he trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section, and the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section."[29]

In addition to these burdens of proof, the trustee may also prove avoidability and the creditor or party in interest may also prove nonavoidability to the extent that the debtor was insolvent or solvent, respectively, at the time of the preference transfer.[30]

Section 548 Fraudulent Transfer Avoidance

Fraudulent transfer avoidance is probably one of the most adversarial recovery actions in bankruptcy proceedings. This makes sense since the transferee may not get all his money back through Chapter 11 or, if he does, the money may not be received until a far future date. Worse, the transferee may only receive a settlement (of less than the full) amount as a result of a liquidation outcome.

The first condition that must be met in order for a transfer to be considered fraudulent and eligible for avoidance is, "[I]f the debtor voluntarily or involuntarily 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."[31]

Fraudulent transfers may be considered either actual fraudulent transfers or constructive fraudulent transfers. An actual fraudulent transfer takes place when the debtor "voluntarily" makes a transfer with the intent to hinder, delay, or defraud. Conversely, a constructive fraudulent transfer takes place when the debtor "involuntarily" makes a transfer that has the same effect as the voluntary intent to hinder, delay, or defraud.

This first condition of actual fraudulent transfer or constructive fraudulent transfer alone makes the transfer avoidable. In other words, none of the other conditions need to be met in order to qualify the transfer to be recovered.

If the first condition is not satisfied, the transfer may still be considered fraudulent and avoidable if two additional conditions are met. It is important

to point out that, unlike the first condition, both of these two additional conditions should be met in order that the transfer be considered fraudulent and subject to avoidance.

The first of these two additional conditions states that the debtor must have "received less than a reasonably equivalent value in exchange for such transfer or obligation."[32]

If there is dispute surrounding this condition, a valuation of the transfer or obligation would be required to test the "reasonably equivalent value in exchange" test.

The second additional condition may be any one of four further conditions.

This second additional condition is satisfied if the debtor, "(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; [or] (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; [or] (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."[33]

Peculiarly, if the debtor "receives less than a reasonably equivalent value in exchange for such transfer or obligation,"[34] this does not, by itself, constitute a fraudulent transfer that the trustee may avoid. This is unusual because, by not recovering this underpayment of cash or value, the debtor would not receive some of its much needed cash/value.

If conditions II through IV do not apply, the trustee will need both a valuation opinion for the "less than a reasonably equivalent value in exchange" and an insolvency opinion in order to avoid fraudulent transfers.

Conversely, the creditor may defend against the trustee's action to avoid the transfer by either (1) providing that the transfer was struck at a reasonably equivalent value in exchange or (2) demonstrating the solvency of the debtor company.

According to Section 548, the trustee may recover fraudulent transfers that were made within two years before the petition filing date. If the trustee uncovers fraudulent transfers that were made earlier than the two-year reach-back period, Section 544, discussed in the next section, offers an alternative, longer recovery window.

Section 544 State Fraudulent Conveyance/ Avoidance Recovery

Section 544 allows the trustee to pursue fraudulent transfer recovery actions against a creditor by enabling the trustee to assume a similar right of a creditor holding an unsecured claim.[35]

Having the same rights as an unsecured creditor provides the trustee with certain rights under the Uniform Voidable Transactions Act ("UVTA").[36]

According to the provisions of the UVTA, the trustee may advance, "[a] claim for relief with respect to a transfer or obligation under this [UVTA] . . . not later than four years after the transfer was made or the obligation was incurred, or, if later, not later than one year after the transfer or obligation was or could reasonably have been discovered by the claimant."[37]

This means that the trustee may avoid fraudulent transfers at least four years after the transfer was made. This reach-back period may be extended one year after the trustee could reasonably discover the fraudulent transfer. In other words, if the trustee is assigned on the date of the petition and at this time would reasonably know about the fraudulent transfer, the reach-back period is five years.

If the trustee is assigned one year after the petition date, then the reach-back period is six years. In any event, the ability to reach back more than two years prior to the petition date, as provided under Section 548(a)(1), gives the trustee much greater powers to better research and identify the important fraudulent transfers to recover for the benefit of the debtor and plan of reorganization.

Section 363 Asset Sales Relief

In order to raise money for the bankruptcy estate, the trustee may identify and sell certain assets that are not used in the ordinary course of business. These sales may not be limited to discrete assets but may also include business units, subsidiaries, divisions, and nonperforming assets of the debtor.

Care should be taken in Section 363 sales for any property sold for which a creditor has a security interest in the property. The trustee must receive the consent of the creditor and identify another replacement property to which a security interest would be applied.

In a Section 363 sale, "the trustee has the burden of proof on the issue of adequate protection."[38] This proof may be demonstrated by obtaining a fairness opinion in connection with the Section 363 sale. On the other hand, "the entity asserting an interest in property [i.e., the secured creditor]

has the burden of proof on the issue of the validity, priority, or extent of such interest."[39]

If there is a dispute in the value or if the sales proceeds do not cover the creditor's interest in the property, the creditor may also obtain a valuation opinion with respect to the sale.

One more noteworthy condition of a Section 363 sale has to do with any successor liability claims that may be filed against the seller at a future date. Generally, the trustee or DIP selling assets in a bankruptcy proceeding will want to ensure that the assets being conveyed are "free and clear of any interest in such property."[40]

The "free and clear" provision in Section 363(f) is meant to release or "discharge" the seller from any successor liability claims. However, there may be limitations to discharging successor liability claims in a Section 363 sale. Some of these limitations will be addressed further in a subsequent section of this discussion.

Recovery Limitations

As the debtor enjoys certain recovery remedy actions, some limits may be imposed on the recoveries in accordance with the Bankruptcy Code. This discussion focuses on a few bankruptcy law provisions that are meant to safeguard the creditor's interest by imposing some limitations on the debtor's recovery. These limitations are Section 361 adequate protection and Section 550 recovery caps and floors relief limitations.

Section 361 Adequate Protection

The Section 361 provision limits the creditor's loss from a decrease in the property value in which the creditor has a security interest. This is because adequate protection is required under certain recovery remedies such as Section 362 automatic stay and Section 363 asset sale.

In other words, Section 361 essentially provides creditors a recovery remedy from the debtor's recovery remedy. However, the creditor's recovery remedy is limited to the decrease in property value.

Section 361 states that if a creditor's interest (i.e., the asset that is collateralized) is reduced because of, for example, a Section 363 asset sale, the creditor should be made whole by way of, "requiring a trustee to make a cash payment or periodic cash payments"[41] for the amount of the collateral reduction or by "providing . . . an additional or replacement lien"[42] for the amount of the collateral reduction or by "granting such other relief . . . as will result in the realization . . . of the indubitable equivalent"[43] for the amount of the collateral reduction.

Depending on the nature of the collateral, it is likely that the trustee and the creditor may obtain a valuation of the collateral that was reduced.

Section 550 Caps and Floors Relief Limitations

Section 550 provides guidance for executing the transfer avoidance remedy. The actual title of Section 550 is not the title presented above. Instead, this title reflects how Section 550 has been applied in case law. The actual title of Section 550 is "liability of transferee of avoided transfer." From strictly a valuation perspective and an economic perspective, the answer does not seem to be so complicated.

However, the discussion below first presents Section 550 and then describes the two approaches that have been applied to Section 550.

Section 550 states, "(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from—(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee."[44]

The debate about how to interpret this bankruptcy provision is focused on the meaning of the phrase, "for the benefit of the estate."

The first approach is referred to as the "ceiling approach" because recovery is limited to the amount of the claim. In cases that have applied the ceiling approach, the courts ruled that the recovery of transfers are capped at the value of the claims by the unsecured creditors.

The second approach is referred to as the "floor approach" because recovery must be at a minimum amount to cover the amount of the claims, but may be greater. In cases that have applied the floor approach, the court ruled that the recovery of transfers must be at least the value of the claims by the unsecured creditors.

In these cases where the recovered transfer value is greater than the unsecured claims (and thus not at a reasonably equivalent value), the debtor company enjoys a windfall.

In two recent bankruptcy fraudulent transfer litigation cases, the court, and notably the same judge, ruled adopting the floor approach in the first case and the ceiling approach in the latter case.

In 2017, the bankruptcy court for the District of Delaware adopted the floor approach *In re Physiotherapy Holdings, Inc.*[45] The ruling in this case relied on the 2012 *In re Tronox, Inc.*,[46] case and the very old and highly criticized Supreme Court ruling *More v. Bay*[47] case in 1931.

In *Physiotherapy*, the bankruptcy court ruled that recovery of fraudulent transfers should not be capped at the claims' amount. That is, the claims' amount represents the floor of recovery, but recovery can be more than this floor level.

Two years later, in a recent case concluded in 2019, the same judge, who ruled in *Physiotherapy*, then ruled in *In re Allonhill, LLC*,[48] maintaining that the debtor may not recover in excess of the claims against it. That is, the claims' amount represents the ceiling of recovery and no level of value in excess of the claims' amount may be recovered.

From a purely valuation perspective, or economic perspective, the approach could be much simpler. One approach could be to simply unwind the fraudulent transfer. If the transfer was made by way of a property transfer, then that property would be returned back to the debtor. Similarly, if the transfer was made by way of a cash payment, then an equal amount of cash would be returned back to the debtor.

One of the ascribed difficulties with the "floor approach" is that the debtor would receive a windfall upon receiving the property back. However, this ignores the likely case that, when the debtor initially made the fraudulent transfer, (1) the windfall was received by the transferee and (2) the debtor received the opposite—a deficit or discount. Thus, receiving a windfall when the recovery action is completed merely makes the debtor whole.

In the case of the floor approach, in the event that the property is not available to be returned, then an alternative approach could be to return the value of the property that was transferred at the transfer date.

Finally, regarding the interpretation of the phrase "for the benefit of the estate," it could simply refer to the transfer recovery action remedy. That is, all recovery action remedies in bankruptcy law are established "for the benefit of the estate." The inclusion of the phrase simply reiterates what is already understood and known.

Valuation Analysis

This section summarizes the different types of valuation analyses that may be provided in a Chapter 11 bankruptcy proceeding. The intent of this section is not to provide guidance on how to perform each valuation analysis.

Having said this, other sections of this discussion present challenges, considerations, and observations that often come into play in performing a valuation analysis.

Solvency Analysis

The solvency analysis is one analysis that is often performed in a bankruptcy proceeding. Generally, distressed companies that file for bankruptcy, whether Chapter 7 or Chapter 11, are insolvent.[49]

A solvency analysis is required by the trustee/DIP when seeking recovery actions such as preference payments and fraudulent transfers. The creditor may also seek a solvency opinion to refute the recovery action. A solvency analysis may be sought pre-petition, at-petition, and at confirmation of the plan of reorganization.

Performing a solvency analysis involves three tests: the balance sheet test, the cash flow (liquidity) test, and the capital adequacy test.

Balance Sheet Test

The balance sheet test considers whether the debtor's total assets (at fair valuation) are greater than the amount of its total liabilities. Contingent liabilities, potential litigation liabilities, and other off-balance-sheet liabilities are included in the balance sheet test. Performing the balance sheet test essentially involves performing a business enterprise valuation.

A business valuation may be performed by applying the discounted cash flow method, the guideline publicly traded company method, and the guideline merged and acquired method. There are a number of additional methods that may be applied in order to value the subject company.

If the fair value of the business assets is greater than the amount of the business liabilities, then the balance sheet test passes.

If the balance sheet test fails, then the subject company is considered insolvent based solely on the balance sheet test.

Cash Flow Test

The cash flow test assesses whether there is sufficient cash flow to meet the current debt of the subject company as it becomes due. This test is performed by continuing the valuation analysis performed for the balance sheet test and adding to it by developing an interactive three-statement model. This interactive three-statement model projects out

the income statement, balance sheet, and cash flow statement with linkages between each of them.

The balance sheet will include a detailed analysis of the debt interest payments and debt principal payments as they become due. The three-statement model is the most detailed and complete financial analysis that is performed.

Outside of a bankruptcy context, performing a valuation analysis typically does not require developing an interactive three-statement model. Once the three-statement model is developed, the final analysis involves determining what ratios are required based on the debt covenant agreements and calculating whether or not these ratios are satisfied in the model. If they are, then the cash flow test passes.

Capital Adequacy Test

The capital adequacy test assesses whether the debtor has unusually small capital. This is addressed by determining if there are sufficient sources of capital (from operations and asset sales) compared to its capital needs, that is, paying its debts.

Capital adequacy involves evaluating the ability to sustain business operations over time and the ability to withstand a reasonable degree of "stress" or variations from projections.

This "stress test" is applied to a normal range of business conditions. It does not include extreme or black swan[50] business conditions.

Typically, no additional analysis is prepared to perform the capital adequacy test. Instead, the ratio analysis that was prepared for the cash flow test is used. However, certain shocks to the projections—the stress test—are modeled and tested to see if any debt covenant agreement ratios fail in the stressed years.

If none of the ratios fail, then the capital adequacy test passes. However, as with the balance sheet test and the cash flow test, simply passing the capital adequacy test does not demonstrate that the subject company is solvent.

Moreover, the progression of the analysis is usually performed in the sequence described here.

Business Enterprise Valuation Analysis

This discussion considered the generally accepted business valuation methods in the above description of the balance sheet test.

Business enterprise valuations are typically performed to value a number of bankruptcy measurements, including the following:

- Fairness opinions, typically in connection with Section 363 business sales
- Adequate consideration opinions
- Reasonably equivalent value opinions
- Reasonableness of certain elements of the plan of reorganization

Intellectual Property and Intangible Asset Valuation Analysis

Nearly all companies own some type of intangible asset whether management knows it or not. Some companies also own intellectual property ("IP"), which the company will be aware of, since there is an application process that is involved in owning IP (collectively, "intangible assets").

The difference between IP and other intangible assets is that IP can be protected more than other intangible assets. Examples of protected IP are patents, trademarks, trade secrets, and copyrights.

Examples of other intangible assets that can be identified and commercialized are contracts, favorable leases, permits, franchises, software, customer relationships, supplier relationships, employee relationships, engineering drawings, technical documentation, operational procedures, and so on.

Tangible asset valuation is also often involved in a bankruptcy. However, this discussion does not consider the valuation of tangible assets.

There are a number of generally accepted methods that can be used to value intangible assets. The following is a list of some, but not all, of the applicable methods:

- Yield Capitalization Method—The value of the intangible asset is estimated by calculating the present value of the projected economic income or cost savings attributable to the intangible asset over a fixed period of time or in perpetuity.
- Profit Split Method—The value of the intangible asset is estimated by calculating the present value of the economic income or cost savings attributable to the intangible asset that could be hypothetically split between a hypothetical licensor and hypothetical licensee.
- Relief from Royalty Method—The value of the intangible asset is estimated by calculating the hypothetical royalty expense that does not need to be paid because the intangible asset does not need to be licensed from an independent, third-party

owner of the intangible asset. The value of the intangible asset is the present value of the prospective stream of royalty payments that are avoided (because the asset is owned) over the useful economic life of the asset.

- Comparable Uncontrolled Transaction/Sale Method—The value of the intangible asset is estimated by comparing the intangible asset to comparable technologies that have been bought or sold during a reasonably recent period of time.
- Reproduction Cost New less Depreciation Method or Replacement Cost New less Depreciation Method—These cost approach methods are based on the economic principles of substitution and price equilibrium. These economic principles indicate that an investor will pay no more to acquire a fungible asset than the cost to recreate it. Within the cost approach, the value of the intangible asset is estimated by the reproduction cost new less depreciation method (recreate an exact duplicate of the asset) or the replacement cost new less depreciation method (recreate an asset of equal utility).

Intangible assets can be used by the debtor to provide a security interest for a secured creditor in instances where the creditor's interest has either decreased in value or was sold in a Section 363 asset sale.

The trustee or DIP may also obtain intangible asset valuations in order to use the intangible asset as collateral in securing DIP financing.

Challenges in Bankruptcy Valuation

This section covers various inherent issues that arise in the course of performing valuations of distressed companies in all stages of the bankruptcy: pre-petition, during the bankruptcy proceeding, pre-plan, and concurrent with a plan confirmation.

Considerations in Selecting the Valuation Analyst

One factor to performing a business valuation for distressed companies in bankruptcy is having a deep understanding of the three business valuation approaches and the many business valuation methods that are within these three approaches. Experienced business valuation analysts encounter throughout their career a wide divergence of businesses they value. This is because no two valuation analyses are the same. There are numerous factors that contribute to this wide divergence.

The following is a list of some of these factors:

- The industry in which the subject business competes and its size
- The stage of the industry and its changing size
- The economic market conditions and black swan events
- The geography in which the subject company competes
- The regulatory environment and changes in it over time
- The nature of technology, its advances, and the impact on new and changing technologies
- The subject company and its idiosyncrasies
- The stage of the subject company: start-up, growth, mature
- The size of the subject company vis-à-vis the size of the market
- The availability and quality of the subject company financial information
- The accessibility of the subject company management
- The quality of the subject company management
- The purpose of the valuation analysis
- The audience of the valuation analysis
- The scrutiny of the valuation analysis

All of these factors, and many more, contribute to the complexities of performing valuation analyses and the divergence of approaches, methods, considerations, financial data or lack of financial data, market data or lack of market data, and so forth. The unique features of distressed company valuations fall well within the range of the diverging analyses described above.

The following factors are relevant to performing distressed company valuations:

1. A strong foundation in understanding business valuation approaches and methods
2. An experienced and seasoned business valuation practitioner
3. A credential in a business valuation organization and in compliance with its professional standards

4. A propensity to perform valuation analyses in a manner that is rigorous, robust, complete, well documented, and well supported

Statutory Guidance

In addition to the factors related to performing distressed business valuations, it is important to understand the bankruptcy law provisions that affect valuation analyses as well as legal guidance from legal counsel, bankruptcy court opinions, and case law precedents.

The lack of statutory guidance on valuation standards such as standard of value and premise of value and their definitions causes some challenges to seeing business valuation analyses performed with more consistency.

Restatements of Historical Financial Statements

The quality, accuracy, and relevance of financial statement information invariably present inherent challenges in nearly every bankruptcy valuation analysis.

Given the constant changes to the debtor, there are inherent challenges in looking at (1) historical performance that bears little similarity to the current status and direction of the debtor and (2) expectations of prospective performance given a limited track record of achieving projections.

Based on the specific assets that need to be valued, historical information may be segregated and accumulated accordingly. This process is challenging because the accounting and financial information based on the structure of the debtor before the petition may be very different than the new structure of the estate in the proposed plan of reorganization.

Therefore, the valuation analyst typically requires the financial statement information pro forma according to the new structure of the estate. This type of forensic accounting work may be best provided by an accounting expert.

Moreover, if fraud was committed within the debtor company, the misstated financial statements will likely need to be reconstructed in order to provide useful input for the valuation analysis. The efforts involved in reconstructing the financial statements is usually quite intensive. In this case also, financial statement reconstruction services may be provided by accounting experts.

Present Value Discount Rate

Estimating a present value discount rate for distressed companies involves a closer look at three of the many inputs: beta, company-specific risk premiums, and capital structure.

In general, beta information may be based on guideline publicly traded companies. This is because the debtor's beta, if public, includes historical price volatility affected by its distressed state. With private companies, this issue does not exist. However, in both the public company and the private company instance, healthy guideline publicly traded companies have limited comparability because this measure does not reflect the distressed nature of the debtor company.

Any additional risks associated with distressed companies may be adjusted in the cost of equity capital. This may typically involve assigning a company-specific risk premium. While this adjustment may be appropriate, the challenge continues to be how this adjustment is estimated.

Given the changing debt levels as the debtor goes through the bankruptcy proceeding, challenges exist in selecting the appropriate capital structure at the stage in the bankruptcy proceeding in which the valuation is performed.

Considerations and Observations in Bankruptcy Valuation

Given the backdrop of bankruptcy law guidelines, the legal framework to maximize debtor financial viability through relief remedy provisions, the contributions made by all the financial advisers to restructure and reorganize the debtor company, and the inherent idiosyncratic challenges involved in a distressed company, there are many lessons learned, and important considerations and observations made, that can inform valuation analysts to produce a reliable and supportable valuation analysis work product.

This discussion of considerations and observations is the result of experience performing valuation analyses in multiple circumstances, both inside and outside the context of a bankruptcy proceeding, across many industries, with companies competing in highly regulated or unregulated environments, and so forth.

This discussion of considerations and observations is not comprehensive. We present important considerations and observations that (1) are fundamental and have an impact on almost every valuation assignment, (2) may sometimes be lost between the forest and the trees, (3) may have arisen lately in certain recent valuation assignments and are

noteworthy, and (4) have arisen in recent court cases.

Financial Information Considerations and Observations

As with any valuation analysis and, even more broadly, any professional services engagement, the first and most important step of the analysis is gathering relevant information. Obtaining accurate and relevant information to rely on in the valuation analysis is challenging.

More importantly, the valuation analyst should be, on the one hand, resourceful in working with the information available. On the other hand, it is equally or more important that the valuation analyst notifies the client, whether legal counsel, the debtor, or the creditor, of the information needs in order that the appropriate experts may be assigned to gather and provide this necessary information.

Therefore, proactively communicating to the client the detailed information priorities early in the valuation assignment is of paramount importance.

If the valuation assignment is performed on behalf of the debtor, the valuation analyst usually has greater opportunities to influence the information available for the valuation analysis. However, if the valuation assignment is performed on behalf of any of the creditor or equity committees, the opportunities to guide the development of relevant information is typically more limited.

What is noteworthy here is the asymmetry of information between the debtor's valuation analyst and the creditor/equity committee's valuation analyst. On the creditor/equity committee side, the analyst should proactively communicate to counsel the need for proper financial information early in the process.

Whether or not other experts get involved in preparing recast financial information based on the direction of the restructuring and reorganization of the debtor company, there still remains helpful information that may be considered by the valuation analyst, whether working on the side of the debtor or creditor/equity committee.

For example, let's assume the valuation analyst is assigned to prepare a solvency analysis of a distressed publicly traded company for purposes of avoiding a fraudulent transfer. The valuation date for this solvency analysis is the fraudulent transfer date. The challenge is that the information that is publicly known or knowable may not reflect the actual conditions at the date of the fraudulent transfer.

In other words, the public information in the financial statement filings and disclosures may not capture the elements of "distress" that could indicate insolvency. That information would not have come out at that early date.

Conversely, the public information in the financial statement filings and disclosures after the fraudulent transfer date may not only capture the elements of "distress," but may also capture other information, such as corporate response actions, market responses, and the like, which are not relevant to the solvency/insolvency analysis.

In order to disassemble this blended information, the valuation analyst may request certain types of documentation prepared by management in the normal course of business that are contemporaneous with the fraudulent transfer date.

These documents include the following:

- Audit work papers that document management's current views and affect the value of debtor assets, such as impairment analyses performed for intangible assets
- Concurrent valuations of certain assets
- Interim financial reports, to be compared to the projections to determine any variances
- If budgets are usually prepared during the time of the fraudulent transfers, examining iterations of these budgets may reveal important patterns that may be considered

The valuation analysis may also involve examining historical projections and comparing them to the current projections. This examination would include noting management's historical accuracy in estimating projections. Did this accuracy change at some point in the past? Did the accuracy change as performance declined? These considerations may be helpful in assessing the current projections.

Further, projections may be compared against current analyst consensus projections of the (1) debtor company, if the debtor company is public and analysts continue to track it, and (2) guideline publicly traded companies. Projections may also be compared to contemporaneous industry outlook information.

All of these types of documents and measures can inform the valuation analyst about the reliability of the projections, which may be adjusted accordingly.

The valuation analyst may also request cash flow reports that are monitored regularly in between quarterly reporting periods. These types of reports are usually prepared to monitor the company's bank reporting requirements and may indicate compliance with debt payments and debt covenant ratios. These reports may reveal patterns that would affect the "ability to pay debts" in the solvency analysis.

Any reports that forecast a potential violation of debt covenant ratios are important and inform the solvency analysis. A solvency analysis that ignores these types of documents leave the analysis up for scrutiny.

Some companies maintain internal procedures to test its capital metrics. These interim reports may inform a solvency analysis at an interim fraudulent transfer date.

The valuation analyst may request board of director minutes that took place before the fraudulent transfer date. These documents may reveal management's discussions about its financial position. The minutes may also reveal potential sources of additional capital that are available to the company from current shareholders and/or executive management. Management presentations to customers, the investment community, and the rating agencies may also be considered and examined.

If management has conducted discussions with banks for additional funding, there would likely be internal analyses that would be developed to support these discussions.

Of course, the valuation analyst should also be cognizant of concurrent interim financial projections that the company produces for different purposes. One set of projections may be prepared for banks to obtain additional funding. These projections may have an upward, optimistic bias.

Meanwhile, a different set of projections may be relied on in the regular internal analyses management prepares to test debt covenant ratios given the company's current debt obligations. These projections may be management's expected scenario or pessimistic scenario.

In any event, if there are differences in these contemporaneous projections, these differences should be evaluated and considered in selecting the projections relied on in the solvency analysis.

All of these internal documents may provide the valuation analyst with relevant information to guide a solvency analysis during interim financial statement disclosure periods.

When examining the documents produced and provided to the valuation analyst, the analyst may be mindful of the nature of the documents. The following are some considerations in evaluating a document:

- Was the document prepared in the normal course of business?
- Was the document prepared contemporaneous with the valuation date or before or after?
- Was the information contained in the document known or knowable as of the valuation date?
- Was the document in draft or final form?
- Was the document prepared for budgeting, forecasting, or planning?
- Was the document prepared to revise budgeting, forecasting, or planning based on interim actual results?
- Was the document prepared for a specific purpose, such as for financial reporting, bank financing, rating agencies, litigation, regulatory agencies, or bankruptcy?
- Was the document relied on by other parties, such as auditors, regulators, acquirers, valuation analysts, or other third parties?

Valuation Assumptions Considerations and Observations

Although the statutory framework does not address some of the important assumptions that guide a valuation analysis, the valuation analyst should nevertheless be cognizant of these assumptions and document them accordingly, especially if the valuation analyst is a member of a VPO and is bound by its professional standards requirements.

For example, if the valuation is prepared for a Chapter 11 debtor company, the valuation report would indicate the premise of value to be a going concern. Similarly, although no statutory guidance currently exists as to the standard of value, the valuation report should document what standard of value is applied in the valuation analysis.

For a going-concern premise of value, the standard of value for distressed debtor companies is typically fair market value.

Additionally, if the analysis involves performing a valuation of the debtor company that would include a valuation of a business segment that will be discontinued, then (1) the ongoing segment would typically be valued (a) based on a fair market value standard of value and (b) based on a going-concern premise of value and (2) the discontinued business segment would typically be valued (a) based on a liquidation value standard of value and (b) based on a liquidation premise of value.

Different premises of value and standards of value may be applied based on the unique facts and circumstances of the valuation assignment.

Section 363 Sales Considerations and Observations

Previously, in the recovery remedies section we discussed Section 363 sales. We indicated that in any Section 363 sale, subsection (f) provides for the asset sale to be "free and clear of any interest in such property"[51] with the meaning of discharging the seller from any future successor liability claims. However, recent court decisions have challenged the "free and clear" provision in Section 363(f). Therefore, future valuation analyses should address some of the issues raised in these decisions.

The decisions held in the multidistrict courts in *In re Motors Liquidation Co., f/k/a General Motors Corp.* provided that successor liability claims are not discharged if the debtor only provides "constructive notice" and does not provide "actual notice" or "constitutionally adequate notice."[52]

The courts further held that claims arising out of the purchaser's conduct post-petition also do not discharge the seller pursuant to section 363(f). "Tort claims by plaintiffs based on a purchaser's post-petition conduct are not claims that are based on a right to payment that arose before the filing of the bankruptcy petition, and as such, they fall outside the scope of a "free and clear" provision of a sale order entered pursuant to section 363 of the Bankruptcy Code."[53]

These rulings give rise to additional risks related (1) to the assets acquired in a Section 363 sale and (2) to the seller. Therefore, providing valuation opinions concurrent with Section 363 sales may include considerations for these additional risks of successor liability claims.

Valuation due diligence would include requesting information surrounding the incidence of any tort claims arising from the subject assets and historical costs associated with the resolution of the tort claims. Also, the analysis would involve understanding the time lag between the claimant's product purchases and their subsequent filing of claims.

There may be other related post-Section 363 acquisition liabilities that the valuation analyst may consider before issuing valuation opinions concurrent with Section 363 sales.

Identification of Additional Assets Considerations and Observations

Valuation analysts who have extensive experience performing other nonbankruptcy valuation assignments, such as transfer pricing, licensing agreements, ASC Topic 805 business combination valuations, ASC Topic 350 long-lived asset impairment testing, and so forth, may have consequently developed particular expertise in valuing intangible assets.

Identifying and valuing intangible assets may be helpful to the trustee or DIP to either monetize these assets through a Section 363 sale or collateralize these assets for secured creditors.

The need to collateralize intangible assets for secured creditors may arise when the security interests of creditors either decline in value or are sold off in Section 363 sales. The importance and relevance of intangible assets continue to rise as new industries and markets emerge from technological advances.

Closing Considerations and Observations

Because the bankruptcy process can be fast and fluid, it is important that communication be open and frequent between the valuation analyst and legal counsel. The valuation analyst should rely on instruction from legal counsel on all legal matters that may affect the valuation analysis. As raised in a number of sections of this discussion, the valuation analysis should remain within the purview of an analyst's skills and expertise.

Analysts who foray into subject matter areas outside of their skills and expertise may compromise the validity of the analysis and conclusion. This also applies to bankruptcy experts and accounting experts.

The valuation analyst provides opinions of value. The analyst does not provide legal, taxation, accounting/auditing, or investment opinions.

Finally, the valuation analyst should perform the valuation analysis in compliance with professional standards.

Summary and Conclusion

Bankruptcy law not only provides relief for distressed companies, it offers a significant public interest benefit. The public interest benefit affects (1) public security holders, in the case of publicly traded companies, (2) parties in interest, that is, parties having business relationships with distressed companies, and (3) public needs related to the economy.

The absolute priority doctrine is an important element of a corporate reorganization. It involves classifying and prioritizing claims and interests against the debtor that are fair and equitable. This means that a plan of reorganization must satisfy all the creditors or interest holders with a higher ranking before a lower-ranking creditor interest holder can receive any consideration.

The goal of bankruptcy law (particularly Chapter 11) is to provide a mechanism whereby distressed companies receive relief in order to reorganize and meet the requirements of their creditors as a going concern. Moreover, the goal of bankruptcy law is to provide this service in a manner that is fair and equitable to all parties involved with the debtor company.

The goal of the valuation analysis is to provide an independent, fair, and market-based assessment of the value of the debtor company equity or the debtor company assets from both sides of the bankruptcy—the debtor and the creditors.

Bankruptcy law currently does not provide important guidance related to business valuation. This guidance should address the appropriate premise of value and the appropriate standard of value.

The role of the various expert service providers to a bankruptcy proceeding is important. Care should be taken that the various expert service providers engage in services related to their area of expertise and avoid engaging in areas outside their expertise that may expose their analyses and conclusions to scrutiny. Three expert service providers were described in this discussion: bankruptcy expert services, valuation expert services, and accounting expert services.

Understanding the recovery remedies available in a bankruptcy proceeding and the limitations of these remedies is important. The recovery remedies raised in this discussion are Section 362 automatic stay, Section 547 preference payment recovery, Section 548 fraudulent transfer avoidance, Section 544 state fraudulent conveyance/avoidance recovery, and Section 363 asset sales relief. The recovery limitations raised in this discussion are Section 361 Adequate Protection and Section 550 Caps and Floors Relief Limitations.

Valuation analyses provided in bankruptcy settings often fall into three areas: solvency analysis, business enterprise valuation analysis, and intangible asset valuation analysis.

There are a number of challenges in bankruptcy valuation, such as selecting the appropriate valuation analyst, navigating the statutory landscape related to bankruptcy valuations, understanding and working within the limitations of the historical financial statements, and the challenges in estimating the appropriate present value discount rate.

There are a number of important considerations and observations that may aid in the valuation analysis. These considerations and observations include evaluating all financial information available as of a specific valuation date, applying the appropriate valuation assumptions based on the specific valuation assignment, including successor liability claims considerations in a Section 363 sale, and identifying additional assets that may be used by the debtor company in its restructuring.

Bankruptcy law is complex, and valuation also is complex. Conducting a business valuation of a distressed company in the many stages of a bankruptcy proceeding is complex. Understanding the inherent challenges of a bankruptcy valuation analysis and how these challenges affect the disparities in the valuation results is important. This discussion clarified some of the complexities of bankruptcy valuation. This discussion also provided a number of important considerations and observations that (1) aid in the valuation analysis itself and (2) assist the many constituents to the bankruptcy proceeding to better evaluate, understand, and apply the valuation.

Notes:

1. U.S. Code, Title 11, Chapter 11; Historical and Revision Notes – Legislative Statements. These legislative statements appear at the beginning of Chapter 11 and provide an overview of the rationale of Chapter 11 and the reforms that superseded the previous version.
2. Ibid.
3. U.S. Code, Title 11, Chapter 11, Subchapter II, Section 1109. Right to be heard, subsections (a) and (b).
4. U.S. Code, Title 11, Chapter 11; Historical and Revision Notes – Legislative Statements. These legislative statements appear at the beginning of Chapter 11 and provide an overview of the rationale of Chapter 11 and the reforms that superseded the previous version.
5. Ibid.
6. Ibid.
7. U.S. Code, Title 11, Chapter 3, Subchapter IV, Section 362(a)(1-8).
8. Ibid., Section 362(b).
9. U.S. Code, Title 11, Chapter 11, Subchapter II, Section 1129; Historical and Revision Notes – Legislative Statements; House Report No. 95-595.
10. Ibid., Section 1129(b).
11. As opposed to the U.S. criminal court system.
12. Henry R. Cheeseman, *Business Law*, 5th ed. (Upper Saddle River, NJ: Pearson Education, 2004), 192–93.
13. All of the other mentions of fairness are more subjective and relate to, for example, a committee choosing its members fairly or the fair treatment of parties. The specific references to these mentions, in order of sections, are: 1102(b)(1), 1113(b)(1)(A), 1114(f)(1)(A), 1114(g)(3), and 1129(b)(2). This last section/subsection merely repeats the mention of "fair and equitable" made in Section 1129(b)(1).

14. U.S. Code, Title 11, Chapter 11, Subchapter II, Section 1129(b)(1).
15. Ibid.
16. Ibid., Section 1129(b)(2)(A)-(C).
17. U.S. Code, Title 11, Chapter 11; Historical and Revision Notes – Legislative Statements, House Report No. 95-595.
18. U.S. Code, Title 11, Chapter 1, Section 101.
19. These four societies and organizations are: the American Institute of Certified Public Accountants, American Society of Appraisers, National Association of Certified Valuators and Analysts, and the Canadian Institute of Chartered Business Valuators. All these four societies and organizations incorporate and include the International Glossary of Business Valuation Terms. However, some societies, such as the American Society of Appraisers, include certain additional terms that are contained in the glossary of the ASA Business Valuation Standards.
20. There is an additional certification program in the valuation of distressed assets and companies. This certification is conferred by the Association of Insolvency & Restructuring Advisors. Typically, only turnaround consultants are eligible to obtain this certification due to the program's certification requirements. Thus, unless the holder of this distressed business valuation certificate also holds a credential in any of the four business valuation societies and organizations, the distressed business valuation credential holder will not (a) be privy to the extensive standards, guidelines, and education promulgated by, and provided under, these four business valuation societies and organizations nor (b) be required to be in compliance with its professional standards.
21. While there may be more standards of value depending on the unique circumstances of the valuation, these three are the most common standards of value and are specifically identified in the glossary of business valuation terms.
22. Accounting Standards Codification, Fair Value Measurement ("Topic 820"), 820-10-35-2, No. 2011-04, May 2011, 203.
23. Revenue Ruling 59-60, 1959-1 C.B. 237, Sec. 2.02.
24. Interestingly, the provision explicitly references a "trustee" as the constituent who may initiate the avoidance of a preference payment. This seems to imply that in the instance that a trustee is not involved in managing the debtor through Chapter 11, the DIP does not have this authority or tool to recover preference payments. If this is the case, the implicit assumption is that the DIP would not seek to recover preference payments that he/she previously made.
25. U.S. Code, Title 11, Chapter 5, Subchapter III, Section 547(b)(1-4).
26. Ibid., Section 547(c)(1).
27. Ibid., Section 547(c)(2).
28. Ibid., Section 547(c)(3).
29. Ibid., Section 547(g).
30. Ibid., Section 547(b)(3).
31. Ibid., Section 548(a)(1)(A).
32. Ibid., Section 548(a)(1)(B)(i).
33. Ibid., Section 548(a)(1)(B)(ii)(I-IV).
34. Ibid., Section 548(a)(1)(B)(i).
35. Ibid., Section 544(b)(1).
36. In 2014, the Uniform Law Commission amended the Uniform Fraudulent Transfer Act for the first time since its creation in 1984 and changed its name to the UVTA. We understand that, at the time of this discussion, 43 states have enacted the UVTA and 2 states have enacted the Uniform Fraudulent Conveyance Act.
37. UVTA (as Amended in 2014), Section 9(a).
38. U.S. Code, Title 11, Chapter 3, Subchapter IV, Section 363(p)(1).
39. Ibid., Section 363(p)(2).
40. Ibid., Section 363(f).
41. Ibid., Section 361(1).
42. Ibid., Section 361(2).
43. Ibid., Section 361(3).
44. U.S. Code, Title 11, Chapter 5, Subchapter III, Section 550(a)(1-2).
45. In re Physiotherapy Holdings, Inc., No. 13–12965 2017 WL 5054308 (Bankr. D. Del. Nov. 1, 2017).
46. In re Tronox, Inc., 464 B.R. 606, 55 Bankr. Ct. Dec. (CRR) 269, Bankr. L. Rep. (CCH) P 82166 (Bankr. S.D.N.Y. 2012).
47. More v. Bay, 284 U.S. 4, 52 S. Ct. 3, 76 L. Ed. 133, 76 A.L.R. 1198 (1931).
48. In re Allonhill, LLC, No. 14-10663, 2019 WL 1868610 at *1 (Bankr. D. Del. Apr. 25, 2019).
49. The one caveat is that a company does not need to be insolvent in order to be approved for Chapter 11 reorganization protection. The company simply has to have debt.
50. A black swan event is an unpredictable or unforeseen event, typically with extreme consequences.
51. U.S. Code, Title 11, Chapter 3, Subchapter IV, Section 363(f).
52. Borde, Manish, "Lessons from the General Motors Bankruptcy for Companies Purchasing Product Lines from Bankrupt Companies, Buyer, Beware!" American Bar Association, Bankruptcy/Insolvency Committee, https://www.americanbar.org/groups/litigation/committees/bankruptcy-insolvency/, accessed September 26, 2019, dated April 27, 2019.
53. Ibid.

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Willamette Management Associates Thought Leadership in Valuation, Damages, and Transfer Price Analyses

Willamette Management Associates consulting experts and testifying experts have achieved an impressive track record in a wide range of litigation matters. As independent analysts, we work for both plaintiffs and defendants and for both taxpayers and the taxing authorities. Our analysts have provided thought leadership in breach of contract, tort, bankruptcy, taxation, family law, shareholder rights, antitrust, fraud and misrepresentation, and other disputes. Our valuation, damages, and transfer price analysts are recognized for their rigorous expert analyses, comprehensive expert reports, and convincing expert testimony. This brochure provides descriptions of recent judicial decisions in which our analysts provided expert testimony on behalf of the prevailing party.

Dissenting Shareholder Testifying Expert Services

In the matter of the *Wayne L. Ryan Revocable Trust, Steven Ryan and First Nebraska Trust v. Constance "Connie" Ryan and Streck, Inc.* (Case No. CI 14-1684), the District Court of Sarpy County, Nebraska, decided a matter described as one of the largest valuation disputes in Nebraska state court history. After the application of prejudgment interest, the fair value of the plaintiffs' ownership interest was estimated to be between $723 million and $804 million.

Willamette was retained to provide both consulting expert valuation services and testifying expert valuation services to the plaintiffs. Willamette managing director Kevin Zanni provided consulting expert services, and firm managing director Robert Reilly provided testifying expert services regarding the Streck fair value valuation.

In *Ryan*, Willamette and another well-known valuation advisory services firm applied the same valuation methodology, but reached significantly different opinions. In a 74-page published opinion, the court concluded that (1) the Willamette fair value conclusion of the subject equity interest was reasonable, and that value was accepted in full by the court, and (2) the defendants' testifying expert applied valuation variables designed to lower his fair value conclusion, and that value was rejected by the court.

In particular, the *Ryan* decision is representative of the Willamette thought leadership in fair value valuation matters related to statutory shareholder rights, dissenting shareholder appraisal rights, and shareholder oppression claims.

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thought leadership

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Property Taxation Testifying Expert Services

In the matter of *Union Electric Company d/b/a Ameren Missouri v. Christopher Estes, Assessor, Cole County, Missouri*, No. 13-52002, 2019 WL 2369464 (Mo.St.Tax.Com. May 28, 2019), upon appeal and remand, the State Tax Commission of Missouri (the "STC"), found in favor of Ameren Missouri, the corporate taxpayer complainant. At issue in the matter was the need for STC to determine the appropriate amount of total depreciation to be applied to the Assessor's cost approach "market value" of the Ameren Missouri real property and tangible personal property.

The STC concluded that the taxpayer presented substantial and persuasive evidence to establish the correct amount of total property depreciation, including the identification and quantification of the taxpayer's economic obsolescence.

John Ramirez, Willamette director of property tax valuation services, provided consulting expert services—which included an economic obsolescence depreciation analysis and economic obsolescence depreciation report—on behalf of taxpayer Ameren Missouri. Robert Reilly, Willamette firm managing director, provided testifying expert services related to this public utility property tax valuation dispute.

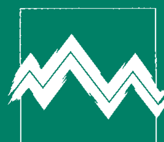
The Missouri STC accepted the economic obsolescence analysis and conclusion—and the total depreciation calculation—prepared by Willamette.

Estate Taxation Testifying Expert Services

In the matter of *Estate of Aaron U. Jones v. Commissioner,* T.C. Memo. 2019-101, the U.S. Tax Court adopted in full the value conclusions put forth by the Estate's valuation expert. In 2009, Aaron Jones gifted ownership interests in two companies: (1) Seneca Jones Timber Company ("SJTC"), a limited partnership that owned and harvested timberland, and (2) Seneca Sawmill Company ("SSC"), an S corporation that operated sawmills. In 2013, the Service issued a notice of deficiency for gift tax of approximately $45 million. The Estate brought this matter to the U.S. Tax Court.

Willamette was engaged by the Estate to provide valuation and testifying expert services. Scott Miller, Willamette vice president, provided valuation consulting services and Robert Reilly, a managing director of our firm, provided testifying expert services. Important issues in the dispute included (1) whether it was appropriate to tax affect the earnings of tax pass-through entities SSC and SJTC and (2) whether the income approach applied by the Estate's valuation expert was more appropriate for valuing the SJTC limited partnership units than the asset-based approach applied by the Service valuation expert.

In this important decision, the Tax Court adopted without adjustment the positions and value conclusions presented in the Willamette valuation expert reports.



Willamette Management Associates

Transfer Pricing Testifying Expert Services

In the matter of *Amazon.com, Inc. & Subsidiaries v. Commissioner,* 934 F.3d 976 (9th Cir. 2019), the Ninth Circuit affirmed the U.S. Tax Court 2017 decision in favor of taxpayer Amazon. The Tax Court case involved a 2005 cost sharing arrangement that Amazon entered into with its Luxembourg subsidiary. Amazon granted its subsidiary the right to use certain pre-existing intangible property in Europe, including the intangible property required to operate Amazon's European website business.

The Tax Court concluded that (1) the Service's determination with respect to the buy-in payment was arbitrary, capricious, and unreasonable; (2) Amazon's CUT transfer price method (with some upward adjustments) was the best method to determine the requisite buy-in payment; and (3) the Service abused its discretion in determining that 100% of the technology and content costs constitute intangible development costs. The Tax Court noted the Service's buy-in payment discounted cash flow analysis improperly included all contributions of value, including workforce in place, going-concern value, and goodwill.

On appeal, the Service argued that "residual business assets" (e.g., workforce in place, going-concern value, goodwill, and future growth options) satisfied the then applicable regulation's definition of "intangible." The Ninth Circuit concluded otherwise, accepting taxpayer Amazon's position that the then applicable regulation's definition of "intangible" was understood to exclude goodwill and going-concern value.

Willamette Management Associates managing director Robert Reilly provided expert testimony in the Tax Court on behalf of taxpayer Amazon in this Section 482 intercompany transfer pricing case.

Willamette Management Associates

Shareholder Litigation Consulting Expert Services

In many instances, an attractive settlement is as good, if not better, than a judicial victory. This was true in the matter of *In Re Legacy Reserves LP Preferred Unitholder Litigation*. In this particular matter, the Delaware Chancery Court approved a settlement between Legacy Reserves LP ("Legacy") and its preferred unit holders that resulted in the preferred unit holders realizing a significant increase in the transaction value.

The plaintiff preferred unit holders brought an action against defendant Legacy to remedy the defendant's alleged breach of contract and breach of the duty of good faith and fair dealing in connection with a proposed transaction in which Legacy would be converted from a partnership to a C corporation. The proposed transaction would result in Legacy and its general partner becoming subsidiaries of Legacy Reserves Inc. ("New Legacy") and Legacy's common and preferred unit holders becoming common stockholders of New Legacy. Pursuant to the terms of the proposed transaction, each outstanding Legacy limited partnership unit would be converted into the right to receive 1 share of New Legacy common stock, each outstanding Series A preferred unit would be converted into the right to receive 1.9620 shares of New Legacy common stock, and each outstanding Series B preferred unit would be converted into the right to receive 1.72236 shares of New Legacy common stock. Based on the announced terms, the preferred investors would receive 17.7 percent of the business, while the common holders would receive 82.3 percent of the business.

Lead counsel for plaintiffs in the litigation retained Willamette to assist and advise them regarding the fair value of the Legacy Series A preferred units and Series B preferred units. After extensive analysis and negotiations, Legacy management signed a memorandum of understanding. Legacy admitted to none of the allegations, and the plaintiffs agreed not to further pursue Legacy on any grounds surrounding the C corporation conversion and the preferred unit conversion. In exchange, the Series A preferred unit holders received 2.9203318 shares of common stock for each preferred unit, while the Series B preferred unit holders received 2.90650421 shares of common stock for each preferred unit. This settlement resulted in the preferred investors receiving approximately 26 percent of the restructured entity and the common holders receiving approximately 74 percent of the entity.

Willamette managing director Timothy Meinhart provided valuation consulting expert services to the preferred unit holder plaintiffs in this matter.

Willamette Management Associates

Application of the Asset-Based Approach to Conclude a Going-Concern Value

Connor J. Thurman

Valuation analysts ("analysts") are often retained by legal counsel to provide valuation services to industrial or commercial companies, including services related to bankruptcy proceedings. One of the services that analysts may provide in a bankruptcy context is the valuation of the debtor company equity or the debtor company assets. When valuing the debtor company equity or the debtor company assets, the analyst may develop the valuation based on the going-concern premise of value. One generally accepted valuation approach that may be applied to value the debtor company is the asset-based approach. An analyst may apply the asset-based approach to conclude the going-concern premise of value related to the debtor company. This discussion provides guidance with regard to (1) the generally accepted debtor company valuation approaches and methods and (2) the application of the asset-based approach to value a debtor company based on the going-concern premise of value.

Introduction

The bankruptcy of an industrial or commercial company often involves the valuation of the assets, properties, or business interests included in the bankruptcy estate. For purposes of this discussion, we refer to these industrial or commercial companies as "debtor companies."

There are numerous reasons why an analyst may be requested to conduct a valuation of the debtor company equity or the debtor company assets. These reasons can include creditor's rights issues, decisions with regard to debtor company liquidation versus debtor company reorganization, consideration of any proposed plans for reorganization, and so forth.

In the valuation of the debtor company equity or the debtor company assets, an analyst may develop the valuation based on the going-concern premise of value. In developing a business valuation based on the going-concern premise of value, there are three generally accepted business valuation approaches that can be applied: (1) the income approach, (2) the market approach, and (3) the asset-based approach.

Inexperienced analysts may exclude (or may not even consider applying) the asset-based approach when valuing the debtor company equity. This may be because those analysts do not believe that the asset-based approach is relevant to such a valuation, or because those analysts simply do not know how to properly apply the generally accepted asset-based approach business valuation methods.

Additionally, inexperienced analysts may (incorrectly) assume that the application of the asset-based approach automatically results in a liquidation premise of value. In fact, the asset-based approach can be applied to value the debtor company equity based on a going-concern premise of value.

This discussion addresses the application of the asset-based approach to value the debtor company on a going-concern premise of value in a bankruptcy engagement.

In the following section, this discussion considers the generally accepted business valuation approaches and methods with regard to the valuation of debtor companies. In particular, this discussion focuses on two asset-based approach valuation methods:

1. The asset accumulation ("AA") method
2. The adjusted net asset value ("ANAV") method

Approaches and Methods to Value Debtor Companies

There are numerous reasons to estimate the value of a debtor company business, business ownership interest, or security within a bankruptcy context. For example, a closely held debtor company may need to enter into a stock sale transaction either before filing for bankruptcy protection, during the bankruptcy period, or while emerging from bankruptcy.

Such stock sales may involve attempts to raise equity capital (and to avoid insolvency), find strategic partners and other investors, or monetize spin-off opportunities. Factors related to both the level of value and the stock rights and privileges may affect the value of the prebankruptcy debtor company stock.

For any purpose, analysts may consider and apply generally accepted business valuation approaches, methods, and procedures in these debtor company valuations. This section summarizes these generally accepted business valuation approaches and methods.

Generally Accepted Business Valuation Approaches and Methods

The generally accepted valuation approaches are the asset-based approach, the income approach, and the market approach. A summary of these three business valuation approaches is presented below.

Asset-Based Approach

The asset-based approach is based on the principle that the debtor company equity value is equal to the value of the debtor company assets less the value of the debtor company liabilities. The asset-based approach is applied less frequently (compared to the income approach or market approach) in the valuation of the debtor company.[1]

To perform an asset-based approach valuation, the analyst may identify and value the following asset and liability categories: net working capital (e.g., accounts receivable and inventory), tangible personal property (e.g., machinery and equipment), real estate (e.g., land and permits, computer software, and customer relationships), intangible value in the nature of goodwill, contingent liabilities, and recorded liabilities.

The application of the asset-based approach may include the application of the generally accepted property valuation approaches—the income approach, the market approach, or the cost approach—to estimate the value of certain debtor company assets.

Two asset-based approach valuation methods are the AA method and the ANAV method. These asset-based approach valuation methods are addressed later in this discussion.

Income Approach

The income approach is based on the principle that the value of the debtor company business is the present value of the debtor company's expected future income. The most common income approach valuation methods in a bankruptcy engagement are as follows:

- The direct capitalization method
- The yield capitalization method (also sometimes referred to as the discounted cash flow ["DCF"] method)

In the direct capitalization method, the selected measure of income is projected for a single future period—that is, for a typical "next period" after the valuation date. This projected income is normalized—or stabilized—in order to represent a typical level of income on a forward-looking basis. The objectives of this income stabilization procedure are such that (1) the effects of business cyclicality are reduced, (2) the effect of an abnormal "last period" projection base are reduced, and (3) the effects of nonrecurring or extraordinary income or expense items are eliminated.

The projected income is capitalized by (i.e., divided by) a direct capitalization rate. There are several procedures that may be used for estimating the appropriate direct capitalization rate, but these procedures are beyond the scope of this discussion.

In the yield capitalization method (sometimes called the discounted cash flow—or DCF—method),

the selected measure of income is projected for several years in a discrete projection period. A yield capitalization rate (also called a present value discount rate) for the debtor company is typically estimated as a weighted average cost of capital. The yield capitalization rate is applied to the discrete income projection in order to conclude the present value of the projected income stream.

Next, in the yield capitalization method, a residual value (also called a terminal value) is estimated. The residual value is estimated at the end of the discrete projection period. There are several procedures that may be used to estimate the residual value.

The sum of (1) the present value of the projected discrete period income stream and (2) the present value of the residual value indicates the value of the total unit of operating assets.

Market Approach

The market approach is based on the principle that the debtor company can be valued by reference to pricing guidance extracted from what investors exchange ownership interests in arm's-length transactions for similar investments. Two market approach valuation methods are as follows:

- The guideline publicly traded company ("GPTC") method
- The guideline merged and acquired company ("GMAC") method

In the application of either the GPTC method or the GMAC method, the analyst identifies and analyzes market data regarding (1) GPTC financial fundamentals or (2) GMAC arm's-length transactions, and then extracts pricing multiples to apply to the debtor company financial fundamentals.

The following discussion focuses on the asset-based approach and its application to estimating the value of a debtor company based on the going-concern premise of value.

Application of the Asset-Based Approach to Value the Debtor Company on the Going-Concern Premise of Value

While the income approach and market approach are also commonly applied, the asset-based approach is a generally accepted business valuation approach. It is described in most of the comprehensive business valuation literature. In fact, analysts are typically required to consider the asset-based approach in their analyses, according to most authoritative business valuation professional standards. In the bankruptcy engagement, the analyst should typically consider the application of the asset-based approach.

Professional standards such as the American Institute of Certified Public Accountants *Statement on Standards for Valuation Services* and the *Uniform Standards of Professional Appraisal Practice* require the analyst to consider applying the asset-based approach in the analyst's valuation development.

In practice, many inexperienced analysts immediately ignore asset-based approach methods because they see it as too difficult to apply. Further, many analysts do not seriously consider the application of the asset-based approach in a bankruptcy engagement because they are not familiar with the procedures necessary to properly apply the asset-based approach valuation methods.

Additionally, the application of the asset-based approach may require estimating a value for each of the assets of the debtor company. This process can be time-consuming and costly to the client. Depending on the ownership interest subject to the valuation, however, the asset-based approach should be given appropriate consideration.

The analyst's selection of the applicable valuation approach is a function of four primary factors: (1) the type of debtor company, (2) the type of subject business interest, (3) the type of subject transaction, and (4) the availability of necessary data.

The asset-based approach typically concludes a marketable, controlling ownership interest level of value. Therefore, the asset-based approach is generally more relevant to the valuation of an overall business enterprise. The asset-based approach is also applicable to the analysis of a debtor company acquisition that is structured as an asset purchase transaction.

In addition, when properly applied using consistent valuation variables, all asset-based approach valuation methods may be used to conclude (1) total business enterprise value, (2) total business asset value, (3) total business owners' equity value, (4) a single class of owners' equity, and (5) a specific block of owners' equity.

There are multiple valuation methods within the asset-based approach. This discussion focuses on the application of two asset-based approach valuation methods:

1. The AA method
2. The ANAV method

Asset Accumulation Method

The AA method can be a time-consuming and complicated asset-based approach valuation method. To apply the AA method, analysts typically begin with the most recent balance sheet of the debtor company. However, the balance sheet of the debtor company serves only as a starting point as each asset is reviewed and likely adjusted. According to *Valuing a Business*:

> [t]he value-basis balance sheet may be materially different from the cost-basis balance sheet in two ways: (1) the balances in the asset and liability accounts have been revalued and (2) several new asset and liability accounts may be added.[2]

It is typical for a debtor company's most valuable assets to be unrecorded assets on the debtor company's cost-based balance sheet. Intangible assets such as the trained and assembled workforce, customer contracts, going-concern value and goodwill, among others, are not typically recorded on a debtor company's balance sheet (unless acquired as part of a business purchase).

In applying the AA method, the analyst will apply generally accepted property valuation methods from the income approach, market approach, and cost approach to estimate the value of the assets of the debtor company.

A summary of the procedures that are typically applied in the AA method follows:

1. Identify all of the debtor company's asset and liability categories.
2. Value all of the identified asset and liability accounts.
3. Calculate the level of value as indicated in the valuation engagement (e.g., equity, market value of invested capital, and others).

The first procedure presented above (identify all asset and liability categories) is fairly straightforward. Typically, the analyst begins with the debtor company's balance sheet to identify both the asset and liability categories. The analyst then notes the certain asset and liability accounts presented on the debtor company's balance sheet. To identify all asset and liability accounts, further due diligence is often required, such as speaking with management and developing an understanding of the debtor company's business.

For instance, if the debtor company is capital intensive, it is likely that most of the assets are tangible assets and can be readily identified by management. However, if the debtor company is a professional services firm, telecommunications firm, or other firm with significant intangible assets, there may be assets of significant value that are unrecorded on the debtor company's balance sheet. These valuable assets may include customer contracts, trademarks or trade names, goodwill, and other intangible assets.

Similar to identifying unrecorded assets, the analyst will have to identify all liabilities, including both recorded liabilities and unrecorded liabilities. Unrecorded liabilities may include contingent liabilities such as those from a pending legal settlement, unrecorded payables (either due to accounting oversight or fraudulent activity), operating leases or capital leases, and other similar liabilities.

When the analyst identifies all of the assets and liabilities of the debtor company, the next procedure is to estimate the value of each asset and liability according to the standard of value for the bankruptcy engagement.

The AA method is typically a more time-consuming valuation method because a value needs to be estimated for each asset and liability. A simplifying assumption is sometimes made by the analyst that unadjusted book value of current assets and current liabilities are representative of the relevant standard of value of these assets and liabilities. Whether this simplifying assumption is appropriate will depend on the facts and circumstances of the specific engagement.

For instance, in the case of a debtor company, the collectability of their recorded accounts receivable may be uncertain. Thus, an analysis of the allowance for doubtful accounts offsetting the total book value of accounts receivable may be appropriate and may be adjusted to reflect additional risk of the creditworthiness of the company's customers.

The following sections present a discussion of the application of the AA method in a bankruptcy engagement.

Current Asset Accounts

Current asset accounts typically include (1) cash and (2) cash equivalents, such as marketable securities. Prepaid expenses, accounts receivable, supplies, and inventory are examples of other current asset accounts.

The account values for current assets do not typically change in a material way under alternative standards of value. Therefore, the analyst may

be able to assume that the current record account balance for each current asset category is equal to the applicable standard of value. However, if there happens to be material differences, the analyst should revalue the materially different current asset accounts.

When estimating the value of accounts receivable, the analyst may create a contra-asset account (e.g., a reserve for uncollectible accounts) to conclude the current value of the asset. The analyst may rely on the age and collectability of the subject receivable when estimating the reserve (or reduction) account. The analyst may apply similar procedures for current asset accounts such as supplies and inventory.

Tangible Real and Personal Property

Tangible assets may include real estate and tangible personal property. Real estate includes land, land improvements, buildings, and building (or leasehold) improvements. Tangible personal property may include machinery and equipment, computer and office equipment, furniture and fixtures, and vehicles.

Depending on the age of the tangible assets, there may be a significant difference between the recorded net book value of these assets and the market value of these assets. If the analyst is experienced in the appraisal of real estate, machinery and equipment, or other real property or tangible personal property, the analyst may revalue these assets of the debtor company. Otherwise, the analyst should rely on property appraisals performed by a qualified real property and/or personal property appraiser.

In the case of land and land improvements, value is commonly based on the generally accepted property valuation method—the market approach, sales comparison method. The value of buildings and building improvements is often based on the generally accepted property valuation method—the cost approach, replacement cost new less depreciation ("RCNLD") method. Buildings and building improvements may be valued by applying the market approach if sufficiently comparable transactions are available.

Machinery, equipment, and other tangible personal property may be valued by applying the cost approach, RCNLD method. The analyst may test the replacement cost new indications by analyzing recent purchases of sufficiently comparable new tangible personal property if such transactions are available.

Intangible Real and Personal Property

Intangible assets can be categorized as (1) intangible real property or (2) intangible personal property.

Intangible real property includes the following asset categories:[3]

1. Real property leases
2. Easements and rights of way
3. Air rights, water rights, and surface-use rights
4. Mineral, mining, and extraction rights
5. Building permits and development licenses

Intangible real property assets within each of the intangible real property categories can be valued by applying generally accepted property valuation methods of the cost approach, the market approach, or the income approach.

Intangible personal property includes the following asset categories:[4]

1. Customer-related intangible assets (e.g., customer contracts, customer relationships)
2. Contract-related intangible assets (e.g., licenses and permits, supplier contracts)
3. Employee-related intangible assets (e.g., employment agreements, assembled workforce)
4. Data-processing-related intangible assets (e.g. computer software, automated databases)
5. Engineering-related intangible assets (e.g., engineering drawings, product formulations)
6. Intellectual property intangible assets (e.g. patents, copyrights, trademarks)

Intangible personal property assets within each of the intangible personal property categories can be valued by applying generally accepted property valuation methods of the cost approach, the market approach, or the income approach.

For the valuation of intangible real property and intangible personal property, the analyst may spend as much effort in the identification of the assets as they do in the valuation of those assets. Typically, internally created intangible assets are not recorded on the company balance sheet. Therefore, the analyst must first identify all intangible assets that are owned by the company, and then value each of the identified intangible assets.

Analysts often apply different property valuation methods to value the various categories of intangible assets. For example, computer software is typically valued using the cost approach, RCNLD method. In contrast, trademarks may be valued using the market approach, relief-from-royalty method. Finally, customer contracts may be valued using the income approach, multiperiod excess earnings method.

In a typical AA method application, the analyst may use one or more income approach methods to estimate the value of the company's intangible assets. Most income approach methods include some form of contributory asset charge procedure. The contributory asset charge procedure helps to eliminate the double-counting of intangible asset values. Similarly, most income approach methods include some form of residual value calculation to help avoid undercounting intangible asset values.

Intangible Value in the Nature of Goodwill

Goodwill (or sometimes referred to as intangible value in the nature of goodwill) typically exists in a debtor company operating as a going concern. In the AA method, analysts often apply the income approach, capitalized excess earnings method ("CEEM") to estimate the value of goodwill.[5]

The CEEM is often applicable to the AA method. This is because it relies on values already assigned by the analyst to the company current assets, real property and tangible personal property, and intangible real property and intangible personal property.

In the application of the CEEM, the analyst applies a fair rate of return (commonly the debtor company's weighted average cost of capital) to all of the company identifiable assets. This calculation results in the indicated required earnings for the company. The analyst then compares the company's actual earnings (typically measured as earnings before interest and taxes) to the company's required earnings.

The difference between the required earnings and the actual earnings indicate either excess earnings (if actual earnings exceed required earnings) or an income loss (if required earnings exceed actual earnings). The difference between the required earnings and actual earnings is capitalized into perpetuity as an annuity to estimate the value of goodwill. If this calculated annuity is a negative value, we refer to this as economic obsolescence.

Other Assets

The "other assets" category is primarily comprised of two types of assets: (1) noncurrent financial assets and (2) excess or nonoperating assets. Typically, the excess or nonoperating assets are tangible assets that are not being used as part of the company's ongoing business operations. Analysts will need to use their professional judgment and expertise to determine whether any of the other assets require a revaluation.

In particular, deferred income taxes may need to be given careful consideration depending on the assumptions of a proposed sale structure or sale of certain assets of the company.

Regardless of the applicable standard of value or premise of value for the particular engagement, the "other asset" category is typically valued based on a net realizable basis. The net realizable basis represents the expected selling price of the asset less the expected costs of disposing of the asset.

Current Liability Accounts

The company current liability accounts often include accounts payable, notes payable, accrued expenses, and income taxes payable. This liability account category also includes the current portion (if any) of the company's long-term debt.

Because all of these liability accounts are typically due in one year or less, there is usually very little revaluation that needs to be performed by the analyst. However, the analyst should include the current portion (if any) of noncurrent liabilities with the long-term liability accounts—then revalue the entire long-term liabilities balance.

Long-Term Liability Accounts

Long-term liabilities are typically recorded on the debtor company's balance sheet. Depending on the purpose of the valuation, revaluation of the long-term liability accounts may be performed in a bankruptcy engagement. The liabilities may be revalued to the amount at which the liability could be extinguished.

The analyst may consider numerous factors in the determination of the current value (as of the valuation date) of the long-term liabilities. These factors may include an analysis of the embedded interest rate versus current market interest rates, the long-term liability time to maturity, debtor company payment history, any prepayment penalties, conversion features, or whether the particular long-term liability is callable.

Significant input from debtor company management, any trustee of the bankruptcy estate, or the company creditors may be helpful in collecting and estimating the inputs needed to estimate the value of the long-term liability accounts.

Contingent Liabilities

Contingent liabilities are not recorded on the company balance sheet. Contingent liabilities may be disclosed in the footnotes to company audited financial statements if they are available. Typically, these disclosures inform the analyst of where to look for contingent liabilities. However, the value of contingent liabilities (if any) is often not disclosed in the footnotes to the company audited financial statements. Moreover, the audited financial statement date may not correspond to the valuation date.

In order to value contingent liabilities in the bankruptcy engagement, the analyst may need to perform a significant amount of due diligence to identify the existence of such contingent liabilities. This due diligence may include interviews with debtor company management, legal counsel for the debtor company, or other parties.

Some examples of contingent liabilities include employee disputes, litigation claims, contract disputes, taxation audits, and regulatory agency reviews. In the case of debtor companies in a bankruptcy context, the existence of contingent liabilities may be more common than for nondebtor companies due to the likely distressed nature of the debtor company operations.

The first step in valuing a contingent liability is the identification of the contingent liability. The second step is to estimate the value of the identified contingent liability. The analyst may use methods such as scenario analysis, decision-tree analysis, and others in order to estimate the value of a contingent liability. These methods all involve the estimation of (1) the amount of the liability payment, (2) the timing of the liability payment, and (3) the probability of the liability payment. The present value of the various payout events is an indication of the contingent liability's value.

Net Asset Value Conclusion

The conclusion of the AA method is the mathematical procedure of calculating the net asset value. At this point in the application of the AA method, the analyst should have valued all of the debtor company asset accounts and all of the debtor company liability accounts. The net asset value is calculated as the total asset value less the total liability value. The net asset value is sometimes also called the total equity value.

The net asset value indication is typically concluded on a controlling, marketable ownership interest level of value. If the engagement calls for the valuation of some ownership interest other than a 100 percent equity interest in the debtor company, the analyst may have to identify any relevant valuation adjustments. Such valuation adjustments can include a discount for lack of control or a discount for lack of marketability.

Adjusted Net Asset Value Method

The ANAV method is a generally accepted business valuation method. The ANAV method typically concludes a controlling, marketable level of ownership interest. If the objective of the assignment is to conclude a different level of value, an adjustment for a discount for lack of control, a discount for lack of marketability, or both may be appropriate.

Other asset-based valuation methods, such as the previously discussed AA method, involve the discrete valuation of each company asset category and liability category. In contrast, the ANAV typically involves an aggregate valuation of the company's total assets and total liabilities.

First, the application of the ANAV method begins with a review of the company's balance sheet based on generally accepted accounting principles ("GAAP") dated closest to the valuation date.

Second, the analyst identifies and separates any nonoperating or excess assets reported on the GAAP balance sheet. Examples of such assets may include undeveloped land or other assets held for investment purposes. Nonoperating assets may also include the tangible assets of company discontinued operations that are being held for disposal. These excess or nonoperating assets are analyzed separately from the ANAV method valuation of the subject company.

Third, the analyst lists all of the reported account balances for the following categories of business operating assets:

1. Working capital assets (including current assets less current liabilities)
2. Tangible assets (including land, buildings, and equipment)
3. Intangible assets (including any recorded identifiable intangible assets)
4. Other assets (such as deferred income taxes and unconsolidated investments)

The sum of these recorded asset balances represents the amount of the company's total net operating assets. Typically, the total company operating assets are analyzed net of all current liability accounts. However, in the application of the ANAV method, the current portion of long-term debt is typically excluded from the total.

Fourth, the analyst begins the process of performing an aggregate revaluation of all the

company's total net assets. One valuation method that is often used to perform this single collective revaluation of the net operating assets is the CEEM, as discussed previously. The CEEM is applied to conclude intangible value in the nature of goodwill.

The CEEM indicated goodwill value represents the additional value (or negative value) compared to the company's recorded cost-based net operating assets. The CEEM goodwill value in the ANAV method will likely be different from the CEEM goodwill value indicated in the AA method. This is because in the AA method, goodwill is identified as an individual intangible asset. That goodwill intangible asset is quantified after (1) all of the company tangible assets have been revalued and (2) all of the company identifiable intangible assets have been revalued.

In the application of the ANAV method, the CEEM analysis value conclusion represents more than the residual goodwill value. That is, the CEEM analysis value conclusion represents an overall revaluation of all of the recorded balance sheet accounts. For this reason, the CEEM analysis value conclusion is often referred to as the intangible value in the nature of goodwill.

Fifth, the analyst adds the net operating assets balance to the goodwill value balance calculated from the CEEM analysis. This summation represents the current value indicated for all of the company's net assets. The analyst may also subtract the debtor company's long-term debt from the estimated net asset value indication. The value remaining after that subtraction indicates the current value of the company equity.

Sixth, the analyst adds the value attributable to any excess or nonoperating assets to the estimated value of the net operating assets in order to estimate the total value of the business enterprise.

A strength of the ANAV method, compared to the AA method, is that the ANAV method is relatively quick and easy to perform. In addition, the process of the ANAV method is often easier to understand and explain to a client or to the court. The AA method requires multiple approaches and methods to estimate the value of individual assets, which can be complicated and confusing to professionals without a background in business valuation.[6]

Conclusion

The asset-based approach is a generally accepted business valuation approach. And, the AA method and ANAV method are both generally accepted asset-based approach business valuation methods. In a bankruptcy context, the asset-based approach may be applied to conclude the value of the debtor company equity based on a going-concern premise of value.

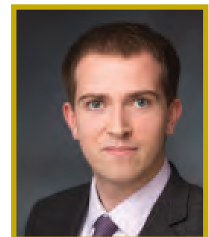
Many inexperienced analysts avoid using (and may not even consider applying) the asset-based approach to value debtor companies in the bankruptcy engagement. This is because these analysts either do not understand how to properly apply the asset-based approach, or mistakenly believe that it cannot be applied to value the debtor company equity in a bankruptcy engagement.

This discussion provided guidance with regard to (1) generally accepted business valuation approaches and methods and (2) the application of the asset-based approach to value a debtor company based on the going-concern premise of value.

Like all asset-based approach business valuation methods, both the AA method and ANAV method typically conclude controlling, marketable ownership interest levels of value. If the bankruptcy engagement calls for a different level of value, then the analyst may need to consider applying valuation adjustments such as a discount for lack of marketability or a discount for lack of control.

Notes:

1. Israel Shaked and Robert F. Reilly, *A Practical Guide to Bankruptcy Valuation* (Alexandria, VA: The American Bankruptcy Institute, 2017), 29.
2. Shannon A. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 351.
3. Shaked and Reilly, *A Practical Guide to Bankruptcy Valuation*, 250.
4. Ibid.
5. For a discussion of the capitalized excess earnings method, please refer to: Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation* (New York: American Institute of Certified Public Accountants, 2014).
6. For additional discussion of the strengths and weaknesses of the adjusted net asset value method, please refer to Scott R. Miller and Robert F. Reilly, "The Asset-Based Approach—The Adjusted Net Asset Value Method," Willamette Management Associates *Insights* (Winter 2018).



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Best Practices Discussion

Due Diligence Procedures regarding Management-Prepared Financial Projections

Justin M. Nielsen and Tia Hutton

In commercial bankruptcy matters, there are many issues that a valuation analyst ("analyst") may face when performing valuation services. These issues may relate to corporate solvency, transactional fairness, or reasonableness of a reorganization plan. One issue in which an analyst may be asked to provide valuation services relates to claims of fraudulent transfer. When analyzing fraudulent transfers, the analyst typically performs three tests in order to determine if a fraudulent transfer has occurred: (1) the balance sheet (or solvency) test, (2) the cash flow test, and (3) the capital adequacy test. In performing the three tests for a fraudulent transfer, the analyst may rely on management-prepared financial projections. This discussion summarizes the three tests involved in a fraudulent transfer analysis. And, this discussion addresses the diligence procedures that the analyst may apply when relying on management-prepared financial projections, including (1) the comparison of the financial projections to relevant industry data and (2) the comparison of management interview data to relevant company and industry data.

Introduction

Bankruptcy in the United States is a legal proceeding by which individuals and businesses that are facing financial difficulties in meeting their outstanding debt obligations may seek relief from part, or all, of their outstanding debt. The bankruptcy process is overseen by federal bankruptcy courts, and bankruptcy procedures are (for the most part) governed by federal law referred to as the "Bankruptcy Code."

In filing for a corporate bankruptcy (Bankruptcy Code Chapter 7 or Chapter 11), there can be many valuation-related issues associated with the debtor company. These issues can include (1) corporate solvency, (2) transactional fairness, and (3) reasonableness of a proposed plan of reorganization for the debtor company.

In particular, an analyst may be asked to provide services related to whether a debtor company was solvent (or insolvent) as of a certain pre-bankruptcy valuation date (such as on the date of an alleged fraudulent transfer).

In a Chapter 11 bankruptcy (i.e., a reorganization bankruptcy, as opposed to a liquidation bankruptcy), under certain circumstances the bankruptcy trustee possesses the authority to avoid, or reverse:

1. certain transfers made by the debtor company or
2. certain liabilities assumed by the subject debtor company.

These transfers are generally referred to as "fraudulent transfers."

To assist the bankruptcy trustee, legal counsel, or the affected creditors in assessing whether a debtor company's transfer was fraudulent, an analyst may be retained in order to opine on whether the debtor company was solvent (or insolvent) at the time of the alleged fraudulent transfer. This type of analysis is often referred to as a "solvency opinion."

In developing a solvency opinion, the analyst typically performs three tests: (1) the balance sheet test, (2) the cash flow test, and (3) the capital adequacy test. Similar to the process of valuing a business in a nonbankruptcy context, the income approach, and specifically the discounted cash flow ("DCF") method, may be applied to perform certain of the tests in a fraudulent transfer analysis.

Two of the components of the DCF method are the following:

1. The estimation/projection of future income and cash flow
2. The estimation of an appropriate risk-adjusted required rate of return used to discount the estimated future income back to present value

While many independent factors influence the estimation of both a debtor company's future income and the appropriate risk-adjusted required rate of return (i.e., present value discount rate), one often underanalyzed consideration in applying the DCF method is the debtor company industry.

This discussion introduces corporate bankruptcy and describes the fraudulent transfer analysis process. This discussion also describes the role of the company industry within the income approach, DCF method analysis, and specifically within the process of aligning the company industry with:

1. any management-prepared projections and
2. the estimated long-term growth rate applied in the calculation of the debtor company terminal value.

This discussion also addresses the importance of management interviews, namely as they relate to management-prepared financial projections applied in a DCF method analysis.

Corporate Bankruptcy and Fraudulent Transfers

There are many reasons why a company may find itself in financial distress and, ultimately, in bankruptcy. Rapid changes in the relevant company industry (such as the migration of customers from legacy cable television services to streaming services in the telecommunications industry) or macro-economic changes (such as the credit crisis and subsequent recession that began in 2008), can adversely affect the profitable operations and going-concern nature of a company.

Bankruptcy in the United States is a legal proceeding in which businesses (and individuals) facing financial difficulties in meeting their outstanding debt obligations may seek relief from all, or part, of their debt.

There are different types of bankruptcies, which are generally referred to by their chapter in the Bankruptcy Code. Which chapter the debtor will file under depends on the debtor company (i.e., often the party initiating the bankruptcy) and the type of bankruptcy.

For example, companies that intend to liquidate in order to satisfy outstanding debt obligations may file under Bankruptcy Code Chapter 7. Companies that intend to reorganize in order to satisfy outstanding debt obligations through continuing operations may file under Bankruptcy Code Chapter 11.

Related to the filing for a corporate bankruptcy (Bankruptcy Code Chapter 7 or Chapter 11), there can be many valuation-related issues. These valuation issues may include the following:

1. Corporate solvency (which, for companies other than partnerships and municipalities, is defined as the sum of a debtor company's liabilities being greater than the sum of the company's assets on a fair value basis, excluding exempt or fraudulently transferred property or assets)
2. Transactional fairness (i.e., analyzing whether certain transactions associated with the debtor company were fair on behalf of the bankruptcy estate)
3. The reasonableness of a debtor's proposed reorganization plan (i.e., analyzing whether the plan to satisfy certain debts associated with company is reasonable and attainable)

Analysts are often retained to perform services related to the above-mentioned valuation issues. An analyst who provides valuation-related services in a bankruptcy context should be familiar with both (1) the reasons to conduct a bankruptcy valuation and (2) the analytical issues that are specific to a bankruptcy-related valuation.

The following list provides some examples, as well as the Bankruptcy Code section citations, of

situations where it may be helpful to retain an analyst in a bankruptcy proceeding.

1. Preference actions solvency analysis (Bankruptcy Code Section 547)
2. Fraudulent transfers solvency analysis (Bankruptcy Code Section 548)
3. Asset sale prices and creditor adequate protection (Bankruptcy Code Section 363)
4. Adequate protection of a creditor's interest (Bankruptcy Code Section 361)
5. Value of secured creditor's claim as fully secured (Bankruptcy Code Rules 3012 and 3018)
6. Confirmation of the reorganization plan (Bankruptcy Code Section 1129)
7. Cram down of the reorganization plan (U.S. Bankruptcy Code Section 1129)
8. Secured creditor relief from the automatic stay (Bankruptcy Code Section 362)

While an analyst can provide valuation-related services in any of the above instances, this discussion focuses on analyst considerations within a fraudulent transfer solvency analysis (i.e., Bankruptcy Code Section 548).

Fraudulent Transfers and Subject Debtor Company Solvency

In a Chapter 11 bankruptcy, and under certain circumstances, the bankruptcy trustee has the authority to avoid or reverse (1) transfers made by the debtor company or (2) liabilities assumed by the debtor company.

To assist the bankruptcy trustee, legal counsel, or the affected creditors in assessing whether a company's transfer was fraudulent, oftentimes an analyst is retained in order to opine on whether the company was solvent (or insolvent) at the time of the alleged fraudulent transfer.[1]

In order to analyze a possible fraudulent transfer, the analyst considers the following three financial conditions at a specific point in time:

1. Does the debtor company recorded liabilities exceed the fair value of the debtor company assets?
2. Does the debtor company have adequate cash flow to meet its liabilities as they mature?
3. Does the debtor company have adequate capital to meet its operating expenses, capital expenditure requirements, and debt-repayment obligations?

By analyzing the above financial conditions, the analyst can assess whether the debtor company's transfer was fraudulent.

As presented in *A Practical Guide to Bankruptcy Valuation*:

> In a solvency opinion, the analyst opines as to the solvency of a debtor company at the time of certain corporate transactions. Generally, the solvency opinion is intended to demonstrate that the debtor company is solvent at the time that a debt is incurred, a dividend is disbursed, a distribution is made, an expense is paid, an asset is purchased, a security claim is issued, a class of equity is redeemed, one class of security is exchanged for another class and so forth.
>
> Typically, the analyst performs the following three tests with regard to the analysis of a potential fraudulent transfer:
>
> 1. The balance sheet test [i.e., does the fair value of the subject debtor company assets exceed the reported value of the subject debtor company liabilities];
> 2. The cash flow test [i.e., does the subject debtor company have adequate cash flow to meet its liabilities as they mature]; and
> 3. The capital adequacy test [i.e., does the subject debtor company have adequate capital to meet its operating expenses, capital expenditure requirements, and debt-repayment obligations].[2]

The three fraudulent transfer tests provide the analyst with quantitative data related to the debtor company's financial repayment ability as of a certain date. If all three tests are "passed" (meaning, if the answer to all three tests is "yes"), then the relevant transfer is typically considered to not be fraudulent. Conversely, failing any one of the three solvency tests may be an indication of a fraudulent transfer.[3]

The following discussion summarizes each of the tests applied in analyzing a debtor company's potential fraudulent transfer.

Balance Sheet Test

The balance sheet test is often referred to as the "solvency test." That is, the balance sheet test "tests" the solvency (i.e., does the fair value of assets exceed the amount of liability?) of the company.

The balance sheet test is a process for analyzing whether a company's liabilities exceed the fair value of the company's assets as of a specific date (i.e., as of the alleged fraudulent transfer date).

The balance sheet test involves the restatement of the assets of the company (both tangible assets and intangible assets) from historical accounting book value to fair value or fair market value[4] as of the date of the alleged fraudulent transfer (or immediately preceding the date of the alleged fraudulent transfer).

The amounts of all of the company liabilities are typically reported on the company financial statements and are subtracted from the estimated fair value of the company assets to assess solvency (e.g., a company is solvent if the fair value of the company total assets exceed the reported amount of the company total liabilities).

In determining solvency by applying the balance sheet test, the analyst typically first considers the highest and best use ("HABU") of the company's assets. The HABU identifies the reasonably probable and legal use of an asset that is physically possible, appropriately supported, financially feasible, and that results in the highest value.[5]

The HABU of the company assets typically indicates the appropriate premise of value to be applied in the balance sheet test (i.e., a going-concern premise of value or a liquidation premise of value). One premise of value that is often applied in a balance sheet test analysis is value in continued use, considering the debtor company assets as part of a going-concern business operation.

After performing the fair value analysis of the company's assets (including financial assets, real estate and tangible personal property assets, and intangible assets), the analyst determines the amount of the company's liabilities. In evaluating a company's liabilities, it is important for the analyst to consider all current liabilities, all long-term liabilities, and (potentially) all contingent liabilities.[6] A contingent liability is a liability that has the potential to occur depending on the result of an uncertain future event (such as unfunded pension liabilities) and is recorded in the accounting records of the company.

Finally, the analyst subtracts the total liabilities from the fair valuation of the total assets as of the alleged fraudulent transfer date.

The company then "passes" the balance sheet test if the fair value of the company assets is greater than the amount of the company's total liabilities. Conversely, if the fair value of the company assets is less than the amount of the company's total liabilities, then the company "fails" the balance sheet test.

Cash Flow Test

The cash flow test analyzes whether a company possesses an adequate level of cash flow to meet its debt obligations as the obligations come due.

The cash flow test analysis considers the repayment of all of the company debt obligations (both principal and interest) and typically requires an analysis of the company's projected net cash flow over the relevant financing period (which is generally equal to the longest term of maturity for any of the company's outstanding debt instruments).

In performing the cash flow test, the analyst typically estimates the projected cash flow available to meet debt obligations by examining the following:

1. Any excess cash available on the alleged fraudulent transaction date
2. The available cash flow generated over the relevant projection period (i.e., financing period)
3. The availability of any unused credit commitments, including lines of credit

A company is cash flow insolvent if it is unable to meet its debt obligations as they mature. The cash flow test differs from the balance sheet test in that it analyzes the company's ability to make payments as they mature as opposed to determining whether the company's assets are sufficient to meet its present and future liabilities.

The cash flow test is "passed" if the company is able to pay its projected debt obligations as they mature (from the excess cash available on the transaction date, the available cash flow generate over the relevant projection period, and/or any company unused credit commitments).

Capital Adequacy Test

The capital adequacy test (also sometimes referred to as the "reasonable capital test") determines whether a company will have adequate capital to meet its operating expenses, capital expenditure requirements, and debt-repayment obligations.

The capital adequacy test is similar to the cash flow test in that, if a company has adequate capital, it will be able to meet its debt obligations as they mature.

The primary goal of the capital adequacy test is to evaluate the likelihood that the company will survive potential business fluctuations subsequent to the alleged fraudulent transfer date.

In order to properly evaluate a company for purposes of applying the capital adequacy test, the analyst typically performs a short-term sources and uses of funds analysis over the period subsequent to the alleged fraudulent transfer date (generally over the four fiscal quarters after the alleged fraudulent transfer date).

As presented in *A Practical Guide to Bankruptcy Valuation*:

> [In performing the capital adequacy test,] [t]he analyst typically assesses and analyzes various debtor company operating scenarios, including the following:
>
> 1. the debtor company management's best estimate of future financial and operational performance;
> 2. whether there has been any change from the debtor company's recent historical financial performance; and
> 3. reasonable variations in the debtor company's revenue growth rate and profit margin.[7]

The capital adequacy test is "passed" if the company is determined to have sufficient cash to (1) pay its operating expenses, (2) fund its capital expenditures, and (3) satisfy its debt obligations.

Fraudulent Transfer Analyses, the Income Approach, and Management-Prepared Financial Projections

Similar to the process of valuing a business in a nonbankruptcy context, there are three generally accepted business valuation approaches that may be considered to estimate the value of a debtor company. Each generally accepted business valuation approach includes several generally accepted valuation methods. The three generally accepted business valuation approaches are (1) the income approach, (2) the market approach, and (3) the asset-based approach.

This discussion focuses on the income approach, and specifically the DCF method, in conducting a fraudulent transfer analysis.

The Income Approach

The income approach is based on the principle that the value of a company is the present value of the income the company is expected to generate. Two valuation methods within the income approach are (1) the yield capitalization method and (2) the direct capitalization method. The yield capitalization method is often referred to as the "DCF method."

As mentioned, the income approach can be used to develop all three fraudulent transfer tests when analyzing an alleged fraudulent transfer of a company. However, the income approach is typically most applicable to both the cash flow test and the capital adequacy test.[8]

The DCF method is a generally accepted income approach method used to value companies on a going-concern basis, and specifically when analyzing an alleged fraudulent transfer. This method has appeal because it incorporates the trade-off between risk and expected return, an important component of the investment decision and value calculation process.

The DCF method provides an indication of value by estimating (1) the future income of a business and (2) an appropriate risk-adjusted required rate of return used to discount the estimated future income back to present value (i.e., present value discount rate).

In applying the DCF method, the analyst often assumes that the estimated future income will eventually stabilize. This long-term stabilized benefits stream can then be capitalized into perpetuity and discounted back to the valuation date. Generally, the value of the long-term stabilized benefits stream is called the "terminal value" ("TV").

While there are many issues the analyst may consider in estimating the future income of a subject debtor company (and estimating an appropriate present value discount rate for a debtor company), applying the DCF method in performing the three tests in a fraudulent transfer analysis should also include appropriate consideration of the subject industry.

The analyst should consider the subject industry in:

1. assessing the reasonableness of management-prepared financial projections used in the three tests and

2. estimating the appropriate long-term growth rate to be used in the TV calculation.

Testing the reasonableness of management-prepared financial projections is especially important in bankruptcy-related engagements, as the management-prepared projections are likely to be scrutinized and challenged.

Further, when estimating the appropriate long-term growth rate to be used in the TV calculation, a subject industry analysis can provide a useful portrait of how the company fits within an industry by considering where the industry has been and where the industry is likely to be going.

As presented in *Financial Valuation Applications and Models*, the following list presents questions that can assist the analyst in developing a subject industry road map:

1. What are the prospects for growth?
2. What are the industry's dominant economic traits?
3. What competitive forces are at work in the industry and how strong are they?
4. What are the drivers of change in the industry and what effect will they have?
5. Which companies are in the strongest/weakest competitive positions?
6. What key factors will determine competitive success or failure?
7. How attractive is the industry in terms of its prospects for above-average profitability?
8. How large is the industry?
9. Is the industry dominated by a few large companies?
10. Are there many public companies in this industry?
11. How much merger and acquisition activity is occurring?
12. What are the barriers to entry?
13. Is it a regulated industry?
14. Who are the customers? Is that base growing?[9]

One of the analyst responsibilities when applying the income approach in a bankruptcy context is to align the appropriate management-projected income measure and risk-adjusted discount rate with the subject industry historical, current, and projected economic performance. This will, in effect, provide the bankruptcy trustee, legal counsel, or the affected creditors with a reasonableness test or "sanity check" with regard to the management-prepared financial projections that are used in the fraudulent transfer analysis.

The following section describes several resources that are available to obtain relevant industry data and information that can be used in an income approach analysis within a bankruptcy context.

Sources of Industry Information

There are many sources of industry information and data—including fee-based, trade association, and free data and information resources. While it is not practical to list all available sources of industry data, some of the more useful sources of industry data and information include the following:

1. First Research: First Research, owned by Dun & Bradstreet, publishes about 500 industry reports on approximately 1,000 industry segments. The reports, which run approximately 8 to 10 pages, typically focus on industry information related to suppliers, customers, and competitors.

   Links to industry-related sources are also provided, and the reports are updated quarterly. First Research industry data are available at www.firstresearch.com.

2. IBIS*World*: IBIS*World* publishes various industry-related reports. Their regular industry reports are typically about 30 to 40 pages in length. These reports are updated periodically (depending on the industry) and include a five-year outlook. The reports are available for the United States and, in some cases, for certain countries outside the United States.

   The IBIS*World* specialized industry reports are updated less frequently, but typically contain roughly the same information as the full IBIS*World* reports. IBIS*World* also publishes business environment reports, which are about three to four pages in length. These reports cover wider economic issues that influence certain industries (such as housing starts and per capita income).

   IBIS*World* reports are available at www.ibisworld.com.

3. CFRA Research: CFRA industry reports (formerly S&P Industry Surveys) cover nearly 70 industries. These reports are typically more globally focused than the First Research and IBIS*World* reports. The CFRA Research reports generally focus on the present situation and future outlook for each industry. Each report contains a section on how to analyze a company in that industry.

The CFRA Research reports are updated twice a year and are available through various platforms, including S&P NetAdvantage (which is available from some public libraries).

4. MarketResearch.com: This website contains reports from various market research companies. The reports included on the website may be screened by country and date, as well as by other criteria. The reports are available on almost every industry and subindustry. The price to purchase these reports, however, is sometimes significant.

   The reports are available at www.marketresearch.com.

5. American Society of Association Executives: This society is a good way to identify trade associations by industry. Trade associations often publish industry forecasts, as well as benchmarking data and other industry-related information.

   The American Society of Association Executives also publishes the annual *National Trade and Professional Associations Directory*. The American Society of Association Executives data are available at www.asaecenter.org/directories/associationsearch.cfm.

Some additional sources of benchmarking industry data and information include the following:

1. Integra: The Integra benchmarking reports provide the normalized financial performance for privately held companies in approximately 900 industry sectors. Users can also upload summary financial statements for an individual company and then select an industry in order to show a side-by-side comparison between the company and its relevant industry.

   The Integra data are available at www.microbilt.com/financial-benchmarking.aspx.

2. *Annual Statement Studies® Financial Benchmark Ratios*: This book, published by the Risk Management Association, is updated and provided annually. It is available both in print format and as an online database. Relevant industry companies are sorted by the North American Industry Classification System ("NAICS") code, and then by sales and asset sizes.

   Financial ratios on over 700 industries are included, including various income and expense ratios such as gross profit, operating expenses, officer compensation, and depreciation and amortization as a percentage of sales.

   The Annual Statement Studies® are available at www.rmahq.org/annual-statement-studies.

3. *IRS Corporate Ratios*: This book, published by Schonfeld & Associates, contains 10 years of corporate tax return data and financial ratios on over 250 industries. The data and information are categorized by NAICS code and asset size.

   IRS Corporate Ratios is available at www.saibooks.com.

4. Bizminer Industry Financial 2.0: This database provides cash flow, profitability, efficiency, and debt/risk ratios on companies sorted by NAICS codes. Five-year comparative analysis is included.

   The Bizminer Industry Financial 2.0 data and information are available at www.bizminer.com.

5. IndustriusCFO: This database, formerly known as FINTEL Industry Metrics, provides ratios and other benchmarking data on privately held companies. Companies are grouped by size and NAICS code. A

business performance scorecard is provided, which gives a snapshot of a subject company's operations compared to its industry peers. Long-term sustainable growth rate data and information are also included.

The IndustriusCFO data and information are available at www.industriuscfo.com.

The analyst may utilize the above-referenced industry resources when applying the income approach in a bankruptcy context to ensure that the subject industry historical, current, and projected economic performance align with the subject management-prepared projections.

In some instances, the analyst may identify significant differences between, for example, the growth expectations presented in management-prepared projections as compared to the growth expectations of the broader industry.

In those cases, additional due diligence may be useful in order to understand and explain the unique circumstances of the company relative to its industry peers. This procedure may help ensure that the fraudulent transfer analysis conclusions are adequately supported and will be able to withstand critique from the bankruptcy trustee, legal counsel, or the affected creditors.

The following section summarizes guidance from the valuation profession regarding the proper consideration of the company relevant industry when applying the income approach, DCF method, in a fraudulent transfer analysis context.

Guidance from the Valuation Profession

It is typically understood that the value of a business is influenced by the operational efficiencies, products, and competitive advantage of the company within the context of the historical, current, and projected state of the company industry.

It is important that the analyst not be myopic when applying the three solvency tests in an alleged fraudulent transfer context. Rather, the analyst should cross-reference a detailed analysis of the company with a broader view of the subject company industry, specifically highlighting where the company may fall within the industry, and why.

Valuation literature provides guidance with regard to the analysis of the company industry. As presented in *Understanding Business Valuation*, the general factors that the analyst should consider in analyzing the relevant industry include the following:

1. Who makes up the industry? Are there many companies or are there very few companies that control everything?
2. Is it a cyclical industry?
3. Is it a new industry with many new companies entering it, or is it a mature industry that has reached its saturation point?
4. What are the barriers to entry, if any, into the industry?
5. Is this a self-contained industry, or is it dependent on another industry?
6. Is the industry dependent on new technology? If so, is the appraisal subject keeping up with the industry?
7. Is the industry expected to change? If so, how will that affect the appraisal subject?
8. What is the forecast for growth within the industry?[10]

Also presented in *Understanding Business Valuation*, Gary Trugman reproduces a list from an American Society of Appraisers course. That list presents industry factors that the analyst may consider in analyzing management-prepared financial projections within the context of the subject industry, such as the following:

1. Growth prospects for the company's industry at the national and local level
2. Demand factors
3. Maturity of the industry
4. Structure of the industry and level of competition
5. Technological or economic obsolescence factors
6. Barriers to competitor entry[11]

Based, in part, on the guidance above, it is important that the analyst vet the assumptions utilized in the income approach, DCF method analysis, to ensure they are reasonable as compared to the historical, current, and projected economic state of the subject industry.

Further, to help ensure the industry data obtained are applicable to the company, the analyst may classify the business activities of the company. Two methods used to classify businesses are the (1) Standard Industrial Classification ("SIC") system and (2) NAICS.

Upon determining an appropriate classification for the company, the analyst may utilize the

aforementioned industry resources to obtain data and information for companies or industries in the same classification.

Considering the data and information previously presented, valuation profession best practices suggest that the analyst appropriately considers the subject industry. Therefore, the analyst can ensure the company-management-prepared financial projections and estimated long-term growth rate applied in a TV calculation are:

1. consistent with the subject industry growth prospects;
2. reasonable as compared to the subject industry historical financial results; and
3. achievable based on the subject industry's geography and expected future outlook of the regional, domestic, and international (if applicable) economy within the subject industry's geographic outline.

As presented in item three above, it is important for the analyst to also consider the geographic economic influences on the subject industry historical, current, and projected economic performance. That is, the regional, national, and international (if applicable) economy may have a direct impact on the subject industry economic performance. The analyst may, therefore, consider and incorporate, as appropriate, geographic economic influences when analyzing the subject industry for purposes of a fraudulent transfer analysis.

Management Due Diligence Interviews

As mentioned previously, in applying the income approach to analyze a company (and specifically when applying the three fraudulent transfer tests), the analyst may consider the following:

1. The subject industry with regard to management-prepared financial projections
2. The subject industry with regard to the estimated long-term growth rate used in the TV calculation

However, the analyst should also be aware of the facts and circumstances surrounding the bankruptcy-related assignment. Namely, company management may purposely provide inaccurate data, information, and management-prepared financial projections due to interests that may not be aligned with the bankruptcy trustee, legal counsel, or the affected creditors.

Further, the company management may purposely provide conflicting data with regard to the subject industry in order to paint a certain portrait of the future operations of the company.

The analyst may juxtapose any data and information provided by company management with nonbiased:

1. industry data,
2. historical company data, and
3. data received from other interviews with company senior management.

In order to perform proper due diligence with regard to management-prepared financial projections that are utilized in a bankruptcy context, the analyst may attempt to interview multiple members of company leadership.

Incorporating the data and information previously presented, valuation profession best practices generally suggest that the analyst assess the reasonableness of management-prepared financial projections by ensuring the projections meet the following criteria:

1. They are consistent with the company's growth prospects.
2. They are reasonable as compared to the company's historical financial results.
3. They are achievable based on the company's operating capacity and expected future capital expenditures.
4. They are reasonable as compared to the company's client and supplier projected financial results.
5. They are reasonable based on the company industry historical and projected financial results.
6. They are reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy.
7. They are consistent with other company leadership interview results with regard to the company's historical, current, and projected financial results.
8. They are extensively documented and justified if the projections have been amended by the analyst.

To the extent possible, the analyst will vet the assumptions on which management-prepared financial projections are based. Further, and as presented in item number eight above, it is important that the analyst document and justify any changes made to the management-prepared financial projections as a result of considering the information uncovered in management interviews and the data analyzed with regard to the subject industry.

Summary and Conclusion

In a bankruptcy context, an analyst may be retained by the bankruptcy trustee, legal counsel, or affected creditors to perform an analysis within a fraudulent transfer context. In performing the three fraudulent transfer tests, the analyst may apply the income approach, DCF method.

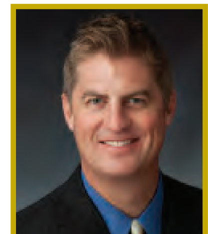
When applying the DCF method to a debtor company, it is important for the analyst to consider any management-prepared financial projections. One component in applying the DCF method is the consideration of the subject industry.

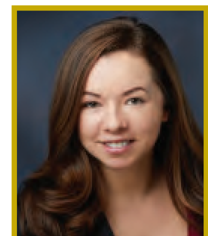
The subject industry may be considered in (1) assessing the reasonableness of management-prepared financial projections used in the three fraudulent transfer tests and (2) estimating the appropriate long-term growth rate to be used in the TV calculation. Testing the reasonableness of financial projections is a typical procedure in bankruptcy-related engagements. This is because the management-prepared projections are likely to be intensely scrutinized.

Further, the analyst may also consider valuation profession best practices (and available industry data resources), and—if possible—conduct due diligence management interviews in order to properly apply the DCF method in performing the three tests included in a fraudulent transfer analysis.

Notes:

1. As presented in U.S. Bankruptcy Code Section 101, solvency is defined as, "(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, as 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 [U.S. Bankruptcy Code] 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."
2. Dr. Israel Shaked and Robert F. Reilly, *A Practical Guide to Bankruptcy Valuation*, 2nd ed. (Alexandria, VA: The American Bankruptcy Institute, 2017), 34.
3. It is important to note that, as presented in *A Practical Guide to Bankruptcy Valuation*, it is generally only necessary for the analyst to perform the balance sheet test in assessing the solvency of a subject debtor company. However, in practice, many analysts will perform all three of the above-listed solvency tests in analyzing a potential fraudulent transfer.
4. It is important to note that, while the U.S. Bankruptcy Code advises that the value of the subject debtor company's assets should be determined "fair," the U.S. Bankruptcy Code is not clear as to the appropriate standard of value to use in a balance sheet test. As presented on page 36 of *A Practical Guide to Bankruptcy Valuation*, "Most analysts apply either the fair value or the fair market value standard of value when performing the balance sheet test."
5. Shaked and Reilly, *A Practical Guide to Bankruptcy Valuation*, 646.
6. Ibid., 36, 608.
7. Ibid., 37.
8. In applying the income approach in a balance sheet test analysis, the analyst relies on the debtor company's projected income from the ownership/operation of the individual assets to value the company's assets. However, it is important to note that ownership/operation income differs from business operating income in that it is derived solely from the use of the debtor company assets rather than from the sale of goods or services. Two methods that may be used in the balance sheet test income approach valuation method are (1) the direct capitalization method and (2) the yield capitalization method.
9. James R. Hitchner, *Financial Valuation Applications and Models*, 4th ed. (New York: John Wiley & Sons, 2017), 68.
10. Gary Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses*, 5th ed. (New York: American Institute of Certified Public Accountants, 2017), 162.
11. Ibid., 263.





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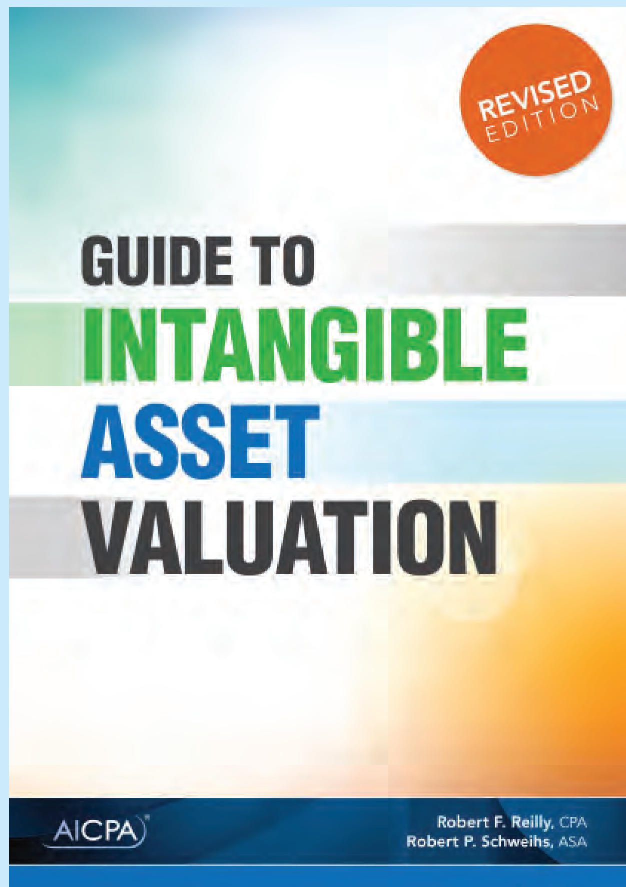
We are pleased to announce the Revised Edition of . . .

Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

Robert Reilly and Bob Schweihs, Willamette Management Associates managing directors, discuss such topics as:

- Identifying intangible assets and intellectual property
- Structuring the intangible asset valuation, damages, or transfer price assignment
- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

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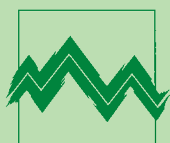

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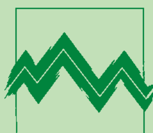

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Bankruptcy Trends and Developments in the Retail Industry

George H. Haramaras

The retail industry is dynamic and changes quickly. Although dramatic headlines referring to retailers in bankruptcy (e.g., "retail apocalypse") may be overstated, the retail industry is at an important stage in its history. Retail bankruptcies are frequent and they experienced an increase in volume in 2018. Big changes are occurring in the retail industry. Accordingly, this discussion examines bankruptcy in the context of the retail industry. This discussion broadly examines the retail industry. This discussion identifies current developments and important indicators associated with the retail industry. This discussion summarizes important operational attributes of retail operators. This discussion examines how the unique attributes of retail affect industry debtors in bankruptcy. Finally, this discussion describes several specific areas of the bankruptcy process relevant to retail debtors and identifies trends in retail bankruptcies.

Introduction

The retail industry is dynamic. It is highly volatile, currently undergoing significant changes, and consists of companies with visible brands designed to capture the attention of consumers. As a result, when a large retailer files for bankruptcy, it can garner disproportionate attention and grab headlines. For example, while Sears Holding Corporation ("Sears") was debatably the most familiar bankruptcy of 2018, it was not the largest: iHeartMedia, Inc., a media company, had over double the amount of debt as Sears at the time of filing.[1]

Similar in size to Sears was FirstEnergy Solutions Corp., an energy product company, which had comparable amounts of debt to Sears at the time of its bankruptcy filing in 2018 (that is, approximately $2 billion less in debt).[2]

However, neither iHeartMedia, Inc., or FirstEnergy Solutions Corp. generated as much interest as the Sears bankruptcy did.

It would be inaccurate to underplay the current significance between the intersection of the retail industry and bankruptcy. While terms such as "retail apocalypse" can be misleading when describing the recent state of retail industry bankruptcies, 2018 did represent an uptick in the number of retailers filing for bankruptcy. It is an important time for retailers.

This discussion develops a clear picture of the retail industry today, and then examines the trends and developments of retail companies in the context of bankruptcy.

Retail Industry Overview

Before beginning our discussion of retail bankruptcies, let's understand the retail industry more broadly.

First, let's define the retail industry for the purposes of this discussion. For this discussion, we define the retail industry as encompassing the majority of Division G (retail trade) of the Standard Industrial Classification ("SIC") system.

Specifically, we define the retail industry as consisting of the companies classified in the following SIC codes:

- 5230 (paint, glass, and wallpaper stores)
- 5250 (hardware stores)
- 5260 (retail nurseries, lawn and garden supply stores)
- 5300 (general merchandise stores)
- 5400 (food stores)
- 5600 (apparel and accessory stores)
- 5700 (home furniture, furnishings, and equipment stores)
- 5900 (miscellaneous retail)

Practically, we define retail as the industry that is made up of companies whose operations involve the purchase (from suppliers) and sale (most often to consumers) of merchandise, or finished goods.

Retail Industry Environment

The retail industry is a mature industry. Market concentration in the retail industry is generally low. Despite the magnitude and prominence of certain retailers, namely Amazon.com, Inc., and Walmart, Inc., the majority of retail activity is carried out by smaller operators. According to IBIS*World*, 65 percent of retailers in the U.S. employ less than 10 employees.[3]

Given that the retail industry is mature and fragmented, specializing in a particular market niche, brand, or market segment can be beneficial for retailers. Specialization may increase a retail operator's customer base and brand loyalty, and it may also increase the quality and consistency of an operator's revenue.

Retailer operations are also subject to macroeconomic and consumer trends, which relate to and support retailers' strategy of specialization.

Per capita disposable income (the amount of discretionary income an individual has for purchasing goods and services) is a particularly significant macroeconomic indicator. As consumer discretionary income increases, so too do purchases of goods by consumers increase. Disposable income varies directly with the macroeconomic cycle.

Generally, as disposable income increases, demand for premium goods increase, while demand for discount goods (or inferior goods) decrease. This can have an effect on retailers, particularly when their merchandise is related to premium or inferior goods.

Prices represent another demand determinant—both in a broader macroeconomic sense (e.g., if the prices of all goods and services across the economy are rising) and in a product-specific sense (e.g., if the price of a particular good has risen). Consumer demand for goods decreases as prices increase (1) across the economy and (2) for the specific goods that retailers sell.

Cultural and sociological trends can also play into retail consumer preferences. Some additional consumer preferences are discussed below.

- E-commerce. This trend involves the increased preference for shopping via e-commerce mediums by consumers. This trend is somewhat related to consumers' responsiveness to price, as shopping online generally saves consumers time and money.

  In addition, the increased prevalence of online shopping is expected to continue to mitigate consumers' preference for physically viewing products before purchase.

  According to IBIS*World*, e-commerce sales were expected to increase at an annualized rate of 12.8 percent through the five-year period to 2018. Amazon.com, the largest e-commerce retailer, grew at an annualized rate of 30 percent through the same period.[4]

  These e-commerce sales trends provide a broader narrative relating to consumer preferences: e-commerce has increasingly become more prevalent and consumers appear to choose the conveniences of online shopping in many situations.

- Intangible experiences versus tangible consumer goods. Increasingly, new generations of consumers value intangible experiences over tangible consumer goods. While this trend is hard to define, such a change in mentality can affect the strategies, brands, and channels in which retailers choose to conduct business.

  Such a trend can lend itself well to retailers who disrupt the traditional conventions and norms of how to sell and define an existing product. Conversely, such a trend can make it hard for a retailer whose operations are built on obsolete strategies or merchandise.

- Specialty retail versus general merchandise. This trend further describes the preferences for where consumers choose to purchase items. Specialty retailers focus on a particular product or market niche, while general merchandisers sell a diversified array of products across many categories.

  Under consideration here are previously discussed factors including price, the ability of a retailer to brand or differentiate

its customer experience, and how consumers prefer to purchase their goods (e.g., online, in person, or at a mall).

Takeaways

While the retail industry is a broad classification, we can deduce some common characteristics. Generally, retailers deal in the selling of merchandise to consumers. Therefore, revenue earned by retailers is subject to the preferences of, and the associations by, consumers. Retailers are also subject to macroeconomic cycles. The intricacies that affect the revenue of retailers have important implications for retail bankruptcies.

Macroeconomic cycles and consumer preferences contribute to the unpredictability of, and volatility in, revenue for individual retailers over the long term. Consumer preferences are fickle and are significantly affected by prices and the economy.

Retailers invest in the cultivation of their brands and market niches, as well as the channels in which they use to deliver their merchandise to consumers. However, if retailers do not dynamically adapt to consumer preferences, adjust to macroeconomic conditions, or invest in the right channel of distribution, then they can see their revenue affected negatively as a result.

Operational Characteristics That Define Retailers

In addition to factors and trends that drive demand and in turn sales, let's also consider certain operational characteristics of retailers. This discussion considers some of the characteristics of retail operations and examines some of the nuances of retailers facing bankruptcy.

Importance of Inventory

One of the defining characteristics of retail operators is their inventory. Given that retailers sell predominantly to end consumers, inventory typically represents finished goods, or merchandise. Pure-play retailers do not generally produce or manufacture their merchandise, but instead purchase their supply of goods from vendors and suppliers.

Management of inventory, therefore, is one factor for the operations of a retailer. When operating as a going concern, retail companies must ensure they implement sound inventory management—that is, the level of inventory is efficiently maintained.

When inventory is efficiently maintained, retailers minimize inventory storage costs while also minimizing the lost sales of certain products due to lack of inventory. Balancing these lost sales and storage costs achieves the right level and mix of products to sell and hold.

As discussed later, inventory is significant when a retailer files for bankruptcy. When a retailer is engaged in the bankruptcy process, inventory can have important implications for reorganization, liquidation, or asset sale considerations.

Given the significance of inventory, it is also important to note that for many retailers, operations are seasonal and fluctuate throughout the year. Specifically, many retailers see increased sales in the fourth quarter of the calendar year as a result of the holiday season.

Seasonal fluctuations were historically a more important consideration for (1) retailers intending to file for bankruptcy and (2) retail debtors in bankruptcy. However, due to the changes in the Bankruptcy Code associated with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), which are discussed below, seasonality in revenue and cash flow is a lesser consideration than before.

Trade Payables and Vendor Relationships

Similar to the significance of inventory, relationships with vendors and suppliers can be important

factors for retailer operations. Just as inventory is one of the defining factors in retailer operations, the payment to suppliers and vendors for such inventory is also key.

Trade payables contribute to an efficient cash conversion cycle. Just as efficient inventory management leads to the conversion of inventory to sales (and in effect, cash), so too is it important to elongate trade payables from suppliers and vendors.

Effectively, trade payables from suppliers represent a form of informal, unsecured credit. This trade credit plays a role in bankruptcy. We discuss the way trade credit affects retail debtors in bankruptcy in a later section.

In short, retailers under normal circumstances might seek to elongate the time it takes to satisfy trade payable obligations. If a retailer is considering bankruptcy however, it might make sense to minimize the amount of trade payables a retail debtor owes immediately prior to filing a petition for bankruptcy.

Unimportance of Accounts Receivable

Another working capital area that defines retailers is the general unimportance of accounts receivable. In most (but not all) cases, sales are made to consumers. Accordingly, retailers receive cash consideration for the sale at the time of the transaction.

The lack of accounts receivable is typically a benefit to a retailer in the bankruptcy process, as cash tied up in receivables means less liquidity for debtors to satisfy creditor obligations.

Potential for Extensive Lease Obligations

Large lease portfolios are another characteristic of retailers. Lease obligations are likely only material for retailers whose business strategy involves significant brick-and-mortar operations.

Obligations related to leases can represent a sizeable cash outflow and can also weaken the ability of a retailer to satisfy all its financing obligations. While some retailers may not carry large amounts of debt on their balance sheets, certain off-balance-sheet obligations, including operating leases, may significantly reframe the effective leverage of an operator. Lease obligations can pose a potential risk for retailers as they are sticky in the short term.

As discussed below, retailers in the bankruptcy process often have some options for relief from certain lease obligations.

Labor-Intensive Operations

Retailers, specifically ones with large brick-and-mortar operations, generally have labor-intensive operations. As traditional retailers rely on a strategy of maintaining physical store locations, quantity and quality of employees are vital to operations.

Unlike lease obligations, retailers can typically eliminate employees from their payrolls in the short term in times of financial distress.

Next, this discussion considers how these operational characteristics affect retailers in bankruptcy.

Retail Debtors in Bankruptcy: Areas of Focus, Considerations, and Trends

Now that we identified certain operational characteristics important to retailers, in the following section we identify certain trends and developments in retail bankruptcies. This discussion considers areas of the Bankruptcy Code relevant to retail debtors, as well as some associated considerations.

To provide further insight into how certain industry characteristics affect retailers in bankruptcy, we examined a data set comprised of companies that filed for bankruptcy.

We used the S&P Capital IQ database to screen for companies that filed for bankruptcy—Chapter

7 or Chapter 11—over the period from January 1, 1999, to September 1, 2019. To obtain meaningful information about the financial characteristics of debtors, we only selected companies that had publicly available financial statements.

While our screening results returned companies with public financial statements, some companies did not have updated financial information that was publicly available (e.g., a company that filed for bankruptcy as of May 25, 2017, whose latest available financials were as of December 31, 2015).

In our data set, approximately 45.1 percent of companies had available financial information within one year of filing, while approximately 79.3 percent of companies had available financial information within two years prior to filing.

Finally, for purposes of obtaining meaningful information, we selected companies that had assets or liabilities greater than $100 million at the time of the initial filing. Narrowing the scope of our data set to a specific asset and liability threshold allowed us to narrow in on a more precise sample of debtors, as well as control for other variables that could affect the data (specifically, size).

While we conducted our analysis independently, we used as a guideline the screening criteria from "Why Are U.S. Retail Reorganizations So Hard?" found in the October 2016 edition of the *American Bankruptcy Institute Journal*.

We supplement the following sections with analysis from our data set.

Bankruptcy Code Section 365(d)(4)

One section of the Bankruptcy Code that is often discussed in the context of retail bankruptcy is Section 365(d)(4):

> (A)
>
> Subject to subparagraph (B), an unexpired lease of nonresidential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that nonresidential real property to the lessor, if the trustee does not assume or reject the unexpired lease by the earlier of—
>
> > (i) the date that is 120 days after the date of the order for relief; or
> >
> > (ii) the date of the entry of an order confirming a plan.
>
> (B)
>
> > (i) The court may extend the period determined under subparagraph (A), prior to the expiration of the 120-day period, for 90 days on the motion of the trustee or lessor for cause.
> >
> > (ii) If the court grants an extension under clause (i), the court may grant a subsequent extension only upon prior written consent of the lessor in each instance.

Section 365(d)(4) deals with leases of nonresidential real property. Specifically, Section 365(d)(4) limits the amount of time—up to 210 days at most—that debtors may assume or reject their lease portfolios. The outcomes of decisions made relating to Section 365(d)(4) have important implications for retail debtors in the bankruptcy process.

On the one hand, the rejection of a lease before it is assumed under Section 365(d)(4) essentially creates a general unsecured claim. On the other hand, the rejection of a lease after it is assumed under Section 365(d)(4) creates an administrative claim above senior lenders.

Given this, it is typically in the best interest of a retail debtor to reject any leases in the 210-day period under Section 365(d)(4) that it does not intend to ultimately assume.

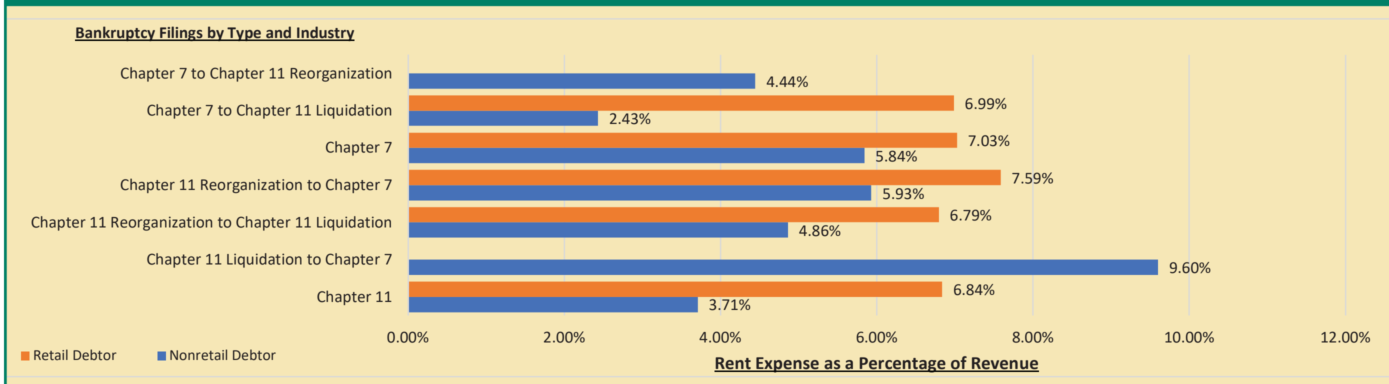
Retail debtors can often have sizeable brick-and-mortar operations. These brick-and-mortar operations typically involve significant lease obligations. As a result, discerning and differentiating the profitable and unprofitable retail locations becomes an important consideration for determining which store locations the debtor should shut down or retain.

Our data set confirms how leases can be significant for retail debtors relative to nonretail debtors. From our data set, we observe trends that confirm the importance of lease obligations. In Figure 1, average rent expense as a percentage of revenue is presented.

For purposes of our analysis, we determined rent expense to be a metric tied to lease obligations. This is because many leases are classified as operating leases and are, therefore, reflected on the income statement as a rent expense.

The data set is bifurcated between retail debtors and nonretail debtors, and it is further disaggregated by the type of bankruptcy filing. Across all bankruptcy filings, retail debtors had a higher average rent expense as a percentage of sales. Retail debtors and nonretail debtors whose filings related to Chapter 11 bankruptcies or Chapter 11 reorganizations reported lower rent expense as a percentage of revenue than debtors whose filings related to liquidations or Chapter 7 bankruptcies.

Figure 1
Rent Expense as a Percentage of Revenue



The 210-day time period is generally considered a short amount of time for assuming or rejecting nonresidential property leases. Relative to the present situation, Bankruptcy Code Section 365(d)(4) previously afforded debtors more lenient options.

While Section 365(d)(4) used to require leases of nonresidential real property to be assumed or rejected within 60 days, courts also had the ability (and regularly exercised such ability) to extend the amount of time for determining the assumption or rejection of debtor lease portfolios through the confirmation of a Chapter 11 plan. Through the BAPCPA, Section 365(d)(4) was amended to its current form.

These changes to Section 365(d)(4) are often cited as a disadvantage for retail debtors. As noted in "Retail Bankruptcies: Threading the Needle in a Tattered Industry" published in the *Journal of Corporate Renewal*:

> retail debtors [prior to the implementation of BAPCPA] had time in bankruptcy to review and analyze their lease portfolios to ascertain and monetize any pockets of value without being subjected to overwhelming pressure from their lenders and landlords.[5]

Retail debtors used to have more time to determine which leases were linked to profitable operations. In contrast, the 210-day period may be unrealistic for retail debtors to assess profitability associated with their lease portfolio and make decisions accordingly.

In fact, arguments exist that cite the change in Section 365(d)(4) as one of the main reasons why liquidations are such a common outcome in retail bankruptcies. There may be some logic to this argument. In addition to the 210-day restriction, other practical considerations create an even shorter window that complicates decision-making for retail debtors. One practical consideration is the necessary time it takes to actually shut down operations—that is, close store locations.

According to the article titled "50/50: Why So Many Troubled Retailers Liquidate" as published in the *Journal of Corporate Renewal*, going-out-of-business sales for terminated store locations may take up to 90 days.[6] Given this, it is often the case that retail debtors assume or reject lease obligations within 120 days after filing.[7]

Such a tight time frame can be challenging for a retail debtor to sufficiently adjust its operations or reach an agreement for reorganization that would allow the debtor to continue to operate.

Another possible effect of Section 365(d)(4), according to the *Journal of Corporate Renewal*, is more unfavorable debtor-in-possession ("DIP") lending terms for retail debtors.[8]

These unfavorable lending terms include (1) shorter lending time frames and (2) more restrictive covenants in financing agreements.[9]

Such hindrances to receiving DIP financing make it harder for retail debtors to adjust their operations, make necessary changes, or realize exit opportunities. Impaired access and strict lending terms for DIP financing can also, therefore, contribute to an increased likelihood that retail bankruptcies end in liquidation.

Bankruptcy Code Section 503(b)(9)

Another important topic for struggling retailers is Bankruptcy Code Section 503(b)(9). Section 503(b)(9) states the following:

> After notice and a hearing, there shall be allowed administrative expenses, other than claims allowed under section 502(f) of this title, including—

(9)

the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.

Section 503(b)(9) involves the trade payables related to goods (or inventory) in association with the ordinary course of business for a debtor. According to the section, trade payables from transactions less than 20 days prior to a retail debtor filing a petition for bankruptcy constitute an administrative claim for retail debtors. As previously mentioned, administrative claims have priority above senior lenders.

In addition, satisfying administrative claims are a prerequisite for confirming a plan of reorganization in a Chapter 11 bankruptcy. Like Section 365 (d)(4), Section 503(b)(9) arose from the 2005 BAPCPA legislation.

While Section 365(d)(4) is significant for retail debtors due to the potential for large liabilities relating to leases, Section 503(b)(9) is significant to retail debtors because inventory can represent a large proportion of the assets of retail debtors. As a result, trade payables can play an outsized role in the operations of a retail debtor. If trade credit afforded to retail debtors abruptly stops, retail debtors can face operational issues that impair their operations (and cash flow) and inflame existing liquidity and solvency issues.

Exhibit 1 confirms the importance of trade payables for retail debtors. From our data set, we calculate the average accounts payable balance as a multiple of cash as well as the average cash ratio for retail debtors and nonretail debtors in our data set. The cash ratio is a liquidity metric computed as cash and equivalents divided by current liabilities.

Exhibit 1
Average Accounts Payable
Cash and Average Cash Ratio
By Debtor Industry

	Average Accounts Payable/Cash	Average Cash Ratio
Nonretail Debtors	12.53x	0.40
Retail Debtors	27.15x	0.21

As presented in Exhibit 1, accounts payable as a multiple of cash is almost twice as much for retail debtors than for nonretail debtors. Similarly, retail debtors hold about half as much cash relative to their current liabilities than nonretail debtors.

Given that trade payables represent, as administrative claims, a higher claim than senior lenders, the treatment of trade payables in bankruptcy essentially represents additional leverage that may not have been otherwise considered. Section 503(b)(9) treats trade payables as another level of obligations that must be paid off before a plan of reorganization is confirmed.

In some situations, trade payables can be so large that vendors can influence the bankruptcy process through the status of their credit as administrative claims after filing or by their significance to retail debtors. The case of Toys“R”Us, Inc. (“Toys“R”Us”), is one example that underscores the importance of trade payables in a bankruptcy.

In 2017, Toys“R”Us management was privately considering whether to file for bankruptcy.[10] Management plans were derailed, however, when the media began leaking that the company was examining filing for bankruptcy. Upon the release of reports that Toys“R”Us was considering a bankruptcy filing, a large constituency of Toys“R”Us vendors stopped offering the company trade credit.[11]

Eventually, most Toys“R”Us vendors refused to deliver any goods to Toys“R”Us without payment in cash.[12] As a result of its trade credit drying up, Toys“R”Us lost control of the bankruptcy process and ended up filing for bankruptcy sooner than it had originally anticipated.[13]

Toys“R”Us ultimately ended up liquidating and divesting the majority of its operations.

Such an example serves to demonstrate the significance of vendors and suppliers, and the credit they afford, to retail debtors in bankruptcy. Accordingly, we note that through Section 503(b)(9), the Bankruptcy Code places importance on the satisfaction of trade payables by debtors.

The Prevalence of Liquidations in Retail Bankruptcies

Given the characteristics of retail debtors, it is clear that Section 365(d)(4) and Section 503(b)(9) can have significant implications for retail debtors in bankruptcy.

In fact, it is a typical assertion that Section 365(d)(4) and Section 503(b)(9)—since BAPCPA legislation was enacted in 2005—negatively affect the outcomes of bankruptcies for retail debtors and increase the likelihood that retail bankruptcies end in liquidation.

There is logic behind the assumption that these Bankruptcy Code sections spur retail debtors into liquidation. In the case of Section 365(d)(4), the time frame for rejecting or assuming leases can be

so short (as previously mentioned, 120 days inclusive of going-out-of-business sales) that retail debtors may not have adequate time to determine the profitability of certain locations, and in turn struggle to make the right strategic decisions in relation to their brick-and-mortar operations.

Likewise, Section 503(b)(9) can give vendors and suppliers the power to prevent the confirmation of a plan of reorganization in the bankruptcy process, as well as potentially damage the liquidity of retail debtors.

Does the empirical evidence, however, support the assertions that the 2005 BAPCPA amendments to Section 365(d)(4) and 503(b)(9) have driven retail debtors to liquidation in bankruptcy? According to the *American Bankruptcy Institute Journal*, in the article titled "Why Are U.S. Retail Reorganizations So Hard?," the "statistics are not very persuasive."[14]

That article draws on bankruptcy data from S&P Capital IQ over an approximate 15-and-a-half-year period, both before and after the BAPCPA amendments went into effect. According to their data, they found only a slight increase—from 47 percent to 49—in liquidation outcomes for retail debtors before and after BAPCPA.[15]

Our data set also confirms that bankruptcies ending in liquidation were comparable for retail debtors before and after BAPCPA implementation. We confirm that liquidations for retail debtors are indeed more frequent relative to nonretailers, both before and after the BAPCPA changes were implemented.

As presented in Figures 2 and 3, it is more likely for a retail debtor over the period to liquidate or file for Chapter 7 bankruptcy than for nonretail debtors.

As presented in Figure 3, Chapter 11 liquidations or Chapter 7 bankruptcies for retail debtors comprised (1) at least a majority of all bankruptcies for a given year in nine of the years presented, (2) 50 percent of all bankruptcies in a given year for four of the years presented, and (3) less than 50 of all bankruptcies for a given year for eight of the years presented.

Overall, Chapter 11 liquidation and Chapter 7 bankruptcies represented 46.3 percent of bankruptcies for all retail debtors in our data set, while non-Chapter 11 liquidation and Chapter 7 bankruptcies represented 53.7 percent of retail debtors in our data set.

The data for retail debtors contrast with the trends seen for nonretail debtors. As presented in Figure 3, Chapter 11 liquidations and Chapter 7 bankruptcies were far less prevalent for nonretail debtors than they were for retail debtors.

In all of the 21 years (including 1 partial year) presented, Chapter 11 liquidations and Chapter 7 bankruptcies represented a majority of filings for nonretail debtors in only 1 year: 2007 (a recessionary period and a precursor to the Financial Crisis).

Overall, Chapter 11 liquidations and Chapter 7 bankruptcies represented 28.8 percent of nonretail debtors, while non-Chapter-11 liquidations and Chapter 7 bankruptcies represented 71.2 percent of all nonretail debtors in our data set.

In addition to this dichotomy between retail debtors and nonretail debtors, we note another trend. In our data set, we see that the percentage of retail debtors with Chapter 11 liquidation or Chapter 7 bankruptcies does not change significantly over the 21-year period.

While changes between years may be significant, no clear trend emerges for retail debtors that demonstrates Chapter 11 liquidations and Chapter 7 bankruptcies occurred less frequently prior to the implementation of BAPCPA in 2005, or that liquidations for retail debtors have been more common since 2005.

Despite this, we do not make assertions about relationships between (1) the prevalence of liquidations for retail debtors and (2) BAPCPA. We note that while our data set may be useful for gleaning observations, it is not a perfect data set. Our sample of retail debtors is relatively small, and our screening eliminated debtors with assets and liabilities of less than $100 million.

Such a data set could represent sampling bias; BAPCPA could, for example, disproportionately affect retail debtors that are smaller in size.

Logically, the effects of the implementation of the BAPCPA amendments to Section 365(d)(4) and Sections 503(b)(9) would imply that liquidation is a more likely outcome for retail debtors—this relationship, however, is not reflected in the observations made in our data set.

From our data set, we observe the following:

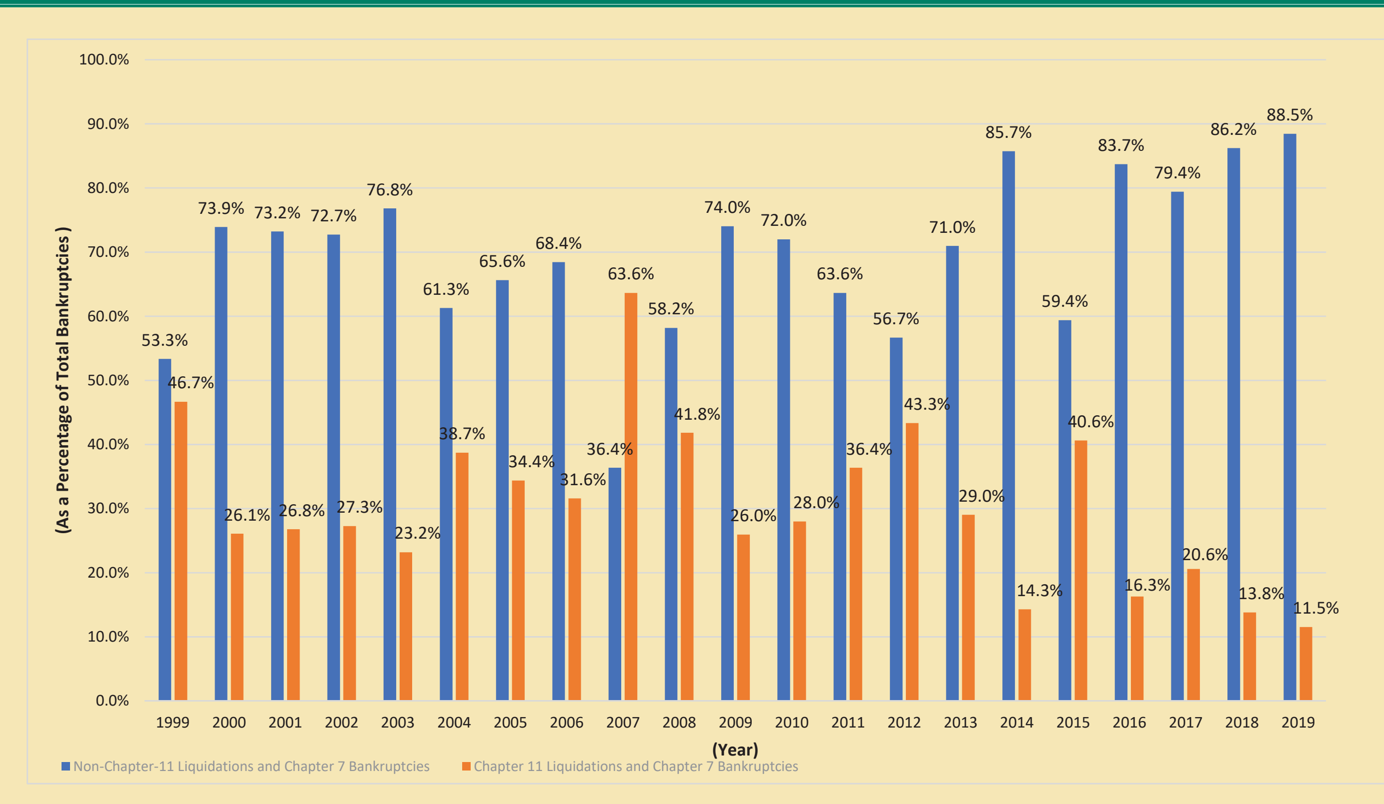
1. Liquidation is a more likely outcome for retail debtors than nonretail debtors.
2. The frequency of liquidation for retail debtors has been relatively consistent over the 21-year period.

Liquidation Values in Retail Bankruptcies

Another explanation that supports the increased likelihood of liquidation for retail debtors is the case that retail debtors might potentially realize higher value by liquidating relative to nonretailers. It might be the case that liquidation presents a

Figure 2
Retail Debtors
Percentage of Liquidations and Reorganizations
As a Percentage of Total Bankruptcies by Year

Figure 3
Nonretail Debtors
Percentage of Liquidations and Reorganizations
As a Percentage of Total Bankruptcies by Year



greater benefit, or at least a greater marginal benefit relative to reorganization, for retail debtors than for nonretail debtors.

There is support for such an explanation. Most often, retailers do not have large levels of property, plant, and equipment ("PP&E"). Additionally, retailers are not capital-intensive. As mentioned previously, retailers typically hold large amounts of inventory relative to total assets. Using our data set, Exhibit 2 confirms that retail debtors, on average, hold much greater levels of inventory than nonretail debtors.

A debtor that is both (1) inventory-intensive and (2) not capital-intensive can have implications for liquidation. Generally, it can be challenging to off-load PP&E, as it can be hard to sell certain land and buildings, as well as specialized equipment. Inventory, on the other hand, is relatively easy to sell. Inventory can be sold quickly, and at a relatively high value relative to its cost basis.

Basically, retail debtors often hold tangible assets that are more liquid in comparison to other debtors, and as a result they may realize a higher value for their assets, more quickly, upon liquidation.

In addition to relatively liquid tangible assets on the balance sheet, retailers also generally have sizeable intangible assets that may be easier to sell, namely customer lists and trademarks, including brands.[16]

The attractiveness of liquidation makes it harder for retail debtors to emerge from bankruptcy under a reorganization. This is due to the best-interests test. This test requires that debtors should prove that all classes of creditors would fare better under reorganization than liquidation in order for a plan of reorganization to be approved.

In many circumstances for retail debtors, continuing operations may not prove sufficiently beneficial, especially when compared to favorable liquidation values for existing assets.

Summary and Conclusion

The retail industry represents a broad constituency. This discussion attempts to find larger trends that could be applicable to retail debtors. While each bankruptcy case is a unique situation, there are lessons to be learned from previous examples.

In addition, unique industry considerations can be useful and lead to insights for company-specific considerations in the context of a bankruptcy. Understanding notable areas relevant to retailers in the bankruptcy process can allow for increased planning and awareness.

Finally, in the context of retail bankruptcies, financial and valuation issues can also surface. In these instances, the valuation analyst can be of service to the various stakeholders in the bankruptcy process and can contribute in multiple capacities.

Exhibit 2
Average Inventory as a Percentage of Total Assets

	Average Inventory as a Percentage of Total Asset
Nonretail Debtors	8.0%
Retail Debtors	33.6%

Notes:

1. S&P Capital IQ.
2. Ibid.
3. IBIS*World* Industry Report, "Retail Trade in the US" (June 2018).
4. Ibid.
5. Jennifer Feldsher and Mark E. Dendinger, "Retail Bankruptcies: Threading the Needle in a Tattered Industry," *Journal of Corporate Renewal* (November/December 2018).
6. Kent Percy, Luke Ericson, and Stephen Potts, "50/50: Why So Many Troubled Retailers Liquidate," *Journal of Corporate Renewal* (October 2017).
7. Ibid.
8. Feldsher and Dendinger, "Retail Bankruptcies: Threading the Needle in a Tattered Industry," *Journal of Corporate Renewal*.
9. Ibid.
10. Richelle Kalnit and Ben Kaplan, "Early Action is Crucial to Maximizing Retail Brand Value in Bankruptcy," *Journal of Corporate Renewal* (June 2018).
11. Ibid.
12. Ibid.
13. Ibid.
14. Chuck Carroll and John Yozzo, "Why are U.S. Retail Reorganizations So Hard?" *American Bankruptcy Institute Journal* (October 2016).
15. Ibid.
16. Carroll and Yozzo, "Why are U.S. Retail Reorganizations So Hard?" *American Bankruptcy Institute Journal.*

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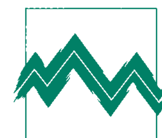

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Overview of the New Saudi Arabia Bankruptcy Law

Andrew W. Duncan and F. Dean Driskell III, CPA

The new bankruptcy laws in the Kingdom of Saudi Arabia represent a significant departure from the antiquated solvency rules of the past. These new laws may attract additional foreign investment from the West. This discussion summarizes the new laws, compares the new laws to U.S. bankruptcy laws, and considers some recent, and interesting, bankruptcy cases currently working through the court system in the Kingdom of Saudi Arabia.

Introduction

In 2016, King Salman bin Abdulaziz Al Saud and the Chairman of the Counsel of Economic and Development Affairs, Crown Prince Mohammad bin Salman, issued a vision and blueprint, called *Vision 2030*, for the future of the Kingdom of Saudi Arabia ("KSA") reflecting a set of long-term goals and expectations.

The vision is based on three pillars:

1. Reestablishing the KSA as the heart of the Arab and Islamic worlds
2. Transforming the KSA into a global investment powerhouse
3. Transforming the KSA into a global hub connecting the three continents of Asia, Europe, and Africa

The KSA also formed the National Transformation Program ("NTP") to seek alternative economic interests to oil production and exportation. The five-year NTP seeks public sector and fiscal reforms, economic diversification, enhanced business environments, and social reforms. The objectives of the NTP are divided into the following eight themes:

1. Transform health care
2. Improve living standards and safety
3. Ensure sustainability of vital resources
4. Social empowerment and nonprofit sector development
5. Achieve governmental operational excellence
6. Labor market accessibility and attractiveness
7. Contribute in enabling the private sector
8. Develop the tourism and national heritage sectors[1]

The seventh theme is the most significant with regard to establishing alternative economic interests to oil production and exportation. The objective of the seventh theme is to facilitate business activity, develop the digital economy, and adapt rules and regulations to attract foreign direct investments, and empower small to medium business enterprises.

An important element to increasing private sector activity, foreign or domestic, is to facilitate procedures for exiting businesses. As such, the KSA launched a new law outlining bankruptcy procedures for 2018 and beyond.[2]

For the first time in its history, the KSA issued a comprehensive set of bankruptcy laws by virtue of Royal Decree No. M/50 dated 28/05/1439H (corresponding to 14/02/2018G) (hereafter referred to as the "Bankruptcy Law"). These new laws, developed

under the auspices of *Vision 2030* and the NTP, were intended to encourage both foreign and domestic investment, and simplify the legal and business framework of KSA.

The Saudi Arabian Ministry of Commerce and Investment ("MOCI") benchmarked the Bankruptcy Law to existing Chapter 11 laws in the United States. This new law contains 17 chapters and over 200 sections.

While the KSA was researching and drafting this new Bankruptcy Law, the Commercial Law Development Program ("CLDP") of the Office of General Counsel for the U.S. Department of Commerce regularly visited the KSA for consultations regarding insolvency law.[3]

These advisers met with lawyers from the MOCI and the Gulf Cooperation Council ("GCC") Secretariat to devise new insolvency laws for the KSA and all GCC countries. The GCC countries include (1) Kuwait, 2) Oman, (3) Saudi Arabia, (4) United Arab Emirates, (5) Qatar, and (6) Bahrain.

Specifically, the CLDP encouraged the GCC countries to decriminalize insolvency and establish specialized courts to handle bankruptcy and insolvency matters. Such amendments to precedent bankruptcy and insolvency laws would provide necessary protection for domestic entrepreneurs and foreign companies operating in the gulf region.

Since the enforcement of the Bankruptcy Law, the CLDP has partnered with the various authorities in the KSA, including the MOCI and the Bankruptcy Commission, to educate business and legal professionals on the new established procedures.

On April 29, 2019, the CLDP supported the MOCI and the Bankruptcy Commission in the launch of the KSA Bankruptcy Law at the First Bankruptcy Conference. This conference included approximately 800 lawyers, judges, and accountants from across the KSA.[4]

In addition, on July 22, 2019, the CLDP conducted judicial capacity building programming at the U.S. Bankruptcy Court in the Southern District of New York for a 15-member delegation from Kuwait and Saudi Arabia. Participating individuals visited federal and New York state courts to witness live commercial proceedings and to learn best practice in adjudicating complex commercial transactions such as bankruptcy.

The delegation also interviewed stakeholders in commercial disputes, such as (1) U.S. bankruptcy judges, (2) lawyers for bankruptcy litigants, (3) U.S. bankruptcy trustees, and (4) claims agents.[5]

Many observers believe that the Bankruptcy Law will ease tensions with Western governments, investors, and financial institutions subsequent to the murder of journalist Jamal Khashoggi, as highlighted in the excerpt below.

> A frequent critic of the KSA government and specifically Prince Mohammad bin Salman, Jamal Khashoggi was murdered at the Saudi consulate in Istanbul on October 2, 2018. Khashoggi was a prominent Saudi journalist and served as an advisor to the royal family for many years. In 2017, he fell from favor, exiled himself to the United States, and began writing critically of the KSA for *The Washington Post*.
>
> As of this writing, there is debate over who is responsible for Khashoggi's death. KSA officials claim he was killed by a "rogue" group of agents sent to return Khashoggi to Saudi Arabia. Turkish officials claim the agents acted on orders of the KSA government. Recently, a United Nations special report concluded Khashoggi was "the victim of a deliberate, premeditated execution, an extrajudicial killing for which the state of Saudi Arabia is responsible."[6]

Objectives of Bankruptcy Law

The KSA has long lacked any significant guidance in the areas of bankruptcy and insolvency (limited exceptions are noted below).

According to article 5 of the Bankruptcy Law, the new bankruptcy procedures aim to achieve the following:

1. Enable the bankrupt debtor or the distressed debtor or the debtor expected to suffer from financial difficulties to benefit from bankruptcy procedures in order to

restructure its financial position, maintain its activities with an aim to contribute to the economy and support it

2. Consider the creditor's rights and to ensure a fair treatment among the creditors
3. Maximize the value of bankruptcy assets, ensure a controlled sale of such assets, and a fair distribution of the sale proceeds to the creditors upon liquidation
4. Reduce procedural costs and time frame, and increase the efficiency thereof especially in restructuring of the position of the small debtors or the sale of the bankruptcy assets and the distribution of the sale proceeds among the same in a fair manner within a specified time frame
5. Undertake administrative liquidation of the debtor where the assets are not expected to cover the costs of the liquidation procedure of small debtors' liquidation procedure

The primary objectives of the Bankruptcy Law are to implement legal process and procedures in the areas of preventative settlement, financial reorganization, and liquidation. The belief is that the new laws will ease the difficulties of distressed debtors by simplifying the restructuring process. Finally, and perhaps most importantly, the hope is the Bankruptcy Law will encourage additional business investment in KSA.

Scope and Topics of the Bankruptcy Law

According to article 4 of the Bankruptcy Law, provision of the law will apply to the following:

1. A natural person practicing a commercial activity or a professional activity or any activity with an aim to generate profits in the KSA
2. Commercial, professional and civil companies, regulated entities, as well as other entities or establishments with an aim to realize profits, registered in the KSA
3. Non-Saudi investors, whether natural or corporate persons, holding assets or practicing a commercial activity or a professional activity or any activity with an aim to generate profits through a licensed entity in the KSA (the Bankruptcy Law shall only apply to the investor assets located in the KSA)

In addition, while the Bankruptcy Law applies to regulated industries (telecom, banks, insurance), the law allows other regulated entities (e.g., Saudi Arabian Monetary Agency and Capital Market Authority) to issue their own rules and regulations related to bankruptcy and insolvency.

Defining Insolvency and Bankruptcy

The Bankruptcy Law defines both "insolvent" and "bankrupt." Insolvent is defined in the Bankruptcy Law as a debtor who fails to discharge a debt on its due date. This definition differs from the U.S. standard definition of insolvent as an inability to pay debts as they become due.

So, the logical question is: What happens if a debtor in the KSA chooses not to pay a debt? Does this make the debtor insolvent?

Bankrupt is defined in the Bankruptcy Law as a debtor without assets. This also differs from the commonly held definition of bankrupt. For instance, does a debtor with $1 worth of assets constitute a bankrupt debtor?

The language contained in the Bankruptcy Law provides some clarity with regard to those important definitions, but the aforementioned questions remain. The financial community will have to wait to see how the KSA courts address these issues in the coming years.

Hierarchy of Debts

The KSA, for the first time in history, established an order of priority for creditor claims. Like U.S. bankruptcy laws, the expenses for the appointed trustees and experts and costs associated with selling the assets will have priority over other creditor claims.

Other debts are ranked as follows:

1. Secured debts
2. Secured financed debts as per Article 184 of the Bankruptcy Law and any other secured financed debts determined by the implementing regulations
3. An amount equivalent to 30 days salary for the debtor's employees
4. Alimony for the debtor's family as determined by the applicable laws or a court order
5. Necessary expenses to ensure the continuity of the debtor's business operations during the relevant liquidation procedures in accordance with the implementing regulations requirements

6. Accrued wages of the debtor's employees
7. Unsecured debts
8. Unsecured governmental official fees, membership fees and taxes in accordance with the implementing regulations requirements

Punishment for Violations

Penalties for violations of the Bankruptcy Law can be severe. The potential penalties include the following:

1. Imprisonment for a term of up to five years and/or a fine up to five million Saudi Riyals (approximately 1.3 million U.S. dollars)
2. Restrictions on owning or operating a profitable business in the KSA

Pre-Existing Legislation

The Bankruptcy Law will replace nearly 100 years of preexisting law as follows:

1. The Law of Settlement Against Bankruptcy issues pursuant to the Royal Decree No. M/16 dated 04/09/1416H (corresponding to 24/01/1996G)
2. Chapter 10 of the Commercial Courts Laws issued pursuant to the Royal Decree No. 32 dated 15/01/1350H (corresponding to 01/06/1931G)
3. All provisions of any applied laws or regulations that are inconstant with the Bankruptcy Law shall be voided

These previous laws lacked (1) detail regarding debtor eligibility for bankruptcy procedures, (2) an automatic stay of creditor claims during bankruptcy proceedings, (3) the option of debtor financing to properly reorganize a business operation, (4) protection for creditors' rights, and (5) clarification regarding a hierarchy of creditor claims.

Previous Bankruptcy Insolvency Issues in the KSA

Prior to the Bankruptcy Law, debtors, creditors, investors, and business professionals faced uncertainty in the KSA bankruptcy arena. Historically, courts have been highly reluctant to declare a debtor bankrupt—even after protracted collection efforts. This process lengthens the bankruptcy proceedings and complicates the KSA business environment for creditors.

From the debtor perspective, the KSA landscape was not much better. There was little protection for insolvent debtors with viable businesses. Liquidation and/or cash infusions were generally the first resort. The new laws better consider restructuring and reorganization as viable options if there is a belief that these efforts will benefit the creditors in the long term.

Other long-standing issues included the following:[7]

1. Disorderly collection of debts resulting in some creditors being paid but others missing out entirely
2. Little scope for workouts with the result that creditors and debtors may both be disadvantaged
3. Reduced prospects of survival of a viable business experiencing a temporary hiccup
4. Lack of or no information on whether a proposed counterparty was insolvent
5. A number of lawsuits resulting from a multiplicity of legal claims
6. Debtors attempting to defeat creditor's claims by concealing assets or disposing of them prior to insolvency at less than fair value or for no value at all

Bankruptcy Procedures

The first step in the new bankruptcy environment is the establishment of a specialized committee ("Committee") to oversee all KSA bankruptcy matters and report directly to the MOCI. The Committee is directed to establish a bankruptcy register,[8] issue licenses for bankruptcy experts and trustees,[9] implement regulations governing the framework of the licensed bankruptcy procedures, coordinate liquidation procedures, and inspect all ongoing bankruptcy procedures.

The three main procedures established by the Bankruptcy Law are (1) preventative settlement, (2) financial restructuring, and (3) liquidation.

Preventative Settlement

The preventative settlement procedures aim to facilitate an agreement between the debtor and its creditors to settle its debts where the debtor maintains the right to manage its activities.

Debtors may request a preventative settlement if any of the following criteria are met:

1. The debtor is experiencing financial distress that may cause the discontinuation of the business or insolvency.
2. The debtor is insolvent.
3. The debtor is bankrupt.

Upon submission of the preventative settlement request, the debtor may receive a suspension of further claims for up to 180 days while still maintaining management authority of the company. The settlement report is prepared and voted on by the relevant debtors and creditors.

Once these steps are completed, the debtor is required to finalize the procedures outlined in the settlement request (with oversight of the licensed bankruptcy trustee) and register the settlement petition with the bankruptcy register. Finally, the debtor should ensure its complete participation in the business's contractual obligations once the preventative settlement proceedings are enforced.

Al-Shehili Engineering Industries Co. Ltd.—Preventative Settlement

In February of 2019, Al-Shehili Engineering Industries Co. Ltd. ("Al-Shehili"), filed for preventative settlement and a suspension of further claims under the new Bankruptcy Law. Al-Shehili produces refrigerators, mechanical pumps, concrete mixers, and other similar machinery and equipment.

In the bankruptcy proceedings, the court began by conducting an analysis of the Al-Shehili financial position and operating history as of December 31, 2018.

The court noted the following factors as important in its analysis of Al-Shehili:

1. The historical level of assets, liabilities, expenses, and revenue during/as of the latest 12-month period ending December 31, 2018
2. The number of employees and their respective salaries, wages, and benefits
3. Previous actions undertaken by creditors
4. The outlook or projections of the company

After completing its due diligence process, the court determined that the bankruptcy proceedings should be opened for Al-Shehili. The court acknowledged two pieces of evidence as sufficient in order to approve the initiation of the bankruptcy proceedings:

1. Improved financial projections based on the reasonable probability that Al-Shehili would win two military manufacturing contracts
2. Assurance from an independent bankruptcy trustee that the majority of creditors would approve the Al-Shehili settlement proposal

The court also granted a stay on creditors' claims for the earlier of 90 days or the court's final approval of the proposed preventative settlement plan. In this circumstance, the court appeared to rule in favor of the preservation of jobs and operational autonomy of Al-Shehili.

Financial Reorganization

Debtors, creditors, and regulators of the debtor may all request a financial restructuring under the supervision of a restructuring officer. Generally, this process allows debtors and creditors to work together for an agreed-upon reorganization—assuming the creditors holding two-thirds of the debt are able to agree.

Under the financial reorganization, claims against the debtor are halted until such time as:

1. the date of the request is rejected,
2. the request is approved by the court, or
3. the earlier termination of the financial reorganization without approval of the court.

If the court approves the plan, it will appoint the trustee who will supervise the execution of the reorganization plan. The trustee is given broad powers to avoid contracts[10] under certain circumstances

(like U.S. law). Any approved plans apply to all creditors.

Saudi Indian Company for Cooperative Insurance—Financial Reorganization

In April 2019, the Saudi Indian Company for Cooperative Insurance ("Wafa Insurance") appealed to the court for permission to initiate financial reorganization proceedings in order to avoid liquidation and protect shareholders' interests. Wafa Insurance sells health, automotive, and other insurance products throughout the KSA.

As with the previously discussed Al-Shehili case, the court began with an analysis of the financial condition of Wafa Insurance. With the exception of fiscal year ("FY") 2016, Wafa Insurance generated annual losses from FY 2011 through FY 2018.

In addition, after examination of the cash flow statements of Wafa Insurance, the court designated it as insolvent. As defined by the Bankruptcy Law, a debtor becomes insolvent upon failure to discharge a debt on its payment due date.

Wafa Insurance management submitted a financial restructuring proposal to the court that included provisions for raising capital to effectively reorganize. The Saudi Arabian Monetary Authority, the central bank of the KSA, confirmed the bankruptcy financing plan proposed by Wafa Insurance was feasible, and the court granted the request to initiate the financial reorganization proceedings.

Following the approval, pursuant with the Bankruptcy Law, the court appointed a trustee or financial reorganization officer. The major responsibilities of the financial reorganization officer are to ensure fairness of the procedure and implementation of the reorganization.

Finally, the court enacted a temporary stay on all creditor claims, provided Wafa Insurance with 150 days to submit a final reorganization proposal, and established a bar date for all creditors to officially file a proof of claim in order to receive restitution.

Liquidation

The liquidation procedure is conducted under the management of the liquidation officeholder, aiming to account for creditors' claims, oversee the sale of bankruptcy assets, and distribute the sale proceeds to the creditors.

Debtors, creditors, and regulators of the debtor may all request a liquidation (considered a "last resort" provision) in the Bankruptcy Law under any of the following conditions:

1. Debtor is insolvent or bankrupt
2. Debtor believes the entity's assets are not sufficient to cover the liquidation
3. Creditor proves the debt due is for a definite amount

As with the financial reorganization, the court will appoint a trustee to liquidate the assets based on priority claims and wind up the company (if necessary). The Bankruptcy Law provides guidance, although the standards are currently undefined, for the liquidation of small debtors. The goal is greater speed and lower costs for liquidation.

Alternatively, if the proceeds from the sale of bankruptcy assets are not expected to cover the expenses of the liquidation procedure, the liquidation process will be managed by the Bankruptcy Commission in a procedure known as an "administrative liquidation."

Shalaal Wadi Banna Food Service Establishment—Liquidation

In June 2019, Shalaal Wadi Banna Food Service Establishment ("Shalaal Wadi Banna") brought a case before the court seeking the authority to liquidate. Shalaal Wadi Banna has operated in the restaurant and food catering industry for over a decade.

When Shalaal Wadi Banna brought its case for liquidation before the court, (1) expenses incurred exceeded annual revenue generated, (2) liabilities were in excess of assets, (3) operations had ceased, and (4) creditors filed a total of 23 recovery lawsuits in attempt to receive restitution for $4.8 million of alleged outstanding debts.

As of June 2019, on its balance sheet, Shalaal Wadi Banna held five vehicles and a moderate amount of cash.

The court approved the application for liquidation noting that Shalaal Wadi Banna (1) provided appropriate notice of the hearing to creditors and (2) was compliant with the Bankruptcy Law's filings and insolvency requirements.

Notably, the court was unwilling to designate a private bankruptcy trustee to Shalaal Wadi Banna due to its lack of capital to adequately cover administrative expenses attributable to the liquidation proceedings. As such, the court appointed the Bankruptcy Commission to conduct the administrative liquidation procedures.

Outstanding Bankruptcy Cases in the KSA

One of the first large tests of the KSA Bankruptcy Law is the case of Ahmad Hamad Algosaibi and

Brothers ("AHAB"). The Saudi business defaulted on approximately $22 billion in loans in 2009 (allegedly precipitated by the Great Recession) to a consortium of international and regional financial institutions including HSBC PLC, Standard Chartered PLC, Citi, Deutsche Bank AG, and BNP Paribas, leading to accusations of fraud and impropriety.

According to a Cayman Islands court, AHAB and its partner, Maan al-Sanea, fraudulently borrowed money to repay interest due on previous loans in Ponzi fashion. The Cayman Island court dismissed the AHAB claim that Sanea defrauded the family business of billions of dollars in unrepaid debts.

Instead, the court ruled that AHAB knowingly entered into the Ponzi scheme that fraudulently obtained approximately $126 billion in loans from more than 100 international banks. The business partners defaulted on the loan obligations at the beginning of the financial crisis.

The Gosaibi family directed blame to Sanea with accusations of fraud, theft, and forgery. Sanea married into the Gosaibi family in the 1980s and soon controlled the operations of AHAB's financial services division. Sanea fraudulently borrowed money through a practice known as "name lending" in which a financial institution extends unsecured credit based only on the borrower's reputation, not their financial condition.

Sanea was subsequently arrested by Saudi police and the KSA courts appointed a liquidator to sell the assets of his company, Saad Group. A commercial court in Dammam, Saudi Arabia, approved an application for financial reorganization filed by Maan al-Sanea and the Saad Group in February 2019.

In addition to appealing the Cayman Islands court verdict, AHAB petitioned the KSA court to use protective settlement procedures contained within the new Bankruptcy Law to assist with dividing up assets to repay $6 billion in debts. The application was rejected by the court in Dammam because it lacked required details.

AHAB subsequently filed a petition for financial restructuring, which was initially denied. After another appeal, Saudi Arabia's Dammam Commercial Court accepted a filing by AHAB to have its decade-long creditor dispute resolved under the Bankruptcy Law in May 2019. The court is now expected to appoint a bankruptcy trustee charged with collecting and assessing creditors' claims against AHAB.

The KSA banks, either partly or wholly owned by the Saudi government, previously acquired hundreds of millions of dollars of the company assets that were not shared with the other creditors. These issues will test the strength and will of the KSA courts and bankruptcy trustees to claw back these preferential asset transfers.

Conclusion

The KSA new bankruptcy laws are relatively unproven and will need to be tested in the court systems, but that need not diminish the significance of the laws. The bankruptcy laws in the United States have been tweaked, changed, and challenged for hundreds of years and are still far from perfect.

What these laws are expected to do is provide a more stable legal footing for addition foreign investment in the Kingdom of Saudi Arabia—and that was likely the primary purpose in the first place.

Notes:

1. *National Transformation Program: Delivery Plan 2018-2020*, Kingdom of Saudi Arabia, 2016.
2. Ibid.
3. http://cldp.doc.gov/programs/cldp-in-action/details/1253
4. http://cldp.doc.gov/programs/cldp-in-action/details/2142
5. http://cldp.doc.gov/programs/cldp-in-action/details/2193
6. Summarized from *Jamal Khashoggi: All You Need to Know about Saudi Journalist's Death, BBC News,* https://www.bbc.com/news/world-europe-45812399
7. https://www.tamini.com/law-update-articles/the-new-saudi-arabian-bankruptcy-law/
8. The Bankruptcy Register is open to public view and will contain contents to be determined by the Committee.
9. Must be a member of the Saudi Organization for Certified Public Accountants or a legally licensed lawyer.
10. Fraudulent conveyances/transfers (transactions intended to defraud or harm creditors) are prohibited by the Bankruptcy Law. In such instances, the court may order the recovery of debtor's assets and/or the payment of compensation.

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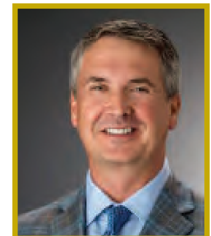

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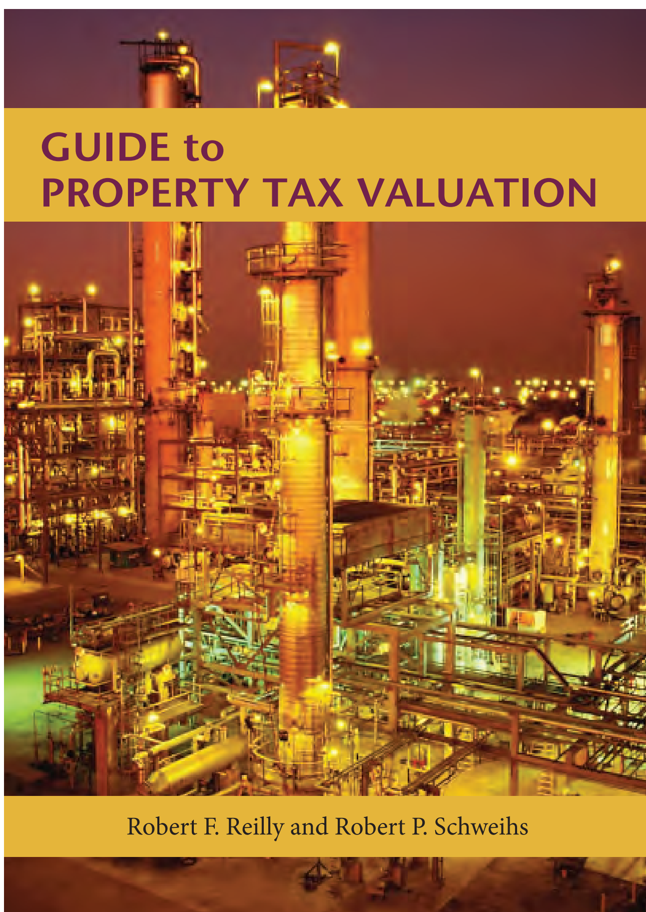

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Thought Leadership Discussion

Estate of Aaron U. Jones v. Commissioner of Internal Revenue: Increasing Acceptance of Tax-Affecting

Scott R. Miller and Curtis R. Kimball

The U.S. Tax Court has issued many judicial decisions throughout the past decades that involve the business valuation of a tax pass-through entity. However, there is ongoing debate with regard to how best to apply income tax in a valuation analysis of a tax pass-through entity. The recent Estate of Aaron U. Jones v. Commissioner of Internal Revenue *decision was an important judicial decision that affirmed that the federal court system is increasingly willing to consider tax-affecting in a valuation analysis of a tax pass-through entity. This discussion summarizes the* Jones *case, the important valuation issues involved, and the ultimate impact that case may have moving forward.*

Introduction

The Internal Revenue Service (the "Service") has consistently opposed the concept of tax-affecting income for the valuation of tax pass-through entity (such as limited partnerships and S corporations) interests for transfer tax purposes under the Internal Revenue Code. This opposition has been observable in many judicial decisions since the *Gross* case[1] in 1999.

In the world of investment markets, however, investors have consistently recognized differences in the valuation of investment interests due to the different tax burdens levied on the cash flow of various types of investment returns.

The latest clash between these two world views was debated in front of—and decided by—Judge Pugh in the U.S. Tax Court case of *Estate of Aaron U. Jones, Donor, Deceased, Rebecca L. Jones and Dale A. Riddle, Personal Representatives v. Commissioner of Internal Revenue*[2] (the "*Jones* case").

The result was a victory for the taxpayer in the *Jones* case and an affirmation by the Tax Court that the federal court system is increasingly willing to consider the investment market world view of tax-affecting income. This is especially true if the facts of the case merit such consideration and the investment and tax issues are properly and thoroughly laid out and analyzed in expert valuation testimony.

The *Jones* case verdict follows the *Kress v. U.S.*[3] case decided earlier in 2019 in the U.S. District Court of the Eastern Division of Wisconsin, which also decided in favor of the taxpayer's position on tax-affecting the income used to value the subject noncontrolling interest in a family-owned S corporation.

Background of the Case

Aaron Jones built his family's forest products businesses from virtually nothing. Starting at age 33 in 1954, he rented an existing old sawmill at Seneca Street in West Eugene, Oregon, and began to

improve and expand the facilities to process logs into studs and other dimensional lumber products for residential and general construction uses. Later, Mr. Jones acquired and managed timberlands in order to assure a sustainable supply of logs for the sawmill operation.

The family business consisted of two companies, Seneca Sawmill Company ("SSC") and Seneca Jones Timber Company, Limited Partnership ("SJTC"). The two companies were operated as a single integrated business.

Seneca Sawmill Company

As of May 28, 2009 (the date of the gifts subject to dispute), SSC was an Oregon-based forest products company that owned and operated two sawmills. Through the use of the sawmills, SSC was primarily engaged in producing dimension and stud lumber.

SSC maintained a technological advantage through its portfolio of more than 25 patents, many of which were developed by Mr. Jones.

The two SSC sawmills, as well as all manufacturing facilities and company headquarters, were located on the same site in the Eugene, Oregon, area. The SSC sawmills included a dimensional mill and a stud mill. The stud mill consisted of two lines (the "stud saw line" and the "hewsaw line") that were housed in adjoining but separate buildings.

Those two mills were considered one mill for financial accounting purposes. Together, the mills produced over 250 million board feet of primarily Douglas fir dimension and stud lumber in 2008.

SSC was also the general partner of SJTC. As the sole general partner of SJTC, the SSC executive management team exercised exclusive control over the management of SJTC.

Further, SSC was dependent on SJTC as (1) a primary supplier of logs used in the SSC sawmills and (2) the provider of short- and long-term debt financing, through the use of the SJTC timberland as collateral.

As of May 28, 2009, the SSC balance sheet prepared in accordance with generally accepted accounting principles ("GAAP") reported total assets of around $100 million. For the latest 12 months ended May 28, 2009, the SSC income statement reported revenue of about $66 million and a pretax loss of about $10 million.

As of May 28, 2009, SSC was a subchapter S corporation, for federal income tax purposes. SSC was organized under the laws of the State of Oregon.

Seneca Jones Timber Company, Limited Partnership

Mr. Jones began to consider acquiring timberlands in the early to mid-1980s when environmental regulations put continued access to federal timberlands at risk. On August 25, 1992, Mr. Jones formed SJTC to invest in, acquire, hold, and manage timberlands and real property and to incur indebtedness, and he contributed the timberlands he purchased in 1989 and 1992 in exchange for an ownership interest.

Mr. Jones contributed the timberlands to SJTC rather than SSC because of tax and liability concerns. SJTC's timberlands were intended to be SSC's inventory.

As of May 28, 2009, SJTC was an Oregon-based limited partnership that owned, managed, and facilitated the harvest of timberlands primarily in Western Oregon. SJTC owned over 165,000 acres of timberland in Oregon and, at the end of 2008, had standing timber inventory on the timberlands of more than 1.4 billion board feet.

SJTC used its logs almost exclusively for (1) sales to the SJTC general partner (i.e., SSC) or (2) trades with third-party companies in exchange for logs to be used by SSC.

As mentioned earlier, the SSC executive management team exercised exclusive control over the management of SJTC. Further, SSC was dependent on SJTC as (1) a primary supplier of logs used in the SSC sawmills and (2) the provider of short- and long-term debt financing, through the use of the SJTC timberland as collateral.

SJTC operated its timber holdings on a sustainable-yield basis, with normal rotation ages of between 45 to 60 years. Any commercial thinning harvests on the SJTC land occurred between 25 and 45 years.

As the lands were harvested, they were replanted with specially selected "super-trees." These newly planted trees were placed on a highly managed fertilization and vegetation control program, which provided them with a superior growth advantage over the natural seeding process. Through this process the SJTC assets were expected to provide a steady supply of timber inventory in perpetuity.

The SJTC management team was identical to that of SSC and was paid by SSC. SJTC had 21 employees as of May 28, 2009, composed primarily of administrative and forestry staff. SJTC relied on SSC for human resources, legal services, and its controller, and it paid a $1.2 million annual fee for administrative services to SSC.

SJTC also used independent contractors for most of its activities on the tree farm, including planting seedlings, road construction, and harvesting trees.

The SJTC forestry staff oversaw between 150 and 200 contractors to ensure that they completed their tasks according to the SJTC standards and objectives.

As of May 28, 2009, the SJTC GAAP balance sheet reported total assets of roughly $125 million. For the latest 12 months ended May 28, 2009, the SJTC income statement reported revenue of about $30 million and a pretax loss of just under $1 million.

As of May 28, 2009, SJTC was a limited partnership, organized under the laws of the State of Oregon.

The Gifts

In 1996, Mr. Jones began to create a succession plan to ensure that his family businesses remained operational in perpetuity. As part of this plan, he formed various family and generation-skipping trusts. He then gifted voting and nonvoting shares of SSC and limited partnership units of SJTC to his three daughters and these related entities.

The transfers all consisted of noncontrolling blocks of interests subject to restrictions on marketability that were part of the organizational documents of SSC and SJTC.

The effective date of these transfers (and, thus, the valuation date) was May 28, 2009.

The fair market values assigned to the shares and limited partnership interests on a per share/unit basis were $325 for SSC voting shares, $315 for SSC nonvoting shares, and $375 for SJTC limited partnership units. The reported gifts totaled approximately $21.7 million. These values were prepared by a firm of independent valuation analysts.[4]

Upon audit, the Service disputed the fair market values assigned to the gifts by the taxpayer.

The values determined by the Service for the shares and limited partnership interests on a per share/unit basis were $1,395 for SSC voting shares, $1,325 for SSC nonvoting shares, and $2,511 for SJTC limited partnership units. The Service's values for the gifts totaled approximately $119.9 million. These values were prepared by firms of independent valuation analysts.

Mr. Jones died in 2014 and his estate representatives continued to pursue a resolution of the tax dispute. When the parties could not arrive at a negotiated resolution, the case went to trial in Tax Court in 2017.

For trial purposes, the taxpayer's attorneys retained Willamette Management Associates ("Willamette") to review and prepare de novo fair market value opinions for the subject interest. The fair market values estimated for the shares and limited partnership interests by Willamette on a per share/unit basis were $390 for SSC voting shares, $380 for SSC nonvoting shares, and $380 for SJTC partnership units. Thus, the taxpayer's reported gifts for trial purposes totaled approximately $23.9 million.[5]

The Service also retained new valuation analysts for the trial. One of the new Service experts submitted a revised valuation for the SJTC interests, increasing the value to $2,530 per unit.

The Service's new analysts did not prepare a new opinion of the value of the SSC shares, but only elected to prepare a rebuttal review of Willamette's SSC stock valuation report. As a result, the Service asserted a total value of approximately $120.5 million for the subject gifts.

Areas of Valuation Disputes and Expert Opinions

The primary areas in dispute regarding the valuation issues in the *Jones* case can be divided into six issues. As stated by Judge Pugh:

> The primary dispute between the parties is whether SJTC should be valued using an income approach or an asset-based approach. The parties have several other points of dispute: (1) the reliability of the 2009 revised projections, (2) the propriety of "tax-affecting", (3) the proper treatment of intercompany loans from SSC to SJTC, (4) the proper treatment of SSC's 10% general partner interest in SJTC, and (5) the appropriate discount for lack of marketability.

Both the Willamette expert opinions and the Service expert opinions for the value of the interests in the two companies are summarized below.

SJTC Valuation

The Willamette valuation variable inputs were as follows:

1. Intercompany loans offset as a clearing account
2. Income approach—discounted cash flow method
   a. Assumed income tax rate: 38 percent
   b. Discount rate: weighted average cost of capital ("WACC") of 13 percent
   c. Projections: five-year projection period prepared by management as of April 29, 2009
   d. Long-term growth rate: 3 percent
   e. Discounted cash flow indicated enterprise value: $75 million
   f. Weight assigned to this method: 65 percent
3. Market approach—guideline publicly traded company method
   a. Projections: five-year projection period prepared by management as of April 29, 2009
   b. Number of guideline public companies: 6
   c. Multiple selection: generally between the median and the low of the range
   d. Metrics receiving the greatest weight: historical and projected (i) EBITDDA (earnings before interest, taxes, depreciation, depletion, and amortization) and (ii) EBIT (earnings before interest and taxes), both at 30 percent
   e. Guideline publicly traded company method indicated enterprise value: $107 million
   f. Weight assigned to this method: 35 percent
4. Asset-based approach: not relied on
5. Third-party debt: $60 million
6. Pass-through entity benefit: 23 percent (relatively high percentage of earnings distributed)
7. Discount for lack of marketability: 35 percent

The Service valuation expert valuation variable inputs were as follows:

1. Intercompany loan treated as part of third-party debt: increases debt by $32.7 million
2. Income approach: not relied on
3. Market approach—guideline publicly traded company method

a. Projections: average of projections prepared by management as of fiscal year-end 2008 and as of April 29, 2009
b. Number of guideline publicly traded companies: 7 (with special emphasis on 5 with large log sales)
c. Multiple selection: slightly below the median
d. Metrics receiving the greatest weight: historical and projected EBITDDA at 100 percent
e. Guideline publicly traded company method indicated enterprise value: $97.4 million
f. Weight assigned to this method: 25 percent

4. Asset-based approach—adjusted net asset value method
    a. Adjusted net asset value: $332.7 million (timberlands increased from book value to appraised value based on a third-party real property appraisal)
    b. Discount for lack of control: 30 percent (sources listed below)
        i. Mergerstat
        ii. Partnership Profiles
        iii. Public company disclosures and analyst reports
    c. Adjusted net asset method indicated enterprise value: $232.9 million
    d. Weight assigned to this method: 75 percent
5. Third-party and related-party debt: $84.4 million
6. Pass-through entity tax benefit: no opinion offered; timberlands appraised using pretax income
7. Discount for lack of marketability: 30 percent

The SSC Valuation

The Willamette valuation variable inputs were as follows:

1. Intercompany loans offset as a clearing account
2. Income approach—discounted cash flow method
    a. Assumed income tax rate: 38 percent
    b. Discount rate: WACC of 16 percent
    c. Projections: five-year projection period prepared by management as of April 29, 2009
    d. Long-term growth rate: 3 percent
    e. Discounted cash flow indicated enterprise value: $27 million
    f. Weight assigned to this method: 65 percent
3. Market approach—guideline publicly traded company method
    a. Number of guideline publicly traded companies: 6
    b. Multiple selection: generally between the median and the low of the range
    c. Metrics receiving the greatest weight: historical and projected (i) EBITDDA and (ii) EBIT, both at 30 percent
    d. Guideline publicly traded company method indicated enterprise value: $47 million
    e. Weight assigned to this method: 35 percent
4. Asset-based approach: not relied on
5. Partnership income related to SJTC ownership interest: included in the SSC historical and projected cash flow
6. Third-party debt: $7.1 million
7. Pass-through entity benefit: 10 percent (relatively low percentage of earnings distributed)
8. Discount for lack of marketability: 35 percent
9. Discount for lack of voting rights: 3 percent

The Service valuation expert valuation variable inputs were as follows:

1. The previous Service independent expert valued the Class A voting stock at $1,395 per share and the Class B nonvoting stock at $1,325 per share. These values represented the Service position during audit negotiations.
2. The Service did not submit an expert valuation report for the Tax Court litigation phase of this matter. Rather, the Service had its new expert submit a review/rebuttal report that "corrected" what they regarded as the Willamette valuation errors.
3. These adjustments included the following:
    a. An upward adjustment to value for SSC's 10 percent ownership interest in SJTC of $28.8 million (based on the adjusted net asset value method less a 30 percent discount for lack of control)
    b. An upward adjustment to value for the $32.7 million intercompany receivable from SJTC

4. The resulting "corrections" increased the implied values to $1,310 per Class A voting share and $1,270 per Class B nonvoting share.
5. A 3 percent discount for lack of voting rights was applied by both valuation firms.

Income Valuation Approach versus Asset-Based Valuation Approach

Although there were a number of areas where the two experts differed in opinion, the issue with arguably the largest impact on value was the issue of applying an income valuation approach versus an asset-based valuation approach.

As noted above, the Service valuation expert used the adjusted net asset value method to value SJTC, relying on a real property appraisal of the timberland owned by the company and applying a discount for lack of control and discount for lack of marketability.

The Service valuation expert argued that an asset-based approach was more appropriate than an income approach for the following reasons:

1. SJTC was, in his opinion, a holding company and an income approach was less appropriate for valuing this type of entity.
2. The real property appraisal relied on in his application of the adjusted net asset value method utilized a form of income approach in estimating the value of the timberland.

Willamette offered the alternate position that an income approach was more appropriate than an asset-based approach to value the noncontrolling, nonmarketable ownership interests in SJTC.

Willamette offered the following reasons for its position:

1. SJTC was, in fact, an operating company that provided timber for processing in the SSC mills and the asset-based approach is often less applicable to the valuation of a noncontrolling, nonmarketable interest in an operating business enterprise than an income-based approach.
2. The asset-based approach assumes the sale of all company assets as of the valuation date. The subject interest was a noncontrolling ownership interest with no ability to initiate the sale of any of the subject company assets. Therefore, this valuation approach was not particularly relevant to a hypothetical buyer or a hypothetical seller of the subject interest.
3. SSC was the sole general partner of SJTC, and SSC executive management had exclusive control over the business and affairs of SJTC. SSC relied on SJTC as a primary supplier of the logs used in the SSC sawmills. Additionally, SSC relied on SJTC to secure short- and long-term debt financing for operations and major capital projects, by providing SJTC timberlands as collateral.

   Therefore, it is very unlikely that SSC would cause the liquidation of the SJTC assets as long as SSC operated as a going-concern business.

   Accordingly, it was an unreasonable assumption that a limited partner would be able to realize the underlying asset value of SJTC.
4. The discounted cash flow method would be particularly relevant to a hypothetical buyer of the subject interest because the projected cash flow of SJTC represented the most likely manner in which a noncontrolling ownership interest would realize a return on investment.

Willamette did not disagree that an asset-based valuation approach could be used to value SJTC with appropriate considerations and adjustments. Rather, the Willamette position was as follows:

1. The Service valuation expert did not apply the asset-based approach in a manner appropriate for the noncontrolling, nonmarketable ownership interest in SJTC.
2. An income valuation approach was more appropriate for the valuation of the noncontrolling, nonmarketable ownership interest in SJTC.

Is Tax-Affecting Appropriate?

One of the noteworthy issues in the *Jones* case was difference of opinion between the Service and Willamette regarding the appropriateness of tax-affecting the pass-through entity earnings.

The Willamette position was to treat the pass-through entities as C corporations from an income tax perspective, and then apply a premium to account for the value attributable to the subject entities' pass-through income tax status versus an otherwise comparable C corporation.

The Service position was that a 0 percent tax rate was appropriate for the valuation of the subject entities due to their pass-through income tax status.

The Willamette reasons for tax-affecting the pass-through entities' earnings included the following:

1. The discount rate relied on in the application of the income approach was an after-tax discount rate.
2. The pool of hypothetical buyers of a subject pass-through entity are often C corporations that would place little to no premium on a subject company's pass-through income tax status.
3. The entities did pay income taxes at the shareholder level (and, therefore, the subject entities did incur a tax expense in the form of distributions for shareholder income tax liabilities).

It was the Willamette position that the value impact of the pass-through income tax structure was related to the following:

1. The excess distributions above income tax liabilities that are not subject to taxation at the capital gains tax rate
2. Any premium that an acquiring company may pay for the entities' pass-through income tax status.

In the *Jones* case, the issue of tax-affecting was not debated between the Service expert and Willamette, but rather between the Service and Willamette.

Judge Pugh noted that "While respondent objects vociferously in his brief to petitioner's tax affecting, his experts are notably silent. . . . They do not offer any defense of respondent's proposed zero tax rate. Thus, we do not have a fight between valuation experts but a fight between lawyers."

The Court's Opinion on the Valuation Issues

The Tax Court agreed with the Willamette valuation inputs and assumptions in all material respects.

Judge Pugh noted that both parties did not dispute that SJTC and SSC were going concerns and were, for the most part, operating companies. On that point, the Tax Court stated:

> The likelihood that SJTC would sell its timberlands goes to the relative weight that we give an asset-based approach in valuing SJTC; the less likely SJTC is to sell its timberlands, the less weight we should assign to an asset-based approach. See *Estate of Giustina v. Commissioner*, 586 F. App'x 417, 418 (9th Cir. 2014) (holding that no weight should be given to an asset-based valuation because the assumption of an asset sale was a hypothetical scenario contrary to the evidence in the record), rev'g and remanding T.C. Memo. 2011-141, 2011 WL 2559847.

Because the Tax Court concluded that the interdependency of the companies should be considered in this case, and that the timberlands would not be sold for the foreseeable future (and could not be sold by the transferred noncontrolling interests), "We, therefore, conclude that an income-based approach, like Mr. Reilly's DCF method, is more appropriate for SJTC than Mr. Schwab's NAV method valuation. See *Estate of Giustina v. Commissioner*, 586 F. App'x at 418."

The reliability and usefulness of the most current projections as of the valuation date (updated projections as of April 29, 2009) was also upheld. These projections were prepared in the same manner as the projections presented in the 2008 annual report and reflected the most current conditions as of the valuation date. The updated projections were prepared in the regular course of business and updated due to the rapidly changing economic conditions at the time.

The Tax Court also agreed with the Willamette tax-affecting methodology which applied a premium for the tax advantages of the company's pass-through income tax status, stating, "We find on the record before us that Mr. Reilly has more accurately taken into account the tax consequences of SJTC's flow-through status for purposes of estimating what a willing buyer and willing seller might conclude regarding its value. His adjustments include a reduction in the total tax burden by imputing the burden of the current tax that an owner might owe on the entity's earnings and the benefit of a future dividend tax avoided that an owner might enjoy. . . . Mr. Reilly's tax-affecting may not be exact, but it is more complete and more convincing than respondent's zero tax rate."

The Tax Court confirmed that the proper treatment of the intercompany loans was to net them out, stating, "By eliminating SSC's receivable and SJTC's payable and treating their intercompany interest income and expense as operating income and expense, Mr. Reilly captured their relationship as interdependent parts of a single business enterprise."

The appropriate treatment of the SSC 10 percent ownership interest in SJTC using an income approach was affirmed by the Tax Court: "In this light we find Mr. Reilly's use of expected distributions to represent the value of the general partner interest to SSC to be reasonable. We, therefore, conclude that Mr. Reilly's treatment of SSC's 10% general partner interest in SJTC was appropriate."

The disagreement over the discount for lack of marketability was also resolved in the taxpayer's favor. The Tax Court concluded that the analysis was explained in sufficient detail and supported by calculations, references to empirical studies, and consideration of the impact of restrictions and other factors specific to the case, as discussed in *Mandelbaum*.[6]

Summary and Conclusion

The Tax Court took a significant step forward in validating a reasonably constructed and thorough analysis of tax-affecting cash flow under the income approach to value in the *Jones* case.

The Tax Court upheld the Willamette valuation of SJTC and SSC noncontrolling, nonmarketable private stock interests in all material respects.

Summarizing its findings, the Tax Court stated:

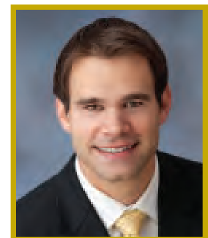
> We summarize our conclusions as follows. First, we do not accept Mr. Schwab's (the Service expert) NAV method for valuing SJTC because there was no likelihood of a sale of SJTC's timberlands and, thus, an asset-based approach was not appropriate for valuing SJTC. Second, we find that Mr. Reilly's use of the 2009 revised projections in his valuation of SJTC was proper. Third, we accept Mr. Reilly's tax-affecting in his valuations of SJTC and SSC as more accurate than respondent's blunt zero-rate approach. Fourth, we conclude that Mr. Reilly properly treated the intercompany loans from SSC to SJTC and SSC's 10% general partner interest in SJTC as operating assets. And finally, we find that Mr. Reilly's discount for lack of marketability was reasonable.

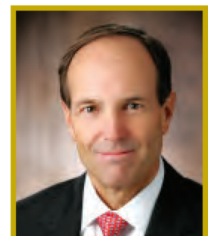
This type of decision signals that the federal courts will accept the best analysis, even if it goes against the judicial findings of other cases.

The Tax Court underlined this position by saying, "And as we admonished in *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. at 452, 'in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach.'"

Notes:

1. Gross v. Commissioner, TCM 1999-254, aff'd. 272 F.3d 333 (6th Cir. 2001).
2. Estate of Aaron U. Jones, Donor, Deceased, Rebecca L. Jones and Dale A. Riddle, Personal Representatives v. Commissioner of Internal Revenue, T.C. Memo 2019-101 (Aug. 19, 2019).
3. Kress v. United States, --- F Supp.3d ---, 2019 WL 1352944 (E.D. Wis. Mar. 26, 2019).
4. The taxpayer reported lower values than those determined by its original appraiser for the SSC nonvoting shares and the SJTC units. Willamette Management Associates was not the appraiser that performed the valuation for the original gift tax return.
5. The taxpayer chose not to dispute the Service's higher value assigned to another, smaller closely held company stock gift.
6. Mandelbaum v. Commissioner, T.C. Memo. 1995-255, aff'd, 91 F.3d 124 (3d Cir. 1996).





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On Our Website

Recent Articles and Presentations

Kyle Wishing and Ben Duffy, managers in our Atlanta office, authored a two-part article that was published in the October 23, 2019, and October 30, 2019, issues of NACVA QuickRead. The title of Kyle and Ben's article is "Confronting Behavior Bias—Parts I and II."

Kyle and Ben's article explores the review and assessment of financial projections that are prepared as part of a corporate transaction. They draw from various aspects of behavioral finance in order to improve the due diligence review of financial projections. Kyle and Ben's article provides a road map for fiduciaries and financial advisers to discover potential forms of bias in financial projections. Common forms of bias are examined and due diligence questions are provided. In part II, Kyle and Ben discuss company-specific considerations related to financial projections.

Robert Reilly, a managing director of our firm, and Casey Karlsen, a senior valuation analyst with Berry Dunn, authored a two-part article that was published in the Summer 2019 and Autumn 2019 issues of the *American Journal of Family Law*. The title of Robert and Casey's article is "Intellectual Property Valuations for Family Law Purposes—Parts I and II."

The valuation of intellectual property is often an issue in family law matters. There are three generally accepted approaches to the valuation of intellectual property. Robert and Casey's article focuses on the market approach to valuation, and specifically on the relief from royalty valuation method. They review common royalty rate data sources. Robert and Casey also discuss normalization adjustments to royalty rate data. Finally, their articles provide an illustrative example of an intellectual property valuation analysis.

Kyle Wishing, a manager in our Atlanta office, and Seth Webber, a principal with BerryDunn, delivered a presentation on November 15, 2019, at the Employee Owned 2019 Conference which was held in Las Vegas. The conference is sponsored by the ESOP Association. The title of Kyle and Seth's presentation was "Tips for Reviewing Management's Financial Projections."

Kyle and Seth discuss the importance of financial projections and common methods applied in the preparation of projections. They then explore common tools that analysts apply to review projections. These tools include common-sized financial statements, ratio analyses, industry benchmarks, and comparison to prior projections. Kyle and Seth also discuss behavioral considerations, including common types of behavioral bias.

John Kirkland, an associate in our Atlanta office, and Nicholas Henriquez authored a two-part article that was published in the December 4, 2019, and December 11, 2019, issues of NACVA QuickRead. The title of John and Nicholas's article is "The Cost of Equity Capital—Parts I and II."

In Part I of their article, John and Nicholas summarize the cost of equity capital measurement process. They then explore the capital asset pricing model, the modified capital asset pricing model, and the build-up model. In Part II of their article, John and Nicholas describe some of the issues related to the cost of equity capital. Some of these issues are controversial in the valuation profession. Issues discussed in this article include the size risk premium, the company-specific risk premium, the market-derived equity risk premium, and the industry risk premium. They also examine the process of selecting guideline publicly traded companies to use for the beta measurement.

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the Fall 2019 edition of the *American Journal of Family Law*. The title of that article was "Intellectual Property Valuations for Family Law Purposes: Part II of II." Part I of that article appeared in the *Journal's* Summer 2019 issue.

Robert Reilly authored an article that appeared in the September/October 2019 issue of *Construction Accounting and Taxation*. The title of that article was "Consider the Sale of the Company to an Employee Stock Ownership Plan."

Robert Reilly had an article republished as a feature article in the online publication at www.quickreadbuzz.com sponsored by the National Association of Certified Valuators and Analysts ("NACVA") on October 9, 2019. That article was titled "Discounts for Lack of Marketability: Consideration for Closely Held Securities, Part I of II." The article originally appeared in the July 13, 2016, issue of quickreadbuzz.com.

Brandon McFarland, Atlanta office senior associate, had a two-part article published in the online publication at www.quickreadbuzz.com sponsored by NACVA. The title of that article was "The Treatment of Synergistic Value in Dissenting Shareholder Appraisal Rights Matters." Part I of that article appeared in their October 2, 2019, issue, and Part II appeared in their October 9, 2019, issue.

Kyle Wishing and Ben Duffy, both Atlanta office managers, also had a two-part article published at www.quickreadbuzz.com. The title of that article was "Confronting Behavior Bias." Part I of that article appeared in their October 23, 2019, issue, and Part II appeared in their October 30, 2019, issue.

In Person

Robert Reilly, firm managing director, and Matt Courtnage, Portland, Oregon, office manager, delivered a continuing education webinar on November 19, 2019. The topic of the webinar was "Valuation of Intangible Assets for Property Tax Purposes."

Robert Reilly and Nate Novak, Chicago office vice president, delivered a webinar for Business Valuation Resources on November 26, 2019. The topic of their presentation was "Application of the Cost Approach to Valuing Identifiable Intangible Assets."

Robert Reilly and Weston Kirk, Atlanta office vice president, will deliver a Business Valuation Resources webinar on January 9, 2020. The topic of their presentation will be "Applications of the Asset-Based Approach to Value Operating Businesses."

Curtis Kimball, Atlanta office managing director, and Scott Miller, Portland office vice president, delivered a continuing education webinar on September 26, 2019. The title of that presentation was "Tax-Affecting and Other Valuation Issues Affecting Pass-Throughs after *Estate of Aaron Jones v. Commissioner*, T.C. Memo. 2019-101."

Kevin Zanni, Chicago office managing director, delivered a presentation on October 1, 2019, in Columbus, Ohio, to the J.P. Morgan Closely Held Asset Management Group. The title of Kevin's presentation was "Valuation Methodology Pitfalls, Valuation Due Diligence Best Practices, and *Estate of Aaron U. Jones v. Commissioner*."

Kyle Wishing, Atlanta office manager, delivered a presentation at the "Employee Owned 2019" ESOP Association conference in Las Vegas on November 15, 2019. The topic of Kyle's presentation was "Tips for Reviewing Management's Financial Projections."

Encomium

Kevin Zanni, Chicago office managing director, was appointed to the American Institute of Certified Public Accountants ("AICPA") SSVS/IVS Bridge Task Force that reports to the AICPA Forensic and Valuation Services Executive Committee.

Fady Bebawy, Chicago office vice president, recently earned the accredited senior appraiser ("ASA") in business valuation professional designation from the American Society of Appraisers.

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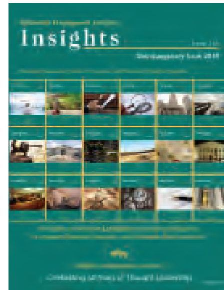

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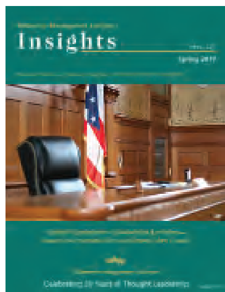

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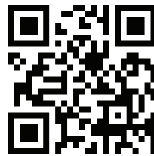

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Willamette Management Associates provides thought leadership in business valuation, forensic analysis, and financial opinion services. Our professional services include: business and intangible asset valuation, intellectual property valuation and royalty rate analysis, intercompany transfer price analysis, forensic analysis and expert testimony, transaction fairness opinions and solvency opinions, reasonableness of compensation analysis, lost profits and economic damages analysis, economic event analysis, M&A financial adviser and due diligence services, and ESOP financial adviser and adequate consideration opinions.

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Our industrial and commercial clients range from substantial family-owned companies to Fortune 500 multinational corporations. We also serve financial institutions and financial intermediaries, governmental and regulatory agencies, fiduciaries and financial advisers, accountants and auditors, and the legal profession.

For 50 years, Willamette Management Associates analysts have applied their experience, creativity, and responsiveness to each client engagement. And, our analysts are continue to provide thought leadership—by delivering the highest level of professional service in every client engagement.

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