A Primer on Valuation Considerations in Bankruptcy

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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

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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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