

A Bankruptcy Perspective in Valuation Engagements – In Good Times and in Bad Times

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Introduction

- The volume of corporate bankruptcy filings has increased materially during the recent economic downturn; however, valuation analysts should be mindful of bankruptcy considerations in the valuation of both financially troubled and financially sound companies
- Bankruptcy is a very technical legal discipline. This Webinar will not present legal instruction. Instead, this Webinar will focus on:
 - how attorneys can use valuation analysts to achieve the client’s legal objectives
 - how valuation analysts can assist attorneys to achieve the client’s legal objectives
- Bankruptcy considerations (and bankruptcy valuation analyses) do not always involve litigation—or even bankruptcy filings
- Webinar participants should listen for:
 - how can I better serve my financially troubled clients?
 - how can I expand my valuation practice to provide a more complete array of valuation services to debtors, to creditors, and to the legal profession?

Discussion Outline

- The valuation analyst's role in bankruptcy matters
- Valuation analyses performed before the bankruptcy filing
- Valuation analyses performed during the bankruptcy filing
- Valuation analyses performed after the bankruptcy filing
- Income tax considerations impact on the proposed plan of reorganization and on other valuation analyses
- Valuation analyst caveats within the bankruptcy environment
- Summary, conclusion, and discussion

Valuation Analyst's Role in Bankruptcy Matters

- Advise the debtor company before the bankruptcy related to:
 - solvency and/or insolvency analyses on certain transaction dates
 - solvency and/or insolvency analyses on certain pre-filing dates
 - solvency and/or insolvency analyses on the bankruptcy filing date
 - how to measure and monitor the “zone of insolvency”
 - avoidance of potential fraudulent transfers
 - creditors' collateral values

Valuation Analyst's Role in Bankruptcy Matters (cont.)

- Advise the debtor company during the bankruptcy related to:
 - income tax attribute considerations
 - creditors' collateral values
 - analysis of creditors' interests
 - fairness of DIP transactions (e.g., spinoff opportunities) to various constituencies
 - liquidation and/or reorganization analyses
 - assessment if the proposed reorganization plan is “fair and equitable”
 - assessment of the reorganization plan feasibility
 - inconsequential value of DIP assets
 - collateral values for DIP financing purposes

Valuation Analyst's Role in Bankruptcy Matters (cont.)

- Advise the debtor company after the bankruptcy protection related to:
 - fair value accounting asset and business valuation issues
 - income tax attribute protection and valuation issues

Valuation Analyst's Role in Bankruptcy Matters (cont.)

- The valuation analyst/financial adviser may serve debtors, creditors, and legal counsel as either:
 - a consulting expert
 - a testifying expert
- Be aware of (1) which of these two roles you have and (2) when (or if) your role has changed (e.g., be aware of the “creeping commitment”)
- Also, be aware of when you act as a valuation analyst (and should comply with AICPA SSVS No. 1) and when you act as a financial analyst (and are exempt from the SSVS)

Valuation Analyst's Possible Alternative Clients in the Bankruptcy Matter

- There are often numerous parties involved in a bankruptcy, including the many debtor company “constituents”
- These parties often have differing interests and differing objectives
- The valuation analyst potential clients include:
 - debtor corporation (pre-filing)
 - debtor in possession (post-filing)
 - secured creditors (Individually or as committee)
 - unsecured creditors (committee)
 - DIP insiders
 - DIP shareholders (different classes)
 - parties that did/will transact with the DIP
 - DIP financing institutions
 - other DIP constituencies
 - the bankruptcy court and/or bankruptcy trustee

Valuation Analyses Performed Before the Bankruptcy Filing

- Providing corporate transaction opinions
 - Advising the boards of both financially troubled and financially sound companies
 - Analyzing proposed merger/acquisition, dividend, executive bonus, financing, and restructuring transactions
 - Performing fairness opinions
 - Absolute fairness of the transaction price and terms
 - Relative fairness of the transaction price and terms
 - Both from a financial point of view
 - Performing solvency opinions
 - Assets exceed liabilities on a fair value basis
 - Debtor company can meet its debt service obligations
 - Debtor company has adequate short-term liquidity
- Advising the debtor company board/management regarding “zone of insolvency” asset and equity values
- These transaction analyses provide a defense to fraudulent conveyance, preferential debt payment, preferential transfer, and other allegations

Determining the Debtor Company Solvency or Insolvency

- Related to preference item and/or fraudulent conveyance claims
- Valuation considerations
 - Similar to the “zone of insolvency,” the solvency/insolvency analysis may be performed over a period of time during which the transfers or preferences are alleged to have been made
 - All assets and all liabilities should be valued to determine whether the debtor company was solvent or insolvent at a specific point in time
 - Solvency/insolvency analyses include all recorded assets and liabilities and all unrecorded intangible assets and (typically) contingent liabilities

Determining the Debtor Company Solvency or Insolvency (cont.)

- Other valuation considerations
 - The solvency/insolvency analyses typically will rely principally on an income approach analysis, and, therefore, on cash flow projections
 - When assessing the solvency of a proposed reorganization plan, the analyst should consider whether or not the elements of the reorganization plan, represented by the cash flow projections, can be reasonably attained
 - In all solvency analyses, the cash flow projections are important, and the analyst should test whether they are credible and supported
 - The analyst should take into account all aspects of the reorganization plan
 - Income tax issues (including NOL use, asset basis adjustments, future income taxes, etc.) are often important to the solvency analysis

Valuation Analyses Performed During the Bankruptcy Filing—Valuation of a Secured Creditor's Collateral

- Valuation of assets, properties, or business interests that serve as creditor's collateral for purposes of:
 - Adequate protection of any creditor security interests
 - Splitting under-secured creditor claims
 - Relief from any court-ordered stay
- Valuation issues
 - Does the debtor entity have no equity value?
 - Is the collateral property needed by the debtor entity?
 - What is the appropriate standard of value and premise of value?

Valuation Analyses Performed During the Bankruptcy Filing—Fairness of Corporate Transactions During the Bankruptcy

- Debtor in possession (DIP) transactions that may occur during bankruptcy:
 - Purchase or sale of a DIP business unit (e.g., subsidiary, line of business)
 - Sale or license of a DIP intellectual property
 - Transfers of assets or business units to/from a related party (e.g., shareholders, managers, directors)
- Fairness of the proposed DIP transaction to:
 - Individual creditors
 - All creditors
 - Other parties
- Valuation issues:
 - Fairness to whom?
 - What is the Appropriate standard of value and premise of value?
 - What is the highest and best use (HABU) of the transaction property?

Valuation Analyses Performed During the Bankruptcy—Valuation of Reorganized Debtor Securities

- The debtor entity may be a C corporation, S corporation, LLC, LLP, etc.
- The debtor securities may include equity securities (common, preferred, convertible) and debt securities (straight, convertible)
- The debtor securities may be issued to:
 - a creditor or creditor class as part of the reorganization
 - the DIP employees as part of a key employee compensation plan
- The debtor securities valuation considerations:
 - What are all the rights and features of the DIP securities?
 - What is the appropriate standard of value and premise of value?
 - What is the appropriate DIP HABU?
 - The analysis should consider both the bankruptcy period and the post-bankruptcy results of operations
 - The analysis may include fairness considerations

Advising the Debtor Entity Board of Directors Regarding the “Zone of Insolvency”

- Related to Financially Sound Companies –
 - In a troubled economy, even a financially sound debtor company can approach insolvency quickly and without warning
 - The “best practice” that can be performed in such a situation is for the attorney and the valuation analyst to conduct client training on (1) the meaning of the “zone of insolvency” and (2) the meaning of “insolvent” from a valuation/bankruptcy perspective

Advising the Debtor Entity Board of Directors Regarding the “Zone of Insolvency” (cont.)

- Related to Financially Troubled Companies –
 - A financially troubled debtor company could be slipping in and out of insolvency on a daily—or even an hourly—basis
 - The debtor company board should be well versed from the lawyer and the valuation analyst on what the “zone of insolvency” means
 - There should be mechanisms set up at the debtor company to monitor the solvency situation
 - The board should be educated as to who are the other “constituencies” who should be considered (e.g. creditors) if the company enters the “zone of insolvency”

Advising the Debtor Entity Board of Directors Regarding the “Zone of Insolvency” (cont.)

- Legal considerations regarding zone of insolvency analyses
 - Setting up a mechanism to track the debtor company “zone of insolvency”
 - Developing a debtor company policy on the due care of the various “constituencies” when the zone of insolvency is entered
 - Balancing of the “business judgment rule” to the interest of the various debtor company constituencies (e.g., equity owners, creditors, employees, etc.)

Advising the Debtor Entity Board of Directors Regarding the “Zone of Insolvency” (cont.)

- Valuation considerations regarding the “zone of insolvency”
 - A valuation is performed as of a specific point in time
 - How do you monitor the almost infinite points in time related to an insolvency?
 - Setting up a system for monitoring debtor company value on an ongoing basis
 - What is a reasonable expectation of monitoring debtor company value in an insolvency environment?
 - Which asset balances and values change quickly—and which do not?

Determining Debtor Company Insolvency

(e.g., related to preference items and/or fraudulent conveyance)

- Valuation considerations
 - Similar to the situation in the “zone of insolvency”, an analysis likely may be performed for a range of time during which the transfers or preferences are alleged to have been made
 - All assets and all liabilities should be valued to determine whether the debtor company was insolvent at a point in time
 - Includes all “recorded” assets and liabilities and all assets and liabilities that are not recorded for GAAP reporting purposes

Assessing the Proposed Plan of Reorganization

(e.g., is the plan fair and equitable to the creditors; is the plan feasible?)

- Valuation considerations
 - The analysis most likely will be based on a set of cash flow projections
 - Instead of arriving at a value of the reorganized business, the analyst is really giving an opinion on whether or not the elements of the proposed reorganization plan, represented by the cash flow projections, can be reasonably attained
 - Therefore, the cash flow projection assumptions are extremely important, and the analyst should be assured that they are reasonably supported
 - The analyst should take into account all aspects of the proposed reorganization plan
 - Income tax issues (including the use of NOLs, asset basis adjustments, future income taxes, etc.) are often important
 - Since the cash flow projections are not discounted in the reorganization plan assessment, it is not possible to take into account non-attainment risk in the selected discount rate. **So, once again, an assessment of the cash flow projection assumptions is important**

Common Valuation Services After the Bankruptcy

- ASC Section 852-10* Fresh-start Accounting Valuations
 - ASC Section 852-10 established criteria allowing for an emerging company to use “fresh start accounting” under certain circumstances.
 - First, there should be a change in control in the voting shares immediately after the reorganization plan confirmation. This means that existing shareholders prior to confirmation should receive less than 50% of the voting shares after confirmation.
 - Second, the valuation analyst should calculate the reorganization value of the assets and compare that value to the total of their post-petition liabilities and allowed claims. If the reorganization value of the assets is less than the total value of the post-petition liabilities, then the debtor company qualifies for fresh start accounting.

*ASC Section 852-10 used to be AICPA SOP 90-7.

Source: Association of Insolvency & Restructuring Advisors, **SOP 90-7: The Basics** written by Sean Raquet, CPA, CFE, October/November 2008

Common Valuation Services After the Bankruptcy

- ASC Section 852-10 Fresh-start Accounting Valuation
 - In theory, fresh start accounting provides the emerging entity with the opportunity to reflect its assets at fair value upon the reorganization plan confirmation. This fair value presentation is more meaningful to financial statement users than the presentation of assets and liabilities at historical cost. By allowing the emerging entity to state its assets and liabilities at fair value, its post-bankruptcy financial position is presented more fairly.

*ASC Section 852-10 used to be AICPA SOP 90-7.

Source: Association of Insolvency & Restructuring Advisors, *SOP 90-7: The Basics* written by Sean Raquet, CPA, CFE, October/November 2008

Common Valuation Services After the Bankruptcy

- ASC Section 852-10 Fresh-start Accounting Valuation Summary
 - The valuation analyst can be an integral and necessary part of the team to estimate the fair value of the reorganized company assets under ASC Section 852-10 “fresh start” accounting.

*ASC Section 852-10 used to be AICPA SOP 90-7.

Source: Association of Insolvency & Restructuring Advisors, **SOP 90-7: The Basics** written by Sean Raquet, CPA, CFE, October/November 2008

Internal Revenue Code Section 382

Tax Attribute Considerations

- IRC Section 382 limits the amount of the net operating loss (NOL) that can be used after an entity ownership change occurs
 - This is a complicated IRC section to plan for and to comply with
 - Section 382 applies after a 50% change in ownership
 - Section 382 limits the NOL tax attribute use to the product of (1) the taxpayer company value multiplied by (2) the statutory tax exempt interest rate
- IRC Section 383 provides the same post-ownership change use limitation for most income tax credits (e.g., the R&D tax credit)

IRS Section 382 Planning Considerations

- Section 382 (l)(5) allows for the election out of Section 382 treatment within a Chapter 11 bankruptcy filing
 - The ownership change of 50% or more must be due to the Chapter 11 restructuring
 - The reorganized company must continue the taxpayer business enterprise operations for two years after the election
 - The reorganized company must not have another Section 382 ownership change for two years after the election
 - The taxpayer company must “recapture” all of the interest expense that was deducted for the past three years (which effectively lowers the amount of the NOL that is carried forward)

IRS Section 382 Planning Considerations

- If there is (1) no two-year continuity of taxpayer, business enterprise operations or (2) another change in ownership of the reorganized taxpayer company within two years, then:
 - The Section 382 limitation effectively becomes zero and the utilization of the NOL tax attribute is lost
 - Accordingly, post-bankruptcy income tax planning regarding the carryover of tax attributes is important
 - Any potential DIP/reorganized company acquirer must be comfortable with (1) the two-year reorganized company holding period and (2) the two-year extended exit strategy

Built-in Gains Tax Considerations

- In the case of a Section 382 election, the valuation of the debtor corporation enterprise is encouraged (Remember: the NOL use limit is the company value times the tax exempt interest rate)
 - It is important to identify any built-in gains that the NOL tax attribute can be used against
 - This identification will increase the amount of the Section 382 limitation

Valuation Analyst Caveats in the Bankruptcy Environment

- There may be no market for the subject debtor company assets or securities.
- Therefore, the analyst may have to conceptualize a market for the subject debtor company assets or securities.
- There are often technical legal issues involved in bankruptcy matters. Don't hesitate to ask the client's legal counsel for legal instructions.
- Don't reach legal conclusions as part of the valuation, fairness, or solvency analyses. That is the lawyer's job.
- Most bankruptcy valuation and solvency analyses rely principally on financial projections. The DIP/reorganized company financial projections should be subject to rigorous due diligence.
- Parties in interest typically have adverse interests. Therefore, the valuation analyst may receive biased or incomplete data—including from the client and the client's legal counsel.
- The debtor company operations will be different after the bankruptcy-compared to during the bankruptcy. That fact may affect the reorganized company asset and equity values.

Valuation Analyst Caveats in the Bankruptcy Environment (cont.)

- The selected standard of value and premise of value (and the related HABU conclusion) can significantly affect the asset and equity value conclusions.
- Be aware of the differing roles of the valuation analyst/financial adviser as (1) a valuation analyst (with SSVS compliance) versus a financial adviser (exempt from SSVS) and as (2) a consulting expert versus a testifying expert.
- Income tax considerations can materially affect both the DIP and the reorganized company asset values and equity values. Don't hesitate to ask for income tax advice or income tax instructions from bankruptcy and/or tax legal counsel.
- From the bankruptcy perspective, there is more to the valuation analyst's role than just providing value opinions. The valuation analyst is often a financial adviser, opining on transactional fairness and/or debtor company solvency/insolvency issues.

Summary and Conclusion

- There are numerous reasons to perform valuation services before, during, and after the bankruptcy filing.
- Some of the most important valuation analyst services involve advising debtor companies (including corporate directors) so as to avoid bankruptcy proceedings.
- Valuation clients can include the debtor company, the DIP, a creditor or creditor classes, insider/independent parties who will/did transact with the debtor, legal counsel for these parties, the bankruptcy trustee, and others.
- The CPA can serve a valuation analyst, a financial advisor, a consulting expert, or a testifying expert in bankruptcy matters.
- The valuation analyst who practices in this area should learn the bankruptcy jargon and other technical (including taxation) issues.
- Questions and discussion.

Thank you for your time!

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