

Valuation Issues in the Bankruptcy Process

When it comes to business bankruptcies, the numbers seem to loom larger with every year. From 2005 through 2008, annual business bankruptcies increased by over 200%. In the years 2009 and 2010, business bankruptcies were more than double for the years 2006 and 2007.

We have seen bankruptcy filings from businesses with long histories such as the 163-year-old Tribune Company, or, more recently, younger companies as Blockbuster, whose goal is to cut its debts from \$900 million to \$100 million, and Circuit City, which seems to be finding a second life online of late. No matter what the size of the company or its reputation, however, valuation plays a key role in the bankruptcy process; and, inevitably, valuation issues will arise.

These issues pervade throughout the entire bankruptcy process--and impact each of the stakeholders along the way. While it is the attorney's job to reach legal conclusions as part of the valuation, fairness or solvency analyses, the valuation analyst may serve debtors, creditors and legal counsel as either a consulting expert or a testifying expert. Whether a valuation expert uses one or all three of the accepted methodologies—the income approach, the sales or company comparison approach, or the cost approach—they are influenced by data and assumptions used under the formulas.

A company typically elects to file for bankruptcy under Chapter 7 of the Code when continued business operations cannot be supported by the income the company is generating. If a company does elect to file a Chapter 7 bankruptcy petition, a trustee is appointed and the debtor then discontinues its operations and all assets are liquidated on an orderly basis. The proceeds are subsequently distributed to the claimholders and creditors in order of priority.

Valuation issues can range from asset/collateral matters, to disputes as to the true value of a business as a whole entity, to fairness issues related to the valuation of securities and cash flow streams being proposed to settle the claims of various stakeholders. What are some of the most common valuation issues in bankruptcy? A few that come to mind are:

- Distressed companies will often defer necessary expenditures that cause a reorganized company to catch up to retain a competitive position.
- If a recent downturn was caused by a low point in a “cyclical” industry, attorneys and valuation experts need to carefully consider the timing and magnitude of an uptick.
- Working capital deficits are common as accounts payable days lengthen;
- Restructuring professional fees can impact significantly on a company's cash flows;
- When there is operational restructuring, severance and costs of closing a business' locations need to be carefully considered.

Working in tandem, counsel and the valuation analyst should be aware of the nuances in market transaction method valuation. For instance, to the extent that financial distress in an industry has been caused by “inflated acquisition multiples,” then great caution should be employed in relying upon such market data.

In addition, it is very important for the analyst to adjust debt to market value in calculating numerator of multiples; to consider that the stock values of distressed companies may not be meaningful; and to utilize “debt-free” market multiples to mitigate the impact different capital structures can have on valuation.

It is the expert’s responsibility to determine the current value of a business’s collateral, as well as determining the extent to which the collateral has recently declined in value or will likely decline in value in the future. In addressing the valuation issues in this regard, a going concern premise of value is typically assumed, unless the subject company is not expected to reorganize. Depending on the facts and circumstances of each situation, all traditional valuation methods should be considered.

In an economic downturn where even venerable, financially sound businesses can approach insolvency, it is important for valuation experts to capably assist attorneys—especially those with a broad range of legal expertise-- in resolving challenging valuation issues, and successfully meeting clients’ objectives in the bankruptcy process.

For more information about MSG’s business valuation, forensic accounting and litigation support services, please visit our web site www.msgcpa.com.