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Valuation Issues in Bankruptcy: Signs of the Times

In continuing tight economic times, bankruptcy is a more common concern than it was during the roaring '90s. And bankruptcy raises a number of valuation issues.

Two types of values must be determined in association with bankruptcy proceedings: reorganization value and liquidation value.

Reorganization value is the going concern value of a company coming out of bankruptcy. Determining an accurate reorganization value is a key component of complying with the "fresh-start" financial reporting required of companies emerging from bankruptcy.

Liquidation value is the value that would result from the orderly liquidation of a bankrupt company's assets. An accurate liquidation valuation is a starting point for any bankruptcy proceeding.

Before a bankruptcy court can confirm a reorganization plan under Chapter 11, the court must determine that the plan would recover amounts for the creditors and equity holders at least equal to what they would likely receive under a Chapter 7 liquidation. Thus, a liquidation value should be determined in every Chapter 11 filing.

Liquidation Value

The liquidation value of larger entities may be based on the assumption of the sale of the entity or major segments of the entity, the sale of individual assets, or, more likely, some combination of both. For smaller entities, however, liquidation value is generally the discounted value of assets plus cash less liquidation costs.

Determining liquidation value may seem like more of an appraisal than a valuation, and appraisers are likely to play a key role. The valuation professional, however, still must make a number of key judgments to deliver an appropriate value.

Take estimating liquidation costs, for example. These costs can be considerable.

and could include:

- Various legal and professional fees
- Projected operating costs during the liquidation period
- Expenses associated with employee terminations such as severance payments
- Taxes on gains when the assets are sold
- Potential costs associated with leases or other contracts

The valuation professional also must consider a variety of other potential concerns. Will the entity be able to retain key personnel through the liquidation process? If not, how will their loss affect the wind-down operation? Will the company be able to manage an orderly liquidation, or will it be forced into a "fire sale?"

Reorganization Value

Reorganization value is determined using the same valuation methodologies employed outside of bankruptcy. The challenge for the valuation professional is predicting the future without having a reliable past on which to base it. Obviously, this means increased risk, which affects discount decisions.

Valuation professionals can look at a number of factors to most accurately gauge that risk. Has the company been able to attract and retain the managerial talent necessary to make the reorganization plan work? Are key customers and vendors still willing to work with the company — and to work with it on acceptable terms? Are there systemic weaknesses in the company's industry or market segment, and what plans does the company have to address them?

Tough questions, and without easy answers. With many companies continuing to struggle, however, understanding the valuation issues involved in bankruptcy is more important than ever.