AMERICAN BANKRUPTCY INSTITUTE

2018 Winter Leadership Conference

# Business Valuations 101


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CONCURRENT SESSION

2018

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## Business Valuations 101 – "What is my Balance?"

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## Case Summary

CASE SUMMARY

## WidgetCo – Seller of the Finest Widgets in the Land

Once upon a time … there was a Debtor in Debtorsville who made the finest widgets in the land. For many years, times were good for WidgetCo. It enjoyed growing revenues and solid profit margins, and expanded its operations to meet the rising demand.

Then things changed. The original designer of the widget developed a new, improved, and lower cost widget, Widget 2.0, and issued a production license to an offshore company. On January 1, 2017, Widget 2.0 became available in Debtorsville.

- Suddenly, WidgetCo had serious competition and serious problems. Most customers preferred Widget 2.0 over Widget 1.0 and there was little WidgetCo could do to retain its customers. Demand for Widget 1.0 plummeted. TBD
- By September 2017, WidgetCo projected year-end sales of only 800,000 units compared to 1,000,000 units in 2016, even though WidgetCo cut prices from $1.00 to $0.75 per widget in an effort to maintain its customer base.
- After its fixed costs, WidgetCo would lose $200,000 in 2017.



CASE SUMMARY

WidgetCo – Seller of the Finest Widgets in the Land

### Other Notable Issues

- WidgetCo operates out of one-half of the building it owns and leases the second half to a tenant who pays WidgetCo monthly rent of $10,000
- WidgetCo currently has all of its cash accounts and loans with Tightwad Bank, which include a mortgage loan on the building of $1,000,000, with an above-market interest rate; a fully drawn $250,000 unsecured line of credit; and $250,000 in cash. The mortgage loan matures on December 31, 2027 and provides for a four percent prepayment premium.
- Tightwad Bank's debt is secured by a mortgage lien, UCC liens on all assets, a deposit account control agreement, and an assignment of rents. The assignment of rents purports to be "an absolute assignment, subject to a license back to the borrower to use the rents until the occurrence of an Event of Default."
- Tightwad Bank has an appraisal showing that the mortgage loan is oversecured. WidgetCo has an appraisal showing that the mortgage loan is undersecured, though it has not shared that appraisal with Tightwad Bank because it does not want exacerbate the Bank's concern. In reality, because of some pending zoning regulations, and for other reasons, the value of the building is unclear and subject to change.
- On October 30, 2017, Widget Co fails to make payments due under the mortgage and the line of credit.
- On November 15, 2017, Tightwad Bank issues WidgetCo a notice of default, accelerates the debts, and invokes the note's default interest rate of 15%
- On December 1, 2017, after an arduous meeting between WidgetCo's Board of Directors and Tightwad Bank's officers, the Board hires Attorney Mike Marsupial, pays him (from the bank's cash collateral) a $100,000 retainer and instructs him to file a Ch. 11 bankruptcy petition on its behalf.
- The silver lining for WidgetCo is that many of its customers simply cannot convert to using Widget 2.0 without the significant cost of redesigning their own production facilities. WidgetCo has hired a top notch financial advisory firm, TopNotch FA's, to help it formulate a restructuring plan. Tightwad has hired HugelyExpensive FA's to help it review WidgetCo's Plan.

CASE SUMMARY

## WidgetCo – Seller of the Finest Widgets in the Land

### The Bankruptcy Filing

- A voluntary chapter 11 petition is filed on December 13, 2017. WidgetCo files a first-day motion for authority to use cash collateral. It offers Tightwad Bank a replacement lien as the sole form of adequate protection. Tightwad Bank, objects, seeking cash adequate protection payments of $25,000 per month, as additional adequate protection. In addition, the Bank demands payment of postpetition interest, every month, at the default rate, plus reimbursement of the Bank's postpetition legal fees.
- To establish its entitlement to postpetition interest and fees, the Bank files a motion under FRBP 3012 to value its collateral. (In a privileged memorandum, Tightwad Bank's counsel advises the Bank that while its right to receive postpetition interest is dependent upon its being oversecured, it may later want to take the position that it is undersecured, to increase the likelihood that it can get stay relief or defeat plan confirmation -- but the Bank is anxious to get postpetition interest, and the loan officer is anxious to show that he obtained adequate collateral -- so the Bank is inclined to persist in making a case that it is oversecured).
- WidgetCo opposes the Bank's request for an early valuation hearing, as a distraction and a waste of resources. It contends that, whatever the collateral value is, it is not declining postpetition, so a replacement lien is sufficient adequate protection. And it says the issue of postpetition interest can be deferred, since in any event -- even if the Bank were oversecured -- the Debtor would not be required to pay that interest on a current basis.
- The Court sets a first day hearing for December 15, 2017, Counsel for the Bank and counsel for the Debteor, Mr. Marsupial, schedule a meeting for December 14, to see what issues they might be able to resolve.



## Oversecured or Undersecured?

## 11 U.S.C. § 506 – Determination of Secured Status

(a)(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. *Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property . . . .*

- Section 506 contemplates bifurcation of allowed claims into secured and unsecured components based on property value
- Value not defined; method of valuation not provided; timing not specified
- Courts must consider purpose of valuation (plan, sale, relief from stay, adequate protection, etc.) and proposed disposition or use of property (retain and use or sell)

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## Assocs. Commercial Corp. v. Rash, 520 U.S. 953 (1997)

Issue: Proper method of valuation where debtor proposed to retain and use collateral and to "cram down" creditor's secured claim to the value of collateral.

Holding: "[T]he value of the property (and thus the amount of the secured claim under § 506(a)) is the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller", i.e., "replacement value"

- Replacement value accurately reflects debtor's continued use of the property and adequately compensates the secured creditor for the additional risks imposed by that continued use (future default, depreciation, etc.)
- Foreclosure value would not reflect reality and would render second sentence of § 506(a) superfluous
- "Split-the-difference" approach (establishing value at the mid-point between foreclosure and replacement values) finds no basis in the Bankruptcy Code
- No guidance as to what replacement value means: Retail value? Wholesale value? Something else?
- No guidance as to appropriate valuation method in other contexts, such as requests for adequate protection

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## Valuation in Other Contexts

### Adequate Protection – 11 U.S.C. §§ 361, 362, and 363

- § 361 – Adequate protection can include: cash payments, additional or replacement liens, or other relief that will ensure that the secured creditor realizes the "indubitable equivalent" of its interest in its collateral
- § 362 – (d) Court shall grant relief from stay (1) for cause, including the lack of adequate protection for a secured creditor's interest in estate property
- § 363 – (e) On the secured creditor's request, the court may prohibit or condition the debtor's use of collateral on its provision of adequate protection

Threshold question: What is the value of the interest in need of protection

Purpose: Protection of the value of the secured creditor's bargained-for rights in the event the debtor fails to pay

Shift in Focus: Debtor's proposed use becomes less important and secured creditor's more so, i.e., foreclosure value

Caveat: Under § 362(d)(1), party opposing relief from stay has the burden of proof

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## Valuation in Other Contexts

### Relief from Stay – 11 U.S.C. § 362(d)(2)

- § 362 - (d) Court shall grant relief from stay (2) of an act against property, if –

(A) the debtor does not have equity in such property; and (B) such property is not necessary to an effective reorganization

Threshold Question: What is the property worth after deducting the claims secured by the property

Purpose: Determining whether the debtor owns a meaningful interest in the property

Focus: Realistic demonstration of equity (if any) and extraction of greatest amount of value from property; debtor's proposed use becomes more important

Caveat: Under § 362(d)(2), party seeking relief from stay bears the burden of proof on the issue of the debtor's equity in property

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## Timing of Valuation

### Depends on Context

- Cram-down: Value determined as of the effective date of the plan
- Adequate Protection: Depends on the Circuit
- Lack of Equity: Depends on the Circuit

## Replacement Value – What does that mean?

Rash says: "Whether replacement value is the equivalent of retain value, wholesale value, or some other value will depend on the type of debtor and the nature of the property"

Factors:

- Type of debtor: Sophisticated or Unsophisticated? Individual or Entity?
- Nature of collateral: Readily available? Customized?
- Available market?

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## 11 U.S.C. § 506 – Rights of Oversecured Creditors

(b) To the extent that an allowed secured claim is secured by property the value of which . . . is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest . . . and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose

- Applies to creditors whose claims are secured by consensual AND non-consensual liens (such as tax or judgment liens)
- Post-petition interest can be calculated at the default rate if it was triggered pre-petition
- In order to cure a pre-petition default to an oversecured creditor in its plan, § 1123(d) might require a debtor to provide for payment of post-petition default-rate interest, as well as attorneys' fees, costs, and other charges
- Caveat: Bankruptcy courts can adjust default interest rate and other fees if equities so require or if unreasonable

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# Adequate Protection Payment Issues



ADEQUATE PROTECTION PAYMENT ISSUES

## Is Lender entitled to adequate protection payment(s)?

### Lenders' potential arguments that they should receive an adequate protection payment:

- Automatic stay is in effect
  - Note: § 362(d)(1) of the Code provides that a court may grant relief from automatic stay to Lender if Debtor is unable (or unwilling) to provide adequate protection
- Debtor wants use of cash collateral
- Debtor proposes to prime Lenders' lien with an additional lien
- Loan is undersecured
- Even though loan is oversecured, collateral value is diminishing
- Lender claims Debtor is using rents generated by real property and should receive an adequate protection payment as a result
- Other considerations:
  - Loan is oversecured – does and can Lender choose between receiving postpetition interest or adequate protection payment?
  - Can Lender receive more than one adequate protection payment? When might those situations occur?

### Debtors' response to Lenders' potential arguments that they should receive an adequate protection payment:

- Debtor does not want to provide Lender with adequate protection payment due to liquidity constraints
- Debtor claims Lender is oversecured and should not be entitled to this type of payment
- Debtor asserts Lender is protected by property generating replacement rents and has liens on those properties per § 552

ADEQUATE PROTECTION PAYMENT ISSUES

## Potential Diminution in Value

Debtor claims there is the possibility that the collateral securing the Lender is diminishing in value:

- This does not necessarily justify Lender receiving adequate protection payments
  - Lender needs to prove that it is suffering from post-petition decline in collateral value
  - If Lender is oversecured, it is unlikely to receive adequate protection even if collateral value is decreasing
- Lender is protected by § 507(b), according to the Debtors
- Lender has done a lien search and has not found any unencumbered assets; therefore, Lender claims that they are not covered under § 507(b)
- Valuation of collateral at time of filing versus current valuation should be performed to demonstrate any changes in value

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ADEQUATE PROTECTION PAYMENT ISSUES

## How is adequate protection payment amount determined?

Lenders' versus Debtors' view on how much adequate protection should be given:

- Lenders determine an amount that they feel would satisfy their needs and issues
- Debtors use their cash flow projections to determine amount which would be feasible given their liquidity needs
- Parties typically negotiate on this point, especially if the Debtors need use of cash collateral

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ADEQUATE PROTECTION PAYMENT ISSUES

## Application of Adequate Protection Payments to Debt

If Lender is given an adequate protection payment, how are those funds applied:

- Does the adequate protection payment reduce the outstanding loan amount?
- If Lender is oversecured, is adequate protection payment applied to postpetition interest?
- Neither?
- Other?
- The adequate protection payment can be made in one payment at the beginning of the case or several payments over the course of the case

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## Absolute Assignment of Rents

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# Absolute Assignment of Rents, It Isn't So Absolute

**In reality, "Absolute Assignments of Rents" are rarely absolute.**

*Blacks's Law Dictionary Definitions*

- Absolute – meaning "Complete; perfect; final; without any conditions or incumbrance."
- Assignment – meaning "The act of transferring to another all or part of one's property, interest, or rights. A transfer or making over to another of the whole of any property, real or personal, in possession or in action, or of any estate or right therein."
- Absolute Assignment – meaning "A transfer between two parties where all benefits are exchanged without any stipulations (a/k/a Collateral Assignment)

*Actual Practice*

- "Absolute Assignments of Rents" are governed by a combination of state and federal law
- Lenders often require a borrower to execute an absolute assignment of rents in conjunction with a financing transaction and other loan documentation such as a deed of trust and UCC security filings
- This assignment conveys the rents to the lender at the time of the assignment but the borrower as a licensee, continues to collect the rents so long as the loan is not in default
- Many states have enacted their own laws defining and governing the use of Assignment of Rents (e.g., Texas Statute: Title 5. Exempt Property and Liens…Chapter 64. Assignment of Rents to Lienholder"). Among other things these laws clarify the assignment, noticing, and enforcement of the assignment.
- In other cases, such as New York and Michigan, documents appear to sometimes grant a true absolute assignment.
- Federal laws, such as 11 U.S. Code § 365, also come into effect when an entity files for bankruptcy protection

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11 U.S. CODE § 365 - EXECUTORY CONTRACTS AND UNEXPIRED LEASES

# 11 U.S. Code § 365 - Executory contracts and unexpired leases

**The Code gives debtors(trustees) the sole right to assign executory contracts and leases**

§ 365 (f)

(1)*Except as provided in subsections (b) and (c) of this section*, notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law, that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under paragraph (2) of this subsection.

(2)The trustee may assign an executory contract or unexpired lease of the debtor only if—

(A)the trustee assumes such contract or lease in accordance with the provisions of this section; and

(B)adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

(3)Notwithstanding a provision in an executory contract or unexpired lease of the debtor, or in applicable law that terminates or modifies, or permits a party other than the debtor to terminate or modify, such contract or lease or a right or obligation under such contract or lease on account of an assignment of such contract or lease, such contract, lease, right, or obligation may not be terminated or modified under such provision because of the assumption or assignment of such contract or lease by the trustee.

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## 11 U.S. Code § 365 - Executory contracts and unexpired leases

**What the Code gives, the Code takes away… the debtor (trustee) becomes highly restricted in its ability to make (absolute) assignments in financial transactions**

(c) The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if—

(1)

(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and

(B) such party does not consent to such assumption or assignment; or

(2) ***such contract is a contract to make a loan, or extend other debt financing or financial accommodations***, to or for the benefit of the debtor, or to issue a security of the debtor; or

(3) such lease is of nonresidential real property and has been terminated under applicable non-bankruptcy law prior to the order for relief

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## Yield Maintenance Provisions

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## ALLOWANCE OF MAKE-WHOLE PREMIUMS

Energy Future Holdings (3d Cir.)

- Note indenture permitted redemption prior to December 1, 2015, by paying note debt plus $400 million make-whole premium
- Issuer filed chapter 11 in DE and soon thereafter (prior to 12/1/15) refinanced notes with lower interest debt
- Bankruptcy Court disallowed make-whole premium because bankruptcy filing is an acceleration and occurred before the refinancing (so, no "pre-payment")
- Third Circuit reversed, based on redemption provision (separate from the acceleration provision) saying debtor could redeem notes by paying the debt plus the "applicable premium."



## ALLOWANCE OF MAKE-WHOLE PREMIUMS

Energy Future Holdings (3d Cir.) (cont.)

- Under governing NY law, redemption can be pre or post maturity, so the indenture language requires payment of the premium notwithstanding the acceleration
- Redemption was voluntary because Issuer elected to file bankruptcy and then to refinance the notes
- Lower courts erred by focusing on the acceleration rather than the separate provision governing redemption
- Distinguished 2d Cir. AMR decision because indenture there said premium *not* owed after acceleration
- *En banc* review sought, but case settled

# ALLOWANCE OF MAKE-WHOLE PREMIUMS

Momentive (2d Cir.)

- Indenture provided for make-whole payment if issuer were to "redeem the Notes at its option."
- Bankruptcy filing caused automatic acceleration of notes, under indenture
- Chapter 11 plan issued replacement notes, without make-whole payment
- Noteholders argued:
  1. Make-whole is due upon redemption regardless of acceleration
  2. Noteholders could rescind bankruptcy acceleration
  3. Redemption was voluntary because debtor could have reinstated the notes



# ALLOWANCE OF MAKE-WHOLE PREMIUMS

Momentive (2d Cir.) (cont.)

- Debtor argued:
  1. Bankruptcy acceleration means postpetition repayment of notes cannot constitute a "redemption"
  2. Even if deemed a redemption, it was not voluntary
  3. Indenture did not provide for make-whole payment, notwithstanding acceleration, with sufficient specificity to overcome NY law which generally provides that any post-acceleration payment is not a "prepayment."
- Bankruptcy Court sided with the debtor. District court affirmed.

## ALLOWANCE OF MAKE-WHOLE PREMIUMS

Momentive (2d Cir.) (cont.)

- Second Circuit, following its prior *AMR* decision, affirmed. Even if issuance of new notes was a "redemption," it was done after the maturity date because bankruptcy acceleration moved the maturity date up to the petition date. Post-acceleration redemption was not "voluntary" or "optional" for purposes of the indenture
- Automatic stay prevented noteholders from rescinding acceleration
- Second Circuit did not take on the Third Circuit's *EFH* analysis, instead relegating it to a "But See" Citation
- Supreme Court denied Cert



## ALLOWANCE OF MAKE-WHOLE PREMIUMS

Tara Retail Group (Bankr. ND W. Va. Sept. 19, 2018)

- Bankruptcy Court sustains objection to make-whole premium component of lender's claim
- Lender accelerated debt ***before*** bankruptcy filing
- Under NY law, acceleration advances maturity date, so post-acceleration payment is not a "pre-payment"
- However, parties may include prepayment premium following acceleration if it is clearly stated in the indenture (for example, what the parties in EFH did)

## ALLOWANCE OF MAKE-WHOLE PREMIUMS

Tara Retail Group (Bankr. N. D. W. Va. Sept. 19, 2018) (cont.)

- Here, lender did not have to accelerate the note. But, having elected to do so, the note could no longer be "prepaid"
- Unlike in EFH, there was no separate provision that would require payment of the premium post-acceleration, so no cause to depart from the general rule that acceleration neuters make-whole payment requirement
- Finally, court seemed influenced by factual circumstances. This debtor filed bankruptcy because of a flood, unlike a debtor that strategically files bankruptcy in order to refinance debt without paying an agreed-upon premium



## ALLOWANCE OF MAKE-WHOLE PREMIUMS

- The Lessons:
- If you want pre-payment premium to be owed after lender acceleration or deemed acceleration, draft the indenture provision to (very) specifically provide for that.
- Consider different courts' approaches in making a venue decision