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ABI Commission to Study the Reform of Chapter 11
Field Hearing on Thursday, February 21, 2013

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Introduction

It is indisputable that the objective of Chapter 11 is to provide a venue for companies to rehabilitate themselves in a feasible manner. Discussion of rehabilitation permeates legislative statements on even the most recent amendments to the Bankruptcy Code, highlighting the long-standing nature of this goal.

One example can be found in Section 1112 of the House amendment regarding conversion of a case to Chapter 7 or dismissal, which suggests that there must be both (i) continuing loss or diminution in value and (ii) ***the absence of a reasonable likelihood of rehabilitation*** (stress added). While other parts of the Bankruptcy Code suggest wider latitude to Courts in considering conversion, Section 1112 highlights the rehabilitative aspects of Chapter 11.

The automatic stay and the exclusivity period further highlight this goal.

Taking rehabilitation as a core tenet or goal of Chapter 11, the following is a discussion of the implications this has on valuation (and any contemplated requirement of market tests), and what that suggests for appropriate methodology and action / changes to the Bankruptcy Code, if any.

Valuation

The fundamental purpose of Chapter 11 valuation is to determine the value being provided to various constituencies "as of the effective date of the plan."[1] In cases where a Debtor is proffering a Plan of Reorganization that provides securities (debt or

[1] 11 U.S.C § 1129(a)

equity) to creditors in a going-concern, valuations that are underpinned by the value of the go-forward operations are most informative in our view. In fact, any methodology that does not rely on the value of the Reorganized Debtor seems to be irrelevant, if not misleading.

And while the Bankruptcy Code provides ample discretion to the Courts to determine value (and the appropriate methodology for determining value) on a case-by-case basis, it is noteworthy that the Delaware Chancery Court – another leading Court in matters of business valuation – defines the relevant construct as "Fair Value" and not "Fair Market Value" in appraisal proceedings and other matters.[2]

Issues with M&A Market Valuation

As we see it, there are fundamental flaws with reliance on market evidence with respect to a company in Chapter 11, and especially with the proposal of requiring a market test every time in lieu of valuation testimony:

- A market test under duress versus the go-forward enterprise value of a rehabilitated Debtor is comparing an apple to a hot dog.
    - A Debtor that has conducted an M&A process – whether prior to or during the proceedings – will be perceived as a forced seller by the market. As such, indications of value by any such process (even if representative in nature) would not necessarily be indicative of the value of the Reorganized Debtor as a going-concern.
    - In addition, M&A efforts that are conducted leading up to a Chapter 11 filing are not necessarily representative, as Boards and Management teams wrestle with issues from stretched vendors, employee rumors regarding distress and competitor poaching (of both customers and employees, etc.), among other things. As a result, these processes oftentimes exclude the buyers that would assign the highest value to the enterprise.

[2] Delaware General Corporation Law § 262, Appraisal Rights

- Furthermore, any attempt to use indications of value by third party acquirers as a proxy for the go-forward enterprise value of a Debtor would necessarily be complicated by such unknowns as:

  (i) what was the business plan that such buyer was anticipating operating under;
  (ii) how was the acquired business going to be capitalized, and what were the return requirements for any invested capital; and
  (iii) what were the other alternative investments available to said buyer – in other words, a third party buyer would not necessarily offer what the assets were worth, but instead what it would be willing to pay relative to other investment alternatives.

  - None of these necessarily relate to the value of a standalone reorganized Debtor.

- In short, relying on any market indication of value would in and of itself require exhaustive discovery and a case-by-case determination by the Court on the relevance or applicability of the market test that was conducted.

In addition, and going back to the core tenet of Chapter 11 – to provide an opportunity for Debtors to rehabilitate – forcing any such "Market Test" as an academic exercise to inform views on value is not a costless exercise. Value diminution could be realized by, among other things:

- Delays associated with conducting any such test;

- Employee uncertainty;

- Customer uncertainty; and

- Competitive attacks (poaching customers, poaching employees, spreading market rumors, etc.).

Going Concern Valuation

Accordingly, it is our view at Gordian that for a Debtor pursuing a Plan of Reorganization that contemplates ongoing operations as a going-concern, the focus should be on the go-forward valuation of the Reorganized Debtor – rather than some market indication of value.

In traditional corporate finance – and as opined on by innumerable valuation experts in Bankruptcy Courts before – there are three primary approaches used in valuing a going concern:

- Comparable Company Analysis;

- Comparable M&A Transaction Analysis; and

- Discounted Cash Flow Analysis.

While the first two approaches are informative and useful as data points, I believe the DCF approach is at its core the most useful in determining the value of a Reorganized Debtor.

- The DCF analysis values a business by determining the current value of estimated future cash flows to be generated by that business.

    - Under this methodology, projected future cash flows are discounted by the business' weighted average cost of capital (the "Discount Rate").
    - The Discount Rate reflects the estimated blended rate of return that debt and equity investors would require in order to invest in the business based upon its capital structure.
    - This is precisely what the Court is trying to determine the value of.

- Aswath Damodaran, a leading expert in the field of corporate valuation says:

    - "By the same token, multiples are also easy to misuse and manipulate, especially when comparable firms are used. Given that no two firms are exactly alike in terms of risk and growth, the definition of comparable firms is a subjective one. Consequently, a biased analyst can choose a

> group of comparable firms to confirm his or her biases about a firm's value. While this potential for bias exists with DCF valuation as well, the analyst in DCF valuation is forced to be much more explicit about assumptions that are often left unstated."[3]

- Accordingly, while all non-market test methodologies have relevance (including occasionally a regression analysis), we feel the DCF approach is the best approach on a number of fronts when considering the need for Courts and Judges to make a determination of value based on multiple experts, as it:

  (a) does no harm to the Debtor;
  (b) approaches value in the most applicable way for what is being measured – the value of the Reorganized Debtor's operations; and
  (c) is the most transparent approach, as it forces the expert to "be much more explicit about assumptions that are often left unstated."[4]

We also note that there are other aspects of the Bankruptcy Code, such as the length of the initial exclusivity period afforded to Debtors, which may also have similar implications on ensuring an appropriate assessment of the valuation of a go-forward Reorganized Debtor.

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[3] Damodaran, Aswath. Damodaran on Valuation: Security Analysis for Investment and Corporate Finance, 2nd Edition. Hoboken, NJ. John Wiley & Sons, Inc., 2006, p. 17
[4] Ibid.

Case Study

Jobson Medical Information Holdings, LLC – US Bankruptcy Court for the Southern District of New York, Case No. 12-10434 (SHL)

Summary:

Gordian was recently engaged in Jobson Medical Information, a situation in which the Company was (i) profitable, (ii) generating sufficient cash flow to service its capital structure and (iii) solvent from a valuation perspective (i.e., positive equity value) – but nevertheless faced the impending maturity of $120 million of secured debt, equating to roughly 6x trailing EBITDA.

Together with counsel, Gordian was able to successfully negotiate with a disparate group of lenders – some of whom had aspirations of owning the Company – on a prepackaged bankruptcy that resulted in modest equity dilution to the private equity sponsor, extension of debt maturities and confirmation of the Plan of Reorganization in 32 days.

In this case, the Company was able to negotiate the consent of all but one debt holder, and was able to – through the plan confirmation process – "cram" the negotiated settlement on the lone holdout. Go-forward valuation of the Debtor was a key factor in the pre-chapter 11 negotiations.
A forced market test – no question – would have resulted in lenders likely not getting out whole – with nothing for anyone else.

But had the Bankruptcy Code mandated that a "market test" be conducted in support of a Debtor's valuation, there is no doubt that the lone holdout – and perhaps other lenders that eventually consented to the Plan – would have litigated and forced this issue. In a case that was otherwise the poster child for the benefits and efficiencies of Chapter 11, aggressive lenders would have been able to game the system for their benefit – to the detriment of all other constituencies, including the shareholders, employees, vendors and customers.