

# Valuation Vantage<sup>®</sup>

Insights and Perspectives on Leading Corporate Finance Valuation Issues<sup>®</sup>

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## The McLean Group's Valuation Practice

As a core competency and complement to its mergers & acquisitions (M&A) practice, The McLean Valuation Service Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

## Fresh Start Accounting

In this challenging economic environment, filing for bankruptcy has become a reality for many companies. Approximately 20% of business bankruptcies in the year ended September 30, 2010 were filed under Chapter 11 reorganization. Chapter 11 reorganization presents a number of complex challenges for companies, including but not limited to, the need for fresh start accounting.

The financial reporting requirements for fresh start accounting were established under Accounting Standards Codification (ASC) 852, previously Statement of Position (SOP) 90-7. Two significant accounting processes take place when implementing fresh start accounting: determining the entity's reorganization value and allocating the reorganization value to the Fair Value of the entity's assets.

### Chapter 11 Reorganization

As one form of bankruptcy available to companies, Chapter 11 allows them to reorganize and continue operations. The debtor may submit a voluntary petition. Alternatively, creditors meeting certain requirements may file an involuntary petition against the company.

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## Rule 26 Expert Witness Disclosures

The Federal Rules of Civil Procedure (FRCP) were established in 1938 to judiciously handle civil lawsuits in the US Federal Courts. In recent decades, a plethora of amendments has been instituted to fine tune 86 FRCP rules. The most notable recent changes to Rule 26 occurred in 1993: the purpose of these revisions was to increase the exchange of general information between parties. More specifically, all parties were required to exchange data and other information during the early stages of a trial, identify expert witnesses, and list all evidence that might be used prior to the trial date.

The modifications made effective on December 1, 2010 revisited previous amendments to clarify language defining pertinent trial information. Previously, expert witnesses were obligated to share "data or other information" considered in formulating their opinions. The new language states the disclosure of "facts or data considered," which eliminates the ambiguous term "other information," and deters parties from spending countless hours arguing in the courtroom about what "other information" should be deemed discoverable.

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## “Fresh Start Accounting...” continued from p. 1

The filing of a petition triggers reorganization proceedings, the goal of which is to maximize recovery by creditors and shareholders by preserving the entity as a viable going concern. As part of the filing, the company submits a plan for reorganization that provides for the treatment of all assets and liabilities. For the plan to be approved, consideration received by the interested parties must exceed amounts they otherwise would have received had the company liquidated under Chapter 7 bankruptcy. In addition, holders of existing voting shares before confirmation receive less than 50% of the emerging entity’s voting shares.

### Valuing the Reorganized Company

Determining the reorganized entity’s value is an important part of reorganization plan development. The reorganized entity’s value, or Enterprise Value, typically is the Fair Value of the company before liabilities. The US GAAP definition of Fair Value is, “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” To determine the US GAAP Fair Value of a company in Chapter 11, a discounted cash flows analysis (DCF) is commonly employed.

DCF analysis estimates the reorganized company’s value by using forecasted future cash flows and by applying an appropriate discount rate. Several factors should be taken into consideration when developing the forecast, including but not limited to:

- Discontinued product lines,
- Forecasted revenue growth rates for remaining product lines,
- Impact of economic and industry factors,
- Estimated capital expenditure requirements,
- Impact of reorganization on operating expenses and margins, and
- Estimated future working capital requirements.

### Allocating the Reorganization Value

Once the reorganization plan, including the determination of the reorganized company’s Enterprise Value, has been approved by the bankruptcy court, the company’s opening balance sheet must be established. The reorganized balance sheet must reflect the discharge of any indebtedness and any exchanges of stock. The reorganization value of the entity must be allocated to the company’s assets in accordance with Accounting Standards Codification 805 (Business Combinations). This is essentially a purchase price allocation (the same process a recently acquired company will encounter) that allocates Fair Value to the specific tangible and intangible assets. Any remaining unallocated Fair Value is attributed to goodwill.

	Closing Balance Sheet, Prior to Reorganization	Adjustments to Closing Balance Sheet, Impact of Chapter 11	Adjustments to Balance Sheet, Fresh Start Accounting	Opening Balance Sheet, Newly Emerged Entity
Current Assets	\$5,000	\$-	\$-	\$5,000
Fixed Assets	25,000	(20,000)	-	5,000
Intangible Assets	-	-	5,000	5,000
Goodwill	-	-	10,000	10,000
Total Assets	\$30,000	\$(20,000)	\$15,000	\$25,000
Current Liabilities	\$50,000	\$(40,000)	\$-	\$10,000
Long-Term Debt	30,000	(25,000)	-	5,000
Total Liabilities	80,000	(65,000)	-	15,000
Equity	(50,000)	45,000	15,000	10,000
Total Liabilities and Equity	\$30,000	\$(20,000)	\$15,000	\$25,000

### Conclusion

Complying with fresh start accounting provisions requires a thorough understanding of valuation methodologies and principles. The guidance of an experienced and independent valuation firm is recommended to assist in this process.

## “Rule 26...” continued from p. 1

Rule 26’s disclosure of expert drafts also hindered a trial’s timeliness. Pains-taking measures by parties to guard or obtain expert draft reports significantly slowed down the trial process. Also, because most communication between a counsel and an expert witness was considered discoverable, counsel would go to great lengths to avoid creating a communication trail that could make its way into court. The revised provision states that expert drafts are no longer discoverable, unless the information is defined as discoverable under Rule 26(a)(1), or if the drafts are considered material for the opposing party in preparing its case. Furthermore, while the new revisions declare that communications between a party and its expert witness are to be protected, an expert witness must disclose compensation for his/her service, facts or relevant data presented by counsel that were used to contrive his/her opinion, and assumptions provided by counsel that the expert relied upon.

The Rule 26 revisions clearly define the expert witness disclosure rules by minimizing the amount of non-material information that is presented in the courtroom so that the trial may focus on the case’s core issues.

# Spotlight on Court Cases

## *WaveDivision Holdings, Inc. v. Millennium Digital Media Systems, LLC, 2010 WL 3706624 (Del. Ch.) (Sept. 17, 2010)*

In this Delaware breach of contract case, the plaintiff, WaveDivision Holdings, Inc. (Wave) sued the defendant, Millennium Digital Media Systems (Millennium) for damages caused when Millennium reneged on the sale of its Michigan and Pacific Northwest systems holdings. The intent of the case was not to determine whether Millennium had breached its contract, but how to value the damages.

In 2006, Millennium agreed to sell its holdings in Michigan & Pacific Northwest systems to Wave for \$157 million, including a “no-shop provision.” Despite this, Millennium simultaneously worked with its private equity creditors to identify alternative financing options. These creditors held high-yield increasing rate notes (IRN) in Millennium and did not receive a pay-out from the sale to Wave. In July 2006, Millennium terminated its contract with Wave and entered into a restructuring agreement with the IRN creditors that transferred control.

The Delaware Chancery Court concluded that Millennium did breach its contract with Wave and, “the proper measure of damages was to put Wave ‘in as good a position as [it] would have been had Millennium not breached,’ or the value it expected to realize from the agreements minus any avoided costs [...] and minus any mitigation.” Both the plaintiff and the defendant hired valuation experts to determine the value of the damages had the contract not been breached. Not surprisingly, the two sides’ respective valuation experts reached markedly different conclusions in valuing the damages.

The plaintiff’s valuation expert used an EBITDA analysis that incorporated Wave’s prior comparable acquisitions to derive an implied valuation multiple and calculate the growth rate from 2006 to 2009. Next, he indexed the multiples to account for the economic downturn in 2009, applied the growth rate to the Michigan and Pacific Northwest systems, and used the valuation multiple to estimate the damages. This methodology resulted in values of \$322 million and \$85.5 million after being adjusted for mitigation.

Millennium’s expert implemented a discounted cash flow (DCF) analysis and individually valued each system to account for operational differences. Furthermore, he relied upon the forecast information Wave provided its bank to finance the purchase as an input source for his DCF analysis. However, he adjusted these inputs downward because he felt they were “overly optimistic” and applied a 3% reduction to cash flow predictions to account for corporate overhead. Using these inputs and conservative growth projections calculated by an independent advisor, the defendant’s expert reached a value of \$122 million—far less than the \$157 million purchase price; thus, the defendant claimed that no damages were infringed on Wave.

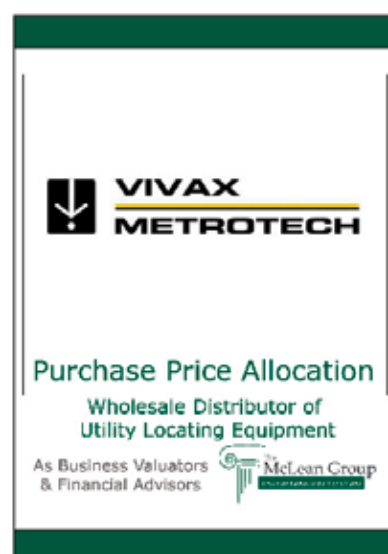
Additionally, the defendant argued, “Wave was entitled to recover no more than the amount the market would have placed [...] at the time of the breach.” This assumes, however, that the buyer would sell the systems immediately following their purchase. In reality, Wave had intended to upgrade these systems and sell them at a later date for a profit, or maintain the higher operating revenues.

The court identified flaws in each argument, noting that Millennium’s approach was based upon “unreliable, self-interested, and thinly justified reductions to the base projections;” meanwhile, Wave’s expert “extrapolated continued success from too small of sample size without grounding the analysis in the specifics of the acquired systems.” Wave argued that EBITDA analysis was common for the industry and noted that Millennium and its private equity creditors used this earnings approach to value the systems previously. Ultimately, the court decided to apply an EBITDA valuation methodology to calculate the damages and included a reduction for overhead expenses, which yielded a total value of \$286 million. After adjustments and subtracting the purchase price, the court arrived at a value of \$14.8 million which it ordered Millennium to pay to Wave.

Historically, DCF analysis has been the backbone of valuation methodology; however, this case highlights the importance of individually analyzing and understanding the unique circumstances involved in each case, instead of applying a one-size-fits-all approach to valuation.



## Select Recent Engagements



## The McLean Valuation Services Group Offices

The McLean Group is a national middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services with bankers in more than 30 offices in the US. Its affiliate, The McLean Valuation Services Group, performs business valuation services for transaction, financial reporting and tax purposes. The McLean Valuation Services Group has dedicated business valuation offices in the following locations:

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