

Exide: a Case Study

On the Paramount Role of Valuation in Corporate Restructuring

by Jonathan Friedland and Mike Xu, Attorneys

In a Chapter 11 reorganization, the ultimate goal is to obtain Bankruptcy Court approval—known as “confirmation”—of a Chapter 11 plan. Among the most important things the Chapter 11 plan does is to classify the claims of creditors and the interests of equity holders, and set forth the distributions that will be made to those classes. The plan is binding on all parties in interest, even if they do not receive any distributions under the plan.

To be confirmed, a Chapter 11 plan must meet certain tests that are set forth in the Bankruptcy Code, including that it be “fair and equitable.” One of the most important elements of the fair and equitable test is the so-called “absolute priority rule.” This rule essentially states that if the plan does not provide for payment in full of all amounts owing to a senior class of creditors or equity holders, then junior classes may not be paid anything (unless the senior class votes to “accept” the plan). On the flip side, a creditor may not be paid more than it is owed.

Whether or not a plan satisfies these tests and can be confirmed may depend in large part upon what the enterprise value of the reorganized company will be, a fact that will be determined by the court at the confirmation hearing. This is especially relevant when a class of creditors are to

receive equity in the reorganized debtor in payment of the class’s claims.

A simple hypothetical illustrates this principle. Suppose senior Class A is owed \$1 million by the debtor and gets 100 percent of the stock of the reorganized debtor as payment of its claims. Class B consists of the existing interests of equity holders of the debtor and is therefore junior to Class A. Under the absolute priority rule, Class A is entitled to payment in full of its claim before any payment can be made to Class B. If Class A is to receive 100 percent of the new equity, of course, there will be nothing left to pay to junior Class B. This plan can be confirmed (assuming all other requirements are satisfied) as long as the value of the new equity does not exceed \$1 million. As you can see, junior Class B will have a powerful incentive to argue that the enterprise value of the reorganized debtor is higher than \$1 million.

Important of Valuation at Confirmation

*Exide*¹ is an actual Chapter 11 case that illustrates the importance of valuation at confirmation, and provides some guidance as to valuation in that context. Exide Technologies manufactured and supplied lead acid and nickel cadmium batteries for transportation and industrial uses worldwide. Before its Chapter 11 filing, Exide owed a syn-

* This article is a sequel to “The Paramount Role of Valuation in Corporate Restructuring,” by Jonathan Friedland, Mike Xu, and James C. Dykstra (*The Value Examiner*, January/February 2008). That article presented an overview of Chapter 11 and described the various contexts in a Chapter 11

case in which expert testimony on valuation can be a key driver. This article discusses the importance of valuation in confirmation of a Chapter 11 plan, illustrated by a case in which competing valuation opinions were considered. ¹ *In re Exide Technologies*, 303 B.R. 48 (Bankr. D. Del. 2003).

dicate of bank lenders approximately \$700 million. Exide had also issued senior notes and convertible notes (which were subordinated to the senior notes), both of which were unsecured, and owed a substantial amount of other unsecured claims.²

Exide proposed a plan of reorganization in September 2003. Under the proposed plan, the bank lenders were to receive preferred stock in the reorganized Exide.³ Exide's position was that the preferred stock was worth less than the amount the bank lenders were owed, so that the plan did not provide for payment in full of their claims against Exide.⁴ The senior note holders were to receive the common stock of reorganized Exide. Exide estimated that its common stock was worth about \$4.1 million and the obligation to the note holders was about \$300 million. Thus, the note holders were to get a distribution worth approximately 1.4 percent their claims. General unsecured claims—other than note holders—were to receive a 1.4 percent payout from a cash pool. Finally, the subordinated note holders were not to receive any distribution under the plan.⁵

In October 2003, a number of parties in interest, including the Official Committee of Unsecured Creditors, filed their objections to the proposed plan. The Committee argued that the reorganized entity would be worth far more than Exide estimated and that, as a result, the bank lenders would receive more than payment in full of their claims under the proposed plan.

In the last week of October, the Court held a confirmation hearing on the plan. At the hearing, experts for each side testified as to the enterprise value of the reorganized Exide. Exide's expert valued reorganized Exide at between \$950 million and \$1.050 billion. The Committee's expert valued reorganized Exide at between \$1.478 billion and \$1.711 billion. The court eventually arrived at a value between \$1.4 billion and \$1.6 billion. This valuation was much closer to the Committee's expert's valuation, and was high enough to prevent confirmation of Exide's plan.

The reasons why the court favored the Committee's valuation are instructive. Both experts used the same three valuation methods that every valuator is familiar with: the comparable company analysis, the comparable transaction analysis, and the discounted cash flow method. What the experts differed in was the data and multiples they used in applying these methods. How did they differ?

Comparable Company Analysis

Exide's view of its go-forward EBITDA was based on the historical data for the year ending in June 2003 (apparently the latest available at the time of the confirmation hearing), which was \$179 million. The Committee's EBITDA was based on the projected earnings disclosed in the debtor's business plan, which was \$196 million. The Committee argued that the historical data did not reflect the benefit of restructuring. The court reasoned that the purpose of the valuation exercise was to look forward, not backward, and used the projected EBITDA figure.⁶

Each side chose a multiple by comparing the enterprise value of comparable publicly-traded companies to their trailing twelve months EBITDA. Both sides seemed to have arrived at a similar multiple, with Exide at 7.2x and the Committee at 7.7x. Exide's expert, however, adjusted his multiple downward to 5.0x to 6.0x, based on his judgment that his comparable for a particular part of Exide's business should be given less weight. The Court rejected the subjective adjustment and determined that the proper multiple was between 7.2x and 7.7x.

Comparable Transaction Analysis

Exide's valuation under this method was based on two recent merger and acquisition transactions, which placed the values of the companies at EBITDA multiples of 6.0x and 7.2x. Exide's expert discounted these multiples based upon his knowledge of the companies involved in the transactions and his opinion that a similar strategic acquisition was not likely for Exide because of antitrust concerns. He assigned a range of 5.5x to 6.0x multiples. The court once again rejected the expert's "subjective" adjustment and adopted a 6.4x factor, which was applied to Exide's \$188 million EBITDA figure that it had previously determined.

Discounted Cash Flow

The DCF analysis seeks to determine enterprise value by discounting the projected cash flow based on the rate of the weighted average cost of capital, which is the weighted average costs of equity and debt. Exide used the cost of equity between 20 and 30 percent, contending that Exide was emerging from Chapter 11 and facing substantial risk in

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² The details of Exide's capital tiers, obligations, and reorganization plan were complex. To facilitate this exposition, we simplify some details, cover the basics only, and round all the figures.

³ The bank lenders could choose to receive a combination of preferred stock and cash rather than preferred stock alone.

⁴ Because the class of bank lenders voted in favor of confirmation of the plan, the absolute priority rule did not prohibit payment to the note holders.

⁵ In addition, the Committee argued that the separate classification and treatment of the various unsecured claims against Exide under the plan

was impermissible under the Bankruptcy Code. This second argument is more complex, but for purposes of this article, Exide's response was that the separate classification and treatment of unsecured claims was permitted based on the fact that the bank lenders were not receiving payment in full on their claims. Thus, resolution of both issues turned on valuation of the reorganized Exide.

⁶ The court did, however, use the projected EBITDA from a revised business plan submitted by Exide. The revised EBITDA was \$188 million rather than the original \$196 million.

In *Williams v. Swimelar*, 2008 WL 18058524 (N.D. N.Y. April 18, 2008), the U.S. District Court for the Northern District of New York affirmed the bankruptcy court's valuation of an insurance agency for Chapter 13 purposes. The debtor valued the business at zero, which was objected to by his creditors. The court found that similar agencies are purchased between one and two times gross commissions; insurance companies have the discretion, but not obligation, to terminate insurance contracts when the agency files for bankruptcy; several insurers entered into agency contracts with the debtor knowing he was in bankruptcy; a Chapter 7 trustee may engage a licensed insurance agent to operate the business prior to a sale; and the lack of a covenant not to compete would not negatively affect value in this case. Therefore, the court valued the business based on the totality of the evidence at one times prior year's gross commissions.

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Growing Your Practice

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know it. Your dog knows it (When my dog Rocko smiles at me I can't resist scratching his ears). Political candidates know it (Jimmy Carter's smile arguably won him the Presidency).

Develop your ability to turn on a smile. It won't make you sick. And it might help you build relationships. **VE**



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executing the five-year plan. The Committee assigned cost of equity a number between 13.6 and 14.6 percent based on the CAPM model. Similarly, Exide argued that its cost of debt was 7.5 percent, while the Committee assumed a cost of debt at 5.9 percent. The court ruled that the debtor's numerous subjective adjustments to the analysis based on the risk that a debtor just emerging from Chapter 11 may not achieve its projections strayed too far from the generally accepted method of determining the discount rate. Accordingly, the court sided with the Committee.

Under all three methods of valuation, the court found that Exide subjectively adjusted the data, the multiples, and the discount rates to bring value calculations in line with current market value. The court rejected these adjustments as inappropriate when seeking to value securities of a reorganized debtor, since the "taint" of bankruptcy will cause the market to undervalue the securities and future earning capacity of the debtor. Instead, the court determined that the more appropriate approach was a straightforward application of the valuation methodologies without subjective adjustments.

The *Exide* decision shows that valuation of a reorganized debtor is often crucial to confirming a plan and emerging from Chapter 11. *Exide* also shows at least one court's views on how valuation should be conducted: that it be forward-looking and avoid subjective adjustments, especially those intended to reflect a market taint stemming from the bankruptcy itself. **VE**



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