



## **Capital Sources and Valuation in Business Bankruptcies**

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Liquidations and reorganizations typically refer to the process of navigating a business through bankruptcy. The bankruptcy of a business will often require the services of a business appraiser to determine the fair market value of a business where there is a debtor in possession, secured creditor claims, and/or a planned reorganization or recapitalization.

Entering into a process of reorganization, a business may have simple capital structures with clearly distinguishable debt and a single class of stock. When a bankruptcy is anticipated or has been filed, loan covenants and stock options, warrants, and agreements have all been reviewed by the interested parties and conversion/liquidation clauses are being implemented. Bankruptcy is often filed to stay that process or to control the process in an orderly fashion.

### **Sources of Capital**

To understand the importance of a valuation expert in the process of a reorganization one must understand the complexities of various capital interests in a business. Capital can be defined as assets made available for the production of other assets. Capital (assets) in a business is generated in three ways. Understanding the basic attributes of these three sources is central in understanding the effective use of a valuation expert in a reorganization or liquidation:

- *Capital contributions (stockholders)*
- *Debt (borrowing)*
- *Net Income (profits)*

Stockholders invest in a company by giving an asset (e.g. cash) to the company in exchange for an ownership interest in the company. That ownership interest can be divided into two types – common stock and preferred stock.

Common stock generally is associated with ownership of the capital of the company, voting rights associated with selecting the Board of Directors and other matters, and the potential (but no guarantee) for dividends.

Preferred stock on the other hand generally has no voting rights, no control over management, but it does have preference when it comes to being paid dividends. Generally, the dividend rate is established and is likely cumulative – meaning that if no dividend is paid this year, the preferred stockholder will get this year's dividend, and next year's dividend before the common stock owners are paid any dividends. If you look at it from a cash flow standpoint, preferred stock looks and acts a lot like debt – there is a principal investment and regular interest (dividends) are either paid or accrued.

Debt is the exchange of assets (cash) for a note promising to pay the principal back over a specified period of time with a state rate of interest paid to the lender to compensate them for the use of the money. Sophisticated debt relationships include various covenants and



conditions imposed on management that, once violated, allow the debt holder to expedite repayment, take collateral, convert the debt to stock, etc. Some of these structures are so complex and restrictive that the relationship looks like a lender/borrower on paper (form) but is effectively that of a stockholder (substance). It is precisely these complexities and contingencies that often force a company in to the need to either reorganize or liquidate. The order of payment priority for the investors (debt and stock) is invariably a complex question begging the need for court oversight – bankruptcy.

### **Valuing the Capital**

Determining the value of the various interests is important as negotiations commence to either “split the pie” or convert one form of capital ownership to another. Therefore, the valuation expert should be able to do the following:

- *Understand complex capital structures*
- *Value debt interests*
- *Value stock interests (preferred and common) – Common stock is rarely valued the same as the same amount of preferred stock*
- *Understand covenants and contingencies associated with debt and stock and their impact on the value of the interest*

A valuation expert with an extensive background in such matters is likely a CPA who has developed expertise in valuation and earned various certifications. This is especially important in comparison to an approach taken by economists or others whom likely are “advising” without the technical or real-world client service background of a CPA.

In interviewing potential experts, it is important to review not only their credentials but also their actual experience in structuring capital for clients, evaluating the pros and cons of options for raising capital on behalf of clients, and analyzing financial statements. All of these abilities are key ingredients in forming a valuation expert that can help you to win your case.

### **About the author:**

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