

BY KAREN MILES

Will Recent Changes to the DGCL Drive the Need for Valuations in Out-of-Court Restructurings?

Amendments to § 272 of the Delaware General Corporate Law (DGCL), which was passed by the Delaware legislature in 2023, have had significant implications for out-of-court restructurings. In particular, the newly added DGCL § 272(b)(2) essentially provides a safe harbor for secured creditors to sell, lease or exchange collateralized assets without a stockholder vote, subject to certain conditions.¹

The first condition for proceeding without a stockholder vote is that the *value* of the collateralized property or assets being sold, exchanged or leased must be less than or equal to the total amount of such liabilities or obligations being eliminated or reduced. This analysis is referred to as the asset-value test in DGCL § 272(c). The second condition is that such sale, lease or exchange is not prohibited by the law governing such mortgage or pledge.

These new DGCL provisions are starting to drive increased demand for valuations to support the asset-value test condition. Secured creditors and companies seeking to effectuate out-of-court restructurings are often interested in avoiding the cost, time and other factors involved in stockholder votes. As such, board members and their advisors now seek outside valuation advisors' opinions in these situations, for much the same fiduciary-related reasons as fairness and solvency opinions are sought in other types of transactions. Whether you are company management, an advisor, a board member or a lender, it is helpful to understand the types of issues that valuation professionals will likely want to consider in preparing a valuation in support of an out-of-court restructuring.

In out-of-court restructurings, lenders frequently will exchange their debt positions for equity positions in the borrower. The asset-value test for this type of transaction would involve the valuation of the company and, in turn, assess the value of the borrower's equity, since this is the asset that is being exchanged. As a result, a valuation of the company's operations is required to assess the equity value. Special considerations arise when valuing

companies in distressed situations, such as those entering into out-of-court restructurings.

While the key overarching valuation approaches (market, income and cost) that should be considered for a distressed company are the same for nondistressed situations, there are a number of pertinent issues that can arise when preparing a valuation of a distressed entity.

One of the critical issues is understanding what gave rise to the company's recent distressed situation. In some cases, the distress might be primarily driven by balance-sheet issues such as overleverage, even though much of the operating business is performing well. In other cases, the company's performance might be the key cause of its current situation. There is a wide spectrum of how both of these factors can impact companies.

Ultimately, understanding the primary reasons that resulted in the company's distressed situation can be crucial in evaluating the forecast and normalized levels of earnings; both are typically key inputs in a valuation process. Reviewing historical performance, including understanding and identifying nonrecurring costs that were incurred (or nonrecurring income that was received), can form a basis for developing normalized levels of earnings and assessing the forecast.

Some examples of issues that distressed companies often experience are overspending in selling, general and administrative (SG&A) categories, underutilized physical locations, insufficient financial analysis leading to sales of products at unprofitable margins, and losses of key customers or contracts. The company might also be subject to unfavorable industry or economic conditions. To the extent that management is focused on improving identified areas of concern in the company's operations, nonrecurring costs will generally arise in the short term.

For example, to right-size the SG&A spend at the company, reductions in force might need to take place. In the short term, this might cause extra severance costs, but in the future, the overall SG&A costs would be reduced. Companies also often hire outside advisors, close or consolidate locations, and eliminate unprofitable product lines. These are examples of actions that in the short term



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¹ Delaware General Corporate Law § 272.

could give rise to nonrecurring costs but in the long run can improve profitability.

Understanding the underlying drivers of the company's performance problems, and the steps the company has taken or will take in the future to address them, are critical to deriving the appropriate adjustments to such earnings metrics as earnings before interest, taxes, depreciation and amortization (EBITDA). Identifying the related costs that have occurred, and the expected go-forward nonrecurring costs, are important in the valuation process.

However, identification is only part of the task. Some costs that management might include in their nonrecurring costs analysis might be costs that other companies routinely include in their expenses, thus making them potentially inappropriate to add back to earnings when using market-approach methodologies. In other situations, the management team might present some costs that are agreed to with their lenders as add-backs for their reporting purposes, but they might be inappropriate for valuation purposes.

While appropriate historical nonrecurring costs are typically added back to arrive at adjusted EBITDA when using methodologies under the market approach, future nonrecurring costs could still impact cash flows. Therefore, different treatment is generally required for future nonrecurring costs in the income-approach methodologies vs. the market-approach methodologies.

Another issue in valuing distressed companies is evaluating whether the company has prepared realistic projected financial information. When valuing companies, you can typically look at recent historical time periods to understand a company's need for capital expenditures, working capital and research-and-development (R&D) spend, but this does not always work in a distressed-company situation. For example, one common concern is whether the company has recently been making the appropriate investments in capital expenditures and/or R&D to support the company's long-run operations and forecast. Investments in these items are often pared back during times of distress, so looking at the most recent history might not be reflective of what the company needs in the long term.

Looking at much-earlier time periods might provide some insight, depending on how the company has evolved. Discussing both the historical and future capital expenditures and R&D needs with management can help evaluate whether the forecast has sufficient levels of these expenditures. Likewise, changes in working capital might have occurred that were caused by financial strain, such as in the case where management stretched out payables. Changes in working-capital management can impact not only the current levels of working capital, but also the changes in working capital recently observed. Given that changes in working capital represent a key input in income-approach methodologies, discussing the historical and current working-capital levels can be useful in evaluating future requirements.

Another factor that is often seen in valuing distressed companies is net operating losses (NOLs). Depending on the situation, a company might have domestic and foreign NOLs or tax credits. Even if the company's auditors have created a valuation allowance against the NOLs for generally accepted accounting principles (GAAP) or other account-

ing purposes, depending on the situation they might still have value in a valuation.

NOLs are typically valued using an income approach that determines the present value of the expected tax savings. Since the U.S. corporate tax rate was reduced in the Tax Cuts and Jobs Act (TCJA) in 2017, as well as in the One Big Beautiful Bill Act in 2025, which extended the rate, the tax savings per dollar of useable domestic NOLs was also effectively reduced. In addition, the TCJA impacted how much taxable income could be offset each year, which, all other things being equal, impacted the timing and present value of domestic NOLs.

Another issue to consider when evaluating NOLs is the limitations on their use in different jurisdictions. For example, § 382 of the Internal Revenue Code limits a corporation's ability to use NOLs after an ownership change. However, various transactions can trigger an ownership change under § 382, including stock issuances and redemptions, and not just a transaction for the entire company. This also can affect the timing and present value of NOLs.

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There can be a lot of complexity surrounding NOLs and tax credits, so it is advisable to involve the company's tax department, and often their outside tax advisors, in understanding the nature and limitations of the company's NOLs. In addition, if the valuation includes a market-multiple methodology, understanding whether the selected comparable companies have NOLs as well, and to what extent, can be useful to consider. To the extent that comparable companies have NOLs, some of that value might be captured in the market multiples.

With respect to the market approach, there are some additional considerations that often occur in the valuation of distressed companies. In a traditional market-multiple methodology, such as the guideline public company (GPC) methodology, multiples of earnings and revenues (and possibly other metrics, depending on the industry) are determined for the publicly traded comparable companies. EBITDA is an earnings-based measure that is frequently used; however, other metrics — such as earnings before taxes, interest and taxes (EBIT), cash flow or others — might be appropriate depending on the industry in which the subject company operates.

Benchmarking on key performance metrics, as well as qualitative factors between the subject company and comparable companies, are considered, and appropriate multiple ranges for the subject company are then determined based on those factors. These multiples are applied to normalized levels of earnings for the subject company to arrive at valua-

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tion indications under the GPC methodology. With respect to the time periods being capitalized, the most recent levels of earnings over the last 12 months (LTM) and the nearest-term budgeted or forecasted period for the next fiscal year (NFY) are typically utilized. However, in a distressed-company situation, what if the LTM and NFY earnings levels are not representative of normalized earnings?

In distressed situations, the company's plans to return to normalized levels of profitability might take a number of years. Therefore, using LTM and NFY market multiples might be challenging in these situations. However, most publicly traded companies of sufficient size have equity analysts providing research reports, and these analysts will often issue earnings estimates for a number of years in the future on the firms they cover.

Based on the information from the equity analysts, it is usually possible to calculate multiples of earnings metrics for one to two years beyond the NFY time period. Utilizing multiples for these time periods further in the future can

allow for more normalized levels of the subject company's earnings to be capitalized, removing some of the concern of capitalizing near-term earnings. Nevertheless, while this can alleviate one issue, the risk of meeting earnings forecasts further out in the future needs to be considered in the selected multiples.

Conclusion

The new DGCL provisions offer creditors and companies a less-burdensome method of effectuating out-of-court restructurings by eliminating the need for a stockholder vote. An asset-value test is a primary condition of taking this path, and it will typically involve the valuation of the distressed company's operations. While the valuation issues involving distressed companies might be complex at times, there are many techniques and methodologies that can be employed to address those issues and to ultimately arrive at an appropriate value to support restructuring transactions utilizing DGCL § 272(b)(2). **abi**

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