

## THE INDEPENDENT FINANCIAL ADVISER'S ROLE IN PREPARING SOLVENCY OPINIONS FOR ACQUISITION FINANCING TRANSACTIONS

Robert F. Reilly and Lyle A. Chastaine

*Independent financial advisers perform solvency analyses—and issue solvency opinions—for a number of bankruptcy-related purposes. Claims of avoidable preference items require only that the financial adviser demonstrate that the total value of the debtor's liabilities exceed the total fair value of the debtor's assets. Claims of an avoidable fraudulent conveyance require that the financial adviser perform three solvency tests: (1) the balance sheet test, (2) the cash flow test, and (3) the capital adequacy test. This discussion summarizes the generally accepted financial adviser's procedures for preparing a solvency opinion.*

### INTRODUCTION

A solvency opinion is a transactional opinion prepared by a financial adviser that opines on the solvency of a debtor at the time of certain corporate actions. A solvency opinion is often prepared at the time of a corporate financing transaction, such as in a leveraged acquisition. A discussion of solvency opinions requires an explanation of the basic concepts of fraudulent conveyance.

First, this discussion will describe what a fraudulent conveyance—or a fraudulent transfer—is. Second, this discussion will explain (1) what a solvency opinion is and (2) when a solvency opinion is used in acquisition financing transactions. And, third, this discussion will summarize the analytical procedures that an independent financial adviser typically performs when assessing a pending financing in order to (1) conduct a solvency analysis and (2) issue a solvency opinion.

### OVERVIEW OF FRAUDULENT CONVEYANCE

A fraudulent conveyance occurs when both of the following two conditions are met: (1) a transaction (or other corporate event) results in financial stakeholders receiving a benefit at the expense of unsecured creditors and (2) the company (a) is insolvent or (b) has unreasonably small capital or (c) has an inability to repay its obligations as they become due.

For purposes of determining if a fraudulent conveyance has occurred, the term insolvent (or insolvency) is defined as the situation where (1) a debtor company's liabilities exceed (2) the fair value of the debtor company's assets.

Litigation or other claims alleging an avoidable fraudulent conveyance are most frequently associated with bankruptcy proceedings.

Allegations that an acquisition financing results in a fraudulent conveyance can affect all the parties to the leveraged transaction, including the acquirer corporation directors, the secured creditors, and the target company sellers—that is, the parties who received the (financed) proceeds in the leveraged acquisition transaction.

It is noteworthy that fraudulent conveyance considerations can affect virtually all leveraged corporate transactions—and not just leveraged M&A transactions.

As an example of a fraudulent transfer that does not involve a leveraged acquisition, let's consider a closely held corporation that obtains a secured loan for purposes of funding either (1) a dividend or (2) a redemption of corporate stock. A successful claim of a fraudulent conveyance could result in:

1. the secured creditors losing their collateral,
2. the rescission of the corporate dividend or stock redemption transaction, and
3. the personal liability of the corporation's directors.

### OVERVIEW OF THE SOLVENCY OPINION

A solvency opinion is a financial adviser's opinion that the corporation will not become insolvent as a result of a proposed financing transaction. Typically (but not always), the proposed transaction is a highly leveraged acquisition

or recapitalization transaction. The U.S. Bankruptcy Code defines insolvent as a ". . . financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation. . . ."<sup>1</sup>

Typically, a solvency opinion—and the underlying financial and valuation analyses—address whether any of the following three financial conditions exists at the time of the leveraged transaction. The solvency opinion analyses are performed by applying three tests that represent the legal (and economic) standards of measuring solvency:

- Do the company liabilities (including the proposed financing) exceed the fair value of the company assets, determined through the balance sheet test?
- Does the company have adequate cash flow to meet its liabilities as they mature, determined through the cash flow test?
- Does the company have unreasonably small capital (including the effects of the proposed financing) determined through the reasonable capital test.<sup>2</sup>

Each of these three solvency tests is summarized below. It is important to note that a solvency opinion is based on information available and/or reasonably foreseeable as of the corporate transaction date.

Ironically, it is the information that is not reasonably foreseeable at the time of the financing transaction that frequently is the most controversial issue in the solvency-related litigation. This is because fraudulent conveyance claims are usually filed years after the subject financing is consummated—and after it becomes obvious that the debtor corporation was insolvent.

## THE "BALANCE SHEET" SOLVENCY TEST

The balance sheet test determines whether the recorded value of a corporation's debts exceed the fair value of the corporation's assets at a specific point in time. This specific point in time is typically the hypothetical instant after the debtor corporation closes the subject financing transaction.

First, the balance sheet test involves the independent financial adviser valuing the corporation's assets at their highest and best use. The financial adviser's highest and best use analysis will determine the appropriate premise of value to use in the valuation of the corporation's assets. For the typical corporation that is operating as a going concern business enterprise as of the solvency test date, the appropriate premise of value is: value in continued use as part of a going concern.

Second, the balance sheet test involves the independent financial adviser subtracting the recorded value of the

corporation's liabilities from the estimated fair value of the corporation's assets. Typically, the financial adviser will use the recorded value (instead of the current market value) for the corporation's liabilities. Presumably, the recorded amount of the liabilities is the amount the debtor corporation would actually have to pay off as of the solvency test date. It is noteworthy that, for solvency testing purposes, the recorded amount of the corporation's liabilities includes the amount of the proposed financing transaction.

Third, when the fair value of the corporation's assets is greater than the recorded value of the corporation's liabilities, then the balance sheet test is passed. It is noteworthy that the balance sheet test is a "pass/fail" test. That means that the debtor corporation cannot be "just a little bit" insolvent. In other words, if the value of the debtor corporation liabilities exceed the value of the debtor corporation's assets by any amount, then the debtor corporation is insolvent.

The balance sheet solvency test typically begins with the financial adviser's going concern valuation of the debtor corporation total operating assets. (Of course, this statement assumes that the going concern premise of value represents the highest and best use of the debtor corporation total operating assets.)

The following discussion summarizes the valuation approaches and methods that an independent financial adviser typically uses in the valuation of the debtor corporation total operating assets.

## The Balance Sheet Test Valuation Approaches and Methods

1. Income approach valuation methods, such as the discounted cash flow method and the direct capitalization method, are commonly used with regard to the balance sheet test. Financial advisers almost always use (and primarily rely on) income approach valuation methods in performing the balance sheet test. Other valuation approaches may also be used. But, the income approach is typically the principal approach with regard to the valuation. This is because income approach valuation methods are particularly applicable to solvency opinion valuation analyses.

As will be discussed later, income approach analyses are always used in the cash flow test of a solvency analysis. This is due to the necessity of considering whether or not the debtor corporation can discharge its debt service obligations as they mature.

By using the same basic income approach analytical model in the valuation of the debtor corporation assets, the financial adviser can ensure that there are consistent assumptions and projections used in both (a) the balance sheet (valuation) test and (b) the cash flow (debt service) test.

2. Market approach valuation methods may also be used in the balance sheet test in the appropriate circumstances. The common market approach valuation methods include: (1) the guideline publicly traded company method and (2) the guideline merged and acquired company method.

Market approach value indications are less applicable to the solvency analysis balance sheet test than are income approach value indications. This is because the market approach value indications are typically subject to the application of valuation discounts and premiums.

3. Asset-based approach valuation methods may also be used by the financial adviser in the balance sheet test. The common asset-based approach methods include: (1) the asset accumulation method and (2) the adjusted net asset value method.

These valuation methods are particularly relevant to the analysis of whether the fair value of the debtor corporation assets (both tangible and intangible) exceed the value of the debtor corporation liabilities.

Of course, the asset-based approach valuation of the debtor corporation tangible and intangible assets should be performed based on the going concern premise of value—if that premise represents the highest and best use of the subject total operating assets.

A detailed explanation of the generally accepted valuation approaches and methods is beyond the scope of this discussion. However, the independent financial adviser performing a solvency opinion balance sheet test should be intimately familiar with both the conceptual development and the practical application of all three generally accepted valuation approaches.

## THE "CASH FLOW" SOLVENCY TEST

The cash flow test analyzes the debtor corporation's ability to meet its debt obligations as they come due.

As part of this test, the financial adviser will typically schedule out all future debt payments (both principal and interest) by due date. Then the financial adviser will analyze the debtor corporation's liquidity available to meet its debt requirements by estimating (1) excess cash available on the solvency date, (2) available cash flow generated during prospective periods, and (3) the availability of unused credit to the debtor corporation.

The cash flow solvency test is "passed" if (and only if), in every prospective period, the debtor corporation can pay its debt:

1. with cash accumulated from prior earnings,

2. with cash flow generated in the current period, or
3. with currently available credit resources.

The question answered by the cash flow test is whether the debtor corporation has the ability to meet its debt obligations (including the obligations associated with the proposed financing transaction) as they become due.

In the cash flow solvency test, it is important for the independent financial adviser to consider:

1. the amount by which the debtor corporation projected cash inflow exceeds the debtor corporation projected cash outflow, and
2. the increased risk associated with the proposed leverage transaction as the projected cash inflow and projected cash outflow amounts converge.

## THE "REASONABLE CAPITAL" SOLVENCY TEST

The reasonable capital test determines whether the debtor corporation has adequate capital to meet its short-term (1) operating expense, (2) capital expenditure, and (3) debt service cash outflow needs.

In the reasonable capital test, the financial adviser typically analyzes the debtor corporation's expected financial performance under various operating scenarios, including the scenarios of:

1. management-prepared financial and operational projections, and
2. zero expected near-term growth and zero expected profit margin improvement.

The reasonable capital test is related, in part, to both the balance sheet test and the cash flow test. For example, even if the debtor corporation has assets that exceed its liabilities, the amount of capital available on the solvency date may be unreasonably small to allow the debtor to meet its operating needs in the near term.

This reasonable capital solvency test is "passed" if (and only if) the debtor corporation is expected in the short term to be able to (1) pay its current liabilities and the current portion of its long-term liabilities, (2) pay its payroll, research and development, and other operating expenses, and (3) make required capital expenditure investments. In other words, the debtor corporation must be able to fund its ongoing business operations.

While considered a separate and distinct solvency test, many financial advisers consider the reasonable capital test to be related to the results of both the balance sheet test and the cash flow test. This is because all three tests

analyze the debtor corporation's financial health on the solvency opinion date.

This reasonable capital solvency test involves the financial adviser's professional judgment that the amount by which the debtor corporation is solvent in the first two tests is not so small that the debtor corporation has an unreasonable small amount of working capital:

1. to fund its current business operations and
2. to provide a corporation's cushion in the event of a short-term business downturn.

As noted earlier, claims of fraudulent conveyance are frequently associated with bankruptcy proceedings. In such proceedings, it is often the case that unanticipated negative events either (1) caused or (2) contributed to the debtor corporation seeking bankruptcy protection. One objective of the capital adequacy (or reasonable capital) solvency test is for the financial adviser to determine if the debtor corporation will be able to withstand such an unanticipated negative event.

## BENEFITS OF AN INDEPENDENT FINANCIAL ADVISER'S SOLVENCY OPINION

All stakeholders to the financing transaction have an interest in avoiding a claim of fraudulent conveyance. The secured creditors to the financing risk their security interest. The debtor corporation directors risk the assessment of personal liability. The recipients of the transaction (e.g., the target company sellers in the case of a leveraged acquisition) proceeds may be at risk to return all (or part) of the proceeds. The transaction's professional adviser fees may be at risk. Of course, for all parties to the leveraged transaction, litigation expenses related to a fraudulent conveyance claim can be considerable.

Corporation laws in many states permit debtor corporation directors to rely on the opinions of independent financial advisers as a defense to a fraudulent conveyance allegation. Of course, this reliance does not eliminate the fiduciary obligations and potential personal liability of the debtor corporation directors. However, the fact that the leveraged transaction participants retained an independent financial adviser to opine on the debtor corporation's solvency may reduce the potential of litigation—particularly when the debtor corporation has filed for bankruptcy protection.

As previously noted, a fraudulent conveyance is a fraud perpetrated in connection with a transaction that affects the rights of unsecured creditors. In the event of the debtor corporation's bankruptcy, the unsecured creditors may assert that corporate transactions in the period immedi-

ately prior to the bankruptcy could have caused the debtor to fail the solvency tests.

Of course, the financial adviser's ex post facto solvency analysis of the prebankruptcy debtor corporation transactions is performed with the benefit of perfect hindsight.

Contemporaneous solvency analyses are easier for financial advisers to perform than retrospective solvency analyses. And, in some instances, contemporaneously prepared solvency opinions may be more reliable than retrospective solvency opinions.

As time passes from the actual date of the transaction, it is more difficult for the financial adviser (1) to objectively assess the effect of the transaction on the debtor corporation and (2) to differentiate the economic effects of the subject transaction from the economic effects of an unrelated event. Accordingly, the importance of a contemporaneously prepared solvency opinion cannot be overemphasized in the context of a corporate capital transaction.

The independent financial adviser's solvency opinion—and the underlying financial analyses—reduce the risk to all parties to the corporate transaction in the following ways:

1. The results of the solvency analysis will assist the transaction stakeholders (and their legal counsel) in assessing whether the transaction may be alleged to be a voidable fraudulent conveyance in the unexpected event of a bankruptcy or other legal proceeding.
2. The existence of an independent financial adviser's opinion—and the documentation that the transaction stakeholders relied on that solvency opinion—may reduce the potential of post-transaction fraudulent conveyance litigation.
3. The existence of an independent financial adviser's solvency opinion may provide evidence that the transaction stakeholders (a) performed all reasonable procedures and (b) fulfilled all fiduciary and other legal duties to avoid perpetrating the alleged fraudulent conveyance.

## SELECTING THE INDEPENDENT FINANCIAL ADVISER

In selecting an independent financial adviser to prepare a solvency opinion, it is important for the transaction stakeholders to consider the financial adviser's qualifications, experience, and expertise. It is noteworthy that the potential audience for the financial adviser's work product—and, therefore, the ultimate test of the transaction solvency opinion—may be a court of law.

Therefore, the selected financial adviser should have the appropriate experience and expertise to convince a

judicial finder of fact that he or she is professionally qualified to perform the solvency analysis.

An equally important factor in the selection of the solvency opinion provider is the independence of the "independent" financial adviser. Obviously, the independent financial adviser must be independent (in appearance and in fact) of the pending transaction.

The transaction stakeholders (and their legal counsel) should realize that it may be difficult to convince a judicial finder of fact of the "independence" of the financial adviser who: (1) negotiated the price and/or structure of the leveraged acquisition, (2) has received a performance fee or commission based on the price of the leveraged acquisition, or (3) does not receive a fee (or who receives a greatly reduced fee) if the pending leveraged acquisition does not close.

In addition, the transaction stakeholders (and their legal counsel) should recognize the risk of having the solvency opinion and/or expert testimony of the selected financial adviser disregarded by the court. That result may have the same effect as not having a financial adviser perform a contemporaneous solvency opinion.

## SUMMARY AND CONCLUSION

The issues of a transaction fraudulent conveyance and of debtor corporation solvency are complicated. This statement is true both from the perspectives of (1) corporate financial economic analysis and (2) commercial and bankruptcy law. In a leveraged corporate capital transaction, errors in assessing debtor corporation solvency can be costly to a multitude of transaction stakeholders.

A contemporaneously prepared solvency opinion from an independent financial adviser is an important component of any defense against claims of (1) a voidable capital transaction fraudulent conveyance and (2) voidable preference payments.

### Notes:

1. U.S. Bankruptcy Code, Section 548.
2. *Pereira v. Cogan*, 294 B.R. 449; 2003 U.S. Dist. LEXIS 7818 (2003).

*Robert Reilly is a managing director of the firm and is resident in our Chicago office. Robert can be reached at (773) 399-4318 or rfreilly@willamette.com.*

*Lyle Chastaine is an associate in our New York City office. Lyle can be reached at (646) 658-6222 or lachastaine@willamette.com.*

### Book Review of Willamette Management Associates *Guide to ESOP Valuation* by William C. Ludwig

The *Guide to ESOP Valuation and Financial Advisory Services* ("the *Guide*"), published by Willamette Management Associates and edited by Robert F. Reilly and Robert P. Schweihs, is a compilation of employee stock ownership plan (ESOP) articles. The authors are some of the more well-known names in the ESOP community.

The *Guide* reflects the current thinking related to ESOP stock purchase/sale transactions, and it is meant for sophisticated ESOP practitioners as opposed to the general public. The *Guide* will also be useful to the management of companies that are contemplating the formation of an ESOP—and to their professional advisers. Some of the chapters are very detailed—taking the reader step-by-step through a transactional process, while other chapters are at an esoteric level—expressing the views of the particular expert author.

The book is logically developed, starting with structuring the ESOP transaction. The *Guide* next covers general ESOP valuation issues and then moves to special factors that affect the ESOP valuation. There are also sections near the end of the book devoted to the perspective of ESOP financial advisers and ESOP trustees. Finally, all of the topics are illustrated and summarized in an illustrative case study. This case study allows the reader an opportunity to visualize an actual ESOP valuation transaction.

The *Guide* is a valuable resource for anyone having any connection to ESOPs.

And the best thing of all—this book is free! (There is a nominal shipping charge—while supplies last.) It is a tough offer to pass up. Interested parties can request a copy of the book by contacting Mike Hartman at (404) 475-2311 or mrhartman@willamette.com.

*William C. Ludwig is a principal in the firm of HPL&S Inc. located in Arlington Heights, Illinois. HPL&S designs and administers qualified retirement plans of all variety, and Bill has been actively involved with ESOPs for over 25 years. Bill may be reached at wcl@hplspen.com.*