
SOLVENCY OPINIONS: USES & ISSUES

“ ‘How did you go bankrupt?’ Bill asked.
‘Two ways,’ Mike said. ‘Gradually and then suddenly.’ ”

-Ernest Hemingway, *The Sun Also Rises* (1926)

Hemingway, in his economic style, illustrates the complexity of bankruptcy risk. It is clear that the inability to meet financial obligations increases with the amount of debt on the balance sheet. It follows that a debt financing or a highly leveraged transaction (the “transaction”) threatens the ability of the post-transaction firm to generate sufficient cash flow to service debts and continue operations as a going-concern. By definition, any leveraged transaction burdens the surviving entity with significant debt obligations. Subsequently, a sudden or gradual bankruptcy poses the inevitable question:

In the event of a bankruptcy or liquidation, do losses incurred by creditors originate from the transaction or from subsequent extrinsic factors?

In the event that a company enters bankruptcy proceedings, the security interests of creditors may be challenged as a fraudulent conveyance. Leveraged transactions, by their nature and structure, extend the opportunity for creditors to legally challenge the insolvency of the borrower several years after the deal closes. For such a claim to be upheld, the courts must find that the exchange was not made for “reasonably equivalent value.” Prerequisites for such a claim include insolvency of the borrower, inability to pay debts as they mature, or inadequate capital to fund operations. A successful charge of fraudulent conveyance can result in the reversal, or unwinding, of an entire transaction, impacting interested parties with extensive litigation and potentially massive economic losses.

In connection with a leveraged recapitalization, interested parties such as new secured lenders and sellers will often, due to fraudulent conveyance concerns, seek an independent determination and opinion as to the impact of the acquisition debt on working capital, cash flow, and equity value.

Solvency Opinions

A solvency opinion, by design, aims to assure the directors of the Company, and/or the lenders in the transaction, that the transaction will not likely subject the Company, and its’ other creditors, to undue financial distress. Houlihan Capital (“Houlihan”) will undertake a solvency opinion assignment for companies engaging in highly leveraged transactions, which may include leveraged buyouts, leveraged recapitalizations, leveraged dividends or other such situations where there may be minimal equity involved. The Federal Bankruptcy Code defines “insolvent” as the condition in which the total of a person’s debts exceeds the value of its property at a fair valuation. Recent case law suggests that the fair valuation of property is its value on a going concern basis. A solvency letter expresses an independent expert opinion on a borrower’s ability to remain solvent under the burden of additional liability, to pay debts as they mature, and to continue operations as a going-concern in dynamic economic conditions.

Some of the advantages of incorporating a Houlihan Solvency Opinion™ into a leveraged transaction include:

- Establishing the lender’s trust in making the loan;
- Proffering a form of due diligence and evidence of good faith; and
- Mitigating the risk of bankruptcy liability for all parties to the transaction.

The value added to all parties is comfort with the transaction through inclusion of a financial expert's opinion. When an independent solvency opinion mitigates the risk of future fraudulent conveyance claims, lenders often will provide funding on more acceptable terms. Beneficiaries include the Board of Directors of the Company, its unsecured and secured creditors, stockholders and financial advisors.

The Solvency Letter is analogous to the Highly Confident Letter. A bidder in a merger or acquisition may seek a Highly Confident Letter from their investment bank, stating that, based on market conditions and its analysis of a transaction, the bank is highly confident that it can raise the necessary capital to complete the deal. Likewise, a "clean" Solvency Letter opines to the ability of the borrower to return that capital (with interest) to its creditors, and sustain sufficient liquidity to operate the business. As the Highly Confident Letter lends credibility to the bidder before the transaction, the Solvency Letter lends credibility to the post-leveraged transaction firm.

Leveraged Transactions

Lenders specializing in highly leveraged transactions prefer a target company that has sufficient assets to serve as collateral. If the collateral value is not adequate to cover the purchase price of the Target, a financing gap exists. When the financing needs of the leveraged transaction exceed the collateral coverage, a borrower will seek additional sources of financing, including equity sponsorship and subordinated debt. Typically, firms with significant fixed assets and unused borrowing capacity utilize several layers of secured debt. The borrowing capacity of the firm is represented by the amount of existing debt on the balance sheet relative to the collateral value of its assets. The lower the pre-transaction financial leverage, the greater the firm's borrowing capacity, and therefore the greater the ease of financing a transaction.

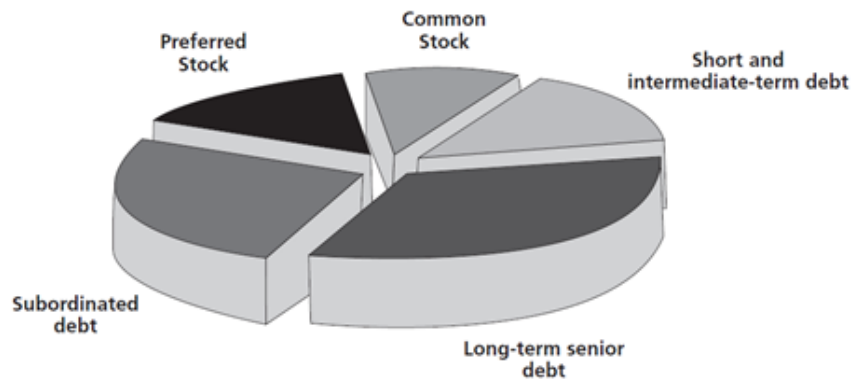
Leveraged transactions often use both secured and unsecured debt. Secured debt, the asset-based loan, may include both intermediate- and long-term senior debt. Loans beyond the collateral value of assets may be justified by the existence of significant, stable cash flows. In order to close the financing gap, unsecured subordinated debt may be taken through a mezzanine layer financing, including subordinated and junior subordinated debt, often with an equity enhancement in the form of shares or warrants. Subordinated debt, by definition, has a secondary or tertiary claim on the assets of the borrower.

It is clear that highly leveraged transactions significantly alter the capital structure of a company.

The post-transaction firm is heavily leveraged, and the Company and the lender seek to reduce debt through retirements and return the firm to a more conservative capital structure. The components of the capital structure differ in terms of their claim on the underlying assets as well as the cost of capital to the going-concern. Secured debt is less expensive than unsecured, and senior debt costs less than subordinated debt. Likewise, short-term debt is typically less expensive than longer-term, which costs less than preferred stock, all of which are less expensive than common stock. The differences in relative cost to the issuer relate directly to the risk-return relationship between debt and equity and the associated claims to the underlying assets of the issuer. Note that any number or combination of transfers in an LBO can be susceptible to fraudulent conveyance claims.

The diagram on the following page represents a typical capital structure for a firm following an LBO. Consider the high financial leverage and large quantity of unsecured subordinated debt. How can parties interested in the transaction gain comfort that the transfer is made for fair and adequate consideration, that the Company possesses adequate working capital to fund operations, and that the Company will be able to service its' debt obligations as they mature? A Houlihan Solvency Opinion™ answers these difficult questions, at the time of a transaction, by preemptively highlighting the potential financial consequences.

Capital Structure of a Hypothetical Leveraged Buyout (LBO)



Fraudulent Conveyance

Rooted in the Statute of Elizabeth and the notion of an exchange of value made with the intent “to delay, hinder or defraud creditors and others of their just and lawful actions, suits, [and] debts,” fraudulent conveyance protects creditor claims to a variety of security interests. From the 16th century sheep farmers’ loan being collateralized by his flock¹ to the highly leveraged transactions of the 1980s and 1990s, the underlying legal principle survives.

Fraudulent conveyance laws apply when a company enters bankruptcy proceedings following a highly leveraged transaction. The laws and statutes protect unsecured creditors from the claims and interests of equity investors and secured creditors. Whereas the original statute identifies only the “intent” to defraud creditors, the modern version recognizes the possibility of “constructive” fraud—an act, statement or omission operating as a fraud regardless of intent. Codified on the state level in the 1919 Uniform Fraudulent Conveyance Act (which later evolved into the Uniform Fraudulent Transfer Act) and on the federal level in § 548 of the Bankruptcy Code, these statutes declare a transaction fraudulent when there is either:

1. Actual Fraud: intent to hinder, delay, or defraud creditors; or
2. Constructive Fraud: the transfer was made without “adequate consideration”; and, at the time of the transfer, the company was rendered insolvent, or the company was credited with unreasonably small capital to fund operations, or the company was left with debt obligations beyond its ability to service as they matured. The term “adequate consideration” is synonymous with “reasonably equivalent value,” and refers to the relative value between that which the debtor surrenders and that which they receive.² Constructive fraud does not require proof of intent but only an objective determination of the first and at least one of the preceding requirements.

Landmark case law including, but not exclusive to *Murphy v. Meritor Savings Bank* (“the O’Day Sailboat case”) confirms that fraudulent conveyance claims pose the greatest legal risk to a leveraged transaction. In this important case, Judge Gabriel of the Bankruptcy Court in Massachusetts professed that the O’Day Sailboat Company was rendered insolvent by a leveraged buyout, and therefore concluded that the secured liens of Meritor Savings Bank, the LBO lender, were a fraudulent conveyance. Judge Gabriel set a precedent in the application of fraudulent conveyance laws to leveraged transactions when he expounded on the going-concern valuation of a company, suggesting that it may exceed the equity cushion of assets less liabilities. He recognized the capitalization of earnings-before-interest-and-taxes (EBIT) and the capitalization of cash flow as methods to derive a going-concern valuation.

¹ Corporate Restructurings, Reorganizations and Buyouts, Joseph W. Bartlett, New York (1991), page 18 [footnote].

² In re Jamison, 21 B.R. 380, 382 (Bankr. D. Conn. 1982).

All parties to a leveraged transaction can be adversely impacted by a successful attack claiming fraudulent conveyance. Directors and controlling shareholders risk a breach of fiduciary duty to creditors, and thus may face personal liability for insolvency of their company. Selling shareholders risk the return of proceeds from the sale; senior lenders risk the revocation of their security interests and the subordination of their claims to other creditors, and the accountants, appraisers, lawyers and investment banks risk the forfeiture of fees earned through the transaction. At the extreme, the entire transaction can, and will, be reversed, possibly years after the initial transfer. It is clear why investment banks, lenders and equity sponsors increasingly address the risk of fraudulent conveyance at the time of a transaction.

Other Important Case Law

- See *Weiboldt Stores, Inc. v. Schottenstein, et al.*, 94 B.R. 488 (N.D. Ill 1988). The Court found that if a LBO leaves a company insolvent and it was done in an attempt to deceive creditors it will be deemed a fraudulent conveyance.
- See *Crowthers McCall Patterns, Inc. v. Lewis*, 129 B.R. 992 (SDNY 1991). The Court held that LBO lenders are obligated to consider the post-transaction solvency of the target company and the rights of its post-transaction creditors when lending funds that flow out of the borrower to the selling shareholders.
- See *Klang v. Smith's Food and Drug Centers*, 702 A.2d 150 (Del. 1997). The Court stated that Boards of Directors are entitled to rely on a Solvency Opinion.

Due Diligence

The codification of fraudulent conveyance law provides a systematic approach to solvency analysis. Consequently, the solvency of any company evaluating a highly leveraged transaction must be examined both at the time of the transaction and from a pre- and post-transaction perspective.

A Houlihan Solvency Opinion™ requires comprehensive due diligence including, but not limited to, the following:

- The Balance Sheet Test
- The Cash Flow Test
- The Capitalization Test
- Analysis of historical and projected financial statements
- Interviews with management, industry experts, consultants, attorneys, accountants, analysts, lawyers, lenders, equity sponsors, investment bankers and other advisors
- Consultation with legal counsel
- Thorough documents review; including SEC filings, loan covenants, operating plans, etc.
- Identification of all contingent liabilities, including letters of credit, convertible securities, tax liabilities, pending litigation, etc.

The Analysis of Solvency

The expectation of solvency analysis is to comfort the participants in a highly leveraged transaction amidst the uncertainty at the time of the transaction. Three tests provide the foundation for a comprehensive analysis of the Company's ability to sustain the burden of debt and the going-concern status quo. The Company must pass judgment on each test to be considered solvent. The answers to the following questions, if insufficient, provide legal standards that could result in the unwinding of the transaction.³

³ The Handbook of Advanced Business Valuation, edited by Robert Reilly and Robert Schweihs, CH. 17.

The Balance Sheet Test

- Is the Company insolvent at the time of the transaction? Will the Company be rendered insolvent as a result of the transaction?
- To what extent do assets exceed liabilities (including contingent liabilities and off-balance sheet items)?
- What is the economic value of the equity cushion at the time of the transaction?
- Will the Company's total invested capital exceed total liabilities after the transaction? If so, what is the expected value of the equity cushion?
- What is the "present-fair-saleable-value" of the Company and what is its "going-concern" value, as determined by capitalization of earnings, capitalization of cash flow, and discounted future cash flow techniques?
- Does the fair saleable value of assets (both tangible and intangible) exceed the market value of liabilities after the transaction?
- Given the value of assets at the time of the transaction, what is the probability of bankruptcy in the future?

The Cash Flow Test

- Will the Company's expected future cash flow sufficiently meet debt obligations as they mature (including those incurred in the transaction)?
- What is the Company's current cost structure?
- Are the base case cash flow projections consistent with historical performance? Are they consistent with management's track record? Are projections consistent with industry trends?

The Capitalization Test

- Is the borrower sufficiently capitalized to fund ongoing operations?
- Is the Company engaged, or about to engage, in a business or transaction for which it has unreasonably small capital?
- How will the leveraged transaction impact the Company's capital structure?
- How may the Company's equity value change over time?
- Do assets exceed liabilities by a sufficient margin to provide an adequate equity cushion on the downside?
- What is the historical (and projected) volatility of assets? Is the equity cushion adequate in supporting such volatility?
- Is the Company's capital adequate to provide a "margin of safety" to protect against unplanned asset sales, material operational changes or debt restructuring?
- Does a reasonable expectation exist that mandatory obligations will be met and operations will be maintained?
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- Does a reasonable expectation exist that mandatory obligations will be met and operations will be maintained?

For assistance with any upcoming transactions, please contact:
info@houlihancapital.com
(312) 450-8600