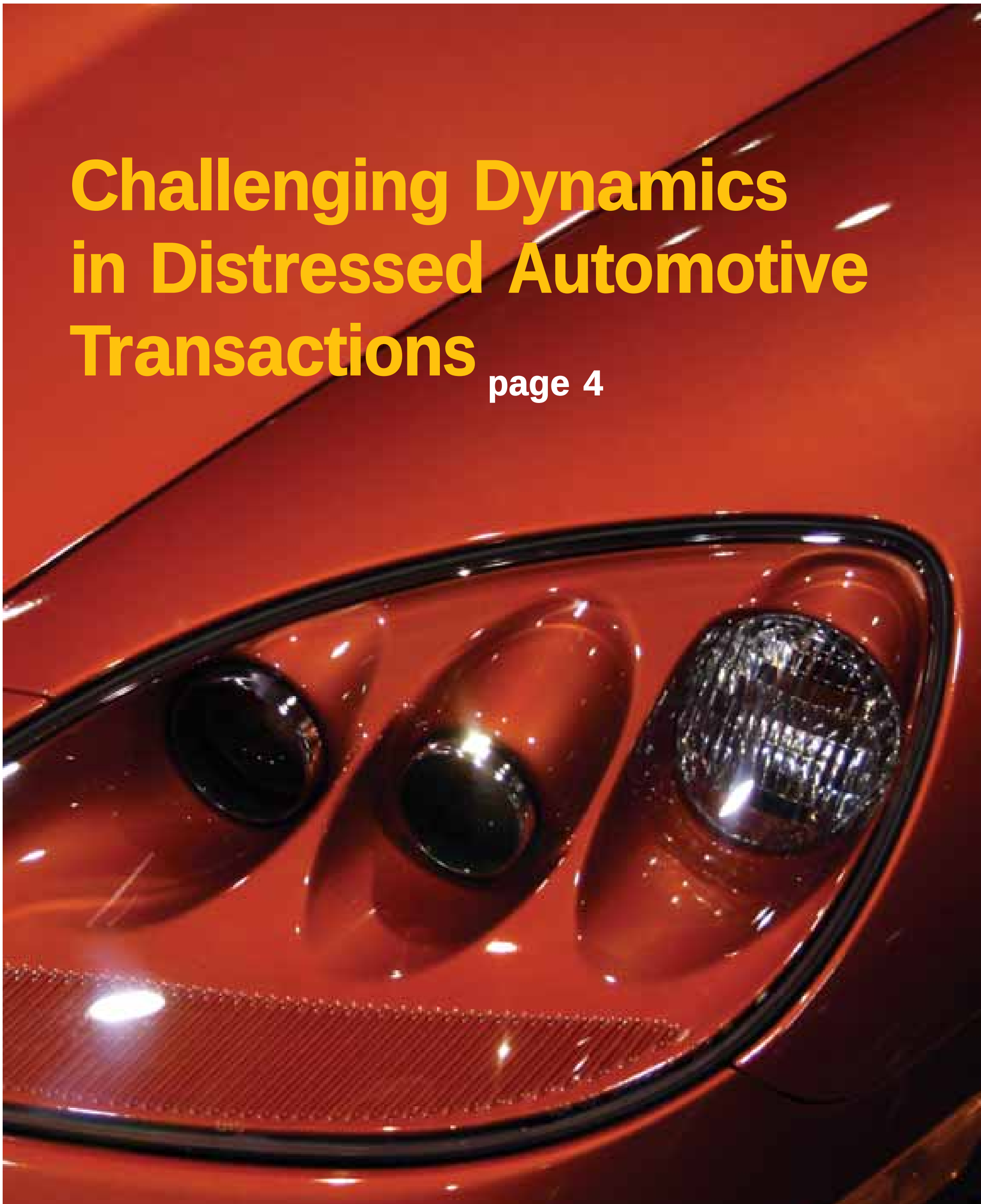
the journal

A publication of Stout Risius Ross



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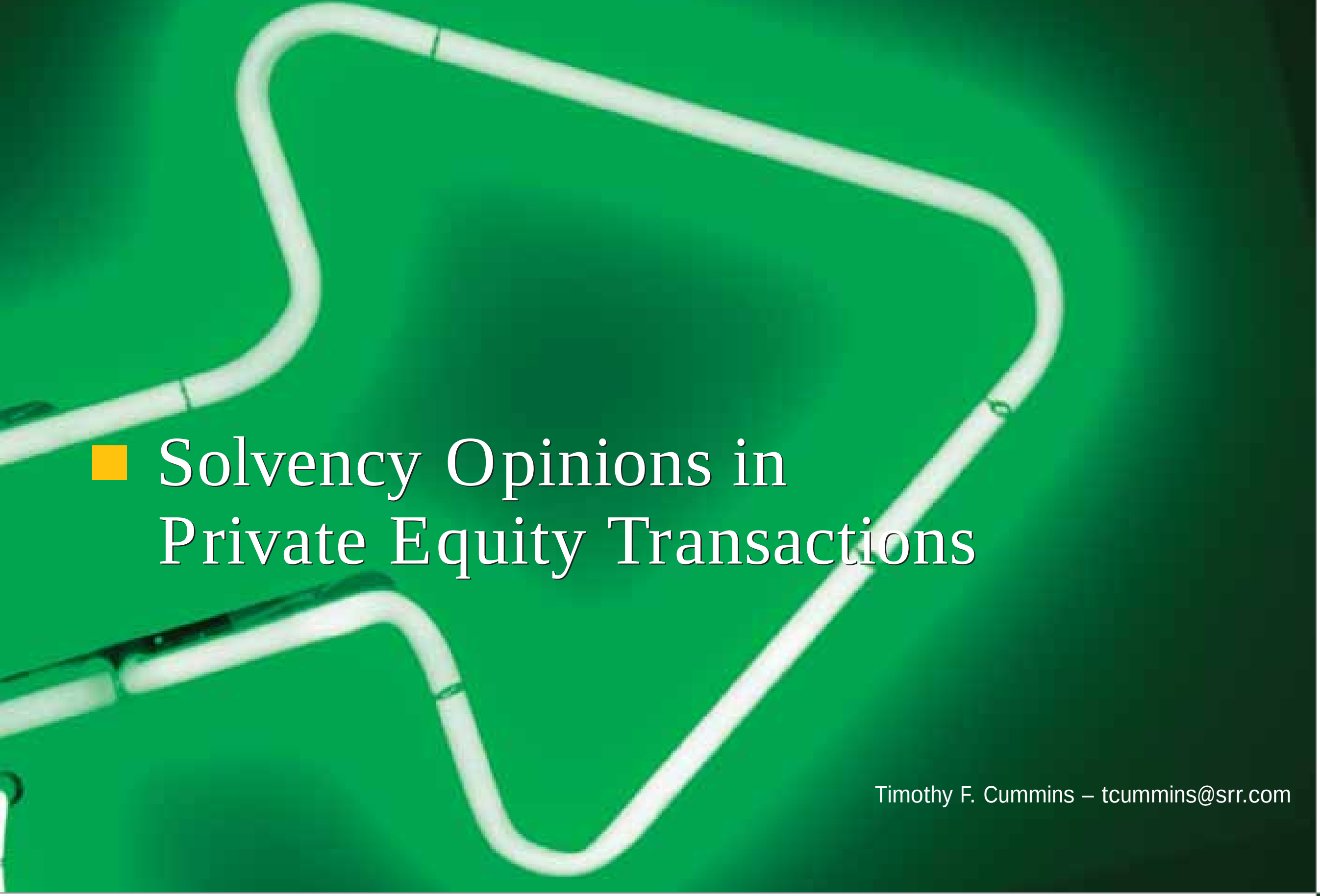
Spring 2006



Solvency Opinions in Private Equity Transactions

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The environment for financial sponsors continues to grow increasingly competitive. Record amounts of private equity capital have been raised in the past few years and by historical standards, long-term interest rates have remained low. The combination of available equity capital, low interest rates and the competition resulting from the continued development of alternative lending sources has resulted in an environment in which credit is relatively easy to obtain and the leverage multiples that financing sources are willing to consider are high in relative terms. One of the results of this confluence of factors has been an increase in the number of highly leveraged deals.

History tells us that a leading indicator for bankruptcy filings is an increase in the level of high-yield debt financing, which is currently at a five-year peak. So, while the current deal making environment may be strong, if extremely competitive, it would seem that bankruptcy attorneys and consultants may become extremely busy if the economic environment changes such that interest rates spike and credit becomes tighter.

We have observed an increase in two types of transactions in particular, the leveraged recapitalization and the secondary buyout (where a portfolio company is sold from one financial sponsor to another). In the post-Enron and Sarbanes-Oxley environment in which we operate today, both of these forms of transaction can more easily raise fraudulent conveyance concerns and board members of companies involved in such transactions would be well-served to seek solvency opinions regarding such proposed transactions.

While solvency opinions do provide corporate boards with a certain degree of protection, board members should realize that the opinions do not provide guaranteed protection against legal action. Financial sponsors should be proactively managing their investments so that they avoid becoming the targets of creditors if one of their portfolio companies files for bankruptcy. If solvency opinions are sought and obtained by the board in a proactive manner, and they are actually used in an informed and logical decision making process regarding a proposed leverage transaction, they can be helpful in the defense against allegations of fraudulent conveyance.

If a portfolio company does ultimately declare bankruptcy, all pre-filing actions by the financial sponsor and all board decisions with respect to that portfolio company will be examined to determine if there are potential claims against the board members or against the company. In such a scenario, business decisions that are likely to draw intense scrutiny include the incurrence of debt and the payment of dividends or redemption of stock.

Foundation and Components of a Solvency Opinion?

The word "insolvent" is an adjective defined as 1) unable to pay debts as they fall due in the usual course of business or 2) having liabilities in excess of a reasonable market value of assets held. The federal Bankruptcy Code itself defines an entity as insolvent if its debts are greater than its assets, at a fair valuation, exclusive of property exempted or fraudulently transferred.

Typically a solvency opinion and the analysis leading to such an opinion are derived from language in Section 548 of the federal Bankruptcy Code regarding fraudulent transfers and obligations, which reads as follows:

> Section 548 (a)(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within two years before the date of the filing of the petition, if the debtor voluntarily or involuntarily:
>
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; or
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

If any one of the three conditions in Section 548 (a)(1)(B)(ii) existed at the time a transfer was made and reasonably equivalent value was not received in the transfer, then the transfer would be considered fraudulent and a trustee could seek to have the transfer set aside or avoided.

In addition, Section 544(b) incorporates state fraudulent conveyance laws into the federal Bankruptcy Code, which essentially allows a trustee to pursue a transaction for more than the two years in arrears now allowed by the revised federal Bankruptcy Code as state statutes are typically longer.

Following from the language in Section 548 (a)(1)(B)(ii), a solvency opinion typically affirms the following factors:

1. The fair value and present fair saleable value of the aggregate assets of the company exceeds the sum of its stated liabilities, including identified contingent liabilities and the liabilities assumed as part of the transaction;
2. As a result of the transaction, the company will not have incurred debts and other liabilities (including subordinated, unmatured, unliquidated, disputed, and identified contingent liabilities) beyond its ability to repay them as they become absolute and mature; and
3. The company will not be left with an unreasonably small level of capital for the business in which it is engaged, as proposed to be conducted by the company as a result of the transaction.

In order to reach an affirmative conclusion in a satisfactory manner, the financial advisor must perform several rigorous analyses which are typically structured around three standard tests.

Test One: Balance Sheet Test

Under the Balance Sheet Test, the fair value and present fair saleable value of the assets of the subject company are compared to their respective total liabilities, including identified contingent liabilities and the liabilities assumed as part of the transaction.

The Balance Sheet Test requires a thorough and complete valuation of the business enterprise and consideration of liabilities, including contingent liabilities. Such a valuation analysis should include full consideration of each of the relevant standard valuation methodologies (an Income Approach, a Market Approach (including a Guideline Company method and Market Transaction method), and an Underlying Asset Approach). The importance of a fully-developed valuation analysis is paramount, as compared to an analysis derived using valuation rules-of-thumb or unexamined thoughts on multiples of EBITDA, as the remainder of the solvency analysis is derived from this underlying valuation analysis. The Income Approach is of particular importance as the cash flow projections relied upon in the Income Approach become the basis for the Cash Flow Test.

Test Two: Cash Flow Test

The Cash Flow Test considers the ability of the subject company to fund its continuing operations and to meet its debt service obligations as they mature. This ability is supported primarily by making adjustments to the projected distributable cash flow of the company to account for the consideration of the repayment of the debt outstanding subsequent to the Transaction, as well as the interest expense on that debt.

There are several sources of cash to which a company can turn to meet these debt service obligations – cash already on hand from prior earnings, cash flow generated in the current period or additional cash from available credit sources (i.e. additional room on the subject company's line of credit). There may in fact be future periods where cash flow generated in a particular year might be projected to fall short of debt service obligations due to a balloon payment or other similar one time obligation. It is not necessarily the case that the company would fail the Cash Flow Test in such a scenario. If the subject company is expected to either have accumulated sufficient cash by that point in time to meet the obligation for that period, or if by virtue of payments already made on the existing debt, the subject company is left with enough debt availability to be in a position to reasonably refinance that debt at that point in time, then it may in fact still be able to pass the Cash Flow Test.

Test Three: Reasonable Capital Test

The Reasonable Capital Test is an analysis to determine whether, based on the transaction, the subject company will be able to meet its mandatory obligations and that operations will be maintained.

In other words, it is necessary to ascertain whether the subject company has adequate capital to meet its obligations as they come due, to operate as a going-concern, and to provide a margin of safety without being forced to make unplanned asset dispositions or change operations materially.

As part of this analysis, it is necessary to assess whether the subject company will meet all of the financial covenants as outlined in the loan agreement. These financial covenants represent operating ratios which are intended to evaluate the ability to meet the debt service obligations.

Downside scenario analyses should be considered on various key cash flow variables, including sales, gross margins, working capital investment, variable interest rates and any other variables referred to in the financial covenants. The sensitivity analyses are performed off of the base case scenario that was utilized in the Cash Flow Test.

Scenario analyses should be performed on a quarterly or even monthly basis if the business is highly seasonal. In addition, a comparison should be made of the working capital and debt levels of the subject company and the guideline companies used in the Market Approach under the Balance Sheet Test in the determination of whether a reasonable level of capital will exist at the subject company subsequent to the contemplated transaction.

Implications in the Event of a Fraudulent Conveyance Claim

What are the ramifications of proceeding with a transaction in which a fraudulent conveyance is later claimed to have occurred? The consequences are not attractive, but financial sponsors that have followed a logical, consistent and diligent process will be better prepared to deal with the fallout. Ultimately, if a portfolio company does file for bankruptcy, directors could be personally liable, secured lenders could lose their security interest and find themselves sharing liquidation proceeds with unsecured creditors, selling shareholders could be forced to return transaction proceeds, dividend recipients could be forced to return the dividend and professional advisors to the transaction could be forced to return their fees. It is in everyone's best interest to avoid each of these possibilities.

It is imperative that any solvency analysis be performed in advance of the completion of a deal so that the financial advisor will have adequate time to do a thorough job, and in the event that a contemplated transaction appears as though it may not pass the critical tests described above, so that the board members considering such a deal will have time to renegotiate the transaction or avoid entering into the transaction if it cannot be renegotiated.

The solvency opinion is based on information available as of the date of the opinion or reasonably foreseeable as of the date of the opinion. However, the need for a contemporaneous analysis is significant because as time passes, it grows increasingly difficult to separate the effects of the transaction on the financial health of the subject company from the effects of any unrelated subsequent events in the marketplace as a whole or specific to the subject company, but unrelated to the transaction.

In selecting a financial advisor to perform such an analysis and provide such an opinion, the financial sponsor should consider both the experience of the advisor in providing such opinions as well as their independence. Both attributes will serve the financial sponsor well should a portfolio company encounter difficulty in the future.