

Alert

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Solvency Opinion Reduces Risk of Liability

Leveraged deals are risky to all parties involved, but are especially risky to secured lenders and to boards of directors and controlling shareholders that approve such deals. Parties to leveraged deals would do well to understand the risks surrounding such transactions and the ways to reduce these risks. A solvency opinion rendered at the time of the transaction is one of the most cost-effective ways to mitigate the risk of potential liability in bankruptcy for all parties to the transaction.

A solvency opinion is a document stating that a borrower is, and will remain, solvent under the burden of additional debt as a result of a transaction. The concept of solvency is defined under the fraudulent conveyance laws and related case law. Transactions typically requiring solvency opinions are leveraged buyouts, leveraged recapitalizations and leveraged dividend transactions. As an adjunct to a solvency opinion, VRC will often provide a capital adequacy opinion (also referred to as a capital surplus opinion). The concept of surplus is governed by Delaware or other applicable state corporate law.

SOLVENCY OPINION CRITICAL

The risks surrounding leveraged deals stem from the potential use of fraudulent conveyance claims by unsecured creditors in a bankruptcy proceeding to contest a leveraged transaction. If the deal is determined to be a fraudulent transfer, a lender's security interest in the company's assets can be voided and the lender risks subordination of its claims to the company's other creditors. Directors and controlling shareholders risk a breach of fiduciary duty to lenders, and thus may face personal liability for the insolvency of the company. In a worst case scenario, the entire deal can be reversed affecting all parties including deal advisors who could be required to return their fees.

A solvency opinion addresses potential attacks under the constructive fraud theories of the fraudulent conveyance laws. Constructive fraud is not concerned with the intent of the parties to the transactions, but the result of the transaction. In general, under the constructive fraud theories, a transfer may be avoided where the leveraged company does not receive reasonably equivalent value for the transfer and if either of the following circumstances exist: (i) the company is insolvent at the time of the transfer, or is rendered insolvent by the transfer; or (ii) the target is left with unreasonably small assets (capital) for its business. The structuring of most leveraged deals causes them to fail the reasonably equivalent value test, which is why such deals are vulnerable to fraudulent transfer claims. All that is left for unsecured creditors to demonstrate is that one of the two preceding circumstances is not true.

Given the risks identified, obtaining a thorough analysis of the proposed transaction on the financial health of the company by an independent third party at the time of the transaction is critical.

SOLVENCY TESTS

A solvency opinion typically addresses three tests: (i) a statement that the fair value of the assets exceeds the liabilities (the balance sheet test), (ii) the entity has the ability to repay its debts as they mature, and, (iii) the entity does not have unreasonably small capital for its business.

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The balance sheet test involves establishing the fair value of the company's equity on a post-transaction basis. If the debtor is a business enterprise and is expected to continue operating as a going concern after the deal, then valuation of the business as a going concern is the appropriate basis of valuation. The most efficient way to do this is to value the business on a debt-free basis and then subtract the fair value of the company's post transaction debt to arrive at net equity. If the equity is greater than zero the company is considered solvent.

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The second and third tests are related and can be accomplished by projecting the company's future cash flows. A company will pass these tests in any projected period if it generates or has access to sufficient cash to fund its operations and is able to pay its debts as they come due. In performing these tests, free cash flow generated by the business is considered together with borrowing availability. Borrowing availability refers to the unused credit under the company's credit line that can be borrowed without causing an event of default. Borrowing availability may also consist of the ability to refinance the company to take advantage of the prior debt repayments.

We are seeing more boards of directors requesting a capital surplus opinion when issuing a significant dividend. This test is similar to the balance sheet test for a solvency opinion. Capital surplus is concerned with whether the value of a company's equity (surplus) is greater than its (i) stated (par) value and (ii) the amount of the contemplated dividend.

CASE STUDY

VRC has issued more than 900 solvency and capital surplus opinions for transactions valued at more than \$60 billion. Many of these opinions have been addressed to the board of directors of public companies. Due to the large number of transactions for which VRC has issued opinions, we have naturally been involved in some transactions where the debtors have later experienced financial distress or filed for bankruptcy. (The occurrence of bankruptcy after a leveraged transaction does not necessarily mean that the company was insolvent as a result of the deal or that a fraudulent conveyance occurred.) One transaction in particular that is worth noting involved Healthco International. In this high profile deal, Healthco International and 69 other different parties (including VRC) were sued by the bankruptcy trustee. It was a unique case in that the trustee settled with one defendant out of court and used the money to fund a much larger suit (\$240 million) against a host of others. Another unique aspect of the case is that it was the first (and perhaps only) case to go to a full jury trial for decision. The verdict was in favor of all defendants and VRC's solvency opinion and court room testimony were essential to the verdict.

For more information on solvency opinions contact your Valuation Research representative or Bryan Browning at 917-338-5615.

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