Solvency Opinions and Concerns about Fraudulent Conveyance in Leveraged Transactions

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The many considerations related to solvency opinions can be quite complicated. Yet these analyses are often required as a condition for consummating sizeable recapitalizations and other risky corporate transactions. A solvency opinion may serve as the means (1) to address the possibility that the transaction could be alleged to be a fraudulent conveyance at some point in the future and (2) to provide comfort to fiduciaries responsible for approving such transactions. This discussion describes each of the three financial tests that are the components of the fraudulent transfer analysis. And, this discussion presents considerations and procedures that (1) enhance the analytical support for the solvency opinion and (2) bolster its usefulness to the intended user.

Introduction

Independent financial advisers are often asked to issue solvency opinions in order to provide an assessment of a debtor company's solvency as of the date of a proposed leveraged transaction.

For instance, a debtor company board of directors may often request that a solvency opinion be procured as part of its due diligence process for certain corporate transactions. Should the board of directors approve a proposed transaction, the solvency opinion (1) provides support for the decision and (2) provides evidence of actions taken in order to fulfil the board's fiduciary duty of care should the transaction be challenged in a fraudulent conveyance claim.

Examples of corporate transactions that may benefit from the preparation of a solvency opinion include, but are not limited to, the following:

1. Leveraged dividend recapitalizations
2. Equity security redemptions
3. Leveraged asset purchases
4. Substantial liability payments

When financial advisers refer to a solvency opinion, they are typically referring to the performance of several tests to determine whether the conditions indicative of a fraudulent conveyance as presented in Bankruptcy Code Section 548 exist as of a specified date. Therefore, the solvency opinion, in this context, is essentially a preemptive fraudulent conveyance analysis.

The three generally accepted tests—and the associated conditions—for fraudulent conveyance and for the related solvency opinions include the following:

1. The *balance sheet test* considers whether the total fair value of the debtor company assets is greater than the total amount of the debtor company liabilities.
2. The *cash flow test* evaluates whether the debtor company will be able to pay its debts and other financial obligations as they become due. The period analyzed is generally from the transaction date through the maturity date of any transaction related debt.
3. The *capital adequacy test* considers whether the debtor company has the capital needed to meet its operating expenses, capital expenditure requirements, and debt repayment obligations during the first few quarters after the proposed transaction.

The analysis of reasonably equivalent value is typically included when analyzing a transaction for fraudulent conveyance purposes. However, it is not typically included as a separate analysis when conducting a pretransaction solvency opinion. This subject is beyond the scope of this discussion.

In a bankruptcy context, the notion of solvency is limited to an analysis of assets and liabilities. However, in the context of this discussion, the terms "solvency opinion" and "solvency analysis" will refer to an analysis of a debtor company that is performed prior to a proposed transaction and includes the performance of the three aforementioned fraudulent transfer tests.

The Balance Sheet Test

The balance sheet test indicates whether, at the time of the transaction, the total fair value of the debtor company assets is greater than the total amount of debtor company liabilities.

First, the analyst typically considers the highest and best use of the debtor company assets. The highest and best use analysis indicates the appropriate premise of value for the valuation aspects of the analysis. A typical premise of value conclusion is value in continued use, as part of a going-concern business enterprise.

Second, the analyst typically estimates the fair value of the debtor company assets, including (1) financial assets, (2) real estate and tangible personal property, and (3) intangible assets.

Third, the analyst estimates the amount of debtor company liabilities including all (1) current liabilities, (2) long-term liabilities, (3) contingent liabilities, (4) disputed claims, and (5) any liabilities attributable to the proposed transaction (i.e., transaction debt).

Fourth, the analyst compares the fair value of the debtor company total assets to the amount of the debtor company total liabilities. The debtor company is considered to "pass" the balance sheet test if the fair value of the total assets exceeds the amount of the total liabilities.

Contingent Liabilities and Disputed Claims

Disputed claims and contingent liabilities can be particularly tricky in a balance sheet test analysis. This is because these liabilities are not usually readily identifiable and may or may not be disclosed in debtor company financial statements or other information provided by the company management.

A contingent liability is an obligation that requires a triggering event to occur before the debtor company is required to pay a specified amount to a creditor. However, a disputed claim involves a dispute about the amount associated with a claim after the events spawning the claim have already occurred.

These types of liabilities are not always obvious. Therefore, a financial adviser should conduct appropriate due diligence to ensure that contingent liabilities and disputes claims are accurately reflected in the analysis.

A significant factor in estimating the amount of a contingent liability or disputed claim—and its impact on the debtor company—is the uncertainty surrounding:

1. the occurrence of a triggering event in the case of a contingent liability or
2. the outcome of a dispute in the case of a disputed claim.

In both instances, financial advisers may typically apply a probability weighting that is reflective of the chances of a certain outcome occurring.

The Cash Flow Test

The cash flow test is designed to consider the debtor company's ability to pay its financial obligations (including any new debt related to the proposed transaction) as they mature.

The starting point for the cash flow test analysis is typically a set of earnings or cash flow projections developed by the company management. The length of the projection period should typically be equal to the repayment period for any new debt related to the proposed transaction.

The financial adviser may use the financial projection to estimate the debtor company's net cash flow, after taking into account the financing and operating obligations as well as capital investment and working capital needs of the company.

The cash flow test is considered "passed" if the debtor company is expected to have the ability to meet its financial obligations and remain in compliance with any debt covenants in each year of the projection period.

The Capital Adequacy Test

The capital adequacy test (sometimes called the "reasonable capital test") indicates whether the debtor company is engaged in a business or transaction for which it has an adequate amount of capital. The capital adequacy test evaluates the debtor company's ability to meet its (1) operating expenses, (2) capital expenditure requirements, and (3) debt repayment obligations.

The goal of the test is to evaluate the likelihood that the company will survive potential business fluctuations over several quarters following the closing of the proposed transaction.

The capital adequacy test involves an analysis of short-term sources and uses of funds, typically for the next four to six quarters following the transaction date.

Typically, the capital adequacy will have an appearance very similar to the cash flow test and should also include the same or similar scenario and sensitivity analyses as well as stress testing.

The capital adequacy test is "passed" if the analysis indicates that the company is expected to have sufficient cash on hand to pay its:

1. operating expenses,
2. capital expenditures, and
3. debt repayment obligations.

As part of the cash flow test and capital adequacy test, the financial adviser generally performs scenario analyses, which may include sensitivity and stress testing, in order to more rigorously assess risks associated with the proposed transaction. This can also be used as a tool to give fiduciaries and managers insight into how the proposed transaction could affect the company under various operating conditions.

Scenario Analyses

The terms "scenario analysis" and "sensitivity analysis" are sometimes used interchangeably. However, for purposes of this discussion, a distinction can be made. While a scenario represents a possible future environment or set of circumstances within which the debtor company could find itself operating, the sensitivity analysis is related to the observed outcomes achieved by changing the financial variables of the scenario.

Often, a scenario analysis is deterministic in nature. That is to say that it has single point estimates for key inputs and outcomes determined by the parameter values.[1]

However, scenario analyses can be stochastic in nature with one or more random variables, and be used to estimate the probability of outcomes within a forecast. An example of a stochastic analysis is a Monte Carlo simulation. While certain elements of this discussion may be applicable to deterministic and stochastic scenario analyses, the focus of this discussion is on deterministic scenarios.

> “No matter the type of scenario, care should be taken to consider and understand the types of operational disturbances, both internal and external, that could cause such scenarios.”

A very basic deterministic scenario analysis will include the base case scenario and a sensitivity analysis of the base case. However, certain situations may call for a more rigorous analysis, which could include sensitivity analyses and stress tests related to several types of scenarios.

Scenarios can be grouped into several broad categories, including the following:[2]

- Single event scenarios are relatively straightforward and are usually not the types of events that would result in a chain of successive events.
- Multi-event scenarios are the result of multiple factors that cause a chain of successive events due to causal linkages between various factors.
- Reverse scenarios are developed by determining what set of conditions will lead to a specified financial result. This type of analysis can be especially challenging because such an analysis involves a comprehensive understanding of the risk dynamics of the subject debtor company.
- Historical scenarios are based on actual historical events. The advantage of the historical scenarios is that the short-, medium-, and long-term effects of the event can be observed. Further, the effect of the event on specified risk factors and the relationships between risk factors can be studied. Based on this study, the financial adviser can make proper adjustments when developing scenarios that assume similar events occur in the future.
- Synthetic scenarios involve hypothetical circumstances that have not been observed, but could occur at some point in the future. An example of a synthetic scenario would be the development of a breakthrough technology.

No matter the type of scenario, care should be taken to consider and understand the types of operational disturbances, both internal and external, that could cause such scenarios. Internal and external factors can be grouped into economic, industry, and company-specific categories. Any combination of factors can be used as the event catalyst or the basis for a scenario.

Scenario Development Considerations

Management-prepared financial projections are typically the starting point of a scenario analysis in the context of a solvency opinion. It is the financial adviser’s responsibility to assess the reasonableness of the financial projection starting point.

The financial adviser should understand the narrative behind the financial projections and the relationships between the assumptions and variables that drive the projections. When developing scenarios, the financial adviser applies this knowledge to ensure that changes to the financial variables:

1. correctly flow through the model and
2. accurately reflect the relationships between cash flow drivers.

The due diligence related to the financial projections also helps the financial adviser to be able to recognize additional scenarios that should be analyzed in order to provide a robustly supported solvency opinion.

The following illustrative questions are financial-projection-specific inquiries that may provide perspective and may aid the financial adviser in identifying aggressive or conservative bias within the financial projections:

1. What is the functional use or purpose of the financial projections?
2. How experienced is the company management team in preparing financial projections?
3. When were the financial projections prepared?
4. How does the current projection reconcile with historical projections?
5. Who prepared the financial projections and what was the process?
6. How comprehensive are the projections and the supporting documentation?

The reasonableness analysis encompasses the evaluation of many factors and requires the understanding of the interrelationships of these factors, while also considering the impact of outside influences on the company-specific risk elements.

The financial adviser should typically develop a thorough understanding of the mechanics of the company's projection model—as well as the story supporting the projection—before moving forward with the scenario analysis.

The financial adviser can then develop one or several scenarios based on economic, industry, or company-specific factors identified during the due diligence process. While general economic and industry data are typically readily available, a financial adviser should consult the company management in order to understand how and what data was used to develop the projection.

There are many company-specific risk factors that can be informative when included in scenarios for the cash flow test and capital adequacy test. Debtor company management may be a valuable resource for assistance in identifying the company's unique areas of risk and the potential impact on financial performance.

Debtor company management can alert financial advisers to the implications surrounding areas of company-specific risk such as the following:

1. Geographic concentration
2. Customer concentration
3. Key person dependence
4. Supplier concentration
5. Technology or other intellectual property obsolescence
6. Lack of product diversification
7. Unique exposure to changes in laws or regulations
8. Potential or existing litigation
9. Strained supplier relations
10. Strained employee relations
11. Plant and physical capacity constraints

Sensitivity Analysis

After developing several scenarios, the financial adviser may run sensitivities of all or certain scenarios to observe the outcomes resulting from incremental changes in the financial variables. A sensitivity is the effect of a set of alternative assumptions regarding a future environment or scenario.[3]

For example, when a financial adviser uses the company management projections as a starting point and then adjusts the variables to reflect small changes in the execution of management's plan, then they have created a sensitivity analysis.

By reviewing the outcomes to various sensitivities, the financial adviser should be able to observe the responsiveness of the cash flow to relatively small changes in the financial variables within the framework of a given scenario.

Stress Testing

A stress test is a projection of the financial condition of a company under a specific set of severely adverse circumstances that may be the result of one or several risk factors resulting in severe consequences that can extend over months or years. The likelihood of the stress test condition is typically not likely, yet plausible.[4]

Examples of stress tests scenarios include, but are not limited to, natural disasters, terrorist attacks, political instability (revolution, regime change, expropriation), regulatory changes, economic depression, company fraud, and war.

Summary and Conclusion

Solvency opinions are typically prepared in the context of a proposed transaction when a corporate board of directors or other intended user requires:

1. evidence of actions taken to fulfil their fiduciary duty and
2. comfort that a proposed transaction is not expected to directly cause the insolvency of the company.

A financial adviser should be sure to conduct proper due diligence and apply the appropriate analytical procedures in order to develop a defensible solvency opinion.

Notes:

1. *Stress Testing and Scenario Analysis* (Ottawa, Canada: International Actuarial Association, July 2013), 3.
2. Ibid., 12–16.
3. Ibid., 4.
4. Ibid.

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