The Use Of Solvency Opinions In Leveraged Transactions

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A solvency analysis is both a logical and financially prudent means of achieving the proper level of assurance with leveraged transactions. Generally, solvency is the ability to meet debt obligations as they come due. The solvency analysis typically includes a three-step process incorporating a review of the fair saleable value of the assets and stated value of liabilities, the cash flow capacity of the company and the ability to meet obligations as they come due.

The Need for Solvency Opinions

Effectively, a leveraged transaction is a change in the capital structure or a wealth transfer, where the value of a company shifts from the market value of its equity to the market value of debt, and some or all of the former equity holders exchange equity stakes for liquid assets. The use of debt to finance acquisitions or the operations of a business is not a risk less solution. Perceived optimism and the benefits to an investor as to the value of a company, particularly through leverage, can be uncertain due to the significant increase in interest charges and repayment schedules. Nevertheless, leveraged transactions have resulted in value added synergies, enhanced financial performance, or effective penetration of new industries.

It must be noted, however, that in declining growth periods, increased interest charges and repayment schedules can be materially damaging to a company's value. The associated, and sometimes underestimated, cost of assuming significant leverage to induce growth is the increased potential for financial distress or failure. Such costs include forgone investment opportunities due to potential cash shortages, difficulty in raising additional capital, disproportionate increases in required rates of return on equity capital and conflicts between creditors and stockholders due to contradictory objectives.

Furthermore, the absence of sophisticated and accurate management restructuring, and cash flow analysis, as well as the uncertainty in properly projecting the company's ability to service the debt payments, can negatively impact the financial strength of a company and ultimately may force the acquirer to cease operations, liquidate some of its assets, or even declare bankruptcy when repayment of debt is becoming unfeasible.

Definitions of Solvency

A solvency analysis is both a logical and financially prudent means of achieving the proper level of assurance with leveraged transactions. Generally, solvency is the ability to meet debt obligations as they come due.

Insolvency is an inability to service debt obligations. The formal definition for insolvency according to the U.S. Bankruptcy Code 11 U.S.C. Section 101 (32):

> "Insolvency is a financial condition such that the sum of [the] entity's debts is greater than all of [the] entity's property, at a fair valuation."
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> "Fair value, in the context of a going concern, is determined by the fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts."

Solvency Tests

Solvency opinions are rendered by independent financial advisors according to a three-step valuation process, which closely examines the fair market value of a company's assets, cash flows, and capital requirements such that:

(1) The fair market value and present saleable value of a company's assets exceeds the stated and identified contingent liabilities;

(2) Post transaction, the company would be able to pay its debt and contingent liabilities, as they mature; and

(3) The remaining capital of the company is a reasonable amount for the business in which it is engaged.

In a highly leveraged transaction, the absence of the proper liquidity, cash flow, and capital analysis can ultimately result in financial distress and bankruptcy for acquiring companies. Solvency opinions confirm that an investor should expect that an acquiring company would remain solvent according to the criteria listed above after an acquisition, merger, or other corporate restructuring that was consummated with debt financing.

Use of Solvency Opinions

Solvency opinions, issued by independent third parties to lenders or to the board of directors of the buyer or the seller, are also utilized as assurance for creditors in case of bankruptcy. In bankruptcy proceedings, the absence of an independent opinion, presented to the parties involved in a given transaction can result in a lender's loss of right to priority repayment of debt from liquidation proceeds.

Without proof of a debtor's solvency under Bankruptcy Code section 547 (i.e. a solvency opinion which opines to solvency prior to and post a transfer of payments) rights to preferential payments may be denied. The debtor can call payments made to creditors that occurred 90 days prior to bankruptcy filings, if prior to the transfer or at the time of the transfer, the debtor was insolvent. However, according to the U.S. Bankruptcy Code, if a creditor can show that the debtor was solvent at the time the disputed transfer was made, it may retain the payment.

Application of the Solvency Opinion

Solvency opinions are rendered by independent financial advisors and provide essential assurance to retaining priority or preferential payment subsequent to providing capital in leveraged transactions. The creditor(s) can be related to or separate from the investing party and are usually banks or investment vehicles specializing in lending capital (e.g. LBO Fund, Venture Capital, etc.).

Corporate recapitalizations, restructurings, or strategic mergers and acquisitions drive leveraged transactions or buyouts for the restructuring or the acquiring entity. Typically, banks and or the investment entities commit capital in exchange for senior debt or for senior preferred equity, respectively. Both assets have priority rights to distributions and repayment over the common equity shareholder in the company.

Methodology Solvency is determined both pre and post the restructuring transaction, and independent appraisers employ different valuation methodologies including: (1) the guideline companies method of the market approach, (2) the transaction method of the market approach, (3) the discounted cash flow method of the income approach, or (4) an asset approach to determine solvency based on the three step process.

Depending on the assumed valuation scenario, namely the consummation of the recapitalization, the assumptions for growth, earnings potential, and resulting leverage, net cash flows may vary accordingly. Ultimately, the positive equity value derived by each method support an opinion of solvency based on fair market and saleable value, debt service, and remaining capital. On the other hand, a negative equity value indication would indicate that the company was currently and/or expected to be insolvent.