

How a Solvency Opinion Clarifies Risks in Highly Leveraged Transactions

Why do companies sometimes fuel transactions by increasing their debt load? Actually, there's method behind this strategy. Corporations often participate in leveraged buyouts and recapitalize and restructure in an attempt to maximize shareholder value and avoid hostile takeovers. Because these transactions substitute debt for equity in the firm's capital structure, they can exploit debt financing's lower cost and tax advantages. But how do companies know that a highly leveraged transaction is worth the gamble?

Savvy companies start the transaction process by getting a solvency opinion from an independent financial advisor. Let's look at how these opinions help mitigate risk for secured lenders and corporate directors, and the ways in which transactional parties can reduce these risks.

Solvency Concerns

In many leveraged restructurings, the financing proceeds are often used to either buy out selling shareholders or pay a large dividend. This is in lieu of reinvestment in the business. Therefore, a company's liabilities increase significantly without a corresponding rise in assets.

Could a leveraged restructuring render the company insolvent (the company's liabilities exceed its asset value)? Certainly, such transactions can result in the assets' book value being lower than the liabilities' book value.

However, this fact alone doesn't necessarily warrant concern by the company's lender. Why? Because the market value of assets often far exceeds their book value. But, the higher leverage imposed in many buyout or restructuring transactions increases the possibility that a company's assets may be lower than its liabilities, even on a fair market value basis.

Recent market and legal developments have increased solvency concerns among lenders and corporate directors. Certain thinly capitalized transactions have brought into focus questions about borrowers' solvency and ability to pay debts.

In addition, the structure of these transactions provides little comfort that adequate consideration was received, since the loan proceeds are paid out to the company's selling shareholders rather than used in the business. Three situations that may cause problems are:

- **Increases in interest expense and principal payments.** Higher debt payments may push into bankruptcy highly leveraged businesses already operating with little margin for error.
- **Constructive fraud tests.** Knowledge that the transaction would lead to insolvency, rather than fraudulent intent, is often sufficient for a finding that a fraudulent transfer has occurred.
- **Attempts to apply fraudulent conveyance law when the company isn't insolvent.** Fraudulent conveyance claims have been used in leveraged buyout transactions as legal maneuvers to block potential transactions.

Three Solvency Tests

To be upheld if challenged, a solvency opinion must address the three key tests embodied in the Bankruptcy Code and fraudulent conveyance laws. These tests are:

1. Balance sheet stability. Is the company's fair salable asset value greater than liabilities following the transaction?
2. Capital adequacy. Will the company have an unreasonably small amount of capital for the businesses in which it's currently engaged or proposes to engage in following the transaction?
3. Cash flow sufficiency. Can the company reasonably expect to meet its obligations as they mature after the transaction?

Rely on an experienced financial advisor to put your deal to the test.

Solvency Opinion Components

For both lenders and corporate directors, a valuable solvency opinion addresses all key issues comprehensively and reasonably in a way that could withstand potential court scrutiny. There are four questions to ask when reviewing a solvency opinion:

1. Has the analyst evaluating business operations exercised proper due diligence?
2. Have all transaction documents, including loan and shareholder agreements, been thoroughly reviewed?
3. Have management's forecasts been used unquestioned, or have the projections been tested for reasonableness and subjected to sensitivity analysis? This analysis would determine what effect changes in macroeconomic conditions (for example, GNP growth, inflation and interest rates) and microeconomic factors (for example, product demand and price levels) have on company sales and profitability.
4. Has the effect of refinancing been properly considered?

These questions can help you determine whether your advisor has sewn as many potential loopholes as possible.

Along with objectively analyzing the company's solvency, the opinion shows good faith on the lender's (as well as the company's) part. In addition, an independent and objective third-party opinion comforts smaller banks buying "participations" in large deals. Ultimately, that makes the deal's syndication easier for the lead bank.

An Opinion Worth Seeking

Rising market volatility, a potential return to higher interest rates, increased shareholder activism and the courts' liberal application of fraudulent conveyance law to leveraged transactions suggest that claims against secured lenders and corporate directors will increase in the years ahead. What can you do? Prudently select an experienced third-party financial advisor to provide your deal's solvency opinion.



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