

THE UNREASONABLY SMALL CAPITAL TEST IN SOLVENCY OPINIONS: MEANING, METHODOLOGY, AND APPLICATION

INSIGHTS

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Among the three core solvency tests, the Unreasonably Small Capital Test (USCT) is the least defined and the most frequently misunderstood. Unlike the Balance Sheet Test (BST) and the Cash Flow Test (CFT) — both of which rely on straightforward comparisons and simple math (once the valuation analysis is complete, of course!) — the USCT asks a different question: Does the company, post-transaction, have enough capital or access to capital to operate through reasonably foreseeable downside conditions?

Courts have repeatedly emphasized that the USCT should focus on the company's forward-looking resilience through analysis of their projections. A business can pass the BST and CFT and still fail the USCT if it is poised to run into trouble under plausible adverse circumstances. This article outlines how courts have historically approached the USCT and presents a practical, defensible methodology for assessing the test.

Legal Framework: What is the Meaning and Intent of the USCT?

We are valuation professionals and not attorneys. However, we believe that the best place to start to determine the meaning of the elusive USCT is case law. Three cases are frequently cited in connection with the USCT. The first case is *Moody v. Security Pacific Business Credit, Inc.*^[1], which established key components of the USCT. The Court held that unreasonably small capital describes a financial condition “short of equitable insolvency” — meaning a company can be technically solvent (passing the BST and CFT) yet constructively insolvent if it is on a path of insolvency post transaction. Interestingly, the Court recognized that ‘unreasonably small capital’ is not defined by the Uniform Fraudulent Conveyance Act (UFC).

The Court further provides intent of the USCT when it held that unreasonably small amount of capital refers to the company's “inability to generate sufficient profits to sustain operations”. We can see that the Court is concerned that having

[1] *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992)

unreasonably small capital, i.e., inadequate capital or access thereto, could potentially impact the company's future operations. This concept also brings up a primary focus of this case regarding the USCT: consideration of the 'reasonableness of the company's projections'.

The next case is *MFS/Sun Life Trust v. Van Dusen Airport Services, LP*^[2]. There are a few takeaways from this 1995 case. The Court once again raised a similar concept brought about in *Moody*: that the USCT is intended to address transfers—such as dividends or distributions—that leave a company technically solvent but ultimately destined to fail. The Court also indicated that to determine adequacy of capital, one should look at factors such as the company's debt-to-equity ratio, historical capital cushion and the need for working capital in the specific industry at issue. As in *Moody*, the Court focused on management's contemporaneous financial projections. Taken together, *MFS/Sun Life Trust* and *Moody* demonstrate that the USCT's adequate capital analysis centers on the transferor's expected future performance, the reasonableness of management's projections, and whether the company will have sufficient capital to sustain operations after the transfer.

Finally, *In re Autobacs Strauss, Inc.*^[3] similar themes were expressed as in *Moody* and *MFS/Sun Life Trust* with the addition of a new concept: (1) a debtor has unreasonably small capital if it cannot generate enough cash flow to sustain operations (as noted in *Moody*); (2) reasonable foreseeability (of projections) is the standard; and (3) whether the debtor had the requisite access to capital markets to raise money, if necessary.

Methodology for Applying the USCT

With the legal framework in mind, we recommend a three-step methodology: (1) evaluate the reasonableness of management's base projections, (2) model downside projection scenarios and (3) assess the debtor's ability to fund any resulting shortfall given the downside projection scenarios. Together, these steps test whether the debtor can sustain operations — meaning it can meet operating expenses, debt service, capital expenditure requirements, and working capital needs — if its projections prove overly optimistic or actual performance falls short.

Step 1: Evaluate the Reasonableness of Management's Projections

Evaluating the company's projections is a critical first step in the application of the USCT. Our analysis typically focuses on three areas:

- (1) Historical performance of the company
- (2) Industry metrics
- (3) Expected biases

For the historical performance, we review the expected future performance as compared to historical results. While past results do not dictate future performance, significant divergences require explanation: we need to understand why and how the company will achieve the projected outcome, and whether those assumptions are reasonable, aggressive, or conservative.

For industry metrics, we utilize as much independent data as possible, including the guideline public company (GPC) data (i.e., comparable company data), industry studies and

[2] *MFS/Sun Life Trust v. Van Dusen Airport Servs.*, 910 F. Supp. 913 (S.D.N.Y. 1995)

[3] *In re Autobacs Strauss, Inc.* 473 B.R. 525 (Bankr. D. Del. 2012)

industry benchmarks. As with historical performance, the company need not mirror the industry exactly, but any material divergence — outperformance or underperformance — requires a clear explanation of the drivers and a reasonableness assessment of those assumptions.

Finally, we qualitatively assess any expected biases from the parties providing the projections and stress-test those biases. Together, these three factors form a holistic view of projection reasonableness — and directly inform the downside scenarios developed in Step 2.

Step 2: Model Downside Scenarios

After we evaluate the reasonableness of management's base projections in Step 1 and we can identify the key assumptions where small input changes produce large cash flow impacts, we can target those areas for stress testing. Scenarios vary by company; common examples include:

- If the company's revenue performance has been historically volatile, we model different scenarios around that volatility. What is biggest drop the company has experienced? How did that affect cash flow?
- If the company's margins have been historically volatile, we model different scenarios around margin assumptions. If the company's margins are expected to deviate from industry benchmarks, we analyze scenarios where margins revert to historical levels.
- If the company's performance is cyclical or seasonal, i.e., they perform well in Quarters 3 and 4, but have a downturn in Quarters 1 and 2, we model this cyclical or

seasonality to determine if they can sustain operations in the down quarters.

On that topic, we perform the USCT on a quarterly basis and over a shorter period than the CFT, which is typically annually over a period of several years. For the USCT, we typically perform a quarterly analysis for a period up to eight (8) quarters as this period will typically satisfy the 'foreseeability rule'.

Step 3: Assess Liquidity and Access to Capital in Downside Cases

With the downside scenarios modeled, we assess the capital required to sustain operations in each scenario. If operating cash flow provides sufficient buffer, the USCT passes. If not, the next question is whether the company has a funding source. When a revolving credit facility exists, we model a revolver draw (and associated debt service) to cover any shortfall.

The most challenging scenario arises when the company lacks a revolver or sufficient revolver capacity. This situation raises the specter of inadequate capital or access to capital. In this case, we assess whether the company could access additional debt. First, we review the existing covenants to confirm new debt would not trigger a violation. Next, we benchmark the company's debt capacity against GPCs using debt-to-total capital (DTC) ratios ^[4], interest coverage ^[5] and debt-to-EBITDA ratio, among other financial metrics. This gives us an idea of the company's capacity to take on additional debt, if necessary. This is the riskiest scenario for sure: we are estimating whether the debtor could obtain required funding at some unknown future date and at unspecified terms. When a company cannot demonstrate access to sufficient capital in the downside scenarios, a

[4] DTC = Debt / (Debt + Equity)

[5] Interest Coverage Ratio = Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA) / Interest

conclusion that the debtor fails the USCT may be warranted.

Alternative Views for Applying the USCT

Some practitioners have dealt with the USCT differently. For example, one method is to simply review the DTC ratios of the GPCs as compared to the subject debtor. If the DTC ratio of the subject debtor falls within the range of the GPCs, they conclude that the USCT passes. We believe this approach is not adequate and it does not test the intent of the USCT. First, the GPCs DTC ratios often span a wide range — 5% to 90% is not unusual — which makes a ‘within-range’ conclusion essentially meaningless as a capital adequacy determination. Second, a debtor with, say, an 85% DTC ratio (near the upper bound) would pass under this approach despite being nearly tapped out on capital access. The company may require substantial additional funding if projections prove aggressive and the industry turns down — leading to insolvency that a static DTC ratio comparison would never flag. A DTC benchmark cannot substitute for a forward-looking analysis tied to the debtor’s specific projections and capital needs.

Conclusion

In conclusion, we reviewed often cited cases that discuss the USCT and put together a framework for this otherwise undefined test. The three-step methodology — assessing projection reasonableness, modeling downside scenarios, and evaluating the ability to fund any resulting capital shortfall — is designed to satisfy the USCT’s meaning and intent as articulated by the Courts. This framework allows practitioners to answer the core question of the USCT: **After the transaction, will the company be equipped to sustain operations through reasonably foreseeable adversity with enough access to capital, if necessary?**

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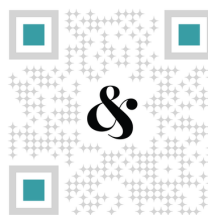
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