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Solvency Opinions

A common myth is that when two parties are dealing at arm's length there is no such thing as "too good of a deal". This view ignores the laws relating to solvency. In fact, if a transaction is done while the seller is insolvent or the seller becomes insolvent as a result of the transaction, then there can be "too good a deal" and that deal can be undone – even years after it closes. The law which explains this rule, some of which is captured in Section 548 of the Bankruptcy Code, is the law of fraudulent transfer.

Fraudulent transfer exposure can be devastating because **civil liability** can be imposed without moral fault on the part of the person being sued for recovery and the look-back period can extend up to six years. No actual fraud or normative wrongdoing is required. Civil liability can result simply from having benefited to the detriment of the other party's creditors where, at the end of the day, there are insufficient assets to satisfy the claims of such creditors.

A FRAUDULENT TRANSFER OCCURS WHEN:

- A transaction (or other corporate event – such as a dividend or other distribution or even an arm's length sale for inadequate consideration) results in the counterparty receiving a benefit at the expense of unsecured creditors; and
- The company (i) at the time of the transaction is insolvent, or (ii) after the transaction either (a) has unreasonably small capital to continue its business or (b) is unable to repay its obligations as they become due.

WHY WORRY?

Sometimes one hears the comment: Why worry? The worst case is that I'll have to pay what some court someday determines to be "fair market value." This approach overlooks the fact that **the remedy can be a complete unwinding of the transaction**, plus loss of any revenues associated with the contested asset.

The very desperation of the seller/borrower should give the buyer/lender warning that the transaction may be subject to fraudulent transfer liability. Particular caution needs to be exercised when:

- Purchasing assets from a company needing to raise money to pay maturing debts;
- Purchasing a cash flowing business or assets from a company which intends to use the proceeds to fund a struggling business unit;
- Entering into any transaction with a company that is subject to a going-concern audit opinion;
- Transacting with any company on terms that seem to be too good to be true, or which is characterized as a "loss leader;" or
- Entering into any transaction which will result in a payment or distribution to shareholders or the repurchase of any securities.

WHAT CAN ONE DO TO MITIGATE THIS RISK?

When solvency warning signs are present, consideration should be given to doing a solvency analysis of the counterparty to the anticipated transaction. Such an analysis should include the following considerations of the financial condition of the counterparty to the transaction:

- Is the counter-party insolvent under the balance sheet or the going-concern test?
- After the transaction, will the counterparty have sufficient capital to continue its business and pay its debts as they mature?

The bankruptcy test for insolvency looks to fair value rather than to accounting rules that focus on the lesser of historic cost or fair value.

ROLE OF A SOLVENCY OPINION AND WHEN SHOULD ONE BE OBTAINED

A solvency opinion is both a valuation opinion and a market test of the company's forward-looking financial statements. In other words, does the value of the company's assets – applying the applicable valuation standard – exceed its liabilities and, given market realities and what other similarly situated companies are experiencing, are the company's cash flow and working capital projections and assumptions reasonable?

A solvency opinion is a portion of the overall due diligence to be completed by both transferor and transferee. It is designed to demonstrate the reasonableness of the assumptions used and to build an evidentiary case in advance of any legal challenge that the company was in fact solvent at the time of the transaction, and that the transaction did not cause the insolvency of the company or leave it with too little working capital to execute on its intended business plan.

To be effective, a solvency opinion needs to be able to pass judicial muster. The fee must be reasonable given the scope and extent of the work done. The hallmarks of a supportable analysis and opinion are:

- Independence,
- The conduct of a thorough and rigorous analysis, based upon market tests, and not made subject to unreasonable time or inquiry restraints, and
- Demonstrated expertise, based either on past experience or appropriate due diligence and inquiry.

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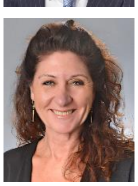

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