

Solvency Opinions: The Problem with Getting a Deal That is Simply Too Good

This guide is intended to provide summary information that may be useful for executives or directors planning future transactions to determine what due diligence may be prudently required. The laws applicable to fraudulent conveyance and preferences are complex. In particular, the law applicable to fraudulent transfers varies significantly from state to state. The case law is extensive. Accordingly, this publication is not intended to constitute legal advice, and in determining what action may or may not be appropriate in a given situation, counsel familiar with local laws and judicial precedents should be consulted.



Introduction

Some people think that when parties are dealing at arm's length, there is no such thing as a deal that's too good. This view ignores long standing laws relating to solvency. In fact, if a transaction is done while the seller is insolvent or, as a result of the transactions the seller becomes insolvent, then there can be "too good a deal," and that deal can be undone – potentially years after the event. The law, some of which is captured in Section 548 of the Bankruptcy Code, is the law of fraudulent transfer.

Fraudulent transfer exposure can be a time bomb, since civil liability can be imposed without moral fault on the part of the person being sued for recovery and since the look back period can extend for up to six years. Where the earmarks of current or potential insolvency are present, special care should be taken to document the adequacy of the consideration that is being exchanged.

Potential fraudulent transfer situations include every time:

- An asset is sold, leased or otherwise conveyed;
- A debt is incurred or restructured;
- Additional collateral is provided to secure a debt;
- Dividend or other distribution is made;
- Stock or other securities are repurchased or exchanged; or
- A guarantee is given.

History of Fraudulent Conveyance

Modern fraudulent transfer law traces its roots to the adoption by British Parliament in 16th century of the Statute of Elizabeth, which made it a crime to enter into a transaction with the intent to hinder, harm or delay creditors.

In pertinent part, the Statute of Elizabeth provides that:

- for the avoiding and abolishing of feigned, covinous, and fraudulent feoffments, gifts, grants, alienations, conveyances, bonds, suits, judgments, and executions,... which ... have been and are devised and contrived of malice, fraud, covin, collusion, or guile, to the end purpose, and intent to delay, hinder or defraud creditors and others of their just and lawful actions, suits, debts, accounts damages, penalties, forfeitures, heriots, mortuaries, and reliefs...

- be it declared, ordained, and enacted ... that all and every feoffment, gift, grant, alienation, bargain ... by writing or otherwise, and all and every bond, suit, judgment and execution, at any time had or made ... to or for any intent or purpose before declared and expressed, shall be from henceforth deemed and taken ... to be clearly and utterly void, frustrate, and of none effect; any pretense, color, feigned consideration, expressing of use or any other matter or thing to the contrary notwithstanding.

However, modern fraudulent transfer principles go far beyond the moral concepts imbedded in the Statue of Elizabeth which required actual intent to interfere with the right of others. No actual fraud or normative wrongdoing is required today. 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.

Conditions of Fraudulent Transfer

Basically, a fraudulent transfer occurs whenever the following two conditions are satisfied:

- 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 counter-party 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.

A benefit is deemed to have been received whenever the counter-party did not part with "reasonably equivalent value." The determination of whether these conditions have been met is applied with the benefit of 20/20 hindsight, and without the protections offered by the Business Judgment Rule. In other words, it makes no difference whether the parties thought at the time that the deal was fair or that the transfer price was reasonable.

The test is objective – not subjective – did the company receive "reasonably equivalent value."

Further, a money judgment may be against any entity that benefits from the fraudulently transferred property – even if the entity took ownership after the transaction. In the Matter of Ohio Corrugating Co. [70 B.R. 920 (Bankr. N.D. Ohio 1987)] the Court ruled that a money judgment may be levied not only against the direct transferee of fraudulently transferred property but also against any entity for whose benefit the transfer was made, even if that entity did not exist at the time of the transfer.

Preferences vs. Fraudulent Transfers

"Preferences" under the Bankruptcy Code are often confused with fraudulent transfers, which are creatures of both the Bankruptcy Code and state law. However, whereas a transaction can be unwound as a preference if consummated within 90 days of bankruptcy, fraudulent transfer principals can be used to unwind transactions that occurred four to six years prior to the commencement of litigation.

Recent "No Fault" Example

A particularly troublesome example of this "no fault" approach is found in the relatively recent case *In re Hennings Feed & Crop Care* [365 B.R. 868 (Bankr. C.D. Ill., 2007)]. Hennings, a dealer in agricultural chemicals, sold chemicals to a variety of end users and other brokers at a "discount price." There was no evidence that the transactions were other than at "arm's length." However, the Bankruptcy Court found that the price charged was less than Henning's cost and ordered that the persons who bought these chemicals refund to the debtor the difference between what they paid and what it cost Hennings to produce such chemicals.

Preferences are in essence payments received by a creditor within the 90-day period immediately preceding the filing of a bankruptcy petition. Trustees or debtors in possession typically sue everyone who received payment of any sort within this 90 days preference period and to sort out the merits of the plaintiff's claims later.

Bankruptcy Code §547 defines a preference as:

1. Payment on an antecedent (as opposed to current) debt;
2. Made while the debtor was insolvent;
3. To a non insider creditor, within 90 days of the filing of the bankruptcy;
4. That allows the creditor to receive more on its claim than it would have, had the payment not been made and the claim paid through the bankruptcy proceeding.

The creditor has the burden of proof to establish that there is a defense to the recovery of the preference such as:

1. contemporaneous exchanges;
2. payments made in the ordinary course of the business of the debtor and the creditor on ordinary business terms; and
3. security interests that secure debts that bring new value to the debtor.

Fraudulent transfers may be pursued either under the Bankruptcy Code as a part of bankruptcy proceeding, or under state law by other creditors or claimants.

The applicable period reviewed is determined by the applicable state statute of limitations – typically four years. The burden is on the trustee, debtor-in-possession or third party claimant to prove all elements of a fraudulent transfer.

Why Worry?

Value oriented buyers abound in the current economic environment. However, the very desperation of the seller/borrower, should give the buyer/lender warning that the transaction may be subject to fraudulent transfer analysis. 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 currently loss-making business;
- 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;" and
- Entering into any transaction which will result in a payment or distribution to shareholders or the repurchase of any securities.

Sometimes one hears the comment:

Why worry? The worst case is that I 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 asset in question can be deemed to be an asset held in constructive trust for the benefit of the creditors of the counter-party.



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 counter-party to the anticipated transaction. Such an analysis should include the following:

- Consideration of the financial condition of the counter-party to the transaction:
 - Is the counter-party insolvent under either the balance sheet or the going concern test?
 - Will, after the transaction, the counter-party have sufficient capital to continue its business?
 - Will, after the transaction, the counter-party be able to pay its debts as they mature?
- Consideration of the adequacy of the consideration being exchanged. Will the counter-party be receiving reasonably adequate consideration for what it is giving up in the transaction?
- Should a “solvency opinion” be obtained. It may well be that the directors of the transferor will want such an opinion as a part of their due diligence and to establish their own due care. However, even if the professional valuation firm rendering such opinion consents to its use by the transferee or lender, prudence may dictate that the transferee or lender obtain its own professional advice on this issue.

In the recent case, *In Re Touse, Inc. et al.* discussed in greater detail later, the court specifically rejected the

reliance by the lending syndicate on a solvency opinion obtained by the borrower, placing special emphasis on the need for lenders in such circumstances to do their own independent due diligence. The court went on to note that “[t]here is something inherently distasteful about really clever lawyers overreaching.”

How do these tests work?

What is the applicable standard?

It is common to hear practitioners in the bankruptcy arena talk about legal or balance sheet insolvency and equitable insolvency or cash flow insolvency. Generally speaking, balance sheet insolvency means that the value of a company’s assets, measured at fair market value, is less than its debts.

The cash flow insolvency means that a company is unable to pay its debts as they become due. The Bankruptcy Code defines insolvency in terms of the Balance Sheet Test, but fraudulent transfer analysis encompasses the principle of cash flow insolvency.

In the case of the so-called Balance Sheet Test, the criteria used can vary with the circumstances in which it is being applied:

The State Law Test Applicable to Dividends and Distributions. The test for whether a dividend or other distribution to shareholders may be legally made is a question of state corporate law. In some cases, such state laws use a balance sheet test that

either (a) looks to whether a capital surplus exists from which to pay such dividends or make such distribution or (b) looks to accounting rules to determine whether the company's assets are in excess of its liabilities. Typically, under this accounting-based balance sheet test, assets are valued at the lesser of historic cost or fair value, and liabilities are valued at face and directors may not be permitted to take into account the appreciated value of such assets. In most states, directors are strictly and personally liable for authorizing a dividend or other distribution to shareholders in violation of these standards.

Fraudulent Transfer law may be applicable to situations where the transferor is not in bankruptcy, as well as to situations where it is in bankruptcy. In non-bankruptcy situations, state law principles control. However, generally speaking, these are generally similar to the principles applied in a bankruptcy context, and so are not separately discussed here.

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. The analysis is done in two parts. First a determination is made as to whether it is proper to value the company's assets on a going-concern basis or a liquidation basis.

IF a going concern basis is used, then good will may be considered as an asset and it is assumed that the assets will either be marketed as a whole: in other words, as a "going concern."

IF a liquidation basis is used, then goodwill should not be considered as an asset. Moreover, a distressed or quick sale is assumed.

Unless liquidation was imminent at the time of the transaction being reviewed, a going concern valuation is typically considered the better valuation methodology.

Cash flow analysis can be highly subjective, as it looks at the projection of future cash flows and debt maturities, and requires an analysis of what the likely

outcome is of various previously unquantified contingent liabilities.

It is particularly difficult, due to the fact that, if the matter ends up in court, it is necessarily going to be subject to judgment using 20/20 hindsight. Given this, it is critical that appropriate procedures be followed, and that the assumptions made be documented and justified, and that, wherever possible, independent market data be obtained and considered. The analysis of the adequacy of a transferor's working capital is similar. The adequacy of such capital is likewise largely a function of the company's expectations as to cash flow, debt maturities and the resolution of contingent liabilities.

Role of a Solvency Analysis

Given the "subjective" nature of a solvency analyses, the focus on future cashflows and the backward looking nature of any judicial review, this is an area where an independent solvency option can be particularly valuable. Such opinions, among other things, test management assumptions against market realities, and provide a contemporaneously documented evidentiary basis for decision making.

Savings Clauses: Too Cute to be Enforced?

Savings clauses are widely used in lending transactions where subsidiary guarantors are jointly and severally liable for a loan made to a corporate parent. The savings clause purports to "save" the guaranty from being voided as a fraudulent transfer by limiting the guaranteed obligation to a dollar amount less than the amount that would render the guarantor insolvent. Although commonly used, these clauses have been rarely tested. However, in recent case that has sent shockwaves through the lending

community, In re TOUSA, Inc, et al [(Case No. 08-10928; Adv. P. 08-1435 (Banker. S.D. Fla. Oct., 2009)], the court ruled that the savings clauses in certain upstream guarantees made by a TOUSA's subsidiaries to secure a \$500 million term loan were invalid, and thus that fraudulent transfers had nevertheless occurred. The court found the clauses to be "entirely too cute to be enforced."

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 a document 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.

Some managements or loan teams may not like bringing in a third party to conduct a fraudulent conveyance analysis. It is, in effect, second guessing the judgment of the team on the job. However, senior management, the general counsel and the board should consider when the risks of a particular transaction justify such a second opinion.

It may well be, in such situations, that an opinion as to the adequacy of the consideration being received would also be appropriate. In essence, an independent determination that the transferor received reasonably equivalent value. This is,

in essence, a fairness opinion, and is described in the Fairness Opinion Summary Guide at www.marshall-stevens.com.

The TOUSA CASE: How not to do a Solvency Opinion

The Bankruptcy Court in the TOUSA Court case, mentioned earlier, was very critical of the solvency opinion rendered to the borrower. The court refused to accept the opinion as credible evidence of solvency, and found the lenders to be reckless in relying on it. Among the court's criticisms were the following:

- Circumstances under which it was created cast doubt on its legitimacy:
 - The valuation firm had no recent industry experience,
 - The \$2 million fee looked like a contingency fee, and
 - The opinion was delivered in remarkably short order (5 days).
- Valuation firm did not do any of its own diligence, but relied entirely on projections provided by top management.
- Management did not revise assumptions given to valuation firm even though it knew they were outdated and overly optimistic.
- Management did not even give honest assessment of projections; CEO did not believe assumptions given to valuation firm were accurate.

Most of the court's criticism was well founded. A solvency opinion should be an independent professional opinion of the issuing firm. In performing due diligence, the issuer of such an opinion should do more than blindly accept management's projections. The purpose of such an opinion is not simply to do a mathematical calculation, but to test the numbers and assumptions against information available in the market.



However, the criticism of the lack of recent experience in delivering solvency opinions in the industry was probably misplaced.

As a practical matter, during good economic times, transaction parties often do not appreciate the value of such opinions. Accordingly, it is likely that the number of opinions rendered in this particular industry over the past several years was very limited. Furthermore, professional valuation firms are often called upon to do work in a wide range of industries and fields of endeavor. While the absence of recent experience in a particular industry may increase the due diligence burden required, it should not be a disqualifier.

Likewise, the criticism of a compensation structure which provides for a premium or additional payment if an opinion is rendered may be a bit off the mark. As a practical matter, professionals rendering solvency opinions will charge a risk premium for such opinions. This is true in the case of virtually all professional opinions. Obviously, if no opinion is rendered, then there is no risk, and no risk premium. As a practical matter, it is completely customary for valuation firms to charge an hourly rate for the work underlying a solvency opinion, and to charge an additional fee if an opinion is ultimately requested and issued.

In TOUSA, it may be that the court was, at a very fundamental level, troubled by the size of the fee generated by a five-day endeavor. For example, the base fee was reported to be \$1 million. At an average billing rate of \$500 per hour, such a fee would represent some 2,000 hours of professional time. In other words, 400 hours of time for each of the five days involved. Assuming ten-hour workdays, this would represent full time for approximately 40 people. Accordingly, the Court may have been skeptical as to the bona fides of the overall effort, not simply the "risk premium" portion of the fee.

Summary

When dealing with a distressed company, the term caveat emptor takes on new meaning. Part of the due diligence that should be considered is a fraudulent transfer analysis. This is a mixed analysis as it involves both legal and factual elements. A part of this due diligence effort may well be an independent solvency opinion.

If such an opinion is obtained, then care should be taken that the opinion is itself the product of reasonable due diligence and not just a blind acceptance of the transferor's valuations and projections. 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. A rushed job against improbably deadlines is not likely going to carry the day.

The hallmarks of a supportable analysis and opinion:

- 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.



About the Author

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Fairness Opinions

In relation to Solvency Opinions, Marshall & Stevens has also released a **Fairness Opinion Summary Guide** to outline the purpose and function of such opinions in the current business environment. This guide is intended to provide a non-technical educational tool for the directors of companies, both public and private and for-profit and not-for-profit, for the trustees of trusts, and for the managers of pass-through entities such as limited liability companies and limited partnerships.

Fairness Opinions and the due diligence process that underlies such opinions can help improve results and control risk in an extraordinary transaction.

While not required in order for a fiduciary to satisfy his or her fiduciary duties in the context of a particular transaction, they have become customary. The failure to obtain such an opinion will definitely be pointed out and commented upon by anyone opposing the transaction.

However, a fiduciary must understand the parameters of the engagement and, working with counsel, requires to make sure that the engagement meets the needs of the situation. Among other things, reputation, independence and compensation structure should be considered.

The complete guide to Fairness Opinions can be found at www.marshall-stevens.com.

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Valuation Consulting since 1932

About Marshall & Stevens

Formed in 1932 and with offices across the US, Marshall & Stevens is an independent full-service valuation firm. Our practice areas include the valuation of businesses and their assets, including real property, machinery & equipment, and intangibles (including intellectual property and goodwill), as well as independent advice as to fairness and solvency.

Marshall & Stevens' clients include publicly traded and privately held enterprises, governmental agencies and nationally recognized law firms and accounting firms. Our professionals bring a wealth of experience, coming from backgrounds in valuation, accounting, investment banking and law.

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