The Corporate Growth Report

June 1990 — Volume 8 – Number 4

The Role of Expert Opinions in Leveraged Buyouts

by Marc S. Margulis, ASA

Solvency opinions are often used by lenders as an aid in gauging the ability of a borrower in leveraged buyouts. However, solvency opinions have several drawbacks, and recently, a new tool has been developed — a Capital Adequacy Report — which has distinct advantages to the typical solvency opinion.

The origins of the solvency opinion can be loosely traced to the fraudulent conveyance statutes

Under 11 U.S,C. Section 548(a) of the Federal Bankruptcy Code and under similar provisions of the Uniform Fraudulent Conveyance Act, the general creditors or a bankruptcy trustee on behalf of the general creditor-scan make either or both of two *prima facie* cases for fraudulent conveyance against a lender in a leveraged buyout transaction.

First, the general creditors of the trustee could prove that the leveraged buyout is an intentional fraud against creditors.

Second, under 11 U.S.C. Section 548(a)(2), they could prove that the target company did not receive fair consideration or reasonably equivalent value in exchange for rights conveyed to the lender, The second *prima facie* case must be supplemented with further proof that the target company:

(i) was rendered insolvent or was insolvent as a result of the transfer of obligations;

(ii) was left with unreasonably small capital with which to carry on its business;

(iii) intended to incur debts that would be beyond its ability to pay as such debts matured and be came due.

Most of us believe — and have reason to believe — that the lender who acts in good faith should have a defense against fraudulent conveyance attacks under Section 548(c) of the Federal Bankruptcy Code.

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The basis of the lender's "good faith" defense is that it reasonably believed that if presently solvent, the target company would not be rendered insolvent by the loan; or that if insolvent at the time of the transaction, the target company would emerge as a solvent company and "be enabled to promote the interest of all other creditors by continuing his business." (*Dean v. Davis* 242 U.S, 444, 1971).

"Good faith" is not defined in the Bankruptcy Code or the UFCA or the new UFTA. Nevertheless, one can presume that a lender acts in good faith where it is not actually aware of circumstances suggesting fraud and where it investigates the target company with the diligence expected of the reasonably prudent lender.

The statutes referred to herein may point to the need for some form of outside, independent due diligence to provide a perspective which would be viewed by the courts as unbiased, but no where in the statutes is there specific reference to solvency opinions.

There is also no case law establishing legal procedures for the solvency opinion, per se, as the keystone for a lender's defense of its nights as a creditor against a fraudulent conveyance attack. Sufficient case law does exist, however, to recommend specific procedures by independent experts including appraisals of the going concern and of its assets and sound

Mr. Margulis is the Vice President in charge of Valuation Services at Valuations Counselors, Inc., Los Angeles.

projections of its future cash flow during the term of the loan.

In *Credit Managers Association of Southern California v. The Federal Company* (629 F 2d 175 C.D, Cal 1985) the court did give great weight to the analyses of asset values and cash flow which had been performed prior to the transaction and denied the fraudulent conveyance attack. But a solvency opinion did not provide the defense in this case or in any other case that we are aware of in which the lender has prevailed,

So, without statutory requirements or legal precedence, why has the solvency opinion flourished? We think there are four reasons:

1. The solvency opinion is a form of due diligence and evidence of good faith. Many legal commentators have agreed that it is important for the lender to establish a pre-closing factual record of good faith and fairness including a view of the target's and of the new principal's operating and credit histories, appraisals of the target as a going concern, appraisals of the target's assets under orderly and forced liquidation circumstances, a conservative cash flow projection after consideration of capital maintenance and asset dispositions, and a schedule of all debts of the target, not just those recognized by the GAAP. In a 1948 case, *Chorost v. Grand Rapids Factory Showrooms* (77 F. supp. 276 (D.N. J. 1948), aff'd 172 F 2d 327,329 (3rd Cir. 1949)), the Court stated:

"A man cannot successfully claim that he is acting honestly when he willfully shuts his eyes for fear that leaving them open will reveal unpleasant facts."

So, without statutory requirements or legal precedence, why has the solvency opinion flourished?

The surest way for a lender to avoid a charge of having willfully shut his eyes to unpleasant facts is to hire independent experts to review the transaction and report their unbiased findings to the lender. Solvency opinions have been seen as offering these assurances despite the fact that they provide the lender with relatively little information about the target. There is also growing concern in the financial community over both the quality and the actual existence of the work and the work papers backing up the opinion letter. We wonder how many lenders have actually reviewed, or at least seen, a provider's supporting work papers. And if they have seen the work papers, we wonder if lenders worry about whether those files will still be obtainable in years to come when they are needed?

2. Despite its high price tag, the solvency opinion doesn't cost the lender anything. The high cost of a solvency opinion has not been an effective deterrent to its growth in usage. Lenders have no real monetary incentive to seek lower-cost alternatives because they don't pay for solvency opinions. Either directly or, indirectly, the borrower pays for the opinion.

3. Some lenders have perceived the solvency opinion as "insurance" against monetary losses suffered by the lender. The solvency opinion has been seen as a form of risk management — like buying a put option, and paying for it with someone else's money. In the event a loss is suffered as a result of an unsuccessful confrontation with the fraudulent conveyance statutes, these lenders have considered seeking restitution from the solvency opinion provider. However, such restitution is subject to (i) the lender convincing a court that the provider of the solvency opinion failed to exercise the degree of care expected of someone in that line of work and (ii) the provider's financial ability to satisfy any judgment obtained.

4. Until now, no one has suggested a viable alternative.

There is one other disadvantage to using solvency opinions. Firms providing solvency opinions are generally closely held corporations with little net worth relative to a lender's potential claim And because they are corporations, they afford little possibility of recourse against their shareholders or officers unless these individually were directly involved in the engagement. Even if an officer or shareholder was directly involved in an engagement and thus might be personally responsible for any failure to exercise the required degree of care, few if any of these individuals would have enough assets to satisfy the claims of a judgment creditor. Thus for those lenders who have looked upon their solvency opinions as "insurance," the economic reality is, typically, that this "coverage" is worthless.

In summary then: there are no statutory requirements for the solvency opinion, no legal precedent established that a lender is more protected with a solvency opinion than with some other form of independent due diligence, and the solvency opinion does not represent effective insurance against monetary losses; but solvency opinions are expensive and this money could be better, spent by the borrower in meeting his or her debt-service obligations or improving operations and staying out of insolvency.

An alternative to solvency opinions is something called adequacy reporting. A typical Capital Adequacy Report is a fully documented, self supporting analysis of the transaction containing:

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a) an appraisal of the fair value of the company as a going concern, inclusive of goodwill and identified or unidentified intangible assets,

b) appraisals of values of the tangible and intangible assets of the company,

c) information on long-term sustainable capital structures observable in comparable companies and industries,

d) estimates of the company's prospective annual cash flows from operations and from sales of assets that maybe available to reduce post acquisition debt,

e) calculations of the company's prospective coverage of post-acquisition fixed charges based on projected financial information.

The CAR doesn't opine on solvency. The lender can do the subtraction of debt from the fair value of the target or its assets, to determine solvency or insolvency.

A CAR is prepared by valuation experts. My company, Valuation Counselors, Inc., has developed this report to aid companies in need of a solvency evaluation without having to pay for the actual opinion. We believe that the most efficacious role for the independent expert is to enhance and support the lender's own due diligence and provide the lender with an unbiased record of good faith prepared from an independent investigation of the facts and circumstances surrounding the proposed transaction.

An appropriate closing remark has been provided by a prominent California bankruptcy trustee. He said, "It should be remembered that the final arbiter on issues of solvency and fraudulent conveyance is the court. The court will make its decision based upon the factual proof and evidence put before it,"

We submit that both the lender and the court can do their jobs better with a Capital Adequacy Report than with the typical solvency opinion.