Solvent or Insolvent – That is the Question

Solvency is always a primary issue for the owner or chief financial officer of an on-going business. But it is a concern that goes well beyond the bean counters. It can also have a major impact on acquisitions, divestitures, payments to shareholders, reorganizations, tax filings, and other financial transactions., A company's selling shareholders, lenders, managers, or directors can potentially face liability for entering into a transaction that renders the company insolvent or occurs during a condition of insolvency, whether or not it enters bankruptcy. Transactions made while a company is insolvent can be voided in court.

On a more positive note, companies that are insolvent are generally permitted to have debts cancelled without incurring taxes on cancellation of debt income.

While articles in this newsletter generally deal with methods of keeping businesses solvent, this article will focus more on determining whether a business is or is not solvent, and some of the implications of insolvency.

Definitions of solvency
It is possible for a debtor to be legally solvent from a balance sheet perspective, but unable to pay its bills – most assets are in the form of machinery, equipment, real estate, or other illiquid forms. Intangible property such as trade names, patents, and property rights can be included in the fair value of assets used for a solvency test, even though these are not easily converted to cash for use in paying bills. It is also possible for a debtor to be legally insolvent (liabilities exceed the fair value of the assets), but currently paying its debts as they mature. Note that as long as debts are being paid, there is little likelihood of creditor action against the insolvent debtor, and creditors are probably not even aware of the insolvency.

Some definitions of solvency are clear-cut, while others depend on valuation concepts. An example of the former is the Uniform Commercial Code, which defines an insolvent debtor as one who either has ceased to pay his debts as they become due or is insolvent within the meaning of the Federal Bankruptcy Code. An example of the latter is the Bankruptcy Code, which states, "Insolvent means … financial conditions such that the sum of … [the] entity's debts is greater than all of such entity's property, *at a fair valuation*…". Similarly, the Uniform Fraudulent Conveyance and Transfer Act defines insolvency as occurring when the present *fair salable value* of the debtor's property is less than

the amount required to pay its debts. As you can see, the latter two definitions hinge on issues of value and valuation.

The fair value of an asset is usually determined based on a market approach and/or an income approach. The income approach involves discounting the future cash flows from the assets at a risk-appropriate discount rate.

If using a market approach, the valuator must determine what the assets could be sold for to a ready and willing buyer. That is a different standard from either (a) a forced liquidation sale, which assumes transaction costs, substantial discounting for third-party risk and a profit margin for the buyer; or (b) what could be obtained in the ordinary course of business if the debtor were allowed to take what ever time was necessary to sell the assets at their customary prices and profit margins.

As in all valuation matters, selection of the basis of valuation depends on the circumstances and assumed financial condition of the company.

Other issues that the valuator of a troubled company needs to be prepared for include:

- Interim statements prepared at the valuation date may not exist, or may not include necessary accruals and adjustments.
- Financial statements include estimates and judgments about such things as allowances for doubtful accounts, allowances for returns, possible asset impairment, contingencies, etc., that may need to be revised.
- The financial statements may not be prepared according to Generally Accepted Accounting Principles (GAAP). While GAAP is not always required (many businesses do their accounting on a tax or cash basis), it is usually necessary for a fair valuation.
- Small changes in assumptions, such as changing a discount rate by one percentage point, could make the difference between an opinion of solvency or insolvency.

Fraudulent conveyance

Solvency analysis is usually done in fraudulent conveyance actions. According to the Bankruptcy Code, a transfer may be considered a fraudulent conveyance and voided if the debtor

- Was insolvent on the date of the transfer ,
- Became insolvent as a result of the transfer,
- Engaged in a transaction leaving it with unreasonably small capital, or
- Intended to incur debts beyond its ability to pay.

For a company to be deemed to have unreasonably small capital, it is not necessary to show that it is or will be unable to pay debts as they mature. The

concept of unreasonably small capital tests whether a company is likely to become insolvent at some future time based on likely business conditions.

There are three tests for solvency: the balance sheet test, the adequate capital test, and the cash flow test. A debtor must pass all three tests to be considered solvent. The three tests provide a legal standard that if not met could lead to the reversal of a transaction that, due to the company's insolvency, is considered a fraudulent conveyance. Courts have significant power in these matters -- a successful fraudulent conveyance challenge can void a new lender's rights to enforce obligations on loans incurred by the debtor, or the rights of selling stockholders of the company to retain the proceeds received by them in a leveraged sales transaction.

Balance Sheet Test
The balance sheet test determines whether the company's asset value was greater than its liability value at the time of the transaction in question. The valuator must value the company before the transaction and determine if the company's value less its liabilities is positive or negative.

Cash Flow Test
The cash flow test determines whether a company incurred debts that were beyond its ability to pay as the debts matured. To do this, you must analyze the business based on a series of projections of future financial performance that are created by varying some key assumptions about operating characteristics of the business. Consider past performance, current economic conditions, and future prospects. Prepare likely cash flow schedules and determine if obligations can be met from operations. Good cash projections should consider cash on hand, borrowing ability, and a sensitivity analysis of operating results that models various scenarios such as management's expectations, a no-growth and no-change scenario, lower than expected sales growth, and continuation of most recent trends.

Adequate Capital Test
The adequate capital test is intended to determine whether a company is likely to survive after the transaction in question, assuming reasonable business fluctuations in the future. Even if the value at which the assets were transferred was adequate and the company was not insolvent at the time of the transaction, bankruptcy could result from the transaction. The issue is whether there was sufficient capital on a post-transaction basis to reasonably expect that the company could survive in the normal course of business. This analysis must consider cash flows, asset values and volatility, expected growth in assets, timing of debt repayments, amount of debt, loan covenants, the company's borrowing base, and the sensitivity to various assumptions.

Probability of bankruptcy
To gauge the probability of bankruptcy, estimate either (a) the probability that the

value of assets will be less than the value of the liabilities, or (b) the probability that debts will not be repaid. Keep in mind that temporary inability to pay current obligations is not uncommon, and can be smoothed over by stretching vendors out, accelerating receivables, obtaining debt covenant waivers, etc. Other factors also come into play – for example, the reluctance of many customers to pay a company that appears to be in trouble could have an impact on the valuation of the company's accounts receivable.

Therefore, the probability of bankruptcy could depend in large part on creditors' tolerance and their perceptions of management, and the willingness and ability of customers to help out. These in turn are often determined by the company's position in the marketplace, the goodwill that it has earned, and general perceptions about the company's prospects.

It is important to distinguish perceptions about the value of the business (used for the balance sheet test) from perceptions about the probability of bankruptcy (reasonable capital test). However, in order to estimate the probability of bankruptcy, it is necessary to have opinions regarding the company's value. Be aware that perceptions of both value and probabilities of bankruptcy are subject to rapid and drastic changes, especially in "new age" companies such as Enron, CMGI, and Exodus, where billions of dollars of "value" were wiped out almost overnight.

Proper analysis of solvency issues requires one to:

1. Identify transactions that are potentially damaging to a debtor company.
2. Assess whether the company received or is receiving less than reasonably equivalent value in a transaction.
3. Determine whether, and at what point, the company became or could become insolvent.
4. Evaluate whether the company had or will be left with unreasonably small capital.
5. Address the company's ability to pay debts as they became due.

It is incumbent on potential lenders, sellers, and creditors, as well as a company's managers and directors, to be aware of solvency issues and to act accordingly.

© Michael Goldman 2002
For more information, please go to www.michaelgoldman.com
Editorial material in these newsletters is intended to be informative, and should not be construed as advice. For advice on any specific matter, please consult your financial or legal adviser.