



Valuation in Fraudulent Transfer Action: The Balance Sheet Test

Published on Alvarez & Marsal (<https://www.alvarezandmarsal.com>)

With a struggling economy and stagnant or falling asset values, creditors and trustees are increasingly filing fraudulent transfer actions to recover assets and cash. These fraudulent transfers often occur in connection with leveraged buyouts (LBOs), where the management / owners of a failing corporation cause a company to borrow on its assets and use the loan proceeds to purchase the management / owner's stock at highly inflated prices.

As a result, the creditors of the company often have little or no unencumbered assets left upon which to collect their debts. Although not all LBOs are fraudulent transfers, a red flag is raised when, shortly after an LBO, the company cannot pay its creditors.

This A&M article explains the assessment of certain valuation components of a fraudulent transfer action.

The Action

U.S. assets may be recovered if they were fraudulently transferred or conveyed by pursuing an action in the bankruptcy court (under the bankruptcy code) or under state law.

1 The bankruptcy code and state law both provide that a transfer made by a debtor is fraudulent if the debtor made the transfer with the "actual intention to hinder, delay or defraud" any creditor of the debtor.

A transfer may also be avoidable as "constructively fraudulent" if such a transfer was made in exchange for less than reasonably equivalent value and the debtor was either insolvent at the time of the transfer, became insolvent or was left with unreasonably small capital to continue in business as a result of the transfer.

The Analysis

Fraudulent transfer liability will often turn on the financial condition and / or solvency of the company / debtor at a particular date in the past. Therefore, to recover assets in a fraudulent transfer case, the moving party must typically show that the company was either insolvent at the time of the transfer or became insolvent as a result of the transfer. Solvency is usually analyzed by addressing the following questions:

1. Are the company's debts greater than the company's assets at a fair valuation?
2. Does the company have the ability to pay its debts as they came due?
3. Does the company have adequate capital for the business or transactions in which it engaged?

The discussion that follows will address the first question, which is commonly referred to as the "Balance Sheet Test."

To perform the Balance Sheet Test, the analyst first must determine the valuation approach. If the entity is a holding company with no operations, an asset approach may be appropriate to use to derive the enterprise value. If the entity is a company generating revenue and operating income, an income approach and / or a market approach may be more appropriate to use in order to determine the enterprise value.

Under an asset approach, the assets are analyzed separately, a value is attributed to each individual asset and the resulting total (i.e., the enterprise value) is then compared to the total liabilities. If the liabilities are greater than the assets at a fair value, the company is usually deemed insolvent.

Under the income and / or market approaches, four methods are typically considered: discounted cash flow, capitalization of earnings, guideline public companies, and merged and acquired companies. An explanation of each method follows.

Discounted Cash Flow (DCF)

Under a DCF, the company's debt-free cash flow is projected over a period of time (typically three to seven years) until such time that the company reaches a stabilized level of growth (i.e., its growing at the same rate as the overall economy). The DCF method is typically used when the company, in the near term, is expected to experience above-market levels of growth in revenue or market share, or if the organization is restructuring its operations. Important factors to consider in developing a DCF include:

- Revenue and expense projections that can be explained and supported
At a minimum, revenue projections should take into consideration historical results, the economic outlook, the industry, the market areas in which the company serves and any expected changes in product or service mix. Internal financial statements can be utilized if the analyst believes they are reliable; if audited financial statements are available they should be utilized. Likewise, projected expenses should take into consideration historical results, the relationship between expenses and revenues (e.g., fixed or variable), industry data and any proposed changes to the company's cost structure.
- A discount rate that accounts for the risk inherent in the future cash flows
This rate is used to bring future cash flows to present value, as it captures the time value of money and the risk associated with a particular company. Typically, a build-up approach is used where the analyst identifies a base rate, such as a long-term treasury rate, and adds an equity risk premium (modified by applying beta), a size premium and, when applicable, a company-specific risk.³All the inputs, with the exception of company-specific risk, are based primarily on objective data points. Conversely, the company-specific risk is a more subjective measurement and there are limited objective data points for this input.
- An appropriate level of projected capital expenditures
Continued capital expenditures are an integral part of any ongoing business. These costs can be estimated by reviewing past capital expenditures and inquiring about future needs.
- Adequate changes in working capital
As a company grows, so do its needs for cash and liquidity. Until the entities cash flows are stabilized, changes — both positive (sources) and negative (uses) — in working capital should be reflected in the projected cash flows.
- A Company-Specific Risk (CSR) factor
CSR is a subjective input into the calculation of a discount risk. Both the valuation literature and the courts have noted that a CSR should be based on both a quantitative and qualitative analysis. The analysis should consider whether the CSR premium is inherently reflected elsewhere, such as in the size premium or within the projected cash flows.
- The calculation of a terminal value
At the point a company's projected cash flows reflect stable operations, a terminal value is calculated. This amount is representative of all future cash flows.
- Discounts and premiums
Once a value conclusion is determined, any applicable discounts and premiums can be applied. These discounts and premiums account for marketability, minority interest, control, key person and blockage issues. There are several approaches that can be used to determine the appropriate discounts and / or premiums and the application of these factors is both subjective and objective in nature.

Capitalization of Earnings (CAP)

The CAP method may be appropriate when a company's operations are deemed to be stabilized (in other words, future growth is expected to mirror the economy as a whole). Important factors to consider in applying a CAP approach include:

- The calculation of normalized earnings
To derive normalized earnings, any non-recurring expenses and expenses not necessary to the operation of the business (e.g., owner perquisites, boats) should be excluded.

- An appropriate level of projected capital expenditures
As with the DCF method, ongoing capital expenditures should be estimated.
- Capitalization rate / multiples
The development of capitalization rates and multiples is similar to the DCF method.

Guideline Public Company (GPC)

The GPC method utilizes publicly available information to estimate value. More specifically, the analyst identifies publicly-traded companies with similar operating characteristics that are in the same or similar industry as the company to be valued. Then, based on the identified companies, various value multiples are derived and applied to the target organization. Value multiples can be based on revenue, EBITDA, EBIT or other relevant measurements. Important factors to consider in applying the GPC method include:

- Identification of public companies that operate in the same or similar industry
In identifying GPCs, the analyst must first understand the business of the target company, the industry in which it operates and the products or services it offers. Once the target business and its industry are identified, the GPCs can be identified. There are various sources in identifying public companies by industry. These entities should be reviewed to determine which companies would provide the most meaningful comparison.
- Analyses related to the business models of the identified public companies compared to the target company being valued
The analyst should consider the differences and similarities between the target company and the GPCs, such as size, scope of product mix and growth in revenue or profit.
- The calculation of normalized earnings (as discussed above)
- Discounts and premiums (as discussed above)

Merged and Acquired Company (M&A)

The M&A method uses private transactions to help derive an estimate value. Similar to the GPC method, the analyst uses value indicators to estimate the values of the target company. Important factors to consider in applying the M&A method include:

- Identification of appropriate comparable transactions
Similar to the GPC method, the first step is to understand the target including the identification of the industry and risk characteristics. Then private transactions that are similar in nature can be identified and analyzed from various databases that track private transactions.
- Possible adjustments to the reported sale price
Because these are private transactions, it is important to understand the nature of the sales price. For example, did the sales price include a non-compete, acquisition of noncore assets or seller financing at below market rates? Also, was the sale an arms-length transaction or was the sale between related parties? The reported sale / purchase price may have to be adjusted for these items.
- The transaction date compared to the valuation date
The databases that track private transactions cover several years. If transaction data will be used that is not close to the valuation date, it may be appropriate to make adjustments or exclusions for the different time periods. For example, if a transaction occurred in 2007, prior to the financial crash, the use of that transaction for a 2009 valuation may not be appropriate.
- Accuracy of transaction data
As the information in the transaction databases are not generally based on audited data or information filed with the SEC, the underlying financial results may not be reflective of Generally Accepted Accounting Principles (GAAP). Adjustments may be warranted.

Summary

In times of financial distress, troubled companies and their creditors often seek to recover assets through bringing fraudulent transfer actions. In this article, financial distress primarily consists of either unreasonably small working capital or actual insolvency (liabilities exceeding assets at a fair valuation).

In this regard, the above discussion provided a summary of the solvency determination solely under a Balance Sheet Test. This test usually requires an extensive analysis of the underlying business. Further, many factors, both internal and external to the

company, should be analyzed and both subjective and objective inputs used to arrive at a value conclusion.

Finally, in any valuation performed related to a fraudulent transfer action, the analyst should understand applicable case law or any controlling precedent in the relevant jurisdiction that may impact the valuation.

Footnotes

1 State law refers to The Uniform Fraudulent Transfer Act (UFTA) which has been adopted by most states.

2 In state court actions, the underlying statute should be reviewed as the tests for insolvency may differ between states. The bankruptcy code should be reviewed for bankruptcy matters.

3 Some analysts use an industry risk premium in place of beta.

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