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creating value in an increasingly complex corporate environment



■ Valuation and solvency analysis in failing firm claims

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For firms pursuing growth through M&A, regulatory constraints imposed by the antitrust laws may pose significant barriers. This is equally true for the strategic buyer pursuing a horizontal or vertical combination, a private equity firm executing an industry roll-up, or a control-oriented purchaser of the debt, or corporate assets, of a financially distressed company, within, or outside of, a formal plan of reorganisation. In cross-border transactions, government policies that differ with respect to consumer, industrial, or trade considerations may also exacerbate the obstacle posed by the concern that a transaction may have the potential to create or enhance market power. Notwithstanding, the US Department of Justice and Federal Trade Commission's 1992 'Merger Guidelines' provide a means of potentially resolving these obstacles using the tools of solvency and valuation analysis employed under the US Bankruptcy Code within the context of what has become known under the Guidelines as the 'failing company' and 'failing division' defence.

The failing company defence argues that a merger is not likely to create or enhance market power if the company: (i) is unable to meet its financial obligations when they fall due; (ii) is unable to reorganise under Chapter 11 of the Bankruptcy Code; (iii) is unable to attract an offer at a price above liquidation value from a competitively preferable buyer; and (iv) will exit the relevant market absent the transaction. The failing division defence posits similarly that a merger is not likely to pose competitive concerns if the division: (i) has negative operating cash flow after proper allocation of costs; (ii) has been unable to attract an offer from a competitively preferable buyer at a price above liquidation value; and (iii) would exit the relevant market if not sold.

Examining the Guidelines' tests within the bankruptcy context – that a company be unable to meet its financial obligations as

they fall due – is consistent with the notion of insolvency in the equity sense. Further, the requirements that the company be unable to reorganise under Chapter 11, and unable to attract an offer exceeding liquidation value, are together suggestive of insolvency in the bankruptcy sense to the extent that they imply creditors would receive more if the company were liquidated than if it were restructured and valued as a going concern. Given these analogies, one possible approach to asserting a failing company defence in support of a merger is to employ the framework used to establish a fraudulent transfer under section 548 of the Bankruptcy Code.

Under section 548, a transfer of assets, or incurrence of an obligation, for less than equivalent value, may be deemed fraudulent, if as a consequence, the debtor (i) was or became insolvent, (ii) was left with unreasonably small capital, and (iii) incurred debts it could not pay at maturity. In practice, these conditions are assessed using the balance sheet test, adequate capital test, and cash flow, or ability-to-pay test. The balance sheet test examines whether the fair value of a firm's assets exceeds the face value of its liabilities; the adequate capital test looks at whether the company's capital is adequate to support its business activities; and the cash flow test asks if the firm can expect to pay its debts as they mature.

When adapting the balance sheet test to a failing company claim, a firm's balance sheet is only the starting point for the analysis as historical financial statements do not reflect fair market values, and may not include all assets and liabilities properly considered in determining solvency. Beyond this recognition, the first step is to determine an appropriate premise of value, whether going concern or liquidation. Generally, 'fair value' as used in the balance sheet test is interpreted to mean fair market value, and indicative of a going

concern premise. For an inoperative company facing imminent demise, the liquidation premise may be relevant, however. The essential structural difference is that the going concern premise assumes the sale of an organized, functioning, interactive group of income-producing assets over a reasonable time period, while the liquidation premise assumes the debtor's assets are sold in a piecemeal fashion, either in an orderly or forced manner.

The valuation date selected in applying the balance sheet test to a failing firm should take into account as appropriate and feasible the circumstances of the failure. Changes in macroeconomic, firm-specific and industry conditions can alter the value of a company over time. Further, as in any business valuation, a valuation for solvency purposes should only consider data and information known or knowable as of a specific date. Consequently, the valuation date directly impacts what data and information can be relied on, as well as the related assumptions.

In performing the balance sheet test, the value of a company's liabilities is taken directly from the undiscounted face value of its debt, in recognition that insolvency would never occur if a company's debts were valued at market. In contrast, the fair market value of a company's assets is determined from the present value of its expected future cash flows, using either an income (discounted cash flow, capitalisation), market (comparable company or transaction), or cost (replacement, reproduction) approach. If the face value of the company's debts exceeds the fair market value of its assets, the company is deemed insolvent.

With respect to the ability-to-pay requirement of the failing company defence, a company will likely be able to pay its debts as they mature under the cash flow test if its capital is sufficient to support its operations over a range of economic and financial conditions pursuant to the adequate capital test. As might be expected given this symbiotic relationship, the steps required to perform the cash flow and adequate capital tests overlap. For example, both might start with the projection of expected future free cash flows as is used in a discounted cash flow valuation, with one scenario assuming management's best estimate, a second, with no changes in revenue or profitability variables, and a third, with adjustments to items that may affect

and/or include revenue growth, gross margins, operating profit margins, depreciation, and capital expenditures, as appropriate and reasonable given the facts and circumstances.

To test the ability of the company to pay its debts as they mature, the firm's scheduled debt payments are matched with its balance of excess cash, free cash flow, and available credit under existing facilities at each payment date per the cash flow test. The process used to test the adequacy of the firm's capital then builds on the foundation of the cash flow test with analyses that compare the company's financial position and operating results over time on a standalone basis and in relation to others in its industry, assessments of the ability of the company to obtain additional or new debt and equity financing, and examination of the potential for the company to default under the provisions of its debt covenants.

A firm will fail the cash flow test if its scheduled debt payments exceed the corresponding sum of its excess cash, free cash flow, and available existing credit. A firm will also fail the adequate capital test if it can be demonstrated that its capital structure cannot withstand reasonable fluctuations in its business without triggering a default under its debt covenants. When using these tests in combination with the balance sheet test, however, it should be noted that the balance sheet test, being a valuation rather than a matching exercise, may suggest an alternative viewpoint due to its consideration of the time value and risk associated with a firm's cash flows.

In sum, though often used to assess solvency in fraudulent conveyance and preferential transfer disputes under the bankruptcy laws, the balance sheet, cash flow and adequate capital tests in part provide a relevant and reliable framework for use in addressing failing firm claims, the specifics of which are subject to interpretation under the Guidelines. Properly applied, the approach can assist acquirers in achieving antitrust clearance for a transaction that may otherwise be blocked, and avoid the costs of a broken transaction, which while likely significant in any event, are particularly prohibitive in today's environment of tightening credit markets, leveraged capital structures and economic uncertainty.

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