Due Diligence and Analytical Procedures for Fraudulent Conveyance Opinions

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The considerations related to fraudulent conveyance opinions can be complicated. Often, fraudulent conveyance opinions are at the center of Bankruptcy Code Section 548 transfer avoidance actions. A fraudulent conveyance analysis involves the following three tests: (1) the balance sheet test (i.e., a solvency analysis), (2) the cash flow test, and (3) the capital adequacy test. If the three tests are passed, then the transfer is generally not considered to be a fraudulent conveyance. This discussion describes each of the tests and illustrates the related analyses. This discussion also presents a procedural and due diligence checklist that may be useful to valuation analysts, the debtor corporation management, creditors, legal counsel, and other users of a fraudulent conveyance opinion.

Introduction

Valuation analysts are often called on to perform analyses and to issue opinions for various bankruptcy-related purposes including fraudulent conveyance avoidance actions.

A fraudulent conveyance may occur when a debtor corporation (1) is insolvent, (2) is unable to pay its debts as they become due, or (3) has unreasonably small capital on the date of the transfer in question. In addition to the existence of these conditions, a debtor corporation would also need to have received less than a reasonably equivalent value in exchange for the subject transfer or obligation in order for such transfer to be considered a fraudulent conveyance.

The purpose of a fraudulent conveyance analysis is to opine on whether the aforementioned conditions, with respect to the debtor corporation, exist at the time of the specified transfer. This discussion describes each of the tests employed in a fraudulent conveyance analysis and illustrates each of the three tests.

The concept of reasonably equivalent value is a complicated topic and is beyond the scope of this discussion. However, it is a topic worthy of discussion and will be addressed in a future *Insights* issue.

This discussion includes a checklist with analytical procedures typically considered in a fraudulent conveyance analysis. The procedural checklist may be used by the debtor in possession (DIP) management, the debtor corporation shareholders, the secured lender financial institutions, secured and unsecured creditor committees, and other parties to a bankruptcy. These parties in interest to a bankruptcy proceeding may use this checklist in their good-faith assessment of the opinion.

Common Factors That Drive Companies to Financial Distress

There are many factors that can drive companies into financial distress. The following list, based on the experience of many debtor companies involved in bankruptcy, presents seven common causal factors.

1. High operating risk combined with high financial risk

2. Risky acquisition strategies
3. Relying on investment bankers without the debtor corporation performing its own due diligence related to proposed acquisitions or other types of transactions
4. Imprudent debt levels driven by commercial banks as a result of a debtor company relying on a bank's analysis of debt capacity without performing its own due diligence
5. Reacting to, rather than anticipating, technological or competitive change
6. Rapid structural change such as increased costs, diminishing markets, shrinking revenues, and technological innovation
7. Fraudulent acts, such as falsifying financial statements

While there are other factors not mentioned here, debtor corporation management is often the catalyst that drives a company into financial distress. Management typically does this by implementing inefficient operating or financial policies. Financial distress can also be precipitated by changes in technology, new distribution channels, and intense competition.

Fraudulent Conveyance Analysis

In a fraudulent conveyance opinion, the analyst opines on the solvency of a debtor corporation at the time of a specific transfer. The analyst also opines on whether the debtor corporation (1) had an unreasonably small amount of capital to continue operations and (2) was expected to be able to meet its debt obligations.

Typically, the analyst will perform the following three tests to determine if a fraudulent transfer has occurred:

1. The balance sheet test (i.e., a solvency test)
2. The cash flow test
3. The capital adequacy test

Conditions of Fraudulent Conveyance

A fraudulent conveyance opinion typically analyzes whether any of these three conditions exist at the time of the specific transfer (after giving effect to any proposed transaction financing):

1. Does the recorded amount of the debtor corporation liabilities exceed the fair value of the debtor corporation assets? (the balance sheet test)
2. Does the debtor corporation have adequate cash flow to service all of its liabilities as those liabilities come due? (the cash flow test)
3. Does the debtor corporation have an adequate amount of capital to run its business operations? (the capital adequacy test)

"Financial distress can . . . be precipitated by changes in technology, new distribution channels, and intense competition."

If all three tests are passed, the transfer is typically considered to not be fraudulent. If any of the three tests is failed as of the transaction date, a fraudulent transfer may have occurred. A fraudulent conveyance opinion is typically based on the information that is available to—or reasonably foreseeable by—the analyst as of the corporate transaction date.

The Balance Sheet Test

The balance sheet test determines whether, at the time of the transaction, the total fair value of the debtor corporation assets (both tangible assets and intangible assets) is greater than the total amount of the debtor corporation liabilities. That is to say, the balance sheet test is used to evaluate the solvency of the debtor corporation as of the transaction date.

First, the analyst typically considers the highest and best use of the debtor corporation assets. The highest and best use analysis indicates the appropriate premise of value for the valuation aspects of the solvency analysis. A common premise of value is value in continued use, as part of a going concern business enterprise.

Second, the analyst estimates the fair value of the debtor corporation assets, including (1) financial assets, (2) real estate and tangible personal property, and (3) intangible assets.

Third, the analyst determines the amount of the debtor corporation liabilities, including (1) all current liabilities (2) all long-term liabilities, and (3) contingent liabilities.

Fourth, the analyst subtracts the amount of the total liabilities from the fair value of the total assets.

The amount of the liabilities specifically includes any new debt related to a proposed corporate transaction.

The balance sheet test is "passed" if the fair value of the debtor corporation total assets is greater than the amount of the debtor corporation total liabilities.

The analyst should consider the income approach, the market approach, and the asset-based approach in the valuation of the debtor total operating assets. A detailed description of each generally accepted valuation approach and method is beyond the scope of this discussion.

Balance Sheet Test Illustrative Example

The balance sheet test involves a fair value estimate of the debtor corporation assets. As presented in Exhibit 1, the analyst relied on the discounted cash flow method and the guideline publicly traded company method, equally weighting the value indication from each method. The resulting fair value indication of invested capital of $455 million is calculated on a marketable, controlling ownership interest basis.

The fair value of invested capital indication represents the sum of the shareholders' equity and the interest-bearing debt (including any proposed transaction debt). The analyst adds the amount of the non-interest-bearing current liabilities to the fair value of invested capital in order to estimate the fair value of total liabilities and equity, which is equal to the fair value of total assets. As illustrated in Exhibit 1, the fair value of the total assets was approximately $481.3 million.

As presented in Exhibit 2, the indicated fair value of total assets exceeded the accounting book value of total assets by $78.3 million. In this case, the accounting book value of the debtor corporation tangible assets was estimated to represent the fair value of such assets. Therefore, the $78.3 million value adjustment relates to intangible assets.

Long-term debt was increased by $50 million to reflect the new borrowings of the debtor corporation as part of a proposed transaction. Consequently, shareholders' equity was adjusted by the residual of $28.3 million. The resulting positive fair value of equity from the solvency analysis indicates that the debtor corporation "passed" the balance sheet test and was solvent as of the transfer date.

The Cash Flow Test

The cash flow test analyzes the debtor corporation's ability to meet its debt obligations as such obligations become due.

First, the analyst typically projects the debtor's expected cash flow for the repayment period for any proposed financing. The cash flow test analysis will consider the repayment of all of the debtor corporation debt (both principal and interest) obligations.

Second, the analyst analyzes the cash flow available to meet debt obligations by estimating (1) any excess cash available on the transfer date, (2) the available cash flow during the projection period, and (3) the availability of any unused credit commitments.

The cash flow test is "passed" if the debtor corporation can pay its projected debt obligations from any one of the three aforementioned sources of cash.

The analyst typically performs sensitivity analyses to "stress test" the various cash flow projection variables. The objective of the sensitivity analysis is to determine whether the debtor corporation can meet its debt obligations under a variety of alternative operating conditions.

Exhibit 1
Fraudulent Conveyance Opinion Illustrative Example
Valuation Summary and Balance Sheet Test Reconciliation

Valuation Approach and Method	Relative Emphasis	Indicated Fair Value ($)
Income Approach—Discounted Cash Flow Method	50%	450,000,000
Market Approach—Guideline Publicly Traded Company Method	50%	460,000,000
Fair Value of Invested Capital (Rounded)	100%	455,000,000
Plus: Non-Interest-Bearing Liabilities		26,291,000
Equals: Fair Value of Total Assets		481,291,000

Cash Flow Test Illustrative Example

Exhibit 3 presents the debtor corporation's "base case" cash flow scenario. The analyst typically uses the projections provided by the debtor management as the base case scenario.

The financial projections provided by debtor management are an important part of the fraudulent

Exhibit 2
Fraudulent Conveyance Opinion Illustrative Example
Balance Sheet Test

	As of the Solvency Date		
	At Accounting Book Value $000	Valuation Adjustments $000	At Estimated Fair Value $000
ASSETS			
Current Assets:			
Cash and Cash Equivalents	7,300	-	7,300
Accounts Receivable—Net	2,680	-	2,680
Inventories—Net	1,868	-	1,868
Deferred Income Taxes	2,597	-	2,597
Total Current Assets	14,445	-	14,445
Tangible Assets			
Net Tangible Assets	34,769	-	34,769
Other Assets:			
Favorable Leases	2,996	-	2,996
Deferred Financing Costs	2,642	-	2,642
Investments for Deferred Compensation Plan	1,528	-	1,528
Other Assets	266	-	266
Total Other Assets	7,432	-	7,432
Intangible Assets			
Trademark	160,560	-	160,560
Other Intangible Assets	25,165	-	25,165
Goodwill	160,621	78,299	238,920
Total Intangible Assets	346,346	78,299	424,645
TOTAL ASSETS	402,993	78,299	481,291
LIABILITIES & SHAREHOLDERS' EQUITY			
Current Liabilities:			
Accounts Payable	10,070	-	10,070
Accrued Expenses	14,610	-	14,610
Other Current Liabilities	1,611	-	1,611
Current Portion of Long-Term Debt	2,750	-	2,750
Current Portion of Capital Lease Obligations	3,446	-	3,446
Total Current Liabilities	32,488	-	32,488
Long-Term Liabilities:			
Long-Term Debt, Less Current Maturities	164,063	50,000	214,063
Capital Lease Obligations, Less Current Maturities	16,521	-	16,521
Total Long-Term Liabilities	180,584	50,000	230,584
Total Liabilities	213,071	50,000	263,071
Shareholders' Equity:			
Total Equity	189,921	28,299	218,220
TOTAL LIABILITIES & EQUITY	402,993	78,299	481,291

Conclusion—Balance Sheet Test

Fair Value of Assets less Liabilities = $218,220,000

The balance sheet test indicates that the debtor corporation is solvent.

Exhibit 3
Fraudulent Conveyance Opinion Illustrative Example
Cash Flow Test
Base Case

	Fiscal Years Ending on or Near December 31,				
	Year 1	Year 2	Year 3	Year 4	Year 5
	$000	$000	$000	$000	$000
Revenue	370,000	397,000	426,000	457,000	489,000
Annual Growth Rate	6%	7%	7%	7%	7%
Projected EBITDA	54,000	57,000	61,000	66,000	71,000
EBITDA Margin	15%	14%	14%	14%	15%
Depreciation & Amortization Expense	(14,000)	(15,000)	(15,000)	(16,000)	(15,000)
Projected EBIT	40,000	42,000	46,000	50,000	56,000
Provision for Income Taxes	(16,000)	(16,800)	(18,400)	(20,000)	(22,400)
Debt-Free Net Income	24,000	25,200	27,600	30,000	33,600
Depreciation & Amortization Expense	14,000	15,000	15,000	16,000	15,000
Capital Expenditures	(10,000)	(7,000)	(7,000)	(7,000)	(7,000)
Net Operating Working Capital Additions	5,000	1,000	1,000	1,000	1,000
Cash Flow to Invested Capital	33,000	34,200	36,600	40,000	42,600
Interest Expense	(8,000)	(8,000)	(8,000)	(7,000)	(6,000)
Debt Principal Payments	(4,000)	(13,000)	(17,000)	(19,000)	(22,000)
Deal Closing Costs	(800)	-	-	-	-
Total Net Cash Flow Adjustments	(15,860)	(22,560)	(26,560)	(27,560)	(29,560)
Total Excess Cash Flow	17,140	11,640	10,040	12,440	13,040
Excess Cash Flow Percentage	50%	50%	50%	25%	25%
Excess Cash Flow for Loan Prepayment	8,570	5,820	5,020	3,110	3,260
Optional Loan Prepayment	-	-	-	-	-
Mandatory Loan Prepayment	8,570	5,820	5,020	3,110	3,260
Cash Surplus/(Shortfall)	8,570	5,820	5,020	9,330	9,780
Beginning Cash Balance	8,500	17,070	22,890	27,910	37,240
Ending Cash Balance	17,070	22,890	27,910	37,240	47,020
Covenant Compliance					
Lease Adjusted Leverage Ratio	5.37	5.11	4.77	4.42	4.07
Maximum Lease Adjusted Leverage Ratio Allowed	5.75	5.70	5.40	4.95	4.60
In Compliance	Yes	Yes	Yes	Yes	Yes
Fixed Charge Coverage Ratio	1.70	1.54	1.43	1.44	1.41
Minimum Fixed Charge Coverage Ratio Required	1.30	1.30	1.20	1.20	1.20
In Compliance	Yes	Yes	Yes	Yes	Yes
Planned Capital Expenditures	10,000	7,000	7,000	7,000	7,000
Maximum Capital Expenditures Allowed	15,000	15,000	15,000	15,000	15,000
In Compliance	Yes	Yes	Yes	Yes	Yes

Conclusion—Cash Flow Test
In each year, is the debtor corporation able to meet its debt obligations as they mature?
YES

conveyance analysis. With that in mind, the analyst will typically not take management's projections at face value. That is, the analyst will evaluate the reasonableness of the projections by considering if they are supported by information gathered through (1) debtor management interviews, (2) debtor company financial and operating information, (3) industry information, and (4) economic data.

Exhibit 3 presents the base case projected cash flow to invested capital less (1) interest expense, (2) debt principal payments, (3) transaction costs, and (4) mandatory debt prepayments in order to demonstrate whether the debtor corporation has sufficient cash flow to meet its debt obligations.

Exhibit 3 also illustrates the debtor's covenant compliance under the base case operating assumptions. This analysis is informative because covenant noncompliance could be considered an event of default, thus making the balance of the debt immediately due to the lender. Without sufficient capital or available remedies for default, the debtor corporation could be rendered insolvent by covenant noncompliance.

In the base case scenario, the debtor corporation (1) meets its debt obligations as they mature and (2) maintains compliance with the loan covenants in each of the five projected years.

The analyst may use the base case scenario as a starting point for a sensitivity analysis. Sensitivity analysis typically includes adjustments to revenue growth rates and/or profitability margins, as well as to factors that are specific to the debtor corporation and the transfer. The goal of sensitivity analysis is to demonstrate whether the debtor corporation is able to meet its debt obligations and maintain compliance with loan covenants under various operating scenarios. The cash flow test is "passed" if, in each period, the debtor corporation has sufficient cash flow to pay its debt obligations.

Exhibits 4 and 5 present the debtor corporation projected cash flow under zero revenue growth and 15 percent decline in earnings before interest, taxes, depreciation, and amortization (EBITDA) scenarios, respectively. In each of the three scenarios, the debtor corporation has sufficient cash flow to pay its debt obligations. Therefore, the debtor corporation "passed" the cash flow test of the fraudulent conveyance analysis.

The Capital Adequacy Test

The capital adequacy test (also referred to as the "reasonable capital test") determines whether the debtor corporation is engaged in a business or a transaction for which it has an adequate amount of capital. The capital adequacy test determines whether the debtor corporation has adequate capital to meet its (1) operating expenses, (2) capital expenditure requirements, and (3) debt repayment obligations. The goal of the capital adequacy test is to evaluate the likelihood that the debtor corporation will survive potential business fluctuations over several quarters following the transfer date.

"The goal of the capital adequacy test is to evaluate the likelihood that the debtor corporation will survive potential business fluctuations over several quarters following the transfer date."

The capital adequacy test involves an analysis of short-term sources and uses of funds, typically for the four fiscal quarters after the transfer date. The analyst typically considers various debtor corporation prospective operating scenarios, including the following:

1. The debtor management's "most likely" estimate scenario of future financial and operational performance
2. No change scenario from the recent debtor corporation historical financial performance
3. Reasonable variation scenarios in the debtor corporation revenue growth rate and profit margins

The capital adequacy test is "passed" if the debtor corporation is expected to have sufficient cash on hand to pay its (1) operating expenses, (2) capital expenditures, and (3) debt repayment obligations.

Capital Adequacy Test Illustrative Example

Exhibit 6 illustrates the "base case" quarterly projection estimate provided by the debtor corporation management as well as the estimated debtor corporation quarterly cash flow, which corresponds to the annual cash flow from the cash flow test analysis.

Exhibit 6 presents the base case projected cash flow to invested capital less (1) interest expense, (2) debt principal payments, (3) transaction costs, and (4) mandatory debt prepayments in order to

Exhibit 4
Fraudulent Conveyance Opinion Illustrative Example
Cash Flow Test—Sensitivity Analysis
Zero Revenue Growth

	Fiscal Years Ending on or Near December 31,				
	Year 1	Year 2	Year 3	Year 4	Year 5
	$000	$000	$000	$000	$000
Revenue	349,000	349,000	349,000	349,000	349,000
Annual Growth Rate	0%	0%	0%	0%	0%
Projected EBITDA	51,000	50,000	50,000	50,000	51,000
EBITDA Margin	15%	14%	14%	14%	15%
Depreciation & Amortization Expense	(13,000)	(13,000)	(13,000)	(12,000)	(11,000)
Projected EBIT	38,000	37,000	37,000	38,000	40,000
Provision for Income Taxes	(15,200)	(14,800)	(14,800)	(15,200)	(16,000)
Debt-Free Net Income	22,800	22,200	22,200	22,800	24,000
Depreciation & Amortization Expense	13,000	13,000	13,000	12,000	11,000
Capital Expenditures	(9,000)	(6,000)	(6,000)	(6,000)	(5,000)
Net Operating Working Capital Additions	4,000	-	-	-	-
Cash Flow to Invested Capital	30,800	29,200	29,200	28,800	30,000
Interest Expense	(8,000)	(8,000)	(8,000)	(7,000)	(6,000)
Debt Principal Payments	(4,000)	(13,000)	(17,000)	(19,000)	(22,000)
Deal Closing Costs	(800)	-	-	-	-
Total Net Cash Flow Adjustments	(12,800)	(21,000)	(25,000)	(26,000)	(28,000)
Total Excess Cash Flow	18,000	8,200	4,200	2,800	2,000
Excess Cash Flow Percentage	50%	50%	50%	50%	0%
Excess Cash Flow for Loan Prepayment	9,000	4,100	2,100	1,400	-
Optional Loan Prepayment	-	-	-	-	-
Mandatory Loan Prepayment	9,000	4,100	2,100	1,400	-
Cash Surplus/(Shortfall)	9,000	4,100	2,100	1,400	2,000
Beginning Cash Balance	8,606	17,606	21,706	23,806	25,206
Ending Cash Balance	17,606	21,706	23,806	25,206	27,206
Covenant Compliance					
Lease Adjusted Leverage Ratio	5.58	5.57	5.40	4.95	4.60
Maximum Lease Adjusted Leverage Ratio Allowed	5.75	5.70	5.40	4.95	4.60
In Compliance	Yes	Yes	Yes	Yes	Yes
Fixed Charge Coverage Ratio	1.63	1.37	1.21	1.28	1.26
Minimum Fixed Charge Coverage Ratio Required	1.30	1.30	1.20	1.20	1.20
In Compliance	Yes	Yes	Yes	Yes	Yes
Planned Capital Expenditures	9,000	6,000	6,000	6,000	5,000
Maximum Capital Expenditures Allowed	15,000	15,000	15,000	15,000	15,000
In Compliance	Yes	Yes	Yes	Yes	Yes

Conclusion—Cash Flow Test Sensitivity
In each year, is the debtor corporation able to meet its debt obligations as they mature?
YES

Exhibit 5
Fraudulent Conveyance Opinion Illustrative Example
Cash Flow Test—Sensitivity Analysis
EBITDA Reduced by 15 Percent

	Fiscal Years Ending on or Near December 31,				
	Year 1	Year 2	Year 3	Year 4	Year 5
	$000	$000	$000	$000	$000
Revenue	370,000	397,000	426,000	457,000	489,000
Annual Growth Rate	6%	7%	7%	7%	7%
Projected EBITDA	46,000	48,000	52,000	56,000	60,000
EBITDA Margin	12%	12%	12%	12%	12%
Depreciation & Amortization Expense	(14,000)	(15,000)	(15,000)	(16,000)	(15,000)
Projected EBIT	32,000	33,000	37,000	40,000	45,000
Provision for Income Taxes	(12,800)	(13,200)	(14,800)	(16,000)	(18,000)
Debt-Free Net Income	19,200	19,800	22,200	24,000	27,000
Depreciation & Amortization Expense	14,000	15,000	15,000	16,000	15,000
Capital Expenditures	(10,000)	(7,000)	(7,000)	(7,000)	(7,000)
Net Operating Working Capital Additions	5,000	1,000	1,000	1,000	1,000
Cash Flow to Invested Capital	28,200	28,800	31,200	34,000	36,000
Interest Expense	(8,000)	(8,000)	(8,000)	(7,000)	(6,000)
Debt Principal Payments	(4,000)	(13,000)	(17,000)	(19,000)	(22,000)
Deal Closing Costs	(800)	-	-	-	-
Total Net Cash Flow Adjustments	(12,800)	(21,000)	(25,000)	(26,000)	(28,000)
Total Excess Cash Flow	15,400	7,800	6,200	8,000	8,000
Excess Cash Flow Percentage	50%	50%	50%	50%	25%
Excess Cash Flow for Loan Prepayment	7,700	3,900	3,100	4,000	2,000
Optional Loan Prepayment	-	-	-	-	-
Mandatory Loan Prepayment	7,700	3,900	3,100	4,000	2,000
Cash Surplus/(Shortfall)	7,700	3,900	3,100	4,000	6,000
Beginning Cash Balance	8,606	16,306	20,206	23,306	27,306
Ending Cash Balance	16,306	20,206	23,306	27,306	33,306
Covenant Compliance					
Lease Adjusted Leverage Ratio	5.75	5.70	5.31	4.93	4.55
Maximum Lease Adjusted Leverage Ratio Allowed	5.75	5.70	5.40	4.95	4.60
In Compliance	Yes	Yes	Yes	Yes	Yes
Fixed Charge Coverage Ratio	1.64	1.36	1.26	1.27	1.23
Minimum Fixed Charge Coverage Ratio Required	1.30	1.30	1.20	1.20	1.20
In Compliance	Yes	Yes	Yes	Yes	Yes
Planned Capital Expenditures	10,000	7,000	7,000	7,000	7,000
Maximum Capital Expenditures Allowed	15,000	15,000	15,000	15,000	15,000
In Compliance	Yes	Yes	Yes	Yes	Yes

Conclusion—Cash Flow Test Sensitivity
In each year, is the debtor corporation able to meet its debt obligations as they mature?
YES

Exhibit 6
Fraudulent Conveyance Opinion Illustrative Example
Capital Adequacy Test
Base Case

	For the Projection Period of:				
	Quarter 1 $000s	Quarter 2 $000s	Quarter 3 $000s	Quarter 4 $000s	Quarter 5 $000s
Revenue	93,000	94,000	96,000	92,000	100,000
Projected EBITDA	14,000	14,000	14,000	12,000	15,000
EBITDA Margin	15%	15%	15%	13%	15%
Depreciation & Amortization Expense	(3,600)	(3,300)	(3,500)	(3,700)	(3,800)
Projected EBIT	10,400	10,700	10,500	8,300	11,200
Provision for Income Taxes	(4,160)	(4,280)	(4,200)	(3,320)	(4,480)
Debt-Free Net Income	6,240	6,420	6,300	4,980	6,720
Depreciation & Amortization Expense	3,600	3,300	3,500	3,700	3,800
Capital Expenditures	(2,300)	(2,500)	(2,500)	(1,600)	(1,700)
Net Operating Working Capital Additions	400	600	600	100	200
Cash Flow to Invested Capital	7,940	7,820	7,900	7,180	9,020
Interest Expense	(1,700)	(2,100)	(2,100)	(2,100)	(2,100)
Debt Principal Payments	(1,000)	(1,000)	(1,500)	(4,000)	(4,000)
Deal Closing Costs	(400)	(200)	(200)	-	-
Total Net Cash Flow Adjustments	(4,990)	(3,690)	(4,190)	(6,490)	(6,490)
Total Excess Cash Flow	2,950	4,130	3,710	690	2,530
Beginning Cash Balance	8,500	11,450	15,580	19,290	19,980
Ending Cash Balance	11,450	15,580	19,290	19,980	22,510
Available Capital	25,000	25,000	25,000	25,000	25,000
Covenant Compliance					
Lease Adjusted Leverage Ratio					5.26
Maximum Lease Adjusted Leverage Ratio Allowed					5.75
In Compliance					Yes
Fixed Charge Coverage Ratio					1.61
Minimum Fixed Charge Coverage Ratio Required					1.30
In Compliance					Yes

Conclusion—Capital Adequacy Test

Does the debtor corporation have adequate capital to operate its business after giving effect to the transaction?

YES

Exhibit 7
Fraudulent Conveyance Opinion Illustrative Example
Capital Adequacy Test—Sensitivity Analysis
Zero Revenue Growth

	For the Period Ending,				
	Quarter 1 $000s	Quarter 2 $000s	Quarter 3 $000s	Quarter 4 $000s	Quarter 5 $000s
Revenue	93,000	93,000	93,000	93,000	93,000
Projected EBITDA	14,000	14,000	14,000	12,000	14,000
EBITDA Margin	15%	15%	15%	13%	15%
Depreciation & Amortization Expense	(3,600)	(3,300)	(3,500)	(3,700)	(3,800)
Projected EBIT	10,400	10,700	10,500	8,300	10,200
Provision for Income Taxes	(4,160)	(4,280)	(4,200)	(3,320)	(4,080)
Debt-Free Net Income	6,240	6,420	6,300	4,980	6,120
Depreciation & Amortization Expense	3,600	3,300	3,500	3,700	3,800
Capital Expenditures	(2,300)	(2,300)	(2,300)	(2,300)	(2,300)
Net Operating Working Capital Additions	400	400	400	400	400
Cash Flow to Invested Capital	7,940	7,820	7,900	6,780	8,020
Interest Expense	(1,700)	(2,100)	(2,100)	(2,100)	(2,100)
Debt Principal Payments	(1,000)	(1,000)	(1,500)	(4,000)	(4,000)
Deal Closing Costs	(400)	(200)	(200)	-	-
Total Net Cash Flow Adjustments	(3,100)	(3,300)	(3,800)	(6,100)	(6,100)
Total Excess Cash Flow	4,840	4,520	4,100	680	1,920
Beginning Cash Balance	7,504	12,344	16,864	20,964	21,644
Ending Cash Balance	12,344	16,864	20,964	21,644	23,564
Available Capital	25,000	25,000	25,000	25,000	25,000
Covenant Compliance					
Lease Adjusted Leverage Ratio					5.33
Maximum Lease Adjusted Leverage Ratio Allowed					5.75
In Compliance					Yes
Fixed Charge Coverage Ratio					1.61
Minimum Fixed Charge Coverage Ratio Required					1.30
In Compliance					Yes

Conclusion—Capital Adequacy Test Sensitivity

Does the debtor corporation have adequate capital to operate its business after giving effect to the transaction?

YES

Exhibit 8
Fraudulent Conveyance Opinion Illustrative Example
Capital Adequacy Test—Sensitivity Analysis
EBITDA Decrease of 15 Percent

	For the Period Ending,				
	Quarter 1 $000s	Quarter 2 $000s	Quarter 3 $000s	Quarter 4 $000s	Quarter 5 $000s
Revenue	93,000	94,000	96,000	92,000	100,000
Projected EBITDA	11,700	11,900	12,100	10,400	12,300
EBITDA Margin	13%	13%	13%	11%	12%
Depreciation & Amortization Expense	(3,600)	(3,300)	(3,500)	(3,700)	(3,800)
Projected EBIT	8,100	8,600	8,600	6,700	8,500
Provision for Income Taxes	(3,240)	(3,440)	(3,440)	(2,680)	(3,400)
Debt-Free Net Income	4,860	5,160	5,160	4,020	5,100
Depreciation & Amortization Expense	3,600	3,300	3,500	3,700	3,800
Capital Expenditures	(2,300)	(2,500)	(2,500)	(1,600)	(1,700)
Net Operating Working Capital Additions	400	600	600	100	200
Cash Flow to Invested Capital	6,560	6,560	6,760	6,220	7,400
Interest Expense	(1,700)	(2,100)	(2,100)	(2,100)	(2,100)
Scheduled Principal Payments	(1,000)	(1,000)	(1,500)	(4,000)	(4,000)
Deal Closing Costs	(400)	(200)	(200)	-	-
Total Net Cash Flow Adjustments	(3,100)	(3,300)	(3,800)	(6,100)	(6,100)
Total Excess Cash Flow	3,460	3,260	2,960	120	1,300
Beginning Cash Balance	7,504	10,964	14,224	17,184	17,304
Ending Cash Balance	10,964	14,224	17,184	17,304	18,604
Available Capital	25,000	25,000	25,000	25,000	25,000
Covenant Compliance					
Lease Adjusted Leverage Ratio					5.71
Maximum Lease Adjusted Leverage Ratio Allowed					5.75
In Compliance					Yes
Fixed Charge Coverage Ratio					1.42
Minimum Fixed Charge Coverage Ratio Required					1.30
In Compliance					Yes

Conclusion—Capital Adequacy Test Sensitivity
Does the debtor corporation have adequate capital to operate its business after giving effect to the transaction?
YES

demonstrate whether the debtor corporation has adequate cash flow to meet its debt obligations.

Exhibit 6 also presents the relevant covenant compliance metrics for the debtor corporation credit facilities for the reasons previously discussed in the cash flow test illustrative example section.

In Exhibit 6, the debtor corporation "passes" the base case scenario of the capital adequacy test, as the debtor has adequate capital to operate its business after giving effect to the transaction. However, the analyst may adjust the base case scenario using the same or similar criteria as applied in the cash flow test. The analyst may determine whether the debtor corporation has sufficient capital to operate its business in each scenario.

Exhibits 7 and 8 present the debtor's projected operating results under zero revenue growth and 15 percent decline in EBITDA scenarios, respectively. In each of the three scenarios, the debtor corporation has adequate capital to pay its (1) operating expenses, (2) capital expenditures, and (3) debt repayment obligations after giving effect to the transaction. Therefore, the capital adequacy test is "passed".

Analytical Procedures Typically Considered in a Fraudulent Conveyance Opinion

I. Engagement Purpose and Objective

A. Identify the purpose of the solvency opinion.

B. Identify the objective of the solvency opinion.

C. Define the solvency analysis assignment.

1. Identify the parties who will use the solvency opinion.
2. Identify the effective date of the solvency opinion.
3. Identify the solvency tests that apply to the subject assignment.

D. Define the engagement in a written client engagement letter.

II. Due Diligence and Collection of Debtor Corporation Data

A. Collect and review the proposed corporate transaction documents.

B. Collect and review the proposed transaction credit facility documents.

C. Collect and review debtor corporation documents including the following:

1. Historical financial information
2. Current financial plans, budgets, projections, and forecasts
3. Description of the debtor corporation business
4. Debtor corporation ownership structure (pre- and post-transaction)
5. Legal documents relevant to the proposed corporate transaction
6. Other relevant debtor corporation operational information

D. Conduct debtor corporation management interviews.

1. Include a discussion of typical valuation elements:
   a. Historical operations and results
   b. Current operations and results
   c. Prospective operations and results
   d. Competitive environment
   e. Industry outlook
   f. Technological changes/developments
   g. Pending litigation and/or contingent liabilities
2. Understand the motives for the transaction/restructuring.

E. Conduct debtor corporation plant/site inspections.

III. Valuation Analysis

A. Economic Environment

1. Consider the historical economic environment.
2. Research and analyze the current economic environment and the expected economic outlook.
3. Consider the relationship of the economic environment to the debtor corporation results of operations.

B. Industry Environment

1. Research and analyze the history and nature of the subject debtor corporation industry.
2. Research the current outlook for the subject debtor corporation industry.

C. Fundamental position of the debtor corporation

1. Consider the debtor corporation capitalization and ownership (both pre-transaction and post-transaction).
2. Review the debtor corporation history.
3. Review and analyze current debtor corporation business operations and financial position.
4. Consider the debtor corporation financial and strategic outlook.
5. Perform a historical financial statement analysis.
6. Perform historical financial statement normalization adjustments, as necessary.
7. Perform a prospective financial statement analysis.
   a. Identify the key financial variables that drive the debtor corporation results of operations.
   b. Analyze the debtor corporation management projections/budgets/forecasts.
   c. Assess the reasonableness of the debtor corporation projections.

IV. Fraudulent Conveyance Analysis

A. Perform the balance sheet test.

1. Estimate the fair value of the debtor corporation total operating assets.
   a Identify the generally accepted business valuation approaches and methods.
   b. Select the business valuation approaches and methods applicable to the debtor corporation.
   c. Perform an income approach valuation analysis—such as the discounted cash flow method.
   d. Perform a market approach valuation analysis—such as the guideline publicly traded company method.
   e. Ensure that all business enterprise or equity value indications are presented on the same level of value:
      i. Typically, a marketable, controlling ownership interest level of value is appropriate for a solvency analysis.
      ii. Apply systematic valuation adjustments to each value indication in order to conclude a consistent level of value.
   f. Prepare a synthesis of all value indications from all of the valuation approaches and methods that were used.
      i. Determine the relevance of each valuation approach and method.
      ii. Conclude the fair value of the debtor corporation operating assets.
   g. Consider any nonoperating valuation adjustments appropriate to the debtor corporation value indication.
   h. Conclude a value of total assets.
   i. Compare the aggregate fair value of total assets to the fair value of total liabilities in order to evaluate the positive or negative balance of the debtor corporation total net assets.
   j. Determine whether the aggregate fair value of the total assets exceeds the fair value of total liabilities balance.
   k. Determine if the debtor corporation "passes" the balance sheet test.

B. Perform the cash flow test.

1. Review the terms of the post-transaction proposed debt obligations.
2. Prepare the debtor corporation detailed cash flow projections through the term of the secured credit facilities.
3. Prepare monthly or quarterly debtor corporation projections for several periods and annual projections thereafter.
4. Determine the debtor corporation quarterly/annual ability to meet the following expenses under the most-likely (or base case) projection of cash flow:

a. Operating expenses
b. Capital expenditures
c. Working capital requirements
d. Interest expense
e. Debt principal payments

5. Select the appropriate economic fundamentals for the analysis of the debtor corporation cash flow, including the following:
   a. Revenue
   b. Cost of goods sold
   c. Operating expenses
   d. Capital expenditures
   e. Working capital requirements
   f. Depreciation and amortization
   g. Interest income and interest expense
   h. Income taxes
   i. Debt principal payments
   j. Dividend payments
   k. Annual cash balances
6. Understand the historical and projected volatility of the selected economic income fundamentals.
7. Perform sensitivity analyses of the cash flow projections.
   a. Review debtor corporation ability to meet financial obligations under each sensitivity analysis scenario.
   b. Analyze, for each projection period (i) excess cash on hand, (ii) available net cash flow, and (iii) unused credit availability.
   c. Consider the debt covenants of secured lenders and determine whether the debtor corporation can meet the debt covenants.
   d. Conclude whether or not the debtor corporation "passed" the cash flow test.

C. Perform the capital adequacy test.
1. Review the cash flow/debt repayment analysis performed in the cash flow test to determine if the debtor corporation has adequate capital to meet its short-term obligations:
   a. Operating expenses
   b. Capital expenditures
   c. Debt service obligations
2. Review the sensitivity analysis of the cash flow/debt repayment analysis to determine if the debtor corporation has adequate capital to meet its short-term obligations.
3. Determine if the debtor corporation has adequate capital to run its business under a range of conditions.
4. Review and consider the level, nature, and sources of funds for expected capital reinvestment.
5. Determine if, in the short-term, the debtor corporation can accomplish the following:
   a. Pay current liabilities and the current portion of long-term liabilities
   b. Pay payroll, research and development, and other operating expenses
   c. Make required capital expenditures
6. Determine whether or not the debtor "passes" the capital adequacy test.

V. Report the Fraudulent Conveyance Analysis Results

A. Prepare a written solvency opinion, as requested by the client.
1. State the purpose and objective of the solvency opinion.
2. State the effective date of the solvency opinion.
3. Define the standard of value used and the premise of value used.
4. Describe the proposed corporate transaction.
5. Describe each of the solvency analysis methods that were employed.
6. Describe the financial, operational, economic, and industry information considered.
7. Define any limiting conditions that affect the solvency analysis and/or the solvency conclusion.

8. Include a summary of the professional qualifications of the principal valuation analyst(s).
9. Opine on the solvency immediately after, and giving effect to, the proposed corporate transaction.

B. Solvency analysis documentation

1. Prepare and maintain the solvency analysis engagement work papers.
2. Include a copy of the signed engagement letter/statement of work.
3. Document the analyst due diligence procedures that were performed.
4. Document all of the information considered.
5. Document the analytical models created.
6. Document the reasoning that supports the solvency conclusion.
7. Include in the work papers sufficient analytical detail so that the solvency analysis can be replicated.
8. Include in the work papers a copy of the signed solvency opinion.

Caveats Regarding any Procedural Checklist

The analyst (and the various parties to the bankruptcy) should consider several caveats regarding the use of any due diligence procedures checklist.

1. No checklist should ever substitute for the analyst's independent professional judgment.
2. The checklist is not intended to be a comprehensive and all-inclusive list.
3. The terminology used in the checklist may have several interpretations.
4. The facts and circumstances regarding a specific leveraged transaction and a specific debtor corporation should be included when considering the appropriateness of any item on the checklist.
5. The checklist should not be used to derive a "quantitative score" to evaluate the quality of a fraudulent conveyance analysis or opinion.

Summary and Conclusion

Bankruptcy-related fraudulent conveyance opinion issues can be complicated. A contemporaneously prepared fraudulent conveyance opinion is an important component in the defense against avoidance actions claiming that a transfer was a fraudulent conveyance.

The checklist provided above, although not comprehensive, presents many of the due diligence and analytical procedures that should be considered by analysts in the preparation of fraudulent conveyance opinions.

The procedural checklist and fraudulent conveyance analysis examples should serve as useful tools to the analyst, the DIP management, the secured lender, the secured and unsecured creditor committees, the legal counsel to all of these parties, and to any other parties involved in a bankruptcy. However, these tool should not be a substitute for the analyst's experience and professional judgment.

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