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Solvency and Fairness Issues for Transactions in Today's COVID Environment

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Back in February 2020, with the Dow roaring at 29,000+ and unemployment between 3% and 4%, it was hard to see the COVID-19 freight train coming our way and even harder to project the fall-out and damage to the U.S. and world economies. Just a month later, the Dow had fallen to between 18,000 and 19,000, nearly one-fourth of American workers had filed for unemployment, and M&A had slowed to a relative trickle. Bankruptcy filings spiked up and distressed M&A was poised for growth. Entire industries (cruise lines, restaurants, traditional retail, and others) were shut down or jeopardized by the pandemic. While the Dow may have recovered, much of the economy has not.

Corporate finance transactions continue, but the profile of transactions may be changing. The use of fairness opinions and solvency opinions to provide due care to Boards of Directors (the "Board") could change significantly, as well, due to the differing, specific types of transactions underway and the general uncertainty and perceived risk of the parties involved in the new deals.

Traditionally, fairness opinions are employed to protect a seller's Board with a third-party confirmation that the consideration received was "fair" from a financial point of view to all (or a portion of or a specific class) of the company's shareholders. Buyers also employ fairness opinions typically when the acquisition represents a material portion of the combined entity. Meanwhile, solvency opinions are generally employed in leveraged transactions, stock redemptions, restructurings, and spin-out/carve-out/spin-off transactions to demonstrate that one or another entity is "solvent" after giving effect to the transaction.

COVID-19 has changed the landscape and heightened the need for solvency opinions and fairness opinions. Although traditional dividend recaps by private equity-backed companies, which often require a solvency opinion, have dropped due to the portfolio companies' conservation of cash during COVID-19, other transactions have surfaced that may require independent opinions or related valuations. The transactions we are seeing now and expect to see in the COVID-19 transaction marketplace that may require independent solvency opinions and/or fairness opinions include

- Affiliated Party Equity Infusions from Private Equity Sponsors
- Dilutive "Down Round" Financings
- Dividend or Leveraged Recapitalizations and Corporate Restructurings
- Distressed Mergers and Acquisitions (M&A)
- Corporate Spin-Off and Carve-Out Transactions
- "Going Private" Transactions
- Transactions Involving Conflicts of Interest (e.g. a Cross-Fund Sale or Investment)
- Employee Stock Ownership Plans (ESOPs)

Affiliated Party/Fund Equity Infusions from Sponsors

With respect to obtaining new capital for existing portfolio companies in need of cash, equity sponsors are considering making add-on investments since the alternative sources of funding are not particularly attractive. Lenders are largely on the sidelines with respect to providing new capital. Meanwhile, soliciting new equity investors would mean giving up Board seats, slowing the speed to close a transaction, and new due diligence requirements. In cases where a fully-funded GP chooses to fund a capital infusion from a newly-vintage fund, there are obvious inherent conflicts-of-interest. Often, these insider transactions are dilutive to existing shareholders. In these cases, it makes sense for the GP to obtain a fairness opinion from an independent financial advisor or nationally-recognized valuation firm due to perceived conflicts of interest.

Dilutive "Down Round" Financings

In the current market, many private companies require equity financing, but the financing could be a "down round," where the current pre-money valuation of a company is below the post-money valuation of its previous round of financing. If an existing shareholder does not participate in the down round up to its ownership percentage, the round will be "dilutive" to that shareholder. In highly dilutive financings, the non-participating shareholder's interest might be "washed out" (reduced substantially) or "burned out" (totally eliminated).

To support the value determination of a dilutive, down-round financing, the company Board or special committee should consider engaging a financial advisor to prepare an independent valuation of the company and deliver a fairness opinion with respect to the fairness of the transaction to existing, non-participating stockholders. Sometimes, obtaining a fairness opinion may not be an option for a company running out of time to close a financing, in which case a valuation of the business (without an attenuating fairness opinion) might suffice. In either case, it makes sense to obtain an independent appraisal of the transaction, since litigation can result from such financings.

Leveraged Recapitalizations and Corporate Restructurings

Many companies that were otherwise healthy may soon face cash flow issues. Companies that were unprofitable and illiquid at the beginning of the year will likely find it difficult to obtain new capital over the next several months, while companies that were profitable and generating cash flow likely have greater flexibility to protect the viability of their businesses.

In the current COVID-19 environment, many distressed and healthy companies are considering corporate recapitalizations and restructurings in order to: 1) stabilize the operations or financial position of the company, 2) enhance the company's cash position, and/or 3) prepare the company for an eventual sale. The recapitalizations and restructurings can range from simple to broad and complex. A recapitalization may mean simply refinancing corporate debt. It may also mean retiring corporate debt or converting or exchanging the debt from one grade to another, redeeming one or more classes of stock, refinancing bank lines, spinning-out core or non-core assets, securitizing intellectual property, or factoring receivables or inventory.

Companies undergoing a financial restructuring or recapitalization may face significant risk in the event that operations deteriorate and financial projections are not met. For dividend or leveraged recapitalizations or the restructuring of the balance sheet of a company, the company's Board will often commission a solvency opinion that demonstrates that the company will be solvent (i.e., that the fair saleable value of the company's assets will exceed its liabilities, the company's debts can be paid as they become due, and the company has adequate capital) post-recapitalization or post-restructuring.

Distressed Mergers and Acquisitions (M&A)

During the pandemic, some companies are finding their profits and cash positions under pressure, as customer demand has slackened, supply chains are disrupted, and lenders are tightening their lending criteria or not lending at all; many are finding it difficult to keep the doors open, much less grow.

Many companies in this situation may consider selling after exhausting other options, including negotiating more liberal payables terms, shortening receivables terms, re-negotiating with their lenders, cutting product/service prices, etc. Boards of Directors of distressed companies considering a sale should make certain that:

- Potential options to maximize shareholder value have been exhausted
- All potential bidders have been properly vetted
- Competing bids have been properly considered

Sales of companies at depressed valuations raise the question as to whether the Board's fiduciary duty has been served with due care. Considering the distressed nature of the transaction, the Board may be well served to obtain a fairness opinion that the price and terms of the offer are fair to the company's shareholders from a financial point of view.

Spin-outs / Spin-offs / Carve-out Transactions

Corporate spin-outs, spin-offs, and carve-outs are popular transactions for public companies trying to: 1) unlock the value of a division, line of business, or non-core operations that may be viewed as undervalued in the public markets (the sum-of-the-parts is greater than the whole argument); 2) streamline and focus on its core operations; and/or 3) improve its overall cash/financial position.

Carve-out and spin-off transaction activity, which is typically done for strategic reasons, was strong through early 2020 at which point companies took a hiatus due to COVID-19. Companies focused inwardly on stabilizing operations while they assessed and adjusted to the on-going impact of the virus, an impact that has proved to be a moving target. But seller-driven behavior may drive new carve-out and spin-out activity; some sellers may seek or need to monetize their assets, pay down debts, and address their liquidity concerns. Moreover, as some stocks remain depressed, it may highlight undervalued, non-core assets that could be unlocked through spin-outs and carve-outs.

Solvency opinions and fairness opinions are staple features of spin-off and carve-out transactions, for both the spun-out/carved out business and the remaining/core company. A solvency opinion can demonstrate that there was no fraudulent conveyance associated with the transaction.

"Going Private" Transactions

"Going Private" transactions have always been alluring to private equity investors who believe that a company is undervalued in the public marketplace and/or unduly encumbered by public securities regulation. While some stocks that were decimated by COVID-19 in March and April have returned to near pre-COVID levels, other stocks have remained lower, adversely affected by cash constraints, revenue and supply-side disruptions, and the lack of available capital caused by the pandemic. Private equity suitors may view undervalued public companies as opportunities to "right the ship," i.e., enhance shareholder value through operational and financial control, strategies, and efficiencies as a privately-held entity. Moreover, the private equity buyers may have a different perception of the company's recovery (a "U-shaped", "V-shaped" or "W-shaped" recovery) for the target company than the public markets have.

For "going private" transactions, a fairness opinion and a discussion of the material factors on which the opinion is based are virtually always provided to the un-affiliated shareholders by the financial advisor to the company.

Transactions Involving Conflicts of Interest (e.g. Cross-Fund Sponsor Sale)

Where companies are distressed, desperate for cash, and with few outside financing options, they may need to resort to transactions involving conflicts-of-interest (i.e., transactions where corporate insiders providing capital do not have an arm's length relationship to a transaction). These transactions may involve a private placement in which an insider investor is offered generous financing terms to continue funding a struggling company. It may also involve M&A and private transactions between companies, with common Boards of Directors or common shareholders, where familiarity with the situation permits rapid action.

A common example of a transaction with inherent conflicts of interest is a private equity cross-fund sale, the sale of a company from a sponsor's fund to another fund controlled by the same sponsor. Due to COVID-19, the private equity firm may want to "rationalize" one of its funds in a stand-alone cross-fund sale or merge inter-fund companies to take advantage of cost or operational synergies between portfolio companies. Moreover, the private equity fund may want to lock in profits or appreciation by the sale of a portfolio company that may not be ready for a broader sales process. Also, the GP may garner transaction or incentive fees from the transaction.

No matter, cross-fund sales, like other "insider" transactions, can pose a large conflict-of-interest for the GPs and funds involved. A fairness opinion provided by a financial advisor to the fund's LPs that the transaction and consideration is fair, from a financial point of view, is a central aspect of all cross-fund sales.

Employee Stock Ownership Plans (ESOPs)

Employee stock ownership plans (ESOPs) represent a viable alternative to an outright sale. Through an ESOP, a company sets up a retirement plan trust for its employees and annually contributes or allocates company stock directly to the plan. There are significant tax advantages for sellers who can permanently defer capital gains.

In addition to the favorable tax treatment, ESOPs may have other advantages under current conditions. First, ESOPs have outperformed conventional companies during challenging times. Second, as owners, employees are more apt to work harder and be more flexible to weather downturns. Third, many believe that the likelihood of closing a sale to an ESOP is greater than a sale to a strategic or financial buyer, since the due diligence and time to close may be simpler and quicker with an ESOP. Fourth, the creation of or sale to an ESOP does not require a change in governance or reporting structure, which may not be true of a conventional M&A transaction. Finally, federal fiscal or tax changes resulting from the pandemic could hasten consideration of an ESOP as a flexible, tax-advantaged corporate alternative.

The creation of an ESOP requires that a fairness opinion be obtained and an annual valuation of the company's stock be commissioned.

SUMMARY

The global COVID-19 pandemic is exacting a toll on lives and businesses perhaps like nothing before. Private equity funds and their businesses have been focused on stabilizing their companies and providing for the safety of their employees and customers. At the same time that funding sources have dried up, funding needs have significantly increased for many companies.

As a result, the types of transactions to help companies survive, and how they are structured, are changing. Many involve instances that require solvency or fairness opinions to protect Boards, especially where current situations make some transactions immediately necessary and more problematic. For these and other transactions, the use of fairness opinions and solvency opinions will be a central and critical component required for the closing of current time transactions.

About Empire Valuation Consultants: Our Expertise and Services

Since our founding in 1988, Empire has grown into one of the nation's leading and most respected financial valuation firms. Fairness opinions and solvency opinions are an important component of our business. Our acceptance procedures are thorough and highly selective; Empire has completed nearly 200 fairness opinions and solvency opinions over the past 15 years or so. Our Opinion work is characterized by its high quality; a highly efficient and "painless" engagement process; and cost competitiveness. In addition to our Opinion work, principal services include valuations for financial and tax reporting (including purchase price allocations, portfolio securities, and stock options), distressed securities and turnaround valuations, trust and estate valuations, litigation support and intellectual property. Empire, has completed nearly 45,000 valuation and opinion projects in its 30-year history, and has more than 80 people in six national offices.

Doug Rogers is a highly experienced and leading business developer in the U.S. valuation industry. Prior to joining Empire, Mr. Rogers was employed at CBIZ Valuation Group where he managed national business development activities for one of the top U.S. valuation firms. Mr. Rogers focused on growing the firm's private equity, hedge fund and public company market share of valuation services, principally solvency opinions, fairness opinions, and the full range of valuations required for financial and federal tax reporting matters. He worked with nearly 175 U.S. funds, hundreds of portfolio companies/investments, and over 100 public companies. Mr. Rogers organized and hosted numerous networking events and presented talks on a wide variety of valuation topics, helping CBIZ become a "go-to" valuation and quality of earnings (Q of E) firm for private equity and hedge funds, as well as public companies. - drogers@empireval.com | 212.714.9835