



**APPRAISAL ECONOMICS**  
Independent Valuation Experts

# THE GUIDE TO SOLVENCY OPINIONS



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# THE GUIDE TO SOLVENCY OPINIONS

## Overview

Solvency opinions provide essential information and assurance to lenders, business partners, investors and board members when faced with a transaction such as an acquisition, restructuring, or recapitalization. In order to provide a solvency opinion, a reliable financial valuation firm must conduct an in-depth evaluation of the business in question. While you can and should conduct certain valuation exercises in-house, a solvency opinion provides a critical external, third-party opinion that will stand up in court and afford some measure of protection for those with a financial stake in a proposed transaction.

## What a Solvency Opinion Is and Is Not

A solvency opinion offers added protection in transactions, but it is not a fail-proof way to protect your interest. It's important to understand the exact benefits that you're afforded with a solvency opinion. A solvency opinion evaluates a business's projected solvency after a leveraged transaction takes place. It takes into account any debt incurred in the transaction. Applying calculated tests to the business's finances will reveal whether the company is likely to remain solvent. However, there would be no need for solvency opinions in bankruptcy cases if solvency were guaranteed.

Solvency opinions include several important tests that support their findings, which may vary dependent upon a company's state of incorporation. These tests include the fair market value of the company's assets and an assessment of whether the company will exceed its stated liabilities and identified contingent liabilities. The solvency opinion will also determine whether the company has adequate means to pay its debts as they mature, and whether the remaining capital available to the company is reasonable for its industry and business activities.

This information is intended to prove that a company is solvent and capable of meeting its financial obligations. A solvency opinion offers added protection in many situations, but it's

important to understand that it is not an absolute guarantee of financial protection. After seeking a solvency opinion, you may find that the company is instead expected to be insolvent as a consequence of the proposed transaction.

## Understanding When You Need a Solvency Opinion

Solvency opinions are valuable in many situations. Understanding when you need a solvency opinion will help ensure that you get the adequate documentation taken care of in a timely manner. When a company is restructuring or acquiring a new business, stockholders or members of the board of directors should ask for a solvency opinion.

Any time there is a major transfer of wealth or change in structure, a company's value will naturally shift. As a result, equity holders may find that they're exchanging equity stakes for liquid assets. There are numerous instances in which it's necessary and even prudent to finance growth with the acquisition of debt. While there's great potential for success in such situations, there's also the potential for failure. This may range from temporary financial distress to complete bankruptcy, and a solvency opinion will help investors and stakeholders assess the situation.

A solvency opinion offers protection for investors in the case of bankruptcy or in the face of debt refinancing. With a solvency opinion, an investing party can prove their right to priority or preferential payment if they have provided capital in a leveraged transaction. A solvency opinion can prove in a bankruptcy ruling that the investor had a reasonable assumption that the company would remain solvent in the future. An independent company's evaluation may in fact reveal that a company is expected to be insolvent, which can also offer valuable insights to sway an investor's or board's decision.

## Properly Assessing Solvency

There are many ways to conduct a solvency opinion, but all methods need to include a close examination of certain critical aspects of a business. There are three common tests used in a solvency opinion.

- A balance sheet test compares the present fair saleable value and fair value of a company's assets with both its current liabilities and the contingent liabilities that will take effect after the leveraged transaction. The company's liabilities are typically given face value.

- A cash flow test evaluates whether a company can meet its debt obligations as they become absolute and mature. This test assesses the company's projected cash flows to determine if there is a margin of safety in the event that a company fails to meet its projections. It will determine the impact of loan covenants existing both before and subsequent to the proposed transaction.
- A reasonable capital test evaluates how much surplus capital a company will retain after a leveraged transaction with the goal of determining whether the company can withstand a downturn. It examines the impact of volatility in asset values, cash flows, and revenues.

To properly assess solvency, the evaluating firm must consider business and overall industry risks, understand the market value of assets, and carefully consider contingent liabilities. While there are some risks and liabilities that apply to nearly any business, many others are unique to particular industries, which help to emphasize the importance of choosing the right firm.

## The Importance of a Solvency Opinion Firm

A solvency opinion is not something that a company can produce in-house. The very nature of the solvency opinion requires that it come from a neutral external third-party. It's also crucial to ensure that the solvency opinion firm you're working with is experienced in your particular industry.

A lender's commitment letter will often specify the need for a solvency opinion from an independent financial advisory firm that has substantial experience in providing opinions similar to the current transaction. If a firm cannot demonstrate relevant and recent experience within a particular industry, a bankruptcy court can find that their solvency opinion is invalid. For this reason, it's crucial that you find a firm that regularly provides financial valuations and has proven experience within your industry or with one that's closely related.

If you have a financial stake in a leveraged transaction or are concerned about protecting yourself in the case of a company's bankruptcy, a solvency opinion is an invaluable tool. Obtaining a solvency opinion from the right firm will help protect your assets in a wide range of circumstances. Appraisal Economics has the experience and expertise that you need on your side to ensure that your solvency opinion is accurate and reliable.

