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Court rulings on solvency and fairness opinions help to define liability for financial advisors

KEY POINTS

- A US Bankruptcy Court decision held that loans to a homebuilding company that subsequently filed for bankruptcy constituted a fraudulent transfer.
- The court emphasised that the solvency opinion provider did not have relevant industry experience, and that its contingent fee arrangement with the company cast doubt on the solvency opinion's credibility.
- Recent solvency and fairness opinion cases highlight the importance for financial opinion providers of carefully drafting engagement letters and subsequent opinions so that they explicitly limit the opinion provider's liability.

On 13 October 2009, the US Bankruptcy Court for the Southern District of Florida entered a final judgment against the senior lenders of liquidating homebuilder TOUSA, Inc in a fraudulent transfer proceeding. Pursuant to federal bankruptcy law (the code), and New York and Florida state law, the court ruled that money lent to Touse by a group of first and second lien lenders before Touse and certain of its affiliates filed for bankruptcy protection on 29 January 2008 constituted a fraudulent transfer. The court cited s 548(a)(1)(B) of the code, which permits the avoidance of any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred within two years before the date of filing of the petition, if the debtor received less than reasonably equivalent value in exchange for such transfer or obligation and met one or more conditions in which it:

- was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
- was engaged in a business or transaction, or was about to engage in a business or transaction that left the debtor with unreasonably small capital;
- intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

The bankruptcy court opinion criticised the asset valuations used by the lenders which exemplifies the second guessing that can confront solvency opinion providers and highlights issues that providers should carefully vet with experienced legal counsel, not only when they are prepared to render such opinions, but also when

The late 2007-2009 financial crisis has spawned substantial litigation over business decisions that were made according to standard and accepted practices before the crisis erupted but that, in its wake, are seen to raise serious questions on the validity of transactional decisions. Given the recent significant volatility of the financial markets and the economy, valuations have become difficult for buyers and sellers to agree upon, and thus are a focus of litigation. This is especially the case when valuations of distressed assets are challenged by creditors as having been made at less than reasonably equivalent value.

they are structuring their fee arrangement in the early stages of such engagements. Contrasting court decisions that held financial advisors not to be liable in providing fairness opinions on transactions emphasise how crucial such vetting is. In these latter decisions, the courts upheld the principle that a financial advisor owes no duty to the stockholders of its corporate clients when issuing a fairness opinion, so long as such limitation on liability is clear and explicitly stated in the contractual relationship.

LIABILITY FOR SOLVENCY OPINIONS: THE TOUSA CASE

The law of fraudulent conveyances is codified in the code and in the Uniform Fraudulent Conveyance Act, both of which aim to protect creditors against the diminution in value of the estates of defaulting debtors. Companies involved in loan or asset purchases with such debtors may find their transactions challenged as fraudulent and ultimately set aside. Courts may find that there has been a 'constructive fraudulent conveyance' if a debtor transfers assets for less than the reasonably equivalent value of those assets, provided that the debtor was either insolvent at the time of or was rendered insolvent by the transfer – even if there was no attempt to defraud creditors. An accurate and defensible valuation of assets obviously is essential to avoiding a fraudulent conveyance challenge.

In the *Tousa* case, the company in July 2007 entered into a \$200m first lien loan and a \$300m second lien loan arrangement with a group of lenders, who received fees, principal and interest payments, and, as collateral, a \$207m tax refund that Touse received in April 2008. Touse used these loans to settle litigation by creditors against Touse and one of its subsidiaries. The lawsuit arose when Touse allegedly defaulted on loans used to finance a failed business venture called Transeastern Properties Inc.

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Courts often apply the ‘balance sheet’ test of insolvency for purposes of s 548(a)(1)(B)(ii)(I), which requires proof that the sum of the debts of a conveying entity is greater than the fair value of that entity’s assets. According to the court, in order to determine if Tousa had ‘unreasonably small capital’ it was necessary to ask whether the company had sufficient capital to support its operations in the event that the company’s performance turned out to be below its expectations. In defining ‘reasonably equivalent value’ the court relied on the principle that ‘reasonably equivalent value’ in the context of a fraudulent conveyance requires a determination of the value that was transferred against the value that was received. Under the court’s analysis, the value received was not limited to the amount of actual cash transferred.

In its ruling (which is currently on appeal to the District Court for the Southern District of Florida), the court avoided the lenders’ liens on the assets securing Tousa and its subsidiaries’ \$500m debt. Further, the court ordered disgorgement and return to the Tousa estates of all fees, principal and interest payments, as well as the \$207m tax refund paid to the lenders. The lenders who were paid in the 2007 settlement of the Transeastern dispute were also ordered to pay \$403 million plus interest back to the Tousa estates. The court based its decision, in large part, on the following of its findings:

- Tousa and its subsidiaries were already insolvent before taking on the \$500m in secured loans.
- The lenders should have known that Tousa was insolvent.
- The Tousa subsidiaries that pledged their assets in the 2007 loan transaction were left with unreasonably small capital, and Tousa and its subsidiaries did not receive reasonably equivalent value for the liens that the new debt placed on its assets.

The solvency opinion fee arrangement

As part of the 2007 loan transaction, counsel for Capital Research and Management Company, a large investor in Tousa bonds, delivered a letter to Tousa’s board that was highly critical of the proposed settlement with Transeastern, stating that the transaction could render Tousa insolvent if the housing slump became a protracted one. Tousa sent this letter to its lenders, which in turn demanded on 27 April 2007, that Tousa provide a solvency opinion as a condition of closing the 2007 loan transaction.

Tousa engaged Alix Partners to render a solvency opinion for Tousa on a consolidated basis. Interestingly, Alix’s fee arrangement for the solvency opinion was what the court described as a ‘contingent fee arrangement’. According to the court, Tousa agreed to pay Alix \$2m if Alix ultimately opined that Tousa would be solvent immediately following the 2007 loan transaction. If Alix did not render such an opinion, however, Tousa would pay Alix only its time charges and reimburse its costs, which the court stated ultimately amounted to approximately half of the \$2m fee.

The court criticised the contingent fee arrangement as casting doubt on the solvency opinion’s credibility. Further, the court noted that Alix’s retention was finalised on 15 June 2007, and within five days Alix had indicated that it expected to deliver a favorable opinion.

Providing a solvency opinion on a contingent, or success fee, basis is not a standard opinion fee arrangement and, if accurately described by the court, it would seem an inappropriate incentive to render a favorable opinion. Alix likely did not intend to enter into a contingent fee arrangement, which emphasises the need for careful drafting at the outset of an engagement.

The solvency opinion provider

The court stated that the lender’s commitment letter ‘required a solvency opinion from a “nationally recognised, independent financial advisory firm that has substantial experience in providing solvency opinions in connection with transactions similar to the Transactions contemplated hereby”’. Because it found that Alix had not provided a solvency opinion for a homebuilder at least since 2005, the court said Alix had an ‘apparent lack of experience’. The court’s opinion did not, however, address:

- Whether Alix had done work for homebuilders during that time period in areas other than solvency opinions.
- Whether any solvency opinion providers had provided a solvency opinion to a homebuilder in that time period.
- How many solvency opinions Alix had provided in that time period to businesses other than homebuilders.

Experience in a particular industry is one factor to be considered to determine if a financial advisor has relevant experience, but that should not be limited to providing solvency opinions (solvency opinions, fairness opinions and valuation opinions are all really just different financial valuation exercises). It also should not be dispositive, especially if the financial advisor has experience in related industries such as real estate. For the most part, solvency opinion providers do not limit their experience to a single industry and in fact their experience usually spans across virtually all industries. The lack of experience in rendering solvency opinions in a particular industry should not render a firm unable to give a credible solvency opinion to companies in that industry, particularly when the financial advisor has experience in that industry outside of solvency opinions (for example, in lending or M&A transactions). In addition, limiting the period to two years seems unnecessarily brief.

LIMITING LIABILITY FOR FAIRNESS OPINIONS: RECENT CASES

Given the second guessing over the solvency opinion regarding Tousa, it is instructive to look briefly at four recent court decisions that offer valuable guidance to financial advisors for avoiding liability when issuing financial opinions. These cases involved fairness opinions, which are given by a financial advisor to the board of directors of a company typically regarding the fairness of the consideration in a transaction from the perspective of the party receiving the consideration (the company or its shareholders). A fairness opinion typically provides the board of directors (or a committee of the board) with an impartial analysis and perspective on the consideration in a transaction, and can be an important

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Biog box

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factor in helping to demonstrate that the board of directors fulfilled its fiduciary duties in recommending or approving the transaction.

Different transactions pose different sets of issues from the party requesting the issuance of a fairness opinion and from the perspective of the financial advisor charged with issuing a fairness opinion. Though such opinions are categorised generally as 'fairness' opinions, they at times vary from the typical 'fairness from a financial point of view' or adequacy of the consideration on which financial advisors generally opine.

Two decisions by the US Court of Appeals for the Seventh Circuit, which paved the way for an Illinois Circuit Court decision involving a high-profile merger agreement, addressed the liability of financial advisors in rendering fairness opinions. Together the decisions affirmed the principle that a financial advisor owes no duty to the stockholders of its corporate clients when issuing a fairness opinion, so long as such limitation on liability is explicitly stated in the contractual relationship. A brief look at each decision illustrates both the potential liabilities involved and the legal defenses for avoiding liability.

1) *The HA2003 Liquidating Trust v Credit Suisse*.

In February 2008, the Seventh Circuit, in contemplating financial advisors' liability in connection with the issuance of fairness opinions, held that financial advisors' responsibilities are set by contract. HA-LO Industries had hired Credit Suisse to issue a fairness opinion in connection with its proposed purchase of Starbelly.com, Inc. Under the terms of the engagement letter, as is market practice, Credit Suisse would use only HA-LO's financial projections, and this reliance on HA-LO's financial projections was reiterated by Credit Suisse in its fairness opinion. Furthermore, again, as is market practice, Credit Suisse was not obligated either to retract or amend its fairness opinion upon acquiring new knowledge relevant to the opinion.

Subsequently HA-LO also retained an accounting firm as a business consultant to review HA-LO's projected revenues from its acquisition of Starbelly.com. Although the accounting firm advised HA-LO that Starbelly.com was 'unlikely to generate anywhere near the projected revenue stream', Credit Suisse issued a fairness opinion stating that the consideration to be paid by HA-LO in the acquisition of Starbelly.com was fair, from a financial point of view, to HA-LO. Credit Suisse was not, however, given the accounting firm's evaluation. After HA-LO filed for bankruptcy, the HA2003 Liquidating Trust formed to liquidate the assets brought an action against Credit Suisse for gross negligence in issuing the fairness opinion. In finding that Credit Suisse had not been grossly negligent, the court held that Credit Suisse could not be held liable for following the exact terms of its contract with HA-LO.

2) *Edward T Joyce, et al v Morgan Stanley*

In August 2008, the Seventh Circuit held that a financial advisor owed no fiduciary duties to the company's stockholders in

regard to issuing a fairness opinion to such company's board of directors. In this case, Morgan Stanley issued a fairness opinion to the board of directors of 21st Century Telecom Group, Inc, in relation to its merger with RCN Corporation. When the stock of RCN sharply declined following the merger, the stockholders of 21st Century, who now held the devalued stock, sued Morgan Stanley, alleging that it owed a duty to advise the stockholders of 21st Century about hedging strategies. The court again relied on the engagement agreement, however, which specifically limited Morgan Stanley's relationship to 21st Century as an independent contractor that owed duties solely to 21st Century. Also, as is standard market practice, the fairness opinion disclaimed any duty to the company's stockholders, explicitly stated that the fairness opinion did not represent an opinion or recommendation as to how the stockholders should vote at the stockholders' meeting on the merger, and contained conflict waiver clauses (as did the engagement agreement) that did not mention stockholders.

3) *Ron Young v Goldman Sachs & Co*

In January 2009, the Illinois Circuit Court explicitly relied on the *Joyce* decision in this case, in which the plaintiff filed a putative class action against Goldman Sachs on behalf of all Wm Wrigley Jr shareholders regarding Goldman's fairness opinion to the board of directors of Wrigley concerning the proposed acquisition of Mars, Incorporated. The opinion held that the consideration to be received by the stockholders of Wrigley in the proposed transaction was fair from a financial point of view, to such stockholders but the plaintiff alleged that Goldman Sachs had a conflict of interest, preventing it from issuing an unbiased fairness opinion.

In granting a motion to dismiss on the grounds of standing, the court considered the language of the engagement letter between Goldman Sachs and Wrigley, the fairness opinion and the proxy materials submitted to Wrigley's stockholders. It found that the engagement letter for the opinion defined Goldman as an independent contractor that owed duties solely to Wrigley, and specifically disclaimed owing any fiduciary duties to Wrigley's stockholders – despite the fact that the fairness opinion was submitted to the stockholders with the proxy materials.

4) *Postscript: Baker v Goldman Sachs*

An interesting follow-up to these decisions can be seen in a September 2009 ruling by the federal district court of Massachusetts in *Baker v Goldman Sachs*, where the court refused to dismiss claims brought by shareholders of Dragon Systems, Inc against Goldman Sachs. Goldman had represented Dragon and its two founders and controlling shareholders in a sale to Lernout & Hauspie Speech Products NV, which subsequently revealed it had been misrepresenting its earnings and filed for bankruptcy. The shareholders sued Goldman for breach of fiduciary duty. Goldman's engagement letter stated that it was acting as advisor 'exclusively for the information of the Board of Directors and

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senior management of the Company', and Goldman cited the Joyce decision in contending that its fiduciary duty was to the company and not the company's shareholders.

The court disagreed, saying that Morgan Stanley's engagement letter in Joyce explicitly stated that it was working only for the corporation as client, while Goldman's engagement letter in Baker specifically addressed individual shareholders who served on the board – creating, the court said, 'a fiduciary relationship apart from the terms of the contract'. The Baker decision shows that engagement letters should explicitly provide that the company, and not any individual in a company capacity (even if designated by indefinite pronouns like 'you') is the intended recipient of the services to be provided.

Contrasting the solvency and fairness opinion cases

It is a standard practice for solvency and fairness opinion providers to rely on the financial projections that management gives them without independently verifying those projections. Such providers do not have the capacity, nor do they get paid, to do due diligence on, or audit, a company's financial projections. Instead, they rely on management's statements that the financial projections are accurate, the company's auditors vetting of the numbers (when possible) and, in the case of a public company, statements filed under penalty of law with the US Securities and Exchange Commission that the company's numbers are accurate. Further, it is not typically within the opinion provider's scope of engagement to inquire with middle

management about the accuracy of financial projections provided by top management.

The court criticised Alix, however, for relying on the financial projections provided by Touse's management in its discounted cash flow analysis of Touse's business without conducting an independent review of how accurate management's projections had been in the past. The court stated that Alix should have conducted a 'bottoms up' analysis of Touse's business, meaning that Alix should have sought input from the lower levels of Touse's management instead of relying on the projections provided by Touse's top managers. The aspect of Alix's engagement agreement on which the court focused was the 'contingent fee arrangement' that the court found objectionable.

By contrast, these recent decisions offer valuable guidance to financial advisors for avoiding liability when issuing financial opinions. First, *Credit Suisse* offers financial advisors some assurance that they may rely on the terms of their engagement letters and fairness opinions. Second, *Joyce* expands on *Credit Suisse*, shielding financial advisors from liability to the stockholders of their corporate clients, at least in the Seventh Circuit, where such limitation on liability is explicitly stated in the engagement letters and related fairness opinions. Finally, in *Young*, the Illinois circuit court, citing to the Seventh Circuit decision in *Joyce*, demonstrated its willingness to enforce the contractual limitations on liability, highlighting the importance of careful drafting in explicitly limiting liability in engagement letters and fairness opinions. This lesson certainly also applies to companies engaged to provide solvency opinions. ■

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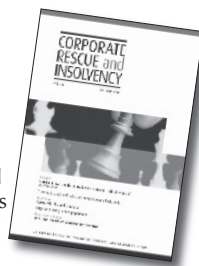
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