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Valuation Analysis of Related-Party Transactions

Related-party transactions often give rise to hotly contested valuation and solvency disputes. When the transaction counterparties are capitalized by different shareholders or creditors, these transactions receive heightened scrutiny due to potential conflicts of interest and other opportunities for self-dealing. Even in the absence of an actual conflict, factors common to related-party transactions create complexity in assessing frequently litigated questions in bankruptcy: Was adequate consideration received upon the sale of the asset? Was the transferring entity solvent upon the sale? What priority should be given to bankruptcy claims arising from related-party transactions?

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Litigants might attempt to answer these questions by making a strict comparison of the related-party transaction to a transaction between third parties. For example, litigants will attempt to support or rebut the related-party transaction by pointing to the structure, terms or price of similar third-party transactions. A deviation from third-party terms can provide fertile ground to criticize the related-party transaction. Yet this comparison is often too simplistic. Accurate valuation or solvency analysis requires an explicit identification and assessment of the factors that frequently distinguish related-party transactions from third-party transactions.

The phrase "related-party transaction" is used here to refer to a transaction in which two or more of the transaction counterparties are either under common ownership or have a similarly correlated economic interest in a transaction. Using this definition, common related-party transactions include the sale or transfer of assets within a corporate family; parent or subsidiary debt guarantees (both implicit and explicit); and "upstream" (*i.e.*, subsidiary to parent) or "downstream" (*i.e.*, parent to subsidiary) financing transactions. This article discusses four factors that commonly distinguish related-party transactions from third-party transactions. A failure to thoroughly evaluate the inport of these factors is likely to result in inaccurate valuation or solvency analysis.

Four Key Factors

Terms of a Related-Party Transaction Might Reflect Economic Benefits (or Costs) Outside of the Immediate Transaction

In a valuation or solvency analysis of a related-party transaction, it will be necessary to determine whether and how to take into account benefits or costs outside of the immediate transaction. Incorporating these indirect benefits might significantly impact a comparison of the terms of the related-party transaction to terms of an otherwise comparable third-party transaction.

For example, consider a subsidiary that provides upstream financing to a parent entity in order to avoid a default on the parent company's debt. Even though the subsidiary is not a guarantor of the parent's debt, it provides the financing because a default of the parent company's debt would negatively impact the financial condition of the entire corporate family. Thus, the subsidiary benefits from avoiding the default, but the *subsidiary's* avoidance of the parent's default is a benefit outside of the immediate transaction.

As a result of this economic benefit, the terms of the upstream financing might differ from the terms of similar financing between unrelated third parties. For example, the repayment terms, interest rate, required credit supports or financial covenants attached to the upstream financing might be more favorable to the parent company, as compared to financing terms that the parent company would obtain from a third party. Considered in isolation, the more favorable terms could be argued to represent an impermissible transfer of value from the subsidiary to the parent company. A subsidiary creditor may posit that this transfer represents an avoidable transfer under U.S. bankruptcy law.

However, in a dispute subsequently challenging the transaction, it is important to determine whether the indirect benefit constitutes sufficient reasonably equivalent value to justify the difference in terms between the upstream financing and a similar third-party transaction. This might be both a legal and a financial question. In a given context, it must be legally permissible to take the external economic benefit (in this example, the avoidance of default) into account. From a financial perspective (the focus of this article), a key question is whether the deviation from third-party terms is economically rational at the time the terms were negotiated.

To fully assess the strength of the challenge to a transaction, one should determine and — if applicable and possible — quantify the net benefit to the subsidiary of the avoidance of default. It will likely be necessary to also determine any benefit or cost to the subsidiary's creditors arising from the upstream financing. The benefit of avoiding default should then be compared to the benefit or cost of the more favorable financing terms provided to the parent company.

To examine the benefits of avoiding default, an analyst will need to assess various issues. How probable was a default? How would the cash flows of the subsidiary be impacted by a parent default? On a probability-weighted basis, what is the expected recovery for the subsidiary's creditors, assuming the upstream financing? How do the subsidiary creditor recoveries compare in the absence of the upstream financing? Simply stated, the higher the probability of default and the greater the recovery to the subsidiary creditors upon the avoidance of default, the more likely the deviation from third-party terms can be economically justified. Stated another way, the terms are likely to be economically rational if the total probability-weighted net benefits conveyed by the upstream financing — including the avoidance of default — are reasonably equivalent to the cost incurred to provide the upstream financing.

Cash Flows Within a Corporate Family Might Be Restricted Due to Obligations to Third-Party Debt or Tax or Corporate Law Regimes

The structure of existing third-party financing transactions might restrict the transfer of cash flows within a corporate family. Examples include "ring-fencing," which explicitly segregates the assets and cash flows of a subsidiary from the rest of the corporate family, and debt covenants that restrict the ability of a subsidiary to pay a dividend to the parent company.

In addition, thin capitalization rules (*i.e.*, rules that limit the amount of financial leverage) might prevent — or create costly tax consequences of — transferring cash flows between entities in different tax jurisdictions. For a challenged related-party transaction, it will be necessary to determine whether and how the restricted cash flows should be treated for a valuation or solvency analysis.

For example, consider a parent company debt for which a foreign subsidiary is not an obligor. Assume that a subsidiary debt covenant or thin capitalization rules restrict the payment of a dividend from the foreign subsidiary to the parent (due to an effective increase in the leverage of the foreign subsidiary). In this case, is it appropriate to include the cash flows of the subsidiary in an analysis of the parent company's ability to repay its debt or an assessment of the adequacy of the parent company's capital? For a balance-sheet solvency analysis, it might be appropriate to include the stock of the subsidiary in the parent company's assets.

However, if there are cash-flow restrictions between the subsidiary and the parent, the only way for the parent company to effectively access the cash flows of the subsidiary might be to sell the subsidiary stock. In this case, any valuation or solvency analysis of the parent must fully reflect the impact of a potentially distressed sale of the subsidiary. The parent company might receive a one-time cash infusion in connection with the sale. However, the parent company would also forego future dividends from the subsidiary and might forego certain synergistic cash flows generated within the corporate family.

With an increase in cross-border restructurings often resulting in multiple debtor estates and distinct creditor groups, the need for such analysis is likely to increase. This financial analysis requires a high degree of integration with bankruptcy laws, often in and across multiple jurisdictions.

Revenue Synergies and Cost Allocations Among Entities in the Same Corporate Family Might Be Difficult to Quantify

It is not uncommon for related parties to generate correlated revenue or jointly benefit from shared costs. Within a corporate family, the allocation of revenue or cost among various entities might not be explicitly done or might be done in a perfunctory way that does not fully reflect how such an allocation would be made between third parties. However, in the context of a related-party transaction dispute, it might be necessary to more precisely quantify the economic benefits or costs incurred by each of the counterparties.

For example, consider a restaurant and concert hall located in close proximity. Both businesses jointly benefit from an overlapping customer base and incur shared marketing costs. They share common ownership but have two different sets of lenders. Now consider a dispute arising in which it is necessary to determine the standalone value of one of the establishments. For example, one might need to determine the solvency of the restaurant in order to determine compliance with debt covenants. Alternatively, the owners of the concert hall might have purchased the restaurant in a transaction that is now being contested by the restaurant's creditors. In either instance, a standalone valuation of the restaurant would require an economically appropriate allocation of the marketing costs.

An allocation of a revenue or cost within a corporate family is dependent on the specific facts and circumstances of the relevant entities. Using the previous example, to properly allocate the marketing costs, the valuation analyst will need to determine the relationship between the customer demand for the restaurant and the customer demand for the concert hall, which will give rise to several key questions. What is the correlation between customer demands, and is there a causal connection between the two sources of demand? For example, does demand for the concert hall *cause* a demand for the restaurant? Further, it will be necessary to understand how both sources of demand are impacted by marketing expenditures. Does $1 of marketing expenditure have an equal or unequal impact on the demand for the two establishments?

To answer these (and related) questions, the valuation analysis will need to incorporate a combination of financial and economic tools that explicitly recognize the related-party nature of the two establishments. A determination of the value or solvency of the restaurant by *only* a benchmark comparison to a hypothetical, the standalone restaurant is unlikely to be accurate. For example, marketing expense as a percentage of revenue for the subject company restaurant (stated on an economically rational basis) is likely to differ from that for standalone restaurants.

Further, the sale price of the restaurant to the concert hall (again, stated on an economically rational basis) might reflect the synergies accomplished by such a sale (or the dis-synergies avoided had the restaurant been sold to a third party). Thus, the price at which the restaurant is sold to the concert hall might differ from the observed transaction values in a typical precedent-transaction analysis. A typical precedent-transaction analysis includes only sales of assets between unrelated third parties.

Boundaries Between Legal Entities Might Be Blurred and Documentation of Related-Party Transactions Might Lack Formality

Large corporate families often consists of hundreds of legally incorporated subsidiaries, often in different countries and states. These legal entities might be created for regulatory, legal or tax reasons. However, from a functional standpoint, these entities are often managed along product lines, functions or broader geographies. Thus, the manner in which the subsidiaries operate might not reflect the corporate formality of the legal structure. When the company is performing, these differences in legal structure and management structure may not matter, as the subsidiaries share a common goal of maximizing the parents' shareholder wealth. However, in financial distress or bankruptcy, interests might diverge among the various creditors to the legal entities. When corporate formalities are not properly observed or documented, legal challenges to the companies' organizational structure and management could arise.

As an example, many related-party transactions lack robust contemporaneous documentation. The terms of an asset sale or loan might only be summarily described. Furthermore, robust, contemporaneous documentation of the analysis supporting the rationale for and terms of the transaction might be lacking. This will be particularly true for instances in which the company did not retain a third-party financial advisor in connection with the transaction. When the transaction is later challenged, lack of documentation might impede a comparison of the transaction to third-party transactions.

For example, intercompany loans often lack documentation that explicitly specifies repayment terms or defines remedies upon a loan default. Instead, the valuation analyst might be needed to rely on the company's common practice when comparing loan terms to third-party transactions. In addition, a supposed lack of documentation might need to be considered in light of the related-party nature of intercompany loans. For example, a cash-sweep provision might be unnecessary for an intercompany loan if the counterparties receive financing from a common central treasury.

Conclusion

Transactions between third parties are always not exact proxies for related-party transactions. Thus, valuation and solvency analyses that are limited to an analysis of third-party transactions will often produce analytical conclusions that are incorrect when applied to related-party transactions. The analysis of a related-party transaction is a fact-intensive one, and the correct analysis will recognize the specific facts and circumstances of the transaction. abi