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Determining Fair Value Of Liabilities In Acquisitions

Law360, New York (December 16, 2009) -- Changes in financial accounting standards relating to the determination and application of fair value have expanded the nature of the valuation exercise that needs to be performed in strategic investments and acquisitions.

While previously the primary financial task was to verify the existing financial position of the business to be acquired, “fair value” has moved the goalposts to focus on the how assets and liabilities will be valued following the acquisition or investment and, to the extent applicable, determining any potential impact on the fair value of the acquirer’s liabilities.

Creditworthiness and Other Nonperformance Risks

While the fair value of assets is independent of the characteristics of the owner, the fair value of a target’s liabilities may be significantly impacted as a result of an acquisition or strategic investment due to changes in nonperformance risk.

Two elements of nonperformance risk may be significantly impacted by an acquisition: creditworthiness and, with respect to nonfinancial liabilities, the ability to deliver services or otherwise perform such obligations.

This change can result from a change due to the acquirer assuming the obligation (and thus imposing its creditworthiness and ability to perform obligations) or a change in the creditworthiness of, or ability to perform by, the target.

Business Combinations

If the transaction is a “business combination,” subject to certain limited exceptions, the acquirer will be required to apply fair value to the target’s liabilities on the acquirer’s consolidated balance sheet (even if the target had not previously applied fair value to

such liabilities and the acquirer does not apply fair value to its liabilities of a similar nature).

Liabilities that have been recorded based on their historic carrying value will be adjusted to reflect the nonperformance risk of the target (or the entity that has assumed the liability) immediately following the transaction.

Distressed Acquisitions and Leveraged Buy-Outs

While these issues will apply to many types of acquisitions and strategic investments, the areas where it may have the most dramatic impact are acquisitions of or investments in distressed or otherwise troubled companies and leveraged buy-outs.

Acquisitions of or strategic investments in distressed companies will likely result in the post-transaction target (or the entity that has assumed the liability) having a significantly improved creditworthiness compared to the pre-transaction target and as a result would increase the fair value of the liabilities acquired.

To the extent there is an increase in fair value of the liability and the new fair value of the liability exceeds the prior value of the liability (whether based on fair value or carrying value), the target's (or its successor's) future earnings may be increased as a result of a decrease in future (implicit or imputed) interest expense as a result of premium amortization.

In contrast, a leveraged buy-out will significantly decrease the creditworthiness of the target. The new debt incurred in order to finance the leveraged buy-out will be based upon the pro-forma balance sheet and creditworthiness of the target.

However, the target's existing liabilities may not be adjusted to reflect the alterations in the target's creditworthiness and as a result their fair value may decrease.

To the extent there is a decrease in fair value of the liability and the new fair value of the liability is less than the prior value of the liability (whether based on fair value or carrying value), the target's future earnings may be decreased as a result of additional future (implicit or imputed) interest expense as a result of discount accretion.

Impact on the Acquirer's Existing Liabilities

In addition to its impact on the target's liabilities, an acquisition or strategic investment may impact the fair value of the acquirer's liabilities.

If the acquirer's credit ratings suffer as a result of the transaction (or its creditworthiness decreases within the band of its current rating) and there are no corresponding changes to the terms of an obligation of the acquirer, the fair value of such liability will decrease to reflect the change in creditworthiness and may impact its future earnings.

Where the value of the assets and liabilities of the target are significant compared to overall assets and liabilities of the acquirer, the potential for significant swings in the acquirer's creditworthiness is much greater.

Conclusion

Acquisitions or strategic investments can dramatically alter the fair value of the liabilities of the acquirer and the liabilities to be acquired in the transaction.

Even if there would be no impact on fair value, the switch from carrying value to fair value in "business combinations" can completely rewrite the balance sheet of the business.

As a result of the potential impact of such changes on the acquirer's balance sheet and future earnings, acquirers and strategic investors should focus on the pro forma impact of a proposed transaction on the liabilities assumed and the existing liabilities of the acquirer.

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