Thought Leadership Discussion

How Solvency Opinions May Reduce the Risk of Fraudulent Transfer Exposure in Leveraged Transactions

Michael F. Holbein, Esq.

A constructive fraudulent transfer occurs where the transferor receives less than "reasonably equivalent value" in exchange for the transfer and the transferor is either (1) insolvent on the date of such transfer; (2) engaged in a business or transaction for which any property remaining with the transferor has unreasonably small capital; or (3) intended to incur, or believed it would incur, debts that would be beyond its ability to repay as such debts matured. A constructive fraudulent transfer may be avoided under the U.S. Bankruptcy Code and applicable state law. Leveraged transactions, in particular, give rise to constructive fraudulent transfer risk. An independent, third-party solvency analysis—prepared at the time of the leveraged transaction—can be useful in defending against such a fraudulent transfer claim.

Introduction

It is not atypical for leveraged transactions to be attacked years after the fact when one of the parties to the transaction later files for bankruptcy protection. In lawsuits brought by trustees, debtors-in-possession, and, in some cases, creditors' committees, a judicial determination that the transaction constituted a fraudulent transfer can result in buyouts being undone, spin-offs being unspun, and intercompany guaranties being avoided.

In these circumstances, a contemporaneously prepared, independent, third-party expert solvency analysis can be a bulwark against a catastrophic financial loss.

To appreciate why, first, it is necessary to understand (1) what an avoidable fraudulent transfer is and (2) how certain transactions can give rise to such a transfer. Second, it is important to know what to look for in a solvency opinion and why such an opinion matters. This discussion covers each of these two topics.

Fraudulent Transfers (and Obligations)

Fraudulent transfer lawsuits usually, though not always, arise in the context of a bankruptcy case.[1] The U.S. Bankruptcy Code specifically provides a mechanism for the avoidance of fraudulent transfers, and it also allows for the pursuit of fraudulent transfer claims available to creditors under state law.

The Bankruptcy Code Fraudulent Transfer Statute

Section 548 of the Bankruptcy Code provides for the avoidance of fraudulent transfers and obligations. At the outset, it is important to remember that, in addition to fraudulent transfers, fraudulently incurred obligations are also avoidable.

The conversations around these transactions are almost exclusively, if only superficially, limited to fraudulent "transfers." Therefore, this discussion employs the same convention—unless the transaction being discussed specifically involves the potentially fraudulent incurrence of an obligation. Nonetheless, the discussion regarding "transfers" applies to "obligations" as well. In this regard, it may be helpful to think of an obligation simply as the transfer of a promise to pay or to perform.

The Bankruptcy Code divides fraudulent transfers into two categories, which are addressed in Sections 548(a)(1)(A) and (B), respectively. The former transfers are typically referred to as "actual" fraudulent transfers. And, the latter transfers are typically referred to as "constructive" fraudulent transfers. However, these two terms are not found anywhere in the Bankruptcy Code.

Actual fraudulent transfers are those transfers "made . . . with actual intent to hinder, delay, or defraud" a creditor.[2]

Intent is found in certain "badges of fraud," derived from case law and borrowed from state statutes. Solvency opinions do not usually play a large role in insulating parties from actual fraud—the best defense here is to avoid fraudulent, or apparently fraudulent, conduct. Therefore, this discussion does not discuss issues related to the avoidance of actual fraudulent transfers in any detail.

Constructive fraudulent transfers are transfers made where:

- the transferor/debtor-to-be voluntarily or involuntarily received less than "reasonably equivalent value" in exchange for the transfer and
- one of three conditions existed.

A transfer is fraudulent if there was no reasonably equivalent value and the transferor was insolvent on the date of such transfer.[3]

Here, an entity is deemed "insolvent" when the sum of all the entity's debts is greater than the sum of all of the entity's property.[4] This analysis is typically called the "balance sheet test."

Alternatively, a transfer is fraudulent if (1) there was no reasonably equivalent value and (2) the transferor was "engaged in a business or transaction, or was about to be engaged in a business or transaction, for which any property remaining with the [transferor] was an unreasonably small capital" (i.e., the transferor was undercapitalized).[5] This analysis is typically called the "unreasonably small capital test" or the "capital adequacy test."

Finally, a transfer is fraudulent if (1) there was no reasonably equivalent value and (2) the transferor "intended to incur, or believed [it] would incur, debts that would be beyond [its] ability to repay as such debts matured."[6] This analysis is typically called the "cash flow test."

A trustee, debtor-in-possession, or, in certain circumstances, a creditors' committee may sue to avoid any of the above-described transfers if made within two years prior to the bankruptcy filing.[7]

This two-year period is referred to as the "look back" or "reach back" period. Such suits have to be brought within two years from the date of the bankruptcy filing.

Once a transfer is avoided under Section 548, it is automatically preserved for the benefit of the estate under Section 551 of the Bankruptcy Code.[8]

In addition, what was transferred, or its value, may be recovered under Bankruptcy Code Section 550. It can be recovered from any of the following:

- The initial transferee,
- Any entity for whose benefit the transfer was made
- Any mediate or intermediate transferee of the initial transferee[9]

State Fraudulent Transfer Laws

In addition to the Bankruptcy Code, states have laws that allow for the avoidance of fraudulent transfers.[10]

The trustee, or trustee equivalent, can employ the "strong arm" powers provided in Section 544 of the Bankruptcy Code to assert these state law causes of action.[11]

The most typical of these state laws, adopted by 43 states in some form or another, is the Uniform Fraudulent Transfer Act ("UFTA"). The UFTA was amended in 2014, and it was renamed the Uniform Voidable Transactions Act ("UVTA"). Like the Bankruptcy Code, the UVTA divides these transactions into two categories.

However, unlike the Bankruptcy Code, the distinction is not between constructive fraud and

actual fraud. Rather, the UVTA separates these two types of transactions into:

1. those transfers that can be avoided by creditors in existence at the time the transfers were made and
2. those transfers that can be avoided by present and future creditors.[12]

Nonetheless, the terms actual fraud and constructive fraud are often still used in the context of the UVTA.[13]

The transactions voidable under the UVTA by creditors in existence at the time of the transaction include those transfers made for less than reasonably equivalent value while the debtor was insolvent (i.e., the first type of constructive fraudulent transfer discussed above).[14]

The UVTA defines insolvency the same as the Bankruptcy Code. That is, when the sum of the entity's debts is greater than the sum of the entity's assets at fair valuation. However, the UVTA adds a presumption of insolvency where the transferor is generally not paying debts as they become due.[15]

Transactions voidable by present and future creditors include actual fraudulent transfers[16] as well as the other two types of "constructive" fraudulent transfers described in the Bankruptcy Code.

Using nearly identical language as the Bankruptcy Code, the UVTA defines the latter two types of transactions as transfers made for less than reasonably equivalent value while the transferor:

- "was engaged, or about to be engaged, in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction"[17] or
- "intended to incur, or believed or reasonably should have believed it would incur, debts beyond [its] ability to pay as they came due."[18]

Just as with avoidance actions filed under Bankruptcy Code Section 548, the trustee, or the trustee equivalent, has two years from the date of the filing of the bankruptcy case to initiate suit. However, the lookback period under the UVTA is four years, twice as long as the lookback period under the Bankruptcy Code.

Once avoided under Section 544 and state law, the transfers are preserved and recoverable under Sections 551 and 550 of the Bankruptcy Code, respectively.

Transactions Giving Rise to Potential Fraudulent Transfer

Whenever something is given—like the transfer of money or property, the grant of a security interest, or a promise to pay or perform—for less than adequate consideration, the potential for a constructive fraudulent transfer exists. As such, any number of commercial transactions can give rise to fraudulent-transfer risk.

Let's consider the following three transactional examples: a leveraged buyout, a spin-off, and an enterprise loan.

- The leveraged buyout: In a typical leveraged buyout, a target company is acquired with borrowed money (the leverage), and the target company's assets are used to secure the loan.

  In other words, the target company gives something of value (a security interest in its assets) and gets nothing in return. This is because the money goes to the acquiring entity, not the target company, to fund the purchase price.

  If the pledge of security is accompanied by a guarantee from the target company, and it often is, the potential fraudulent transaction is compounded. This is because the target company will have incurred an obligation, the loan guarantee, for nothing in return. This presents fraudulent transfer risk.
- The spin-off: In certain restructuring transactions, a parent company may wish to spin off a business unit.

First, the parent will usually transfer its assets into a subsidiary, often created for the sole purpose of the spin-off. The subsidiary usually finances this acquisition.

Second, the parent will sell or distribute its shares in the subsidiary, completely divesting itself of ownership of the now spun-off company. There are a multitude of legitimate business reasons for a parent to spin off a subsidiary, all in service of maximizing shareholder value.

But if financial distress follows and leads to bankruptcy for either the parent or the spun-off company, the transaction will likely come under scrutiny.

Often, the transaction is lopsided. For example, the spun-off company may assume the parent's debt or borrow too much to purchase the assets. Or, the parent may receive inadequate consideration for the assets transferred. This occurrence presents fraudulent transfer risk.

- The enterprise loan: It is routine for corporate families to utilize large loan structures where funds are distributed by the lender, usually on a draw, either to the subsidiaries directly or to the parent and then by the parent amongst the subsidiaries. The subsidiaries are co-obligors or guarantors under the loan agreement.

  Often, a lockbox and sweep arrangement pulls cash from the subsidiaries daily.

  If certain subsidiaries are underperforming and their affiliates are co-obligating or guarantying, while subsequently repaying their own debts without receiving any true upside, there is fraudulent transfer risk.

The typical characteristic of all of these transactions is the potential disparity between what was given and what was received.

Put differently, a transfer may be made for less than reasonably equivalent value in exchange.

Ultimately, in the ensuing fraudulent transfer litigation, experts will be called on to answer the question: What were the thing given and the thing received actually worth?

But this is only half of a constructive fraudulent transfer claim. The other half—insolvency, undercapitalization, or cash flow deficits—also requires expert testimony. In that regard, a solvency opinion can be thought of as expert testimony for use in case of future litigation.

The Solvency Opinion

To be most effective (i.e., to have the greatest evidentiary weight), a solvency opinion is performed by an independent third-party analyst, typically one with experience in the particular industry. The solvency opinion is based on independently obtained or verified information and should not be outcome-driven.

The analyst should not be incentivized to opine in favor of solvency. This independence will lend the opinion credibility and provide a possible edge over an opinion prepared specifically for litigation.

Solvency opinions generally include analyses that mirror the "constructive" fraud provisions of the Bankruptcy Code and the UVTA—a balance sheet analysis, an adequacy-of-capital analysis, and a cash flow analysis.

Solvency opinions may also include an analysis of market capitalization (the number of shares outstanding multiplied by the price per share). Internal information is often verified against publicly available information, and all analysis assumptions are subject to update and revision in order to account for market changes and manipulation.

Balance Sheet Test

A balance-sheet test in a solvency opinion is designed to answer in advance whether the debtor meets the Bankruptcy Code definition of insolvent. In other words, do its liabilities exceed the value of its assets at fair valuation? The question often is reframed in reverse as—Is the debtor solvent?

In valuing the debtor's assets, valuation analysts generally rely on the going-concern premise of value rather than on the liquidation premise of value as the measure of highest and best use. Contingent and disputed debts are often weighted based on the likelihood of payment.[19]

Cash Flow Test

A cash flow test is designed to determine whether the debtor will be able to pay its debts, including any debts with the associated transaction, as they come due. Not coincidentally, it mirrors the fraudulent transfer analysis in the Bankruptcy Code and the UVTA.

It is important to note that cash flow can often be positively affected by restricting cash outflow with new debt and deferring payment on the transaction debt. Failure to account for this manipulation can signal an outcome-driven opinion. Inevitably, where cash flow is an issue, capitalization is as well.

Capital Adequacy Test

A capital-adequacy test is designed to determine whether the debtor can endure future business fluctuations. This analysis often includes stress testing against various scenarios likely to have an impact on the debtor's business.

This stress test analysis is designed to satisfy the fraudulent transfer inquiry into potential undercapitalization.

Summary and Conclusion

The second prong of the fraudulent transfer analysis (whether it is the solvency analysis, the cash flow analysis, or the capitalization analysis) can often be overlooked by fraudulent transfer plaintiffs. This is often the case because plaintiffs are more focused on the nuance issues of value, which serve as the starting point (i.e., the first prong) for determining whether a claim exists.

Most often, the parties entering into transactions like those described above are financially sound at the time of the transaction. However, given the four-year state law look-back period, it is typical for litigation to ensue years after the transaction if the debtor experiences financial difficulties.

In some of these litigations, the plaintiff's expert—with the benefit of hindsight—will opine that the debtor was in financial distress long before anyone could have reasonably known.

An independent, third-party solvency analysis—an analysis that was prepared contemporaneously with the transaction—can provide an invaluable tool to counter such a claim.

Notes:

1. Creditors may assert state law fraudulent transfer claims where no bankruptcy has been filed. However, once a bankruptcy case is filed, most courts view the claim as property of the bankruptcy estate and prohibit suits by individual creditors.
2. 11 U.S.C. § 548(a)(1)(A).
3. 11 U.S.C. § 548(a)(1)(B)(ii)(I).
4. 11 U.S.C. § 101(32)(A).
5. 11 U.S.C. § 548(a)(1)(B)(ii)(II).
6. 11 U.S.C. § 548(a)(1)(B)(ii)(III).
7. 11 U.S.C. § 548(a)(1).
8. 11 U.S.C. § 551.
9. 11 U.S.C. § 550(a).
10. Alaska, Kentucky, Louisiana, Maryland, South Carolina, and Virginia have not adopted the UFTA or updated UVTA and instead have different statutes or a patchwork of common law providing for the avoidance of fraudulent transfers. The differences between these laws, though interesting, is beyond the scope of this discussion.
11. 11 U.S.C. § 544(b)(1).
12. UVTA, § 4, "Transfer or Obligation Avoidable as to Present or Future Creditor"; § 5 "Transfer or Obligation Avoidable as to Present Creditor."
13. One of the reasons given for the renaming accomplished by the 2014 amendment (from "Fraudulent" to "Voidable") was to address the inconsistent use of the term "fraudulent" with respect to constructive fraud, which doesn't qualify as fraud under any other understanding of the concept. See UVTA, Prefatory Note. No substantive change was intended by the change in terminology. Id. This is not unlike the change in terminology that accompanied the 1984 adoption of the UFTA in replacement of the Uniform Fraudulent Conveyance Act. There, the change was meant to recognize the applicability of the Act to transfers of realty and personal property. To the drafters, the term "conveyance" apparently connoted a transfer restricted to personal property. See UFTA, Prefatory Note.
14. UVTA, § 5(a). This category also includes transfers made to insiders in repayment of antecedent debt while the transferor was insolvent and where the insider had reason to know about the transferor's insolvency. UVTA, § 5(b). This is similar to insider preference avoidance found in Section 547 of the Bankruptcy Code; the difference being that the preference avoidance statute in the Code does not include a scienter (i.e., knowledge) requirement.
15. UVTA, § 2(a) and (b).
16. UVTA, § 4(a)(1). To show intent, the UVTA includes a nonexclusive list of "badges of fraud." UVTA, § 4(b).
17. UVTA, § 4(a)(2)(i).
18. UVTA, § 4(a)(2)(ii).
19. Contingent debt describes financial liabilities that are not yet, and may never become, due. Instead, the debtor's obligation to pay is predicated on a triggering event (e.g., a guaranty). A disputed debt is usually fixed in amount, the debtor simply contests its obligation to pay. Caution should be taken when weighting contingent and disputed debts. The bankruptcy court will also consider expert analysis rendered with the benefit of hindsight.

Michael F. Holbein is a partner at Arnall Golden Gregory LLP and a member of that firm's Bankruptcy, Creditors' Rights & Financial Restructuring practice. A bankruptcy litigator, Michael defends and prosecutes matters for trustees, financial institutions, and trade creditors at both the trial and appellate levels. Over the span of his career, he has defended and prosecuted numerous complex, multi-million-dollar fraudulent transfer lawsuits.