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Proving or Contesting Debtor Insolvency Under the Balance Sheet Test

Analyzing Insolvency in Preference and Fraudulent Transfer Litigation

THURSDAY, MAY 10, 2012

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Today's faculty features:

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Insolvency

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Elements of a Preference Claim

Section 547 states in relevant part:

> "(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—
>
> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;

Elements of a Preference Claim (cont.)

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of the title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title."

In essence, a preference claim is:

- A transfer of the debtor's interest in property made within 90 days before the filing of the petition
- to a creditor on account of an antecedent debt
- made while the debtor was insolvent.

Elements of a Fraudulent Transfer Claim

Section 548 states in relevant part:

> "(a)
>
> (1) The trustee may avoid any transfer . . .of an interest of the debtor in property . . .that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
>
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

Elements of a Preference Claim (cont.)

(B)

(I) 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;

(II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;

(III) 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; or

(IV) Made such transfer to or for the benefit of an insider, or incurred obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business."

In essence, a constructive fraudulent transfer claim is

- A transfer of a debtor's interest in property made within two years before the filing of the petition for which the debtor did not receive reasonably equivalent value
- while the debtor was insolvent, or
- which transfer left the debtor inadequately capitalized, or
- which transfer left the debtor unable to pay its debts as they became due.

Presumptions under Section 547 of the Bankruptcy Code-90 Day Insolvency Period

- Section 547(f) provides "[f]or purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition." 11 U.S.C. §547(f).
- This creates a rebuttable presumption that the debtor is insolvent in the 90 days leading up to the petition date.

No insolvency presumptions under Section 548 of the Bankruptcy Code

- In contrast, there is no explicit presumption of insolvency of the debtor for purposes of claims brought under Section 548 of the Bankruptcy Code

Definition of Insolvency:

- Section 101 of the Bankruptcy Code defines “insolvent” in relevant part to mean:
- “With reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation, exclusive of
  i. Property transferred, concealed or removed with intent to hinder, delay, or defraud such entity’s creditors; and
  ii. Property that may be exempted from property of the estate under section 522 of this title;”

What is the applicable law for determining insolvency?

Actions brought under Section 544 of the Bankruptcy Code

- Section 544(b) allows a trustee to step into the shoes of a creditor with a viable cause of action against the debtor and avoid any transfer of the debtors' property that is voidable under "applicable law."
- Applicable law in each state generally refers to the Uniform Fraudulent Transfer Act ("UFTA") or the Uniform Fraudulent Conveyance Act ("UFCA")* as adopted by that state.

*Although the majority of states have adopted the UFTA and a few minority have retained the UFCA, some states have not adopted either the UFTA or the UFCA.

The Definition of Insolvency under the UFTA: Not Paying Debts

- Under the UFTA, a debtor who is not generally paying its debts as they become due is presumed to be insolvent. UFTA §2(b).
- The advisory notes to the UFTA note that the presumption was established to assist creditors who might have trouble obtaining records of the debtor, and often those records are incomplete.
- Furthermore, as the advisory notes say "insolvency is most cogently evidenced by a general cessation of payment of debts."

The Definition of Insolvency under the UFCA: Fair Saleable Value

- Under the UFCA, a debtor is deemed to be insolvent when the "fair salable value" of its assets exceeds its "probable liability on his existing debts as they become absolute and matured." UFCA §2(1)
- "FSV" means the value that can be obtained if the assets are sold with reasonable promptness in an existing, as opposed to theoretical, market.
- Therefore, a debtor may be insolvent when the value of the debtor's assets exceeds the value of his liabilities, but the assets are illiquid and the liabilities are short-term.
- This definition is considered to be more creditor friendly than the "fair valuation" standard under the Bankruptcy Code.

Burden of Proof of Insolvency

Burden of Proof under Section 547

- Because there is a rebuttable presumption of insolvency for preference actions if the transfer is made within ninety days of the Petition Date, a creditor defending a preference action has to produce "some evidence" that the debtor was solvent at the time the transfer was made.*
- Once the creditor rebuts the presumption of insolvency, the burden shifts back to the trustee to affirmatively demonstrate that the debtor was indeed insolvent when the transfer was made.*
- The ultimate burden of proof lies with the trustee, to prove, by a preponderance of the evidence that the debtor was insolvent at the time of the transfer.*

*5-547 Collier on Bankruptcy P547.13

Burden of Proof under Section 548

- Trustee bears the burden of proof of the elements of a voidable transfer by a preponderance of the evidence.
- The burden of proof never shifts. *See Smith v. Litchford & Christopher, P.A. (In re Bay Vista of Va., Inc.)*, 428 B.R. 197, 221 (Bankr. E.D. Va. 2010).
- Once the trustee establishes the prima facie case, the defendant must show that it gave value to the debtor and acted in good faith in order to rebut the trustee's evidence.

How do you know if a debtor is insolvent?

- Ultimately, whether an entity is insolvent is a fact specific inquiry.
- "The Bankruptcy Court has broad discretion when considering evidence to support a finding of insolvency. Insolvency is a question of fact." *Lawson v. Ford Motor Co. (In re Roblin Indus.)*, 78 F.3d 30 *10 (2d. Cir. 1996) (internal citations omitted)

Insolvency Tests

- Although insolvency is a fact specific inquiry, there are generally three tests used to determine whether an entity is insolvent.
  1. Balance Sheet Test
  2. Cash Flow Test
  3. Adequate Capital Test

Insolvency Tests: Balance Sheet Test

- Traditional test: when a corporation "has liabilities in excess of the reasonable market value of the assets held." *See Trenwich Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n.74 (Del. Ch. 2006)
- Narrow view: when a corporation has "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued." *See Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004).
- Commentators have criticized the narrow view as improperly importing the "no reasonable prospect" standard from Delaware receivership law.

Insolvency Tests: Balance Sheet Test

- What "is the appropriate time frame under which a hypothetical sale of assets must take place to achieve a valuation that is 'fair' for a going concern"? *Travellers Int'l, AG v. TWA (In re TWA)*, 134 F.3d 188, 194 (3d Cir. Del. 1998).
- Overwhelming number of cases hold that a "fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time." *In re TWA*, 134 F.3d at 194 (citing multiple cases)
- A reasonable time period should be viewed from the perspective of the creditors, who on one hand want enough time to avoid a forced sale of assets, but on the other hand do not want too much time to lapse such that the creditor would receive less satisfaction of its claim because of the time value of money *Id.* at 195.

Insolvency Tests: Cash Flow Test

- Case law is not clear whether this test is a forward looking test or limited to the present moment.
- The forward-looking version of the test asks whether the company will be able to pay its debts as they become due in the near future. *Blackmore Partners, L.P. v. Link Energy L.L.C.*, 2005 WL 2709639, *3 (Del. Ch. 2005) (unpublished opinion).
- The present moment version of the test asks whether the debtor is currently paying its debts as they become due in the ordinary course. *U.S. Bank N.A. v. U.S. Timberlands Klamath Falls, L.L.C.*, 864 A.2d 930, 978 (Del. Ch. 2004) (however, court applied test in a forward looking manner).

Insolvency Tests: Adequate Capital Test

- This test is intended to determine whether a company is left with adequate capital to operate after it engages in the transaction in question.

- Even if the company was not insolvent at the time of the transaction, the transaction might render the company insolvent.

INSOLVENCY UNDER THE BALANCE SHEET TEST

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Balance Sheet Test in Preference Actions

- "made while the debtor was insolvent…" 11 U.S.C. Section 547(b)(3).

Balance Sheet Test in Fraudulent Transfer Actions

- "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" 11 U.S.C. Section 548.

Definition of "Insolvent" for Entities Other Than Partnerships or Municipalities

- "The term insolvent" means—(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of each entity's debts is greater than all of such entity's property, **at a fair valuation**, exclusive of—(i) property transferred, concealed, or removed with intent to hinder, delay or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of this title." 11 U.S.C. Section 101(32)(A)(bold emphasis added).

Different Definition of "Insolvent" for Partnerships

- "with reference to a partnership, financial condition such that the sum of each partnership's debts is greater than the aggregate of, **at a fair valuation**—(i) all of such partnership's property, exclusive of the kind specified in subparagraph (A)(i) of this paragraph; and (ii) the sum of the excess of the value of each general partnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner's nonpartnership debts." 11 U.S.C. Section 101(32)(B)(bold emphasis added).

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Definitions of "Insolvent" Under State Law Vary—e.g., California

- "(a) A debtor is insolvent if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets.
- (b) A debtor which is a partnership is insolvent if, at fair valuations, the sum of the partnership's debts is greater than the aggregate of all of the partnership's assets and the sum of the excess of the value of each general partner's nonpartnership assets over the partner's nonpartnership debts.
- (c) A debtor who is generally not paying his or her debts as they become due is presumed to be insolvent.
- (d) Assets under this section do not include property that has been transferred, concealed, or removed with intent to hinder, delay, or defraud creditors or that has been transferred in a manner making the transfer voidable under this chapter.
- (e) Debts under this section do not include an obligation to the extent it is secured by a valid lien on property of the debtor not included as an asset."

- California Civil Code section 3439.02.

2-Step Process

- "Although the Code does not define "fair valuation," courts have generally engaged in a two-step process of analysis. *See, e.g., Matter of Taxman Clothing Co.*, 905 F.2d 166, 169-170 (7th Cir. 1990). First, the court must determine whether a debtor was a "going concern" or was "on its deathbed." Second, the court must value the debtor's assets, depending on the status determined in the first part of the inquiry, and apply a simple balance sheet test to determine whether the debtor was solvent. *Id* at 170. We agree that a "fair valuation" of a debtor's assets must begin with a determination of whether a debtor is "a going concern" and end with the application of a balance sheet test to determine solvency." In re DAK Industries, Inc., 170 F.3d 1197, 1199 (9th Cir. 1999).

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2-Step Process (Cont.)

1. Going concern vs. Deathbed.

2. Valuation of the Debtor's assets on a balance sheet basis based on the going concern vs. deathbed determination.

Going Concern Value vs. Deathbed

- "The overwhelming consensus in the case law is that the valuation should be made from the vantage of a going concern. [Citations omitted] The going concern value is not the proper standard, however, if the business was "on its deathbed" or if its liquidation was clearly imminent when the transfers were made. *Id.* This sometimes becomes a difficult factual issue because the determination of whether the business was on its "deathbed" is frequently made *after* the business has succumbed to its financial ills. However, "caution should be taken not to consider property as 'dead' merely because hindsight teaches that the debtor was traveling on the road to financial ruin." *In re Taxman Clothing, supra* at 170 *quoting* 2 Collier on Bankruptcy." In re DAK Industries, Inc., 195 B.R. 117 124-125 (Bankr. C.D. Cal. 1996)(aff'd by 9th Circuit at 170 F.3d 1197).

- "Fair valuation" for purposes of section 101(32) is generally defined as the going concern or fair market price "[u]nless a business is on its deathbed." [Citation omitted] When a business is in a precarious financial condition or on its financial deathbed, a liquidation value should be used to value the assets." In re Schwinn Bicycle Co., 192 B.R. 477, 486 (Bankr. N.D. Il. 1996).

Determination of Whether Liquidation Was Imminent

- "…The only dispute for this court to resolve is a factual matter: whether DAK had reached the point of peril such that liquidation was clearly imminent on the date of the challenged transfers." In re DAK Industries, Inc., 195 B.R. 117, 125 (Bankr. C.D. Cal. 1996).

- "…DAK operated for 30 months after seeking bankruptcy protection. Two and one-half years is a significant period of time. Although a struggling debtor, with a few last gasps, could limp along for a few months after filing bankruptcy, it is difficult to conceive that a terminally ill business could forestall its inevitable demise for two and one-half years. This ongoing effort, taken together with the fact that DAK's statements and schedules reflected a solvent debtor, leads this court to the inescapable factual conclusion that DAK was a going concern at the time of the transactions questioned here by the trustee, and as a going concern, had sufficient value—if operated efficiently and with a reasonable reorganization plan—to have theoretically paid its creditors in full." In re DAK Industries, Inc., 195 B.R. 117, 125 (Bankr. C.D. Cal. 1996).

Deathbed Analysis

- "We grant that going-concern value is not the proper standard if the business is "on its deathbed." [Citation omitted] But the question is whether Taxman *was* on its deathbed on November 29, 1980, and the evidence is that it was not, because the assets that it could realize on in the ordinary course of its business exceeded the expenses of realizing on them, plus its (other) liabilities. The deathbed, and death, came later. "[C]aution should be taken not to consider property as 'dead' merely because hindsight teaches that the debtor was traveling on the road to financial run." 2 Collier on Bankruptcy, *supra*, paragraph 101.31[5], at p. 101-94." In the Matter of Taxman, 905 F.2d 166, 170 (7th Cir. 1990).

The Debtor's Statements and Schedules Are Not Controlling

- "The Schedules of Assets and Liabilities filed by Schwinn Bicycle Company, the parent corporation of the other Debtors, showed an excess of assets over liabilities. However, Debtor's schedules are not persuasive, let alone dispositive or controlling. For analysis of possible insolvency, reliance should be on more accurate evidence, such as current appraisals, opinion valuation testimony, or actual sales of the assets. [Citations omitted] The Seventh Circuit in *Taxman* has noted the great potential for inaccuracy in relying solely on a schedule of assets and liabilities in assessing insolvency." In re Schwinn Bicycle Co., 192 B.R. 477, 487 (Bankr. N.D. Il. 1996).

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Going Concern Valuation

- "As a going concern, the court applies the balance sheet test to measure the debtors' solvency. The balance sheet method "contemplates a conversion of assets into cash during a reasonable period of time." [Citations omitted] "Fair value, in the context of a going concern, is determined by the fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts." [Citation omitted]" In re Heilig-Meyers Corp., 328 B.R. 471, 477-478 (E.D. Va. 2005).

- "Where the going concern value is the appropriate standard, the appraisal must take into account the additional value element which flows from the combination of the various assets into an economic unit." *Collier on Bankruptcy*, paragraph 101.32[4], 101-116; *see also In re DAK Industries*, 170 F.3d 1197, 1200 (9th Cir. 1999)("If the debtor was a going concern, the court will determine the fair market price of the debtor's assets as if they had been sold as a unit, in a prudent manner, and within a reasonable time."). Contrary to the debtor's interpretation of *In re Trans World Airlines*, nothing therein prohibits consideration of the entire economic unit when assessing the conversion into cash value of a company's assets." In re Heilig-Meyers Corp., 328 B.R. 471, 481 (E.D. Va. 2005).

Going Concern Valuation (Cont.)

"When a business is a going concern, fair value "is determined by the fair market price of the debtor's assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor's debts." *In re Roblin Indus., Inc.*, 78 F.3d at 35. Courts generally look at a combination of valuation methodologies to determine valuation, including: (a) actual sale price, (b) discounted cash flow method, commonly referred to as DCF, (c) adjusted balance sheet method, (d) market multiple approach, (e) comparable transactions analysis, and (f) market capitalization. *See, e.g., In re Coated Sales, Inc.*, 144 B.R. 663, 670 (Bankr. S.D.N.Y. 1992)(actual sale)…" In re Iridium Operating, LLC, 373 B.R. 283, 344 (Bankr. S.D.N.Y. 2007).

Liquidation/Deathbed Value

- "When a court finds that a debtor was on its deathbed, it must apply a liquidation test to determine insolvency. Under this test, the value of a debtor's assets is the aggregate price the assets would fetch at a liquidation or distress sale. In applying this test, courts may rely on actual sale prices received for debtor's assets." In re Heilig-Meyers Co. (Bankr. E.D. Va. 2004) 319 B.R. 447, 457 aff'd, (E.D. Va. 2005) 328 B.R. 471

- "A Seventh Circuit panel examined the issues of realistic valuations in *Covey v. Commercial National Bank of Peoria*, 960 F.2d 657 (7th Cir. 1992). In that case, the Seventh Circuit interpreted the solvency issue in a fraudulent conveyance context and stated that, where possible, a determination of what a willing buyer would pay for the entire package of the debtor's assets and liabilities is the best evidence of value. *Id.* At 660. "Market value of both assets and liabilities determines solvency… The proper value to assign to Debtor's assets during the ninety days before bankruptcy is the value that was actually received for those assets about three months after the bankruptcy filing…" *Id.*" In re Schwinn Bicycle Co., 192 B.R. 477, 489 (Bankr. N.D. Ill. 1996).

Proving or Contesting Debtor Insolvency Under the Balance Sheet Test

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Evidence Used to Determine Insolvency

- Counsel provides solvency engagement legal instructions to the financial advisor
- Debtor descriptive data and documents needed
- Debtor financial and business information needed
- Solvency valuation approaches and methods
- Balance sheet test general information
- Balance sheet test income approach information
- Balance sheet test market approach information
- Cash flow test documents and data
- Capital adequacy test documents and data
- Working with your financial advisor expert

Provide Legal Instructions to the Expert

- Provide a written assignment to the expert
- Describe the objective of the opinion – solvency or other
- List all dates for solvency tests
- Describe all events that raise the issue of solvency tests
- Explain all legal claims (fraudulent transfers, preference items, others)
- Discuss the standard of value to use
- Discuss the premise of value to use
- Provide statutory authority and judicial precedent, if you want the financial advisor expert to follow that guidance

Data and Documents Needed About the Debtor

- Company history
- Company locations
- Debtor lines of business, SIC codes
- Brochures and marketing materials
- Competitors, direct and indirect
- Major suppliers
- Major customers
- Number of employees, unionized?
- List of key executives
- List of principal stockholders
- Type of legal entity
- Type of income tax entity

Data and Documents Needed
General Financial and Business Information

- Historical annual financial statements – five years prior to each solvency date
- Historical YTD interim financial statements – for each solvency date and one year earlier
- Balance sheets as of each solvency date
- Description of the debtor accounting principles used
- Income tax returns – five year prior to each solvency date
- Financial plans, budgets, forecasts, projections – five years prior to each solvency date
- Income normalization adjustments – discontinued operations, nonrecurring items, effect of accounting changes, discretionary expenses, lease capitalization impact, etc.
- Prior business or asset appraisals
- Prior offers to buy debtor company or debtor stock
- Prior sales of debtor company or debtor stock
- Corporate organization chart
- Corporate organization accounting consolidation scheme

Fair Value of Assets Minus Value of Liabilities – Generally Accepted Valuation Approaches and Methods

- Income approach valuation methods
  - Discounted cash flow method – discrete period income projection plus terminal value is used in all three solvency tests
  - Direct capitalization method – expected next period income divided by a direct capitalization rate
- Market approach valuation methods
  - Guideline publicly traded company method – pricing multiples extracted from selected public companies
  - Guideline transactions method – pricing multiples extracted from selected M&A transactions
  - Backsolve method – pricing multiples extracted from the arm's-length sales of the debtor corporation stock

Fair Value of Assets Minus Value of Liabilities – Generally Accepted Valuation Approaches and Methods (cont.)

- Asset-based approach valuation methods
  - Asset accumulation method – discrete valuations of tangible assets and intangible assets; discrete valuations of recorded liabilities and contingent liabilities
  - Adjusted net asset value method – accounting book value of net assets plus (or minus) a capitalized excess (or deficient) return on net assets

Balance Sheet Test
General Information

- Copy of fixed asset subsidiary ledger
- Listing of owned and leased real estate
- Summaries of any lease terms
- Descriptions of owned commercial intangible assets
- Descriptions of owned/licensed intellectual property
- Descriptions of all contingent liabilities
- Detailed description (and reconciliation) of intercompany accounts

Balance Sheet Test
Income Approach Valuation Information

- Financial projections and business plans (as of each solvency date)
  - Changes in product, pricing, location, or other revenue factors
  - Explanations for revenue increases
  - Fixed versus variable cost relationships
  - Explanations for profitability increases
  - Consideration of working capital investments
  - Consideration of capital expenditure investments
  - Explanation of depreciation rates
  - Assumptions regarding asset sales
  - Assumptions regarding refinancings
  - Analysis of income tax rate (including NOL)
  - Justification for expected long-term growth rate

Balance Sheet Test – Income Approach Cost of Capital Information

- Cost of capital components
  - Cost of debt for all debt instruments
  - Cost of equity –
    - selected guideline companies
    - industry benchmarks
    - company-specific risk factors (from commercial bank memos, investment bank memos, BOD minutes)
  - Income tax rate
- Capital structure
  - Selected guideline components
  - Industry benchmarks
- Long-term expected growth rate (in net cash flow)

Balance Sheet Test
Market Approach Valuation Information

- Selection of benchmark public companies
  - Used in internal management comparisons
  - Used in commercial bank comparisons
  - Used in investment bank comparisons
  - Used in potential buyer comparisons
- Selection of benchmark M&A transactions
- Selection of pricing multiples
  - Operational metric multiples
  - Revenue multiples
  - Gross income multiples
  - Net income multiples

Cash Flow Test
Documents and Data

- Cash balance restrictive covenants
- Lease repayment schedule
- Debt repayment schedule
- Debt covenants and restrictions
- Debt capacity available
- Capital expenditures and other uses of cash
- Asset sales and other sources of cash
- Intercompany debt obligations

Capital Adequacy Test
Documents and Data

- Cash balance restrictive covenants
- Details of all working capital account balances
- Monthly operational budgets (as of each solvency date)
- Prior year monthly operational budgets (as of each solvency date)
- Short term capital expenditure commitments

Working with Your Expert

- Ask the expert for periodic data and document requests
- Provide access to the discovery data base
- Provide legal instructions and directions
- Make sure the financial advisor understands the assignment
  - All solvency dates (and reasons)
  - Other types of analyses
  - Other types of opinions
- Provide reasonable deadlines

Working with Your Expert (cont.)

- Provide all relevant documents and information
  - Deposition transcripts
  - Discovery documents
  - Other
- Don’t expand the expert’s role beyond his/her expertise
  - GAAP accounting expert
  - Tax accounting expert
  - Industry practices expert
  - Bankruptcy law expert

Evidence Used to Determine Insolvency Summary and Conclusion

- Provide legal instructions to the expert, as needed
- Assist the expert in the collection of data and documents
  - General debtor information
  - Debtor financial information
  - Balance sheet test valuation information
  - Cash flow test information
  - Capital adequacy information
- Guidelines for working with the financial advisor expert
- Questions and discussion

Q&A

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