EXPERT WITNESSES

ABA Section of Litigation

Spring 2019, Vol. 15 No. 2

April 30, 2019

Ways Experts Help Determine the Avoidability of Transfers in Bankruptcy

The measurement of the solvency of a firm is critical to resolving competing creditor and shareholder claims in bankruptcy litigation.

By Boris J. Steffen

A goal of the Bankruptcy Code (Code) is to encourage a fair distribution of estate assets between similarly positioned creditors. To facilitate this objective and deter a debtor from favoring a particular creditor, the Code provides that preferential and fraudulent transfers may be avoided for the benefit of the estate. This article discusses the tests and metrics used by the court to evaluate if a preferential transfer or fraudulent transfer is avoidable and highlights the ways in which financial experts can assist counsel in the collection and analysis of evidence and presentation of expert testimony.

Causes of Action

Preferential transfers are covered under 11 U.S.C. § 547. Section 547(b) requires the trustee to prove a 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 . . .; (3) made while the debtor was insolvent; (4) made . . . on or within 90 days before the date . . . of the petition" or within one year before the filing if the creditor was an insider; and (5) that enables the creditor to receive more than it would have in a Chapter 7 liquidation, had the transfer not occurred, or as otherwise provided by the title. The rebuttable section 547(f) presumption that the debtor was insolvent on and during the 90 days immediately prior to the petition does not relieve the plaintiff of its burden of ultimate proof under section 547(g).

Fraudulent transfers are covered under 11 U.S.C. § 548, which provides for the avoidance of certain transfers made, or obligations incurred, by the debtor, voluntarily or involuntarily, on or within two years of the petition date. For example, under section

EXPERT WITNESSES

Section of Litigation

Spring 2019, Vol. 15 No. 2

548(a)(1)(A), a trustee may avoid a transfer undertaken "with actual intent to hinder, delay, or defraud" a creditor (in such a case, it is not necessary to prove insolvency). In assessing intent, courts have looked to whether the debtor and its insiders believed it was going to continue as a viable enterprise. *VFB LLC v. Campbell Soup Co.*, No. Civ.A.02-137 KAJ, 2005 WL 2234606, at *32 (D. Del. Sept. 13 2005), *aff'd*, 482 F.3d 624 (3d Cir. 2007). Under section 548(a)(1)(B), a trustee may avoid a transfer in which the debtor "received less than a reasonably equivalent value in exchange" and (1) at the time was or was rendered insolvent, (2) had unreasonably small capital, or (3) was unable to pay its debts when due. Furthermore, section 544(b) allows for the avoidance of any transfer made, or obligation incurred, that is voidable under applicable law (generally, state Uniform Fraudulent Transfer Act (UFTA) or Uniform Fraudulent Conveyance Act) by a creditor holding an unsecured claim.

Standards of Proof

A number of tests/metrics are used to evaluate if a preferential transfer or fraudulent transfer is avoidable.

> **Actual intent.** Defendants rarely admit to making a transfer or incurring an obligation with the intention of hindering, delaying, or defrauding creditors. Consequently, plaintiffs may prove intent based on the "badges of fraud," or "circumstances so commonly associated with fraudulent transfers that their presence gives rise to an inference of intent." *Sharp Int'l Corp. v. State St. Bank & Trust Co. (In re Sharp Int'l Corp.)*, 403 F.3d 43, 56 (2d Cir. 2005).
>
> **Reasonably equivalent value.** Courts generally hold that reasonably equivalent value should be evaluated from the perspective of the debtor's creditors. *Stanley v. U.S. Bank Nat'l Ass'n (In Re TransTex. Gas Corp.)*, 597 F.3d 298, 306 (5th Cir. 2010). The process requires a determination of whether the debtor received anything of value (*Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors (In re R.M.L., Inc.)*, 92 F.3d 139, 149 (3d Cir. 1996)) and if the value received was reasonably equivalent to what was transferred. 5 Collier on Bankruptcy § 548.05[2][a] (2009).
>
> **Balance sheet test.** Courts use the balance sheet test to determine if a debtor is insolvent. *Paloian v. LaSalle Bank Nat'l Ass'n (In re Doctors Hosp. of Hyde Park, Inc.)*, 507 B.R. 558, 632 (Bankr. N.D. Ill. 2013). Under 11 U.S.C. § 101(32)(A), insolvency occurs when "the sum of such entity's debts is greater than all of such entity's

EXPERT WITNESSES

ABA Section of Litigation

Spring 2019, Vol. 15 No. 2

property, at a fair valuation." A court does not need to determine the precise value of each asset and liability, though it does need to determine if the debtor's liabilities exceed its assets. *In re W.R. Grace & Co.*, 281 B.R. 852, 866 (Bankr. D. Del. 2002); *Briden v. Foley*, 776 F.2d 379, 382 (1st Cir. 1985).

Fair valuation. Fair valuation "is generally defined as the going concern or fair market value '[u]nless a business is on its deathbed.'" *Fisher v. Enter. Truck Line, Inc. (In re CXM, Inc.),* 336 B.R. 757, 760 (Bankr. N.D. Ill. 2006) (quoting *In re Utility /Stationery Stores, Inc.*, 12 B.R. 170, 176 (Bankr. N.D. Ill. 1921)). Further, it is what "an informed willing seller under no compulsion to sell and an informed willing buyer not pressed for an immediate return would attribute to the property." *Covey v. Commercial Nat'l Bank of Peoria,* 960 F.2d 657, 660 (7th Cir. 1992). Debts consist of liabilities on a claim and are defined broadly. 11 U.S.C. § 101(12).

"Needless to say, a fair valuation may not be equivalent to the values assigned on a balance sheet." *Orix Credit All., Inc. v. Harvey ex rel. Lamar Haddox Contractor, Inc. (In re Lamar Haddox Contractor, Inc.)*, 40 F.3d 121 (5th Cir. 1994). Consequently,

> [i]n making factual determinations of solvency, it is appropriate to adjust the asset values shown on the most contemporaneous balance sheet available to reflect "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."

Indus., Commercial Elec., Inc. v. Babineau (In re Indus. Commercial Elec. Inc.), Adv. No. 02-4591-JBR, 2004 Bankr. LEXIS 438, at *22 (Bankr. D. Mass. Apr. 8, 2004).

Unreasonably small capital test. Unreasonably small capital is "'a financial condition short of equitable [or balance sheet] insolvency' and . . . the focus of the test is on transfers 'that leave the transferor technically solvent but doomed to fail.'" *ASARCO LLC v. Ams. Mining Corp.,* 396 B.R. 297, 396 (S.D. Tex. 2008). Likewise, "'unreasonably small capital' means 'difficulties which are short of insolvency in any sense but are likely to lead to insolvency at some time in the future.'" *Vadnais Lumber Supply v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 B.R. 127, 137 (Bankr. D. Mass. 1989). Unreasonably small capital also "refers to the inability to generate sufficient profits to sustain operations." *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1070 (3d Cir. 1992).

EXPERT WITNESSES

Section of Litigation

Spring 2019, Vol. 15 No. 2

Inability to pay test. A debtor is unable to pay its debts when due if it "intended to or believed that it would incur debts beyond its ability to pay as they matured." 11 U.S.C. § 548(a)(1)(B)(i)(ii)(III). Also referred to as the cash flow or equitable solvency test (J. B. Heaton, *Solvency Tests*, 62 Bus. Law. 988 (2007)), the test considers if "the debtor was objectively unable to pay its debts or reasonably should have come to that conclusion." *Tronox Inc. v. Kerr McGee Corp.*, 503 B.R. 239, 323–24 (Bankr. S.D.N.Y. 2013) (citations omitted). Failing either the objective or subjective prong at the time of the transfer indicates an inability to pay. *ASARCO*, 396 B.R. at 399; *WRT Creditors Liquidation Trust v. WRT Bankr. Litig. Master File (In re WRT Energy Corp.)*, 282 B.R. 343, 415 (Bankr. W.D. La. 2001).

Experts' Input

Financial experts may provide testimony on one or more of these tests or metrics to aid the court in its evaluation.

Actual intent. Financial experts conduct investigations to establish facts and circumstances from which intent is inferred. *First Nat'l Bank v. Davison (In re Davison)*, 296 B.R. 841, 845 (Bankr. D. Kan. 2003), *aff'd*, 2004 WL 2852352 (B.A.P. 10th Cir. June 29, 2004). In section 548 cases, courts cite eight badges of fraud:

> (1) the lack or inadequacy of consideration; (2) the family, friendship or close associate relationship between the parties; (3) the retention of possession, benefit or use of the property in question; (4) the financial condition of the party sought to be charged both before and after the transaction in question; (5) the existence or cumulative effect of a pattern or series of transactions or course of conduct after the incurring of debt, onset of financial difficulties, or pendency or threat of suits by creditors; (6) the general chronology of the event and transactions under inquiry; (7) a questionable transfer not in the usual course of business; and (8) the secrecy, haste, or unusualness of the transaction.

Pereira v. Grecogas Ltd. (In re Saba Enters., Inc.), 421 B.R. 626, 643 (Bankr. S.D.N.Y. 2009). The UFTA similarly lists eleven badges.

Reasonably equivalent value. Among the issues that courts analyze in reasonably equivalent value assessments are "(1) whether the value of what was transferred is

EXPERT WITNESSES

ABA Section of Litigation

Spring 2019, Vol. 15 No. 2

equal to the value of what was received; (2) the market value of what was transferred and received; (3) whether the transaction took place at arm's length; and (4) the good faith of the transferee." *Barber v. Golden Seed Co. (In re Ostrom-Martin, Inc.)*, 129 F.3d 382, 387 (7th Cir. 1997). Benefits can be direct or indirect. However, while the exchange need not be exact (*BFP v. Resolution Trust Corp.*, 511 U.S. 531, 538 n.4 (1994)) and "there is no set minimum percentage or monetary amount necessary" (*Lowe v. B.R.B, Enters., Ltd. (In re Calvillo)*, 263 B.R. 214, 220 (W.D. Tex. 2000)), the benefit must be concrete and quantifiable. *Lisle v. John Wiley & Sons, Inc. (In re Wilkinson)*, 196 F. App'x 337, 342 (6th Cir. 2006).

Balance sheet test. Contemporaneous market evidence is not necessarily reliable or conclusive evidence of solvency. *Tronox*, 503 B.R. at 298; *In re W.R. Grace & Co.*, 446 B.R. 96, 106 (Bankr. D. Del. 2011). Courts nevertheless have considered market evidence proffered by financial experts in determining solvency. *VFB LLC*, 2005 WL 2234606, at *31; *In re Iridium Operating LLC*, 373 B.R. 283, 352 (Bankr. S.D.N.Y. 2007). Such evidence may include the values of publicly traded stock and debt securities at the time of the transaction, private transaction values and market data for similar assets, or contemporaneous transactions.

Courts rely on the testimony of valuation experts, particularly in cases where market evidence is not reliable. *Tronox*, 503 B.R. at 296; *W.R. Grace*, 446 B.R. at 105–06 n.11. The three standard valuation methods used are the discounted cash flow, comparable company, and comparable transaction methods. *Tronox*, 503 B.R. at 316–18 (citation omitted).

"Assets and liabilities must be valued based upon information known or knowable as of the date of the challenged transfer." *Sharp v. Chase Manhattan Bank USA, N.A. (In re Commercial Fin. Servs., Inc.)*, 350 B.R. 520, 541 (Bankr. N.D. Okla. 2005). Debts are valued at face value. *Hanna v. Crenshaw (In re ORBCOMM Global L.P.)*, 2003 Bankr. LEXIS 759, at *8 (Bankr. D. Del. June 12, 2003). Contingent liabilities are discounted for their probability of occurrence. *In re Xonics Photochems. Inc.,* 841 F.2d 198, 200–01 (7th Cir. 1988). "Hindsight bias is to be fought rather than embraced." *Paloian v. LaSalle Bank, N.A.,* 619 F.3d 688, 693 (7th Cir. 2010). "Subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of the valuation." *Doctors Hosp. of Hyde Park*, 507 B.R. at 646. Further, "[b]ecause projections tend to be optimistic, their reasonableness must be tested by an objective standard anchored

in the company's actual performance. However, . . . parties must also . . . incorporate some margin for error." *Moody,* 971 F.2d at 1073.

Whether to value the debtor as a going concern or in liquidation is also a factor. The standard procedure is to determine if the debtor was a going concern or "on its deathbed" on the relevant date and value its assets accordingly. *Sherman v. FSC Realty LLC (In re Brentwood-Lexford Partners, LLC)*, 292 B.R. 255, 267 (Bankr. N.D. Tex. 2003) (citation omitted). "Liquidation value is appropriate if at the time in question the business is so close to shutting its doors that a going concern standard is unrealistic." *Gillman v. Sci. Research Prods. (In re Mama D'Angelo)*, 55 F.3d 552, 555 (10th Cir. 1995).

Unreasonably small capital test. Whether a debtor has unreasonably small capital requires analysis of the debtor's capital structure. *WRT Energy*, 282 B.R. at 411. "In order to determine the adequacy of capital, a court will look to such factors as the company's debt to equity ratio, its historical capital cushion, and the need for working capital in the specific industry at issue." *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995). Concurrently, "courts generally examine cash flow, focusing on whether the debtor was left in a position in which it was unable after the transfer to generate sufficient profits to sustain operations." *WRT Energy*, 282 B.R. at 411. "Moreover, the test for unreasonably small 'capital' should include . . . all reasonably anticipated sources of operating funds, which may include new equity infusions, cash from operations, or cash from secured or unsecured loans over the relevant time period." *Moody*, 971 F.2d at 1072 n.24. However, "[b]ecause projections tend to be optimistic, their reasonableness must be tested by an objective standard anchored in the company's actual performance. Among the relevant data are cash flow, net sales, gross profit margins, and net profits and losses." *Id.* at 1073.

Parties should "also account for difficulties that are likely to arise." *Id.* However, "[w]hile a company must be adequately capitalized, it does not need resources sufficient to withstand any and all setbacks." *MFS/Sun Life*, 910 F. Supp. at 944.

Inability to pay test. That a debtor should have concluded it was unable to pay its debts can be inferred subjectively from where "the facts and circumstances surrounding the transaction show that the debtor could not have reasonably believed that it would be able to pay its debts as they matured." *WRT Energy*, 282 B.R. at 415. Objectively, courts consider "(1) the number of debts; (2) the amount of

EXPERT WITNESSES

Section of Litigation

Spring 2019, Vol. 15 No. 2

any delinquency; (3) the materiality of non-payment; and (4) the nature of the debtor's conduct of its financial affairs." *ASARCO*, 396 B.R. at 401–02. In evaluating these factors, courts frequently consider contemporaneous cash flow projections, liquidity and leverage measures, the debtor's payment history and practices, check holds to vendors, timing of invoice payments, past-due accounts, demand letters, and collection efforts. *Id.* at 399–400.

Conclusion

Though it is relatively simple to describe the solvency tests used in bankruptcy litigation, applying them can be challenging. Each test examines different, though related, measures, by a variety of means. Consequently, it is possible for the indication of solvency to differ among tests. Financial experts can assist counsel in analyzing and understanding these outcomes.

Boris J. Steffen is the senior managing director of GlassRatner Advisory & Capital Group.