

More Than One Way To Weigh Debtor's Insolvency

Monday, Apr 14, 2008 --- Under § 547 of the Bankruptcy Code, prebankruptcy preferential transfers of the debtor's property or payments by the debtor made while insolvent may be recovered. As to the insolvency element of the cause of action, the Code establishes a rebuttable presumption of insolvency during the 90 days prior to the filing. 11 U.S.C. § 547(f).

If rebutted, or if the transfer was to an insider and occurred outside of the 90-day window, the plaintiff has the burden of proving insolvency under the guidelines of the Code's definition found at 11 U.S.C. § 101(32).

The analysis under case law often centers on various methods of valuation applied under different circumstances, and whether any one method or another is appropriate.

Discussion

Section 101(32)(A) of the Bankruptcy Code defines "insolvent" as the "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation." 11 U.S.C. § 101(32)(A). This standard for solvency is typically called the "Balance Sheet Test." *In re Trans World Airlines, Inc. v. Travellers Int'l AG.*, 180 B.R. 389, 405 n.22 (Bankr. D. Del. 1994).

Under this test, in order to determine whether the debtor is insolvent, the assets and liabilities of the debtor must be valued to determine whether the debtor's liabilities are greater than the debtor's assets. *In re Trans World Airlines, Inc. v. Trans World Airlines, Inc.*, 134 F.3d 188, 190-91 (3d Cir. 1998).

For purposes of determining insolvency, liabilities are always valued at their face value. *In re Trans World Airlines*, 134 F.3d at 196-97, *Orbcomm Global, LP v. Hanna*, 2003 WL 21362192, *3 (Bankr. D. Del. 2003).

The issue in preference cases, therefore, is what proof can be presented to establish the value of the debtor's assets at the time periods at issue. There are two possible methods of valuation: (1) going concern and (2) liquidated value in a forced sale.

The Third Circuit has stated that where bankruptcy is not "clearly imminent" on the date of the challenged transfer, the weight of authority holds that assets should be valued on a going concern basis. *Moody v. Security Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1067 (3d Cir. 1992); *In re Trans World*

Airlines, 134 F.3d at 193. See *In re Taxman Clothing Co.*, 905 F.2d 166, 169-70 (7th Cir. 1990) (under Bankruptcy Code going concern valuation is proper unless business is on its deathbed); *Fryman v. Century Factors, Factor for New Wave*, 93 B.R. 333, 341 (E. D. Pa. 1988) (same); *Vadnais Lumber Supply, Inc. v. Byrne*, 100 B.R. 127, 131 (Bankr. D. Mass. 1989) (liquidation value appropriate if, at the time in question, the business is so close to shutting its doors that a going concern value is unrealistic).

Forced sale or liquidation values only apply where the debtor is wholly inoperative, defunct or dead on its feet. *In re Trans World Airlines, Inc. v. Trans World Airlines, Inc.*, 203 B.R. 890, 895 (D. Del. 1996), rev'd on other grounds, *In re Trans World Airlines*, 134 F.3d at 190.

Bankruptcy is not clearly imminent at the time of the challenged conveyance, and the assets should be valued on a going concern basis, where the debtor continues to operate and satisfies all of its obligations to its creditor constituency. See *In re Hechinger Inv. Co. of Delaware*, 327 B.R. 537, 548 (D. Del. 2005).

Therefore, unless the debtor corporation is on its “deathbed” at the time of the challenged conveyance, the Third Circuit likely will use the going concern method of valuation.

Under the going concern method, a fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time. *In re Trans World Airlines, Inc.*, 134 F.3d at 194.

A reasonable time is “an estimate of the time that a typical creditor would find optimal: not so short a period that the value of the goods is substantially impaired via a forced sale, but not so long a time that a typical creditor would receive less satisfaction of its claim, as a result of the time value of money and typical business needs, by waiting for the possibility of a higher price.” *Id.*

Courts in other jurisdictions have followed similar thinking. See *Lawson v. Ford Motor Co. (In re Roblin Industries)*, 78 F.3d 30 (2d Cir. 1996). In the Fourth Circuit, the Bankruptcy Court for the Eastern District of Virginia addressed the issues at length in *In re Heilig-Meyers Co.*, 319 B.R. 447 (E.D. Va. 2004), aff'd 328 B.R. 471 (E.D. Va. 2005).

In applying a two-part analysis, the bankruptcy court first determined whether the debtors were operating as a going concern or were on their deathbed before selecting a valuation methodology.

Citing its earlier decisions on the issue, the court observed that a debtor on its deathbed “is one where the debtor is in a precarious financial condition so that liquidation was imminent when the petition was filed ... ” or “one only nominally in existence,” or “wholly inoperative, defunct or dead on its feet.” *Id.* 319 B.R. at 457.

When a court finds that a debtor is on its deathbed, it must apply a liquidation

test to determine insolvency. Under this test, the value of the 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. *Id.*, 319 B.R. at 457.

In Heilig-Meyers, the bankruptcy court also discussed the concept of a going concern debtor and the applicable valuation method in that instance.

If a debtor is operating as a going concern, the court must perform the applicable balance sheet test of insolvency.

The going concern threshold is very low; a debtor may be financially unstable, but it is still a going concern as long as the amount it could realize from converting its assets to cash in the ordinary course of business exceeds the expenses of conducting business. See *In re Taxman Clothing Co., Inc.*, 905 F.2d 166, 170 (7th Cir. 1990); see also *In Re Art Shirt Ltd., Inc.*, 93 B.R. at 333, 341 (E.D. Pa. 1988) (stating that "a business does not have to be thriving to receive going concern valuation").

After a court finds that a debtor is a going concern, it must apply a balance sheet test to determine insolvency. The balance sheet test "contemplates a conversion of assets into cash during a reasonable period of time." *Travellers Int'l AG v. Trans World Airlines, Inc.* (*In re Trans World Airlines, Inc.*), 134 F.3d 188, 194 (3d Cir. 1998); see *In Re Roblin Indus., Inc.*, 78 F.3d at 35.

The value of a going concern debtor's assets is therefore the assets' estimated aggregate fair market value assuming there is a willing buyer, and the sale is completed within a reasonable time to pay the debtor's assets. See *458 *In Re Roblin Indus., Inc.*, 78 F.3d at 35-36.

In applying this test, courts should not rely solely on asset book values contained in debtors' financial statements or bankruptcy schedules but should consider other sources of information such as expert opinions, appraisals, and the debtor's actual operating experience. See *id.* at 36-38; *Devan v. CIT Group* (*In re Merry-Go-Round Enterprises, Inc.*), 229 B.R. 337, 342-343 (Bankr. D. Md. 1999); *Foley v. Briden* (*In Re Arrowhead Gardens, Inc.*), 32 B.R. 296, 299-300 (Bankr. D. Mass. 1983); see also *In re DAK Indus., Inc.*, 170 F.3d at 1200. *Id.* at 457-458.

On appeal, the district court affirmed the determinations of the Heilig-Meyers bankruptcy court. *Heilig-Meyers Co. v. Wachovia Bank, N.A.*, 328 B.R. 471 (E.D. Va. 2005). The district court opinion is insightful for its attention to proof issues, and its acceptance of the lower court's determination not to accept either side's expert report in favor of an asset-by-asset analysis taking into account "the debtors' unique financial situation." *Id.* at 479.

The district court approved the method of assessing each asset's value as though it were a part of an operating unit, taking the GAAP prepared balance sheet as a starting point, and then making modifications as necessary to establish asset values that more accurately reflect the debtor's financial

condition as a going concern at the time of the transfers at issue. *Id.* at 480-481.

By contrast, courts seemed to uniformly look to liquidation value in situations where the debtor was on its deathbed or bankruptcy was otherwise imminent at the time of the transfer, and apply what is commonly referred to as a "liquidation valuation" to value the debtor's assets for purposes of determining solvency.

This comes up in the case where the creditor challenges the presumption of solvency as a defense to the claim, and also where the presumption is not applicable such as in cases involving claims against insiders.

In a case involving a creditor's claim that the debtor was insolvent at the time of the transfer, the Bankruptcy Court for the Northern District of Illinois observed that where the debtor was found to have not been a going concern at the time of the transfer, any other valuation method besides liquidation valuation "would be misleading and would, in fact, fictionalize the company's true financial condition." *In re CXM, Inc.*, 336 B.R. 757 (Bankr. Ct. M.D. Ill. 2006).

In the CXM case, the creditor relied solely upon the debtor's schedules to establish the valuation of the debtor's assets for purposes of the insolvency analysis. The court found this to be "not persuasive," and noted the Seventh Circuit's decision in the matter of *Taxman Clothing Co., Inc.*, 905 F.2d 166, 170 (7th Cir. 1990) for its finding that there was "great potential for inaccuracy in relying solely on a schedule of assets and liabilities in assessing insolvency. *In re CXM, Inc.*, 335 D.R. at 761.

Instead, the court relied on a valuation determined by the price received in a sale of substantially all of the debtor's assets under Section 363 of the Bankruptcy Code shortly after the petition date.

The court observed that "the sale of substantially all of the debtor's assets after the filing of the petition for relief, as is the case here, is a more accurate measure of the debtor's assets and possible insolvency, and is the kind of evidence that can be reasonably relied upon by courts in determining the issue of the debtor's insolvency or lack thereof." *Id.*

Citing from its earlier decision in *In re Schwinn Bicycle Co.*, 192 B.R. 447 (Bankr. N.D. Ill. 1996), the bankruptcy court observed further that "while statements made in a debtor's schedules can constitute evidence which may be used in subsequent proceedings, the magnitude of the discrepancy between the scheduled values and the actual sale prices strongly suggest that any inference which can be drawn from the schedules is not worthy of serious consideration." *In re CXM, Inc.*, 336 B.R. at 761.

Finally, the court stated that "it is proper under circumstances such as those found here to value the assets at the value actually brought in the open market and not as balance sheet value, because, 'in the last analysis, all

sophisticated valuations must yield to the realities of the marketplace.”” In re CXM, Inc., 336 B.R. at 761 (citing In re Schwinn Bicycle Co., 192 B.R. at 488).

Conclusion

There are two basic methods for asset valuation employed to determine solvency for purposes of preference litigation.

Where the debtor is found to have been functioning as a going concern at the time of the transfer, the valuation of assets contemplates the conversion of the assets into cash during a reasonable period of time, and the valuation method generally employed involves an asset-by-asset assessment as reflected on the GAAP prepared financial statement with adjustments to the value of each asset established based upon the particular circumstances of the debtor at the time of the transfer.

On the other hand, where the debtor is on its deathbed at the time of the transfer, a liquidation valuation is employed in which event it is appropriate to consider a subsequent post-bankruptcy sale of assets as an accurate measure of the value of those assets, understanding that in the last analysis, “all sophisticated valuations must yield to the realities of the marketplace.”

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