

Solvency Analysis in Preference & Fraudulent Transfer Actions

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The question of solvency in a preference or fraudulent transfer action depends upon the fair valuation of the debtor's assets at the time of the contested transfer, along with other solvency analyses. The question of whether to use a "going concern" versus a "liquidation" analysis depends upon whether the debtor was effectively "on its death bed" at the testing date. If the going concern premise is applied, then the bankruptcy courts typically rely on an appraisal of the business, i.e., the value of the assets used in an ongoing enterprise, as the basis for the solvency analysis. By contrast, if it is determined that the business was not a going concern at the transfer date then an asset-by-asset analysis under a liquidation scenario will be used.

Solvency is judged by whether the debtor is able to pay its debts as they come due. Accordingly, there is a two-pronged definition:

1. A debtor is insolvent if the sum of the debtor's debts are greater than all the debtor's assets, at a fair valuation, or
2. A debtor who is generally not paying his debts as they become due is presumed to be insolvent.

Ultimately, stakeholders may rely on a so-called Solvency Opinion, which is designed to assess a company's overall financial condition at a designated time and using a variety of tests determine whether the entity was solvent or insolvent. The three tests that are typically applied include:

1. The Balance Sheet Test
2. The Capital Adequacy Test
3. The Cash Flow Test

Below we discuss each of these tests along with relevant case law interpretation.

The "Balance Sheet" Test – *In re TWA v. Travelers*¹

TWA lost a judgment to Travelers and thereafter obtained a stay of enforcement by depositing \$13.7 million with the clerk of the court. 88 days later, TWA filed a chapter 11 bankruptcy. TWA then filed an adversary proceeding seeking to avoid (set aside) the \$13.7 million deposit as a preference. The question for the court was whether TWA solvent or insolvent at the time it made the \$13.7 million deposit/transfer.

Under Section 547 of the bankruptcy code ("Code"), a trustee or debtor-in-possession (DIP) can avoid a transfer made by the debtor to a creditor on account of a pre-existing debt within 90 days before the filing if the debtor was insolvent at the time of the transfer. The Court followed the Code's guidance under Section 101(32)(A) that an entity is insolvent when "the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."

TWA argued that the Code required "fair valuation" of only the Company's assets (i.e., not its liabilities), that under this standard TWA would be considered insolvent at the time of the transfer, and, hence, the deposit should be considered a voidable preference.

¹ *In re Trans World Airlines, Inc. v. Travelers Int'l AG.*, 180 B.R. 389, 405 n.22, (Bankr. D. Del. 1994).

The US Court of Appeals sided with the bankruptcy court and valued the assets using a “fair value” standard and fixed the liabilities at their face value. TWA was found to be insolvent at the time it made its \$13.7 million deposit, and the transfer was, therefore, a voidable preference under section 547(b). Hence, under the Code’s solvency or “balance sheet” test, assets are to be marked-to-market while liabilities are valued at their carrying amounts.

Valuation Methodology – Balance Sheet Test

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

1. Going Concern Value
2. Liquidation Value

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.² Forced sale or liquidation values apply where the debtor is inoperative, defunct or dead on its feet. Therefore, unless the debtor corporation is on its “deathbed” at the time of the challenged conveyance, the court likely will use the going concern method of valuation. However, simply because a company may continue to have its doors open, does not imply going concern status. The question revolves around whether the entity has sufficient resources and cash flow to continue as a going concern. If it does not, then it most likely will be valued under a liquidation scenario.

Under the going concern method, a fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time.³ And, 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.”⁴

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 relatively 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.⁵ In other words, if the company is not generating positive cash flow from operations, then it would be considered defunct and a liquidation premise would be more applicable.

When a court does determine 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.

² See, *Moody v. Security Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1067 (3d Cir. 1992). See also, *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); lastly, see *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).

³ *In re Trans World Airlines, Inc.*, 134 F.3d at 194.

⁴ *Id.*

⁵ See *In re Taxman Clothing Co., Inc.*, 905 F.2d 166, 170 (7th Cir. 1990);

The value of a going concern debtor's assets is the assets' estimated "aggregate" fair market value assuming there is a willing buyer, and the sale is completed within a reasonable time.⁶ In applying this test, courts should not rely 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.⁷

In the Heilig-Meyers bankruptcy,⁸ the 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.⁹

Lastly, courts have 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. Given the assets are exposed to a normal auction process and liquidated within a short time of the petition date, the price received in a section 363 sale represents a reasonable proxy for the value of the debtor's assets at the time of the contested transfer. At minimum, it serves as a sanity check against which to test the liquidation analysis.

Other Solvency Tests

Capital Adequacy Test – This solvency test seeks to determine whether an entity possessed adequate capital resources with which to continue operations on or about the testing date, e.g., contested transfer date, by meeting operating expenses, recurring debt obligations, necessary capital expenditures, etc. Inadequate capital may be the result of poor financial condition or as a result of the transfer in question.

If the company is found to have insufficient capital, it can still satisfy the Capital Adequacy Test if it can demonstrate its ability to raise the necessary capital. Accordingly, this test involves examining various capital adequacy ratios and assessing an entities capital raising prospects to determine the sufficiency of the entities overall liquidity and capital resources.

Cash Flow Test – This solvency test seeks to determine whether the entity had sufficient cash flow to meet expected debt obligations as such debts mature. In other words, was the entity generating sufficient levels of operating cash flow with which to service its liabilities? This test requires a formal financial analysis, for example, in a post-transfer context, to assess the effects of the transfer on the firm's cash flow.

Often, the cash flow test utilizes an analysis of future debt payments in a post-transaction setting contrast against the company's forecast cash flow to determine cash flow sufficiency. Under this test, the entity must be able to fund its ongoing business operations and, thereafter, repay its debt obligations.

Conclusion

Under the Balance Sheet Test, there are two basic methods for asset valuation employed to determine solvency for purposes of a preference or fraudulent transfer action. 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. In determining the value of assets in a going concern context, the value

⁶ See *458 In Re Roblin Indus., Inc., 78 F.3d at 35-36.

⁷ See *Devan v. CIT Group* (In re Merry-Go-Round Enterprises, Inc.), 229 B.R. 337, 342-343(Bankr. D. Md.1999).

⁸ Heilig-Meyers Co. v. Wachovia Bank, N.A., 328 B.R. 471 (E.D. Va. 2005).

⁹ Id. at 479, 480-481.

of the enterprise may be assessed using accepted methodology including an income, cost or market approach. Or, an asset-by-asset approach may be used. Once the enterprise value is determined it is contrast against the debtor's liabilities to determine solvency.

On the other hand, where the debtor is on its deathbed at the time of the transfer, a liquidation valuation is employed in which case it is appropriate to consider a subsequent post-bankruptcy sale of assets under, say, Section 363 as a reasonable indicator of their true market value.

Lastly, there are two additional solvency tests that should be employed: The Capital Adequacy Test and the Cash Flow Test, which focus on the firm's liquidity and capital resources, along with its operating cash flow in assessing solvency.

Restructuring Expertise

During a preference or fraudulent transfer action, it is often important to assess the solvency of an entity and that analysis requires skill and experience with solvency related analyses. VALCOR is uniquely qualified to assist with solvency related matters and has a considerable track record of valuing entities experiencing financial distress.

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Note: VALCOR is not hereby rendering any accounting, legal or tax advice and the reader is encouraged to seek out competent tax counsel when evaluating restructuring options.