The Balance Sheet Test in Fraudulent Transfer Cases: Is It Appropriate to Fair Value Liabilities?

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Proving insolvency is an important element of a fraudulent transfer claim. Therefore, it is surprising that courts diverge on how they interpret the most basic of the solvency tests, the balance sheet test. Some courts hold that the balance sheet test compares the recorded amount of liabilities to the fair value of assets. Other courts hold that the balance sheet test compares the fair value of liabilities to the fair value of assets. This discussion examines these differing interpretations of the balance sheet test and recommends a unifying principle to reconcile these differing interpretations.

Introduction

In fraudulent transfer law, insolvency often is an important contested issue. It is an affirmative element of a "constructive" fraudulent transfer claim, meaning that a plaintiff *must* prove the transferor's insolvency to win (or prove a similar financial condition like unreasonably small capital). From a defendant's perspective, proving solvency could afford a defense to the fraudulent transfer claim. Because insolvency is such a significant question, fraudulent transfer cases frequently involve a "battle of the experts" offering competing valuations of the transferor entity.

It is surprising, then, that courts diverge on how they describe the most basic of the fraudulent transfer solvency tests, known as the "balance sheet test." At its simplest, the balance sheet test asks whether a transferor's liabilities exceed the transferor's assets: if yes, then the transferor is insolvent; if no, then the transferor is solvent. The test is more complicated in practice. This is because both the Bankruptcy Code and state law say to compare balance sheet accounts at "fair valuation."[1]

Most balance sheets are prepared under generally accepted accounting principles ("GAAP"), which do not necessarily reflect a "fair valuation."[2] So before comparing assets and liabilities, a solvency analyst may need to adjust each balance sheet account from a GAAP-based balance to a "fair valuation."

Nonetheless, courts disagree on exactly which accounts on the balance sheet should receive a "fair valuation." Some courts, particularly in bankruptcy, say that only assets should be stated at "fair valuation."[3] But other courts, particularly those applying state law, say that liabilities should be stated at fair valuation as well.[4]

This judicial divergence is particularly baffling, because both the Bankruptcy Code and state law define the balance sheet test using nearly identical language.[5] In fact, most state fraudulent transfer statutes borrow their insolvency language directly from the Bankruptcy Code.[6]

To muddy the waters even more, courts often do not literally follow either of the two tests. Courts in the "do not value liabilities" category in fact *do* value certain types of liabilities, like

contingent liabilities, thus acknowledging that liability valuation is sometimes appropriate. Courts in the “do value liabilities” category *do not* perform certain types of liability valuation procedures, like discounting liabilities to reflect default risk, thus recognizing that some aspects of liabilities should not be stated at fair valuation. In short, neither formulation fully reflects how courts apply the balance sheet test in practice.

This discussion examines these two interpretations of the balance sheet test. Although the two interpretations appear radically different if applied literally, courts have deviated from literal applications in favor of a fairly consistent balance sheet test. In that test, some aspects of liabilities are valued but other aspects are not. This discussion provides a principle that more fully reflects how courts apply the test in practice.

The principle is this: the only liability valuations that should be performed in the balance sheet test are those that would be relevant to a *hypothetical buyer of the debtor’s entire package of assets and liabilities*. From a buyer’s perspective, certain types of liability valuation, such as adjusting contingent liabilities to their expected value, are appropriate, because they affect the price that the buyer would be willing to pay for the debtor. Other types of liability valuation, such as discounting to reflect a debtor’s default risk, are irrelevant to price and, therefore, have no place in the balance sheet test.

Not only does this principle more accurately describe how courts apply the balance sheet test, it also offers a consistent method to evaluate which types of liabilities—such as contingent liabilities, unliquidated liabilities, non-interest-bearing debts, and below-market-rate debts—are good candidates for fair valuation when conducting the balance sheet test.

The Two Prevailing Interpretations of the Balance Sheet Test

Courts have interpreted the federal and state balance sheet tests differently, giving rise to two general interpretations of the test.

In federal court, the prevailing view is that the balance sheet test requires a “fair valuation” of assets only, comparing the fair value of assets to the face value of liabilities.[7] For example, the Delaware Bankruptcy Court has held on several occasions that “debts are measured at their face value and not their market value.”[8]

The bankruptcy court based this conclusion primarily on the text of the Bankruptcy Code, which defines insolvency as the “financial condition such that the sum of [an] entity’s debts is greater than all of such entity’s property, *at a fair valuation*.”[9] The bankruptcy court interpreted the phrase “at a fair valuation,” which appears at the very end of the definition, to modify the immediately preceding language only (“all of such entity’s property”)—in other words, the asset-side of the balance sheet only. Numerous bankruptcy courts have agreed with this interpretation.[10]

Under this interpretation of the balance sheet test, if a transferor has $1,000 in bond debt, a $1,000 court judgment entered against it, or $1,000 in accounts payable, then in each case the transferor has a $1,000 liability, no fair valuation required.

State law follows a seemingly opposite interpretation. Although each state has its own fraudulent transfer statute, most states have adopted the Uniform Fraudulent Transfer Act or its successor, the Uniform Voidable Transactions Act.[11]

Both of these uniform acts include a balance sheet test that compares fair value of assets to the *fair value* of liabilities. For example, the drafters of the Uniform Fraudulent Transfer Act wrote in their official commentary that the insolvency test "contemplate[s] a fair valuation *of the debts* as well as the assets of the debtor."[12]

The drafters of the more recent Uniform Voidable Transactions Act went even further and altered the definition of insolvency to "make *clearer* that 'fair valuation' applies to debts as well as to assets."[13] The Uniform Voidable Transactions Act's updated balance sheet test now provides that a transferor is insolvent "if, at a fair valuation, the sum of the debtor's debts is greater than the sum of the debtor's assets."[14]

By moving the phrase "at a fair valuation" from the end of the sentence to the beginning, the drafters took direct aim at bankruptcy court decisions interpreting the phrase "at a fair valuation" as applying to assets only.

This split in federal and state law is problematic. This is because plaintiffs frequently assert federal and state fraudulent transfer claims together in one action. A debtor in bankruptcy has the exclusive standing to assert fraudulent transfer claims, both federal and state.[15]

As a result, bankruptcy courts often must resolve both claims in the same case. But if the claims apply different balance sheet tests, then the bankruptcy court potentially could reach inconsistent results. In theory, a debtor could be solvent and insolvent at the same time, depending on which law applied. Not only would this result be impractical, it also would be bad policy: as a number of courts have noted, federal and state fraudulent transfer law stems from the same roots and should be interpreted consistently.[16] There should be only one balance sheet test.

Courts Do Not Literally Follow Either of the Two Interpretations of the Balance Sheet Test

A deep dive into the case law reveals that neither interpretation of the balance sheet test is a fully accurate description of what courts do in practice.

Although many federal courts say to not value liabilities, these same courts in fact do value certain types of liabilities when conducting the balance sheet test. For example, even federal courts reduce "contingent liabilities" to their expected value.[17]

> **"Because the [contingent] liability is uncertain to occur, valuing it at face would overestimate the debtor's exposure."**

A liability is contingent if it is uncertain to occur, such as a pending lawsuit against a debtor that could lead to a money judgment. Because the liability is uncertain to occur, valuing it at face would overestimate the debtor's exposure.[18]

For instance, if a lawsuit asserted a $1 million claim against the debtor, but the plaintiff had only a 5 percent probability of success, then treating the judgment as a $1 million liability for purposes of the balance sheet test would be inappropriate. A court instead would value the judgment by multiplying its face amount against the probability of occurrence ($1 million × 5 percent), ultimately valuing the contingent liability at $50,000.[19] In other words, the court would engage in a form of liability fair valuation.

But as even state law recognizes, not every type of liability valuation is appropriate under the balance sheet test.[20] For example, a court should not discount a liability to reflect a debtor's risk of nonperformance.[21]

To understand why, consider a company that issues public bonds at a face value of $1,000. If the company is financially troubled and at risk of defaulting on the bonds, then the market price of those bonds may fall below face to reflect this risk of nonperformance. For instance, if the company has only $500 in assets with which to pay the bonds, then the market may value the bonds at not more than $500 notwithstanding their $1,000 face amount.

Although this type of valuation may occur in the market, it has no place in the balance sheet test, because it would skew the test in favor of solvency. A well-informed creditor would never value a liability at greater than the debtor's ability to pay—in other words, at greater than the value of the debtor's assets.[22]

Likewise, a well-informed debtor would never value a debt at a greater amount than what creditors would accept.[23] Liabilities would never exceed

assets, and solvency under the balance sheet test would be a foregone conclusion. Thus, even if liabilities must receive a "fair valuation," certain types of valuation procedures are not appropriate for the balance sheet test.

As these examples demonstrate, a liability fair valuation sometimes, but not always, is appropriate under the balance sheet test. But the two prevailing formulations of the test speak in absolutes ("do" or "do not" value liabilities) and, therefore, do not fully capture this nuance.

Reconciling the Law: Liabilities Should Be Valued from the Perspective of a Hypothetical Buyer

Because the fair valuation of liabilities sometimes is appropriate under the balance sheet test, the question becomes, when? Based on how courts apply the test in practice, a common principle emerges: liabilities should receive only a "fair valuation" that is relevant from the perspective of a hypothetical solvent buyer pricing the debtor's collective assets and liabilities.

Judging solvency from the perspective of a buyer is not new or unique in bankruptcy. As the Seventh Circuit held nearly 30 years ago, "[t]o decide whether a firm is insolvent within the meaning of [fraudulent transfer law], a court should ask: What would a buyer be willing to pay for the debtor's entire package of assets and liabilities?"[24]

If the overall amount is positive, then the debtor is solvent. And, if negative, then the debtor is insolvent.[25] Approaching the balance sheet from this perspective helps reconcile some of the inconsistencies in the case law.

For example, let's consider contingent liabilities, which courts reduce to their expected value (even those courts belonging to the "do not value" group). From the perspective of a hypothetical buyer, valuing contingent liabilities is appropriate: to determine a price for the debtor's package of assets and liabilities, the buyer must reduce contingent liabilities to their expected values. Because this type of valuation is relevant to determining what a buyer would pay for the debtor, it is an appropriate type of valuation to perform in the balance sheet test.

Now let's consider valuing liabilities for default risk—a practice disfavored even by those courts in the "do value" group. From the perspective of a hypothetical buyer, this is not an appropriate type of valuation procedure. A debtor's default risk may matter to creditors, but not to a buyer. The buyer will be assuming the debtor's liabilities.

Therefore, the debtor's ability to pay those liabilities going forward becomes irrelevant. Conducting the balance sheet test from the perspective of a hypothetical buyer thus confirms that a "fair valuation" of liabilities does not include valuation for default risk.

What Other Types of Liabilities Should Be Valued under the Balance Sheet Test?

Outside of contingent liabilities, at least three other categories of liabilities—unliquidated liabilities, non-interest-bearing debts, and below-market-rate debts—are candidates for fair valuation.

Unliquidated Liabilities

Liabilities are "unliquidated" if their amounts are undetermined. Examples include environmental liabilities or mass tort liabilities where the underlying wrongdoing already has occurred but the amount of the damages is not yet known.

Courts generally value unliquidated liabilities by estimating their amount and then reducing that amount to present value.[26]

Valuation in the form of discounting to present value is appropriate from a buyer's perspective. This is because a buyer assigning a price to a future liability would take into account the time-value of money.

Although discounting to present value is not controversial, parties have disagreed over the appropriate discount rate. Here again, the rate should be one relevant to a hypothetical buyer. For example, in the *Tronox* bankruptcy case, the parties disagreed about the appropriate discount rate that the court should use to reduce the debtor's environmental liabilities to present value.[27]

The plaintiff advocated for a risk-free discount rate based on U.S. Treasury bond yields (2.5 percent), while the defendant advocated for a 5 percent discount rate that incorporated a risk premium to reflect the chance that the debtor would default on its environmental liabilities. The court selected the risk-free rate, finding that the debtor's ability to pay its liabilities was irrelevant for purposes of determining solvency.[28]

By rejecting a discount rate that incorporated default risk, the court valued the debtor's

environmental liabilities from the viewpoint of a hypothetical buyer—without expressly saying so.

Non-Interest-Bearing Debts

Like unliquidated debts, non-interest-bearing debts that are due in the future are candidates for valuation under the balance sheet test by reducing them to present value.[29] Because a hypothetical buyer acquiring the liability would have no obligation to make interim interest or coupon payments, valuing the debt to reflect the time-value of money is appropriate.

Debts with Below-Market Interest Rates

Debts bearing some of the characteristics of unliquidated or non-interest-bearing liabilities may also be candidates for fair valuation. One such example is a debt with a below-market interest rate.

Let's consider a debt that is not quite non-interest-bearing, but that is almost there: for example, a debt bearing a 0.5 percent rate for a long term. The same reasons for valuing a non-interest-bearing debt at present value also could apply to this low-rate debt. A hypothetical buyer could assume the debt (and acquire the company's associated assets) more cheaply than originating new debt at a market price to acquire the same assets.

Discounting the debt to reflect its below-market rate, therefore, could be appropriate under the balance sheet test, particularly if the debt is long term. This is a true gray area in the law, as little-to-no court guidance exists.

However, if a court accepts that a "fair valuation" of liabilities should be conducted from the viewpoint of a hypothetical buyer, then the court should also accept that debts with below-market rates may be given a "fair valuation" in the balance sheet test.

Conclusion

Although courts do not apply the balance sheet test in a consistent manner, conducting the test from the perspective of a hypothetical buyer helps reconcile the differences between the two prevailing iterations of the test, and captures how courts apply it in practice. Because the case law in this area is so sparse, this principle also provides a consistent method to evaluate whether to—and how to—value any unusual liabilities in future cases.

Notes:

1. *See* 11 U.S.C. § 101(32) (defining insolvency as the "financial condition such that the sum of [an] entity's debts is greater than all of such entity's property, *at a fair valuation*.") (emphasis added); Uniform Fraudulent Transfer Act ("UFTA") § 2 ("A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets *at a fair valuation*.") (emphasis added); see also Uniform Voidable Transactions Act ("UVTA") § 2 ("A debtor is insolvent if, *at a fair valuation*, the sum of the debtor's debts is greater than the sum of the debtor's assets.") (emphasis added).
2. *See, e.g.*, Lids Corp. v. Marathon Inv. Ptrs., L.P. (In re Lids Corp.), 281 B.R. 535, 540 (Bankr. D. Del. 2002) ("[T]he Balance Sheet Test is based on a fair valuation and not based on Generally Accepted Accounting Principles ('GAAP'), which are used to prepare a typical balance sheet.").
3. *See, e.g.*, In re Lids Corp., 281 B.R. at 545–46.
4. *See, e.g.*, Waller v. Pidgeon, 2008 WL 2338217, at *4–7 & n.8 (N.D. Tex. June 5, 2008), *aff'd* 324 F. App'x 431 (5th Cir. 2009).
5. *See* n.1, *supra*.

6. *See* UFTA § 2 cmt 1 ("Subsection (a) is derived from the definition of "insolvent" in . . . the Bankruptcy Code. . . ."); UVTA § 2 cmt 1 (same).

7. *See, e.g.*, In re Lids Corp., 281 B.R. at 545–46; Hanna v. Crenshaw (In re ORBCOMM Global, L.P.), 2003 WL 21362192, at *2 (Bankr. D. Del. June 12, 2003); Faulkner v. Kornman (In re Heritage Org., L.L.C.), 413 B.R. 438, 503 n. 53 (Bankr. N.D. Tex. 2009); Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A., Ltd. (In re Payless Cashways, Inc.), 290 B.R. 689, 700 n.28 (Bankr. W.D. Mo. 2003).

8. In re Lids Corp., 281 B.R. at 545–46 (citing Travellers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.), 134 F.3d 188, 196 (3d Cir. 1998)); In re ORBCOMM Global, L.P.), 2003 WL 21362192, at *2.

9. 11 U.S.C. § 101(32) (emphasis added).

10. *See, e.g.*, In re Heritage Org., L.L.C., 413 B.R. at 503 n. 53; Hoffinger Indus., Inc. v. Leesa Bunch & McMasker Enters., Inc. (In re Hoffinger Indus., Inc.), 313 B.R. 812, 819–20 n.4 (Bankr. E.D. Ark. 2004); In re Payless Cashways, Inc., 290 B.R. at 700 n.28.

11. According to the Uniform Law Commission's statistics that are published on its website, 45 states adopted the Uniform Fraudulent Transfer Act after it was published in 1984, and 20 have since adopted the updated Uniform Voidable Transactions Act, which was published in 2014. As of October 1, 2019, four more states, including New York, currently have pending legislation to enact the UVTA.

12. UFTA § 2 cmt 1 (emphasis added).

13. UVTA § 2 cmt 1 (emphasis added).

14. *Id*. § 2; *compare with* 11 U.S.C. § 101(32) (an entity is insolvent if "the sum of [the] entity's debts is greater than all of such entity's property, at a fair valuation.").

15. Deutsche Bank Trust Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.), 818 F.3d 98, 111 (2d Cir. 2016) ("Once Tribune entered bankruptcy, the creditors' avoidance claims were vested in the federally appointed trustee [under] 11 U.S.C. § 544(b)(1)"); *see also* Ahcom, Ltd. v. Smeding, 623 F.3d 1248, 1250 (9th Cir. 2010) ("When the trustee does have standing to assert a debtor's claim, that standing is exclusive and divests all creditors of the power to bring the claim"); In re PWS Holding Corp., 303 F.3d 308, 314 (3d Cir. 2002) ("§ 544(b) places the debtor in possession in the shoes of its creditors, giving it the right to prosecute individual creditors' fraudulent transfer claims for the benefit of the bankruptcy estate").

16. *See, e.g.*, Moody v. Sec. Pac. Bus. Credit, Inc., 971 F.2d 1056, 1068 (3d Cir. 1992) (citing U.S. v. Tabor Court Realty Corp., 803 F.2d 1288, 1299 (3d Cir. 1986) (consistent treatment of the two is "essential to promote commerce nationally."); Granfinanciera, S.A. v. Nordberg, 492 U.S. 33, 60–61 (1989) (noting that the Bankruptcy Code merely codified existing law and did not create a new fraudulent transfer cause of action).

17. *See, e.g.*, In re Xonics Photochemical, Inc., 841 F.2d 198, 199–200 (7th Cir. 1988).

18. *Id*. at 200 (the uncertainty of the liability is "a compelling reason not to value contingent liabilities on the balance sheet at their face amounts").

19. *Id*.; *see also* WRT Creditors Liquidation Trust v. WRT Bankruptcy Litigation Master File Defendants (In re WRT Energy Corp.), 282 B.R. 343, 400 (Bankr. W.D. La. 2001) ("The court concludes that the fair value of a contingent liability is properly determined by multiplying total debt guaranteed by the probability that the debtor would be required to make good on the guarantee.").

20. *See, e.g.*, UVTA § 2 cmt 1 (discussing instances where valuation is not appropriate).

21. *See, e.g.*, UVTA § 2 cmt 1 (noting that although liabilities should be valued, they should not be valued for risk of nonperformance); see also Travellers Int'l AG v. Trans World Airlines, Inc. (In re Trans World Airlines, Inc.), 134 F.3d 188, 196–97 (3d Cir. 1998).

22. *See, e.g.*, *id*. (adopting the bankruptcy court's reasoning that discounting for risk of default would be circular and lead to solvency).

23. *Id*.

24. *See, e.g.*, Covey v. Commercial Nat'l Bank of Peoria, 960 F.2d 657, 660 (7th Cir. 1992).

25. *Id*.

26. *See, e.g.*, Tronox Inc. v. Kerr McGee Corp. (In re Tronox Inc.), 503 B.R. 239, 313–14 (Bankr. S.D.N.Y. 2013) (estimating the debtor's massive environmental liabilities and then discounting that amount to present value).

27. *Id*. at 314–15.

28. *Id*.

29. *See, e.g.*, UVTA § 2 cmt. 1 (discounting appropriate "for non-interest-bearing debt that is due in the future in order to reduce the debt to its present value").

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