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## Proving Solvency: Defending Preference and Fraudulent Transfer Litigation

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*Litigating solvency can be a complicated endeavor. This article provides a general road map for proving solvency in the defense of preference and fraudulent transfer litigation. The three common measures of solvency are discussed: the “balance sheet” test; the “unreasonably small capital” test; and the “ability to pay debts” test. The article also provides practical suggestions for defense counsel.*

### INTRODUCTION

A company that files for bankruptcy protection acquires a number of important rights, including the ability to pursue allegedly preferential and fraudulent transfers. Many an annoyed vendor has just recovered from the financial (and occasionally emotional) pain of non-payment of significant invoices, only to have the wound reopened when the vendor is served with a lawsuit seeking the return of payments that it did, quite legitimately, receive.

Frequently it makes little sense to incur the burden and expense of attempting to prove solvency when defending avoidance actions. The debtor (or the bankruptcy trustee) benefits from a presumption of insolvency in non-insider preference cases and may have been in a precarious financial condition for some time leading up to the bankruptcy filing. Moreover, the amount at issue in the litigation may not justify the cost of hiring an expert and litigating solvency.

There are cases, however, where the debtor's financial condition and the amount at issue justify the expense of attempting to prove solvency. Indeed, a debtor need not be insolvent to file for bankruptcy protection and avoidance litigation can involve substantial amounts. Because insolvency is a necessary element of a preference or constructive fraud claim under the Bankruptcy Code,<sup>1</sup> proof of solvency, *standing alone*, will defeat the claim. A serious and legitimate challenge to insolvency also can be valuable in settlement negotiations.

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1. The Bankruptcy Code as amended is codified in Title 11 of the United States Code, 11 U.S.C.A. §§ 101–1532 (West 2004 & Supp. 2006). Citations hereafter will be to the sections of the Bankruptcy Code as codified in Title 11.

The purpose of this article is to provide a general roadmap for proving solvency in preference and fraudulent transfer litigation. While the primary focus is on claims brought under the Bankruptcy Code, many (if not most) of these principles apply to state law claims as well.<sup>2</sup>

A solvency analysis involves up to three tests: the “balance sheet” test; the “unreasonably small capital” test; and the “ability to pay debts” test. In a preference action only the balance sheet test applies; any (or all) of the tests may be at issue in fraudulent transfer litigation. The three tests are discussed below.

## I. SOLVENCY: THE BALANCE SHEET TEST

### A. IN GENERAL

Under section 547 of the Bankruptcy Code, an allegedly preferential transfer may be avoided if, among other things, the transfer was “made while the debtor was insolvent.”<sup>3</sup> Similarly, under section 548 of the Bankruptcy Code, an allegedly fraudulent transfer may be avoided if, among other things, the debtor “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.”<sup>4</sup> For entities other than partnerships and municipalities, the Bankruptcy Code defines “insolvent” as:

a 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,

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2. See, e.g., *Fidelity Bond and Mortgage Co. v. Brand* (*In re Fidelity Bond and Mortgage Co.*), 340 B.R. 266, 288 (Bankr. E.D. Pa. 2006) (Balance sheet test for insolvency same under Bankruptcy Code and Pennsylvania Uniform Fraudulent Transfer Act); *Kaler v. Red River Commodities, Inc.* (*In re Sun Valley Prods., Inc.*), 328 B.R. 147, 155 (Bankr. D.N.D. 2005) (“The language of UFTA and section 548 are nearly identical. . . . Considering the similarities in purpose and language, many courts have concluded that the UFTA and section 548 are *in pari materia*, and that the same analysis applies under both laws. The Court finds the reasoning behind these cases persuasive and will analyze the transfer at issue only under the purview of section 548.” (citation omitted)); *Advanced Telecomm. Network, Inc. v. Allen* (*In re Advanced Telecomm. Network, Inc.*), 321 B.R. 308, 332 (Bankr. M.D. Fla. 2005) (definitions of insolvency under New Jersey law and Bankruptcy Code “functionally equivalent”); *Tomsic v. Pitocchelli* (*In re Tri-Star Techs. Co.*), 260 B.R. 319, 324–25 (Bankr. D. Mass. 2001) (definitions of insolvency under Bankruptcy Code and UFTA “no different, except that a general failure by the debtor to pay its debts as they become due provides a basis for a presumption of insolvency” under the UFTA (citation omitted)); *Salisbury v. Texas Commerce Bank-Houston, N.A.* (*In re WCC Holding Corp.*), 171 B.R. 972, 985 (Bankr. N.D. Tex. 1994) (“There is little case authority defining the Texas standard by which the Court should judge whether WCC’s assets were unreasonably small following the April 18, 1988 transaction. However, under § 24.005(a)(2)(A)’s counterpart in the Bankruptcy Code, § 548(a)(2)(B)(ii), there is case authority sufficient to guide the Court in assessing the adequacy of WCC’s assets under § 24.005(a)(2)(A).”); *Ferrari v. Barclay’s Bus. Credit, Inc.* (*In re Morse Tool, Inc.*), 148 B.R. 97, 130 (Bankr. D. Mass. 1992) (“Where Massachusetts [fraudulent conveyance] law is silent, the Court may look to the law of other jurisdictions that have adopted the UFCA and to decisions construing analogous provisions of the Bankruptcy Code.” (citations omitted)); *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1067–68 (3d Cir. 1992) (“The fraudulent conveyance provisions of the Bankruptcy Code are modeled on the UFCA, and uniform interpretation of the two statutes is essential to promote commerce nationally. . . . [A]lthough the UFCA’s ‘present fair salable value’ language differs from the Bankruptcy Code’s ‘fair valuation’ requirement. . . , we find the bankruptcy cases instructive on the proper valuation standard here.” (citation omitted)).

3. 11 U.S.C.A. § 547(b)(3) (West 2004 & Supp. 2006).

4. 11 U.S.C.A. § 548(a)(1)(B)(ii)(I) (West 2004 & Supp. 2006).

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 [the Bankruptcy Code].<sup>5</sup>

The key term—"at a fair valuation"—is not defined in the Bankruptcy Code.<sup>6</sup>

The Bankruptcy Code definition of insolvency is referred to generally as the "balance sheet" test, perhaps to distinguish it from the "equity" test (the ability to pay debts as they come due).<sup>7</sup> However, the debtor's balance sheet is only the starting point, as values reflected on a company's financial statements (typically recorded in accordance with Generally Accepted Accounting Principles or "GAAP") are not dispositive and it may be necessary to look beyond the balance sheet to identify assets and liabilities:

To label it a "balance sheet" test may be a misnomer. Financial statements prepared in accordance with [GAAP] do not record assets at fair market value. Instead, they are recorded at the historical, original purchase cost and reduced each year by an estimate of depreciation. Within the contemplation of § 101(32) "property" may include assets not even listed on the balance sheet. Debts are recorded only to the extent that they are known and quantifiable; many nonrecorded liabilities usually surface in an insolvency analysis. . . . [T]he balance sheet is only the starting point in the analysis.<sup>8</sup>

In short, financial statement "accounting conventions" are not controlling, nor are values reflected on a debtor's bankruptcy schedules, although some courts

5. 11 U.S.C.A. § 101(32)(A) (West 2004 & Supp. 2006).

6. See, e.g., *Liquidation Trust of Hechinger Inv. Co. of Del., Inc. v. Fleet Retail Fin. Group* (*In re Hechinger Inv. Co. of Del.*), 327 B.R. 537, 548 (Bankr. D. Del. 2005) ("The Bankruptcy Code does not mandate what constitutes a 'fair valuation.'"); *Total Technical Servs., Inc. v. Whitworth* (*In re Total Technical Servs., Inc. and TTS, Inc.*), 150 B.R. 893, 900 (Bankr. D. Del. 1993) ("Fair value is not defined by the Bankruptcy Code."). See also *Travellers Int'l AG v. Trans World Airlines, Inc.* (*In re Trans World Airlines, Inc.*), 203 B.R. 890, 893 (D. Del. 1996) ("The meaning ascribed to the term 'fair valuation' is crucial, in that it guides the interpretation of a debtor's financial data, which then enables a court to determine if the debtor's liabilities exceed its assets, that is, whether the debtor is insolvent."), *rev'd in part on other grounds*, 134 F.3d 188 (3d Cir.), *cert. denied*, 523 U.S. 1138 (1998).

7. See e.g., *HomePlace of America, Inc. v. Salton, Inc.* (*In re Waccamaw's HomePlace*), 325 B.R. 524, 529 (Bankr. D. Del. 2005); *Trans World Airlines, Inc. v. Travellers Int'l AG* (*In re Trans World Airlines, Inc.*), 180 B.R. 389, 405 (Bankr. D. Del. 1994), *rev'd in part on other grounds*, 203 B.R. 890 (D. Del. 1996), *rev'd in part on other grounds*, 134 F.3d 188 (3d Cir.), *cert. denied*, 523 U.S. 1138 (1998). See also *Shubert v. Lucent Techs. Inc.* (*In re Winstar Comm'ns, Inc.*), 348 B.R. 234, 274 (Bankr. D. Del. 2005) ("This test of insolvency, the so-called 'balance sheet' insolvency, compares the 'fair value' of all of the debtor's assets with the face or 'stated' value of its liabilities on the relevant date. It is different from equity tests that focus on a debtor's current ability to pay debts as they become due.") *aff'd*, C.A. No. 06-147-JJF, 2007 WL 1232185 (D. Del. Apr. 26, 2007); 2 LAWRENCE P. KING, ET AL., *COLLIER ON BANKRUPTCY* ¶ 101.32[4], at 101-153 (15th ed. 2005) ("The Code definition of insolvency is essentially a balance sheet test." (footnote omitted)).

8. See *In re Trans World Airlines, Inc.*, 180 B.R. at 405 n.22. See also, e.g., *Lids Corp. v. Marathon Inv. Partners, L.P.* (*In re Lids Corp.*), 281 B.R. 535, 540 (Bankr. D. Del. 2002) ("This standard for solvency is typically called the 'Balance Sheet Test.' . . . However, this may be a misnomer because the Balance Sheet Test is based on a fair valuation and not based on [GAAP], which are used to prepare a typical balance sheet."); *Peltz v. Hatten*, 279 B.R. 710, 743 (Bankr. D. Del. 2002) ("While the inquiry is labeled a 'balance sheet' test, the court's insolvency analysis is not literally limited to or constrained by the debtor's balance sheet. Instead, it is appropriate to adjust items on the balance sheet that are shown at a higher or lower value than their going concern value and to examine whether assets of a company that are not found on its balance sheet should be included in its fair value."), *aff'd*, Civil No. 00-CV-00996, 2003 WL 1551287 (3d Cir. Mar. 25, 2003).

attribute varying degrees of evidentiary significance to those figures.<sup>9</sup> Defense counsel (and their experts) should be particularly wary about placing too much reliance on the debtor's balance sheet entry for "goodwill" as an independent asset with material value.<sup>10</sup> Additionally, and whether they appear on the balance

9. See, e.g., *Fisher v. Enterprise Truck Line, Inc. (In re CXM, Inc.)*, 336 B.R. 757, 761 (Bankr. N.D. Ill. 2006) ("A Debtor's schedules are not persuasive, let alone dispositive or controlling."); *Heilig-Meyers Co. v. Wachovia Bank, N.A. (In re Heilig-Meyers Co.)*, 328 B.R. 471, 488 (E.D. Va. 2005) ("Although the values reported in financial statements to shareholders are based on accounting methods that are inapplicable to the determination of solvency under the Bankruptcy Code, such reported values are 'competent evidence from which inferences about a debtor's insolvency may be drawn.'"); *Zeta Consumer Prods. Corp. v. Equistar Chem., L.P. (In re Zeta Consumer Prods. Corp.)*, 291 B.R. 336, 347 (Bankr. D.N.J. 2003) ("As the case authority notes, in many cases, fair valuation may not be reflected in the values assigned those assets on a financial balance sheet. Generally, financial statements and balance sheets reflect the book values of assets, which is usually the cost of the asset reduced by any depreciation. Book value ordinarily does not reflect the true market value of the asset. Nevertheless, while book value may understate or fail to reflect the fair value of a debtor's assets, it provides some competent evidence as to insolvency and forms a starting point for purposes of the insolvency analysis." (citation omitted)); *Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A. Ltd. (In re Payless Cashways, Inc.)*, 290 B.R. 689, 698 (Bankr. W.D. Mo. 2003) ("In the Eighth Circuit a financial statement showing positive net worth at the beginning of the preference period is sufficient to rebut the presumption of insolvency."); *WRT Creditors Liquidation Trust v. WRT Bankr. Litig. Master File Defendants (In re WRT Energy Corp.)*, 282 B.R. 343, 369 (Bankr. W.D. La. 2001) ("In determining a debtor's insolvency, a court must examine the actual values of the assets [at the time of the transfer] and not arbitrary values assigned by the debtor.' 'A fair valuation may not be equivalent to the values assigned on a balance sheet. Financial statements reflect the book value of assets.' Book value may not be equivalent to fair market value." (brackets in original) (citations omitted)); *In re Trans World Airlines, Inc.*, 180 B.R. at 410 ("Accounting conventions are not the controlling principles for the legal determination of whether a debtor's debts exceed the fair value of its assets for purposes of insolvency."); *Brown v. Shell Canada, Ltd. (In re Tenn. Chem. Co.)*, 143 B.R. 468, 471-72 (Bankr. E.D. Tenn. 1992) ("Cost less depreciation may be the correct book value under generally accepted accounting principles, but it is not necessarily close to the fair value. . . . Market value minus depreciation for five to six years does not automatically equal market value or any other measure of fair value. As a result, the schedules and the report to the U.S. Trustee are not good evidence of the fair value of Tennessee Chemical's property in April, 1989. The schedules and the report cannot prove solvency under the bankruptcy definition of insolvency."); *aff'd*, 112 F.3d 234 (6th Cir. 1997); *Berquist v. Anderson-Greenwood Aviation Corp. (In re Bellanca Aircraft Corp.)*, 56 B.R. 339, 385 (Bankr. D. Minn. 1985) ("it is well established that values assigned by a debtor to assets for balance sheet or other purposes are not determinative of their fair valuation"); *aff'd and remanded*, 850 F.2d 1275 (8th Cir. 1988); *DeRosa v. Buildex Inc. (In re F&S Central Mfg. Corp.)*, 53 B.R. 842, 849 (Bankr. E.D.N.Y. 1985) ("Asset values carried on a balance sheet, even if derived in accordance with 'generally accepted accounting principles,' do not necessarily reflect fair value: "'Generally accepted accounting principles'" are not synonymous with any specific [valuation] policy.' Therefore, a balance sheet, such as that submitted by the defendant, which does not indicate how the debtor's assets were valued, has no probative weight at all." (bracket in original) (citations omitted)).

10. See, e.g., *Kendall v. Sorani (In re Richmond Produce Co.)*, 151 B.R. 1012, 1019 (Bankr. N.D. Cal. 1993), *aff'd*, 195 B.R. 455 (N.D. Cal. 1996) ("[G]enerally accepted accounting principles do not control the determination of solvency in a trustee's avoidance action. Rather, the inquiry must be to what extent an asset would have value for a creditor attempting to satisfy its claim. Good will and organization expense could not be sold to satisfy a creditor's claim. Thus, these assets should be disregarded in determining solvency, at least under the facts presented here." (citations omitted)); *Coated Sales, Inc. v. First Eastern Bank, N.A. (In re Coated Sales, Inc.)*, 144 B.R. 663, 672 (Bankr. S.D.N.Y. 1992) ("First Eastern's assertion that CSI's subsidiaries carried goodwill in the aggregate amount of \$1,780,000 is tenuous at best. Goodwill not only represents the favorable consideration shown by the public, but it is the ability of a business to generate income in excess of normal rates. At the time of the transfer, the subsidiaries were in financial despair, clinging to a parent whose sound financial condition was a falsehood. None of the subsidiaries were operating at a profit, rationalizing that no

sheet, “contingent” assets (as well as contingent liabilities) require careful analysis.<sup>11</sup>

Although application of the balance sheet test can lead to any number of disputes, in almost every case the primary debate will be about the value of the debtor’s assets. Indeed, solvency battles generally morph into valuation fights. As in any valuation exercise, valuing the debtor’s assets can be a complicated endeavor:

The application of an assets-and-liabilities test requires of necessity a valuation of the property involved. This may be a difficult task, however, because value is not a natural or fixed quality, but will vary according to the purposes and policies which dictate the determinative judgments and the processes by which it is ascertained.<sup>12</sup>

Accordingly, and although there may be cases where expert testimony is unnecessary, in general a defendant that is serious about litigating solvency should

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potential buyer offered more than the reasonable value of the tangible assets.” (citation omitted)); 2 COLLIER, *supra* note 7, ¶ 101.32[4], at 101-159 (“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 to an economic unit. Closely allied to the matter under discussion is the further question of whether, and under what conditions, ‘good will’ constitutes an independent item to be included in the aggregate of the debtor’s property. The courts have quickly discounted fantastic claims of such assets and generally exhibited a great reluctance to accept good will as a separate asset, particularly where the enterprise was already in a seriously distressed condition.” (footnotes omitted)). *But see* Mellon Bank, N.A. v. Metro Comm’ns, Inc., 945 F.2d 635, 647 (3d Cir. 1991) (“in determining insolvency under section 548(a)(2)(B)(i), it is appropriate to take into account intangible assets not carried on the debtor’s balance sheet, including, *inter alia*, good will”), *cert. denied sub. nom.*, Comm. Unsecured Creditors v. Mellon Bank, N.A., 503 U.S. 937 (1992).

11. *See, e.g., In re Advanced Telecomm. Network, Inc.*, 321 B.R. at 335 (“In making a determination as to solvency, both contingent liabilities and contingent assets are appropriately considered.”); *In re WRT Energy Corp.*, 282 B.R. at 370 (“contingent assets or liabilities should be included as part of the balance sheet insolvency test”). *See also* Mellon Bank, N.A. v. Official Comm. Unsecured Creditors (*In re R.M.L., Inc.*), 92 F.3d 139, 156 (3d Cir. 1996) (“[I]f a debtor’s treatment of an item as an ‘asset’ depends for its propriety on the occurrence of a contingent event, a court must take into consideration the likelihood of that event occurring from an objective standpoint. . . . Far from ‘hindsight’ or ‘post-hoc’ analysis, a court looks at the circumstances as they appeared to the debtor and determines whether the debtor’s belief that the future event would occur was reasonable. The less reasonable a debtor’s belief, the more a court is justified in reducing the assets (or raising liabilities) to reflect the debtor’s true financial condition at the time of the alleged transfers.”); *In re Trans World Airlines, Inc.*, 180 B.R. at 405 n.22 (“Within the contemplation of § 101(32) ‘property’ may include assets not even listed on the balance sheet.”); *In re Xonics Photochemical, Inc.*, 841 F.2d 198, 200 (7th Cir. 1988) (“It makes no difference whether the firm has a contingent asset or a contingent liability, the asset or liability must be reduced to its present, or expected, value before a determination can be made whether the firm’s assets exceed its liabilities.”); *infra* note 74 and accompanying text.

12. 2 COLLIER, *supra* note 7, ¶ 101.32[4], at 101-153 (footnote omitted). *See also* ROBERT F. REILLY & ROBERT P. SCHWEIHS, THE HANDBOOK OF ADVANCED BUSINESS VALUATION, at 340 (Irwin Library of Inv. & Fin. 2000) [hereinafter “REILLY & SCHWEIHS”] (“The balance sheet test determines whether, at the time of the transaction, a company’s asset value was greater than its liability value. As a first step in conducting the balance sheet test, the assets of the company are valued as a going concern as of the date of the transaction. Then the value of the company’s liabilities is subtracted from the asset value. The balance sheet test is passed if the sum of the value of the company’s assets is greater than the sum of the value of its liabilities. For purposes of this analysis, a valuation of the company should be performed.”); JAMES H. ZUKIN, FINANCIAL VALUATION: BUSINESSES AND BUSINESS INTERESTS, at 13-2 (1990) [hereinafter “ZUKIN”] (“One of the most important applications of valuation analysis of late has been in the area of solvency or capital adequacy.”).

retain a skilled expert. A defendant who chooses to “go at it alone” may not fare well at trial.<sup>13</sup>

Initially, defense counsel should identify which entity’s or entities’ solvency requires evaluation. A debtor may focus on the solvency of a single entity where consolidation with affiliated entities is appropriate; alternatively, a debtor may focus on the solvency of affiliated entities on a consolidated basis where only a single entity’s solvency is properly at issue. Although the correct answer will depend on the facts of the case, the point here is that a defendant need not accept the trustee’s position as to which debtor’s solvency is relevant.<sup>14</sup>

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13. See *In re Waccamaw’s HomePlace*, 325 B.R. at 530 (rejecting solvency testimony of defendant’s CFO as “superficial at best and insufficient to overcome the presumption”); *Peltz v. Worldnet Corp. (In re USN Comm’ns, Inc.)*, 280 B.R. 573, 585 n.19 (Bankr. D. Del. 2002) (“Defendant has presented no expert testimony to rebut the presumption of Debtor’s insolvency. . . . [T]he issue here is whether Plaintiff should be forced to proceed with the burden of proving Debtor’s insolvency for the purposes of § 547(b) where the *only* evidence submitted by Defendant to rebut the § 547(f) presumption of insolvency is the Form 8-K. I find that he should not.” (emphasis in original)). See also, e.g., *Brandt v. Samuel, Son & Co., Ltd. (In re Longview Aluminum, L.L.C.)*, Case No. 03 B 12184, 2005 Bankr. LEXIS 1312, at \*17 (Bankr. N.D. Ill. July 14, 2005) (“It is generally accepted that whenever possible, a determination of insolvency should be based on seasonable appraisals or expert testimony.”); *Miller & Rhoads, Inc. Secured Creditors’ Trust v. Robert Abbey, Inc. (In re Miller & Rhoads, Inc.)*, 146 B.R. 950, 956 (Bankr. E.D. Va. 1992) (“Numerous cases have held that the schedules are not dispositive or controlling and that courts should rely upon more accurate evidence, such as current appraisals, opinion testimony or actual sales of the assets in determining insolvency.” (citation omitted)). But see *VFB LLC v. Campbell Soup Co.*, No. 05-4879, 2007 WL 942360, at \*4 (3d Cir. Mar. 30, 2007) (“basically the district court regarded the hired expert valuations as a side-show to the disinterested evidence of VFI’s capitalization in ‘one of the most efficient capital markets in the world.’”); *id.* at \*8 (“Absent some reason to distrust it, the market price is ‘a more reliable measure of the stock’s value than the subjective estimates of one or two expert witnesses.’”); *In re Hechinger Inv. Co. of Del.*, 327 B.R. at 548 (as to breach of fiduciary duty and fraudulent transfer claims; “because valuation is, to a great extent, a subjective exercise dependent upon the input of both facts and assumptions, the court will give deference to ‘prevailing marketplace values,’ rather than to values created with the benefit of hindsight for the purpose of litigation” (citation omitted)); *In re Longview Aluminum, L.L.C.*, 2005 Bankr. LEXIS 1312 (although plaintiff presented expert and defendants did not, defendants prevailed on solvency); *In re WRT Energy Corp.*, 282 B.R. at 370 (“Insolvency and ‘fair valuation’ may be established to the court’s satisfaction by expert testimony, financial statements, public documents, appraisals, or a combination of these.” (citations omitted)); *In re Golden Mane Acquisitions, Inc.*, 221 B.R. 963, 970 (Bankr. N.D. Ala. 1997) (where primary asset was office building and record contained evidence of offers and eventual sale value, court gave little weight to expert testimony); *Energy Coop., Inc. v. Cities Serv. Co. (In re Energy Coop., Inc.)*, 109 B.R. 822, 828 (N.D. Ill. 1989) (“[A] sale is the best evidence of the worth of a property. Short of that, a firm commitment to buy at a certain price would be entitled to considerable probative value. Neither of those conditions are present here. As such the [expert opinion testimony] is entitled to little weight on the question of value. Particularly is this so in light of the other objective evidence in this case bearing more precisely on the issue of the refinery value.”).

14. See, e.g., *Askanase v. Fatjo*, 130 F.3d 657, 670 (5th Cir. 1997) (court rejected trustee’s argument that insolvency of parent corporation applied to subsidiaries because parent and subsidiaries supposedly were single business enterprise; “the Trustee cites no legal or accounting authority for his argument that [parent’s] solvency necessarily determines the solvency of its subsidiaries. . . . [I]t could be that [parent’s] subsidiaries were solvent but that [parent’s] debts were so great that [parent] on a consolidated basis is insolvent. Thus, [parent’s] balance sheet solvency does not necessarily determine the solvency of its subsidiaries. . . .”); *Clay v. Dehner (In re Perry, Adams and Lewis Secs., Inc.)*, 34 B.R. 155, 156–58 (Bankr. W.D. Mo. 1983) (“To demonstrate the insolvency of the debtor as of the date of transfer, the plaintiff adduced in evidence a consolidated balance sheet of all the debtors. . . . It is clear from the facts . . . that, while the consolidated balance sheet may show the debtors, all considered as one entity, were insolvent as of the date of the transfer, Briarbrook Development Corporation was itself solvent. When the uncontradicted testimony of the defendant is to the effect that he dealt only with Briarbrook Development Corporation, it is the solvency or insolvency of that entity which is in issue.”)

## B. THE PRESUMPTION OF INSOLVENCY

In preference actions, section 547(f) of the Bankruptcy Code affords the debtor a presumption that it was “insolvent on and during the 90 days immediately preceding the date of the filing of the petition.”<sup>15</sup> Thus, the statute presumes that the debtor was insolvent under the balance sheet test for purposes of non-insider preference claims. To rebut the presumption, the defendant must provide “non-speculative evidence that is sufficient to permit a court to conclude that the debtor was indeed solvent at the time of the transfer.”<sup>16</sup> If the defendant rebuts the presumption of insolvency, then the presumption “disappears completely” and the debtor or trustee “must prove insolvency as if the presumption never existed.”<sup>17</sup>

Although a debtor may (and frequently does) depict the section 547(f) presumption as a kind of impregnable fortress, in truth a defendant need only provide “some evidence . . . showing that [the debtor was] solvent at the time the challenged transfers were made. . . .”<sup>18</sup> As the legislative history makes clear:

Subsection (f) creates a presumption of insolvency for the 90 days preceding the bankruptcy case. The presumption is as defined in Rule 301 of the Federal Rules of

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(footnotes omitted)); *U.S. v. Gleneagles Inv. Co., Inc.*, 565 F. Supp. 556, 577 (M.D. Pa. 1983) (“Because the business of the Raymond Group was conducted as though the Raymond Group was a single entity and because the Defendants urged the Court not to look at the solvency of individual Raymond Group members, . . . we will deal only with the financial position of the Raymond Group as a whole and not in terms of its individual parts.”), *aff’d sub. nom.*, *U.S. v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987); *Cissell v. First Nat’l Bank of Cincinnati*, 476 F. Supp. 474, 478–82 (S.D. Ohio 1979) (rejecting defendant’s argument that court should consider solvency only of parent corporation and not of consolidated entity; evidence established that all of defendant’s officers treated parent and subsidiaries on consolidated basis during relevant time period and that parent’s method of operation was to treat subsidiaries as simply divisions of larger consolidated operation and not as separate and distinct entities). See also *American Classic Voyages Co. v. JP Morgan Chase Bank (In re American Classic Voyages Co.)*, Adv. No. 03-56998, 2007 WL 1237828, at \*1 n.5 (Bankr. D. Del. Apr. 27, 2007) (“The Court would normally be required to first identify who the transferor is, since it is that entity’s solvency which is relevant to the preference analysis.”).

15. 11 U.S.C. § 547(f) (West 2004 & Supp. 2006). No such presumption exists with respect to either fraudulent transfer claims or insider preference claims based on transfers made outside of the 90 day window. See generally 11 U.S.C. §§ 547, 548 (West 2004 & Supp. 2006).

16. See *Argus Mgmt Group v. J-Von N.A. (In re CVEO Corp.)*, 327 B.R. 724, 729 (Bankr. D. Del. 2005). See also *Hanna v. Crenshaw (In re ORBCOMM Global, L.P.)*, Nos. 00-3636, 00-3637, 00-3638, 00-3639, 00-3640, 00-3641, 00-3642, 02-1914, 2003 WL 21362192, at \*2 (Bankr. D. Del. June 13, 2003) (“The party challenging an avoidance action bears the burden of rebutting th[e] presumption by offering non-speculative evidence sufficient to permit a court to conclude that the debtor was indeed solvent at the time of the transfer.”).

17. See *Union Meeting Partners v. Lincoln Nat’l Life Ins. Co. (In re Union Meeting Partners)*, 163 B.R. 229, 239 (Bankr. E.D. Pa. 1994) (“if the party opposing the claim of a preference produces evidence to meet or rebut the presumption, then the presumption disappears completely and the burden of proving insolvency reverts to the Debtor.” (citations omitted)); *In re Tenn. Chem. Co.*, 143 B.R. at 472 (“Once the presumption of insolvency has been rebutted, the trustee must prove insolvency as if the presumption never existed.”).

18. See *In re Waccamaw’s HomePlace*, 325 B.R. at 529 (emphasis added). See also *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*6 (“A creditor may rebut the Bankruptcy Code § 547(f) presumption ‘by introducing some evidence that the debtor was not in fact insolvent at the time of the transfer. If the creditor introduces such evidence, the trustee must prove insolvency by a preponderance of the evidence.’” (citation omitted)); *In re Zeta Consumer Prods. Corp.*, 291 B.R. at 347 (“If the creditor comes forward with some evidence of solvency, the trustee or debtor-in-possession loses the benefit of the presumption and must prove the debtor’s insolvency by a preponderance of the evidence.”);

Evidence, made applicable in bankruptcy cases by Section 253 and 254 of the Bill. The presumption requires the party against whom the presumption exists to come forward with some evidence to rebut the presumption, but the burden of proof remains on the party in whose favor the presumption exists.<sup>19</sup>

Thus, the defendant need not win the “battle of the experts” to rebut the presumption; the debtor retains the ultimate burden of proving insolvency:

The effect of [the section 547(f)] presumption is merely to shift the burden of going forward with evidence, and not the burden of proof. The party against whom the presumption operates must come forward with some evidence to rebut the presumption, but the burden of proof remains on the trustee, as with the other elements of a preference, to show insolvency at the time of the transfer.<sup>20</sup>

If the presumption is rebutted, the debtor or trustee must prove insolvency by a preponderance of the evidence.<sup>21</sup>

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Payne v. Clarendon Nat'l Ins. Co. (*In re* Sunset Sales, Inc.), 220 B.R. 1005, 1017 (B.A.P. 10th Cir. 1998) (“The presumption of insolvency set forth in § 547(f) merely means that if the creditor does not produce some evidence of solvency, the trustee will prevail on the issue as to the ninety-days preceding bankruptcy.”), *aff'd*, 195 F.3d 568 (10th Cir. 1999); Grove Peacock Plaza, Ltd. v. Resolution Trust Corp. (*In re* Grove Peacock Plaza, Ltd.), 142 B.R. 506, 510 (Bankr. S.D. Fla. 1992) (“[O]nce the creditor has provided some evidence of solvency, the burden shifts to the plaintiff.”); Wolkowitz v. Am. Research Corp. (*In re* DAK Indus., Inc.), 170 F.3d 1197, 1199 n.1 (9th Cir. 1999) (“if a creditor produces some evidence that the debtor was solvent . . . the trustee bears the burden of proof with respect to the debtor’s insolvency”); *In re Bellanca Aircraft Corp.*, 56 B.R. at 384 (“Section 547(f) thereby requires the party against whom the presumption exists to come forward with some evidence to rebut the presumption.”).

19. H. REP. NO. 95-595, at 375 (1977), as reprinted in 1978 U.S.C.C.A.N. 5963, 6331. See also *In re Total Technical Servs., Inc. and TTS, Inc.*, 150 B.R. at 899 (“This section does not change the burden of proof, which remains with the debtor. Section 547(f) changes only the burden of going forward with evidence.”); 3 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 2D § 57:10, at 57-56 (2006) (“As explained in the legislative history of the [Bankruptcy] Code, [the Section 547(f)] presumption is defined in Rule 301 of the Federal Rules of Evidence. It does not relieve the trustee of the ultimate burden of proof on the issue. Rather, it merely requires that the transferee come forward with ‘some evidence’ to rebut the presumption.” (footnote omitted)); FED. R. EVID. 301 (“a presumption imposes on the party against whom it is directed the burden on going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast.”); 5 COLLIER, *supra* note 7, ¶ 547.12, at 547-128 (“This presumption of insolvency is rebuttable, and the creditor has the initial obligation to present ‘some evidence’ that the debtor was solvent at the time the transfer was made. If the creditor’s evidence sufficiently rebuts the presumption, the evidentiary burden shifts back to the trustee to affirmatively demonstrate the debtor’s insolvency.”).

20. 5 COLLIER, *supra* note 7, ¶ 547.03[5], at 547-39 (footnote omitted). See also *In re Heilig-Meyers Co.*, 328 B.R. at 477 n.1 (presumption overcome in earlier summary judgment proceedings by, among other things, financial statements showing shareholders’ equity, bankruptcy schedule showing shareholders’ equity, and statements by debtors’ senior management; insolvency not proven at trial); *In re Total Technical Servs. Inc. and TTS, Inc.*, 150 B.R. at 899 (“There is financial information of record to support Whitworth’s position that the debtors were solvent. This evidence satisfies Whitworth’s burden of going forward and therefore rebuts the presumption of § 547(f)”; court ultimately concluded that debtor was insolvent.); *In re Trans World Airlines, Inc.*, 180 B.R. 389 (presumption rebutted; insolvency proven); *In re Coated Sales, Inc.*, 144 B.R. at 666 (“Although insolvency is presumed under § 547(f), this presumption was rebutted by First Eastern on the first day of trial”; insolvency proven).

21. E.g., *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*6, \*12; *In re Zeta Consumer Prods. Corp.*, 291 B.R. at 347; *In re Trans World Airlines, Inc.*, 180 B.R. at 404.



### C. DETERMINING THE APPROPRIATE PREMISE OF VALUE

A critical issue in any solvency analysis is the threshold determination of whether the debtor's assets should be valued using a going concern premise of value or a liquidation premise of value.<sup>22</sup> "A *premise of value* is an assumption as to the set of actual or hypothetical transactional circumstances applicable to the subject valuation (e.g., going-concern or liquidation)."<sup>23</sup> The going-concern premise of value essentially is synonymous with the fair market value standard, while the liquidation premise of value is akin to a forced sale or distress value standard.<sup>24</sup>

Application of different premises of value can yield dramatically different value conclusions for the same assets.<sup>25</sup> Typically, going concern value will be higher—perhaps much higher—than liquidation value.<sup>26</sup> Among other things,

22. "A 'going concern' is a commercial enterprise actively engaging in business with the expectation of indefinite continuance." *In re Lids Corp.*, 281 B.R. at 541. See also *In re Payless Cashways, Inc.*, 290 B.R. at 702 ("A commercial enterprise is a going concern if it is actively engaged in business with the expectation of indefinite continuance."). Cf. *In re Trans World Airlines, Inc.*, 180 B.R. at 410 n.26 ("[T]he 'going concern' valuation concept can be easily confused with the 'going concern' accounting presentation of GAAP").

23. SHANNON P. PRATT, ROBERT F. REILLY & ROBERT P. SCHWEIHS, *VALUING A BUSINESS*, at 28 (4th ed. McGraw Hill Cos. 2000) (emphasis in original) [hereinafter "PRATT, REILLY & SCHWEIHS"].

24. See, e.g., *Doctors Hospital of Hyde Park, Inc. v. Desnick (In re Doctors Hospital of Hyde Park, Inc.)*, Adversary No. 02 A 00363, 2007 WL 641399, at \*63 (Bankr. N.D. Ill. Mar. 2, 2007) ("Generally, fair valuation reflects the price that a willing buyer would pay in an arm's length transaction."); *In re Winstar Comm'ns, Inc.*, 348 B.R. at 274 ("Fair valuation is generally interpreted as fair market value, that is the amount a hypothetical willing buyer would pay to a willing seller, rather than a distressed or liquidation value."); *In re CXM, Inc.*, 336 B.R. at 760–61 ("'Fair valuation' for purposes of § 101(32) is generally defined as the going concern or fair market price '[u]nless a business is on its deathbed.' Under those circumstances a liquidation value should be used to value the assets." (citation omitted)); *In re Heilig-Meyers Co.*, 328 B.R. at 477–78 ("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 Payless Cashways, Inc.*, 290 B.R. at 703 ("As a going concern a company's assets should be measured at market value rather than at distress value."); *In re WRT Energy Corp.*, 282 B.R. at 369 ("'[F]air valuation . . . means a fair market price that can be made available for payment of debts within a reasonable period of time, and 'fair market value' implies a willing seller and a willing buyer.' For purposes of a 'fair valuation,' the fair market value of the property must be measured by what the property would bring if actually sold on the market at the time of the transfer, assuming an informed, hypothetical willing seller and an informed, hypothetical willing buyer not under compulsion to buy or sell, and having a reasonable amount of time to sell the property." (citation omitted)); *Daley v. Chang (In re Joy Recovery Tech. Corp.)*, 286 B.R. 54, 77 (Bankr. N.D. Ill. 2002) ("The first step in this analysis is to determine whether valuation should be on a fair market or liquidation basis. Fair market value is defined as the value that a willing buyer would pay for the assets as a going concern."); *In re Trans World Airlines, Inc.*, 134 F.3d at 193–94 (Applying going-concern premise; "[t]he cases generally direct us to look at 'market value' rather than 'distress value,' but then also caution that the valuation must be analyzed 'in a realistic framework' considering amounts that can be realized 'in a reasonable time' assuming a 'willing seller' and a 'willing buyer.'" (citations omitted)).

25. See PRATT, REILLY & SCHWEIHS, *supra* note 23, at 33 ("the value conclusions reached under each premise, for the same business, may be dramatically different").

26. See, e.g., *In re Heilig-Meyers Co.*, 328 B.R. at 477 ("The conclusion that a debtor is a going concern or on its deathbed dictates whether to value the debtor's assets based on their liquidation value or the value they would fetch if sold over a reasonable period of time; the assumption being that a going concern could wait for a better offer and presumably a higher price. As such, there is value to being a going concern."); *In re Tenn. Chem. Co.*, 143 B.R. at 475 ("The court is making the usual assumption that going concern value is greater than forced sale, liquidation, or salvage value. Going concern value means that value is added to the property because it can be operated as a business.").

“the assets of a going concern are more valuable because the seller is not forced to sell and may take a reasonable time [to] wait for a higher offer.”<sup>27</sup> Indeed, “the overwhelming body of authority makes clear that a fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time.”<sup>28</sup> Moreover, under the going concern premise of value, it is assumed that the debtor is sold as a mass assemblage of income producing assets, which would include the value of the synergistic relationship among the debtor’s tangible and intangible assets.<sup>29</sup> Consequently, when a business is valued as a going concern, it should be valued *in its entirety*. The debtor (or its expert) cannot simply purport to add up the value of the debtor’s individual assets:

[G]oing concern valuation incorporates more than a summation of market values attributable to an entity’s various assets. It indicates the market value of an ongoing business as a whole and thereby includes an additional element of value that attaches to property, considered in the aggregate, by reason of the property having

27. *In re Heilig-Meyers Co.*, 328 B.R. at 481. See also *In re Trans World Airlines, Inc.*, 134 F.3d at 194–95 (accepting 12–18 months as a “reasonable time” to market assets; “[l]ogic and common sense inform us that the amount that can be realized from the sale of an asset varies as a function of the time period over which the asset must be sold.”); *In re Bellanca Aircraft Corp.*, 56 B.R. at 385 (“The law is substantially uniform that the mandates of fair valuation contemplate an estimate of proceeds realizable within a reasonable time frame through either collection or sale at regular market price.”); 2 COLLIER, *supra* note 7, ¶ 101.32[4], at 101-155 (“Valuation, in general, will signify the reasonable estimate of what can be realized from the assets by converting them into or reducing them to cash, under carefully guarded if not idealized conditions. . . . It is necessary to look at market value, and not distress value, to reach a fair valuation. . . . [T]he underlying policy requires disregard of, and allowances for, unavoidable sacrifices or other adverse effects caused by the particular distress of the debtor. Accordingly, ‘saleable value and fair value are not synonymous.’ In particular, the latter test ordinarily is not met by reliance on the sum which could be realized at a foreclosure, execution or receivership sale. Nor is it satisfied by equating it with the price which the debtor could obtain if he or she were forced to *instantly* dispose of the assets in question. . . . Couching the mandates of fair valuation in positive terms it can be said that they direct the estimate of what can be realized out of the assets within a reasonable time either through collection or sale at the regular market value, conceiving the latter as the amount which could be obtained for the property in question within such period by a capable and diligent effort from an interested buyer ‘who is willing to purchase under the ordinary selling conditions.’” (emphasis in original) (footnotes omitted)).

28. *In re Trans World Airlines, Inc.*, 134 F.3d at 194. Of course, what constitutes a “reasonable period of time” may vary, depending on the facts of the case. See, e.g., *In re Winstar Comm’ns, Inc.*, 348 B.R. at 274 (“the determination of what is a reasonable period of time depends on the facts of each case”); *In re Trans World Airlines, Inc.*, 134 F.3d at 195 (“We believe that the proper point of reference for determining a ‘reasonable’ time period in the case of § 101(32)(A) should begin with the financial interests of the creditors. The reasonable time should be 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. . . . In light of the size and nature of Trans World Airlines, the bankruptcy court’s determination that 12 to 18 months was a ‘reasonable time’ to value TWA’s assets is not clearly erroneous.” (citation omitted)). See also, e.g., *In re Trans World Airlines, Inc.*, 203 B.R. at 896 (“Given the ‘reasonable period of time’ requirement, fair valuation does not refer to the value of assets in either the worst or best circumstances.”); *Pioneer Home Builders, Inc. v. Int’l Bank of Commerce (In re Pioneer Home Builders, Inc.)*, 147 B.R. 889, 891–92 (Bankr. W.D. Tex. 1992) (“The law is well settled that the value of an asset under the balance sheet test is neither the asset’s value in the best case, nor is it the asset’s value in the worst case.”).

29. See *infra* note 32.

been assembled for the conduct of the business and the property's fitness for such use. This additional increment of value reflects in part, not only the business' earning power, but the ready availability of customer lists, established supply lines, and other attributes making it possible for a purchaser to step in and immediately commence operations. . . . If the business is in fact being conducted at the relevant time. . . . then its assets must be valued, not as isolated articles separated from the whole, but as parts of the whole and as useful in that relationship. Only where a business is wholly inoperative, defunct, or dead on its feet, will going concern valuation be abandoned in favor of an item by item fair market valuation."<sup>30</sup>

Accordingly, "[w]here 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 to an economic unit."<sup>31</sup> Under the liquidation premise of value, however, it is assumed that the debtor's assets are sold piecemeal and without a normal level of exposure to the market.<sup>32</sup>

Given the potentially significant consequences of applying a going concern versus a liquidation premise of value, the first skirmish in a solvency dispute may be over the appropriate premise of value.<sup>33</sup> Thus, application of the balance sheet test may involve a two step process:

In general, courts engage in a two-step process for an insolvency analysis. First, the Court must determine whether the debtor was a "going concern" or was "on its

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30. *In re Bellanca Aircraft Corp.*, 56 B.R. at 386–87 (citations omitted).

31. *In re Heilig-Meyers Co.*, 328 B.R. at 481. See also *In re DAK Indus., Inc.*, 170 F.3d at 1199 n.3 ("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. If the company was on its deathbed, i.e., only nominally extant, then the court will determine the liquidation value of the assets, such as a price expected at a foreclosure sale."). Cf. *In re Payless Cashways, Inc.*, 290 B.R. at 702 ("Both experts . . . testified that an EBITDA analysis is used to take advantage of the synergy created by a going concern. In other words, an EBITDA analysis, provided the correct multiples are used, should result in a higher valuation than an individual asset valuation.").

32. See PRATT, REILLY & SCHWEIHS, *supra* note 23, at 33 ("Value as a going concern—Value in continued use, as a mass assemblage of income producing assets, and as a going concern business enterprise. . . . Value as a forced liquidation—Value in exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of a forced liquidation; this premise contemplates that the assets of the business enterprise will be sold individually and that they will experience less than normal exposure to their appropriate secondary market."); *id.* at 314–15 ("Under [the going concern] premise, it is assumed that the subject assets are sold as a mass assemblage and as part of an income-producing business enterprise. This premise of value contemplates the mutually synergistic relationships (i.e., the value enhancement) (1) of the company's tangible assets to the intangible assets and (2) of the company's intangible assets to the tangible assets. . . . Under [the forced liquidation] premise, it is assumed that the subject assets are sold piecemeal, and not as part of a mass assemblage. It is also assumed that the assets are not allowed a normal level of exposure to their normal secondary market. Rather, the assets are permitted an abbreviated level of exposure to a market of the highest bidders present (who may or may not represent the collective demand-side marketplace for such assets), such as in an auction environment. Due to the forced liquidation market transaction assumption, this premise assumes no contributory value (or other economic interrelationships) from the subject tangible assets to the subject intangible assets, or vice versa.").

33. See, e.g., *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*6 ("In determining a 'fair valuation' of the entity's assets, an initial decision to be made is whether to value the assets on a going concern basis or a liquidation basis."); *In re Joy Recovery Tech. Corp.*, 286 B.R. at 77 ("The first step in this analysis is to determine whether valuation should be on a fair market or liquidation basis."); *In re Trans World Airlines, Inc.*, 134 F.3d at 193 ("The first question we must answer is how to

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.<sup>34</sup>

Because a debtor seeking to prove insolvency will benefit from the lower asset values typically achieved under a liquidation scenario, the debtor has an incentive to argue that the liquidation premise applies. However, the liquidation premise of value applies *only* when, on the transfer date, the debtor was in a precarious financial condition, on its deathbed and/or only nominally in existence.<sup>35</sup>

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measure properly a ‘fair valuation’ of TWA’s assets according to 11 U.S.C. § 101(32)(A).”); *Schwinn Plan Comm. v. AFS Cycle & Co., Ltd. (In re Schwinn Bicycle Co.)*, 192 B.R. 477, 486 (Bankr. N.D. Ill. 1996) (“In applying the balance sheet test, the focus is on valuation of the debtor’s assets. As a result, it is first necessary to determine the proper valuation standard that is to be applied.”); *In re Miller & Rhoads, Inc.*, 146 B.R. at 955 (“the first step in determining the insolvency issue is to determine how to value the debtor’s assets.”). See also *In re Winstar Comm’ns, Inc.*, 348 B.R. at 274 (“the Court must decide whether ‘fair value’ under the facts of this case means that the Debtor’s assets at the time of the transfer must be valued as a going concern or on some other basis, such as a liquidation sale.”); 2 COLLIER, *supra* note 7, ¶ 101.32[4], at 101-158 (“One of the most vexing problems in the valuation of the assets of a business enterprise as of a specified date is the question whether, and under what conditions, it should be treated as a going concern requiring appraisal of its property as an active unit rather than an item-by-item basis.”).

34. *Union Bank of Switzerland v. Deutsche Fin. Servs. Corp.*, No. 98 Civ. 3251(HB), 2000 WL 178278, at \*9 (S.D.N.Y. Feb. 16, 2000) (citations omitted). See also *Heilig-Meyers Co. v. Wachovia Bank, N.A. (In re Heilig-Meyers Co.)*, 319 B.R. 447, 457 (Bankr. E.D. Va. 2004) (“Although not defined by the Code, a survey of case law reveals that a determination of fair valuation requires a two-part analysis. First, the court must determine whether on the date of the subject transfer the debtors were collectively operating as a going concern or were on their deathbed. Second, the court must determine the value of the debtors’ assets using either a balance sheet test if the debtors were a going concern or a liquidation test if the debtors were on their deathbed.” (citations omitted)), *aff’d*, 328 B.R. 471 (E.D. Va. 2005); *In re WRT Energy Corp.*, 282 B.R. at 368–69 (“Courts generally conduct a two-step analysis to determine whether a debtor is insolvent under the balance sheet test. First, the court determines whether it is proper to value the debtor’s assets on a ‘going concern’ basis or a ‘liquidation’ basis. Second, the court conducts a ‘fair valuation’ and assigns a value to all the debtor’s assets and liabilities as of the date of the challenged transfer.” (citations omitted)); *In re DAK Indus., Inc.*, 170 F.3d at 1199–1200 (“Although the Code does not define ‘fair valuation,’ courts have generally engaged in a two-step process of analysis. 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. 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.” (citations omitted)).

35. See, e.g., *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*6 (“If liquidation in bankruptcy was not ‘clearly imminent’ on the transfer date, then the entity should be valued as a going concern. [A] business does not have to be thriving in order to receive a going concern valuation. Before the going concern valuation is to be abandoned, the business must be ‘wholly inoperative, defunct, or dead on its feet.’” (citation omitted)); *Sharp v. Chase Manhattan Bank USA, N.A. (In re Commercial Fin. Servs., Inc.)*, 350 B.R. 520, 544–45 (Bankr. N.D. Okla. 2005) (“Authorities indicate that the point at which an entity must be a going concern is the date of the challenged transfer. There is no requirement that a solvency analyst choose unrealistically rosy assumptions to insure that the entity continues as a going concern into perpetuity. The decision whether to assess an entity as a going concern is legally binary: if an entity is not ‘on its deathbed,’ . . . it cannot be valued using a liquidation premise, but must be valued as a going concern. . . . [I]t is not inconsistent to value an entity as a going concern even when its financial and operational data project continuing losses over a period of years to a point of its eventual demise.” (citations omitted) (footnote omitted)); *In re CXM, Inc.*, 336 B.R. at 760 (“‘Fair valuation’ for purposes of § 101(32) is generally defined as the going concern or fair market price ‘[u]nless a business is on its deathbed.’” (citation omitted)); *In re Heilig-Meyers Co.*, 319 B.R. at 457 (“This court has

Indeed, courts generally *presume* that debtors should be valued as going concerns: “Before the going concern valuation is to be abandoned, the business must be ‘wholly inoperative, defunct, or dead on its feet. . . .’”<sup>36</sup> The “going concern” threshold is low and the requirement is easily met; the fact that bankruptcy counsel had been consulted, a restructuring was necessary or the business was struggling will not necessarily demonstrate lack of a going concern.<sup>37</sup> Moreover,

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defined the condition of a debtor on its deathbed as one where the debtor is ‘in a precarious financial condition’ so that ‘liquidation was imminent when the petition was filed,’ and the debtor ‘could continue in business postpetition for only a brief period.’ Other courts described a deathbed debtor as one only ‘nominally in existence’ or ‘wholly inoperative, defunct or dead on its feet.’” (citations omitted); *In re Payless Cashways, Inc.*, 290 B.R. at 705 (“liquidation value is appropriate if, at the time of the transfer, the company is ‘so close to shutting its doors that a going concern standard is unrealistic.’” (citations omitted)); *In re WRT Energy Corp.*, 282 B.R. at 369 (“A liquidation analysis is used to determine ‘fair valuation’ of assets where the debtor is ‘financially dead or mortally wounded.’ . . . If bankruptcy was not clearly imminent on the date of the challenged transfer, the court must achieve a ‘fair valuation’ of the debtor’s assets on a ‘going concern’ basis.” (citations omitted)); *In re Lids Corp.*, 281 B.R. at 541 (“As long as liquidation in bankruptcy is not clearly imminent on the Valuation Date, the company must be valued as a going concern. . . . As of the Valuation Date, Lids planned to continue operations as usual. Therefore, it must be valued as a going concern on that date.” (citation omitted)); *In re Trans World Airlines, Inc.*, 134 F.3d at 193 (“Because liquidation in bankruptcy was not clearly imminent on the date of the challenged transfer, we concern ourselves with how to achieve a fair valuation of TWA’s assets on a ‘going concern’ basis.”); *In re Schwinn Bicycle Co.*, 192 B.R. at 486 (“‘Fair valuation’ for purposes of § 101(32) is generally defined as the going concern or fair market price ‘[u]nless a business is on its deathbed.’ When a business is in a precarious financial condition or on its financial deathbed, a liquidation value should be used to value the assets.” (citation omitted)); *In re Trans World Airlines, Inc.*, 203 B.R. at 895 (“Generally, in conducting asset valuation for insolvency determinations, the fair market value of assets is to be used, rather than a forced sale value. Forced sale or liquidation values apply where the debtor is ‘wholly inoperative, defunct, or dead on its feet.’” (citation omitted)); *In re Total Technical Servs., Inc. and TTS, Inc.*, 150 B.R. at 900 (“Services was in business at the relevant times, and thus its assets should be ascribed a going concern or fair market value.”).

36. *Fryman v. Century Factors, Factor for New Wave (In re Art Shirt Ltd., Inc.)*, 93 B.R. 333, 341 (E.D. Pa. 1988). See also *supra* note 35; *In re Joy Recovery Tech. Corp.*, 286 B.R. at 77 (“The general rule is that the fair market value should be used to value assets unless the company is on its deathbed.”); *In re Trans World Airlines, Inc.*, 134 F.3d at 193 (“The first question we must answer is how to measure properly a ‘fair valuation’ of TWA’s assets according to 11 U.S.C. § 101(32)(A). . . . The cases generally direct us to look at ‘market value’ rather than ‘distress value.’ . . .”); *In re Bellanca Aircraft Corp.*, 56 B.R. at 385 (“it is clear that liquidation value, or a distressed or forced sale price is generally not the proper standard”).

37. See, e.g., *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*7 n.12 (company was going concern even though several significant assets remained under construction and company had hired bankruptcy counsel to provide restructuring advice); *In re Heilig-Meyers Co.*, 319 B.R. at 457–58 (“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. . . . [T]he court finds that debtors were operating as a going concern on May 25, 2000. While a debt restructuring may have been necessary on that date on account of management’s liquidity concerns, there is no doubt that debtors had sufficient assets to continue operating for some period into the future.”); *In re Joy Recovery Tech Corp.*, 286 B.R. at 77 (“Though the firm was seriously weakened by the expected loss of a major account and other problems, there is no evidence that the company was facing its imminent demise when the transaction at issue occurred.”); *In re Golden Mane Acquisitions, Inc.*, 221 B.R. at 969 n.11 (Rejecting argument that debtor was on its deathbed on transfer date; “[w]hile the evidence does not suggest that the debtor was by any means flourishing financially [on the transfer date], it does indicate that the debtor was operating on that date. The fact that the debtor was renting office space and collecting rent on the date of the transfer also suggests that it had not yet given up. . . . The fact that the debtor, on the date of transfer, may have been treading water, with an eye toward selling the property for a fair market price which, in the opinion of the owner, was an amount that at least would have been sufficient to pay all

hindsight should not be used to determine the debtor's status on the transfer date.<sup>38</sup>

Defense counsel should be sensitive to the premise of value applied by a debtor's expert. If the debtor's expert relies on asset liquidation values to evaluate the solvency of a business that was a going concern on the transfer/valuation date, the expert's conclusions may be challenged on that ground.<sup>39</sup> When the debtor's

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of the debtor's creditors, does not in itself prove that the debtor was defunct as a going concern on that date."); *Jones Truck Lines, Inc. v. Full Service Leasing Corp.*, 83 F.3d 253, 258 (8th Cir. 1996) ("There was ample evidence that Jones was a going concern on April 15, 1991 despite its financial troubles. Jones continued to operate, its officers were optimistic, and its managers and lenders continued to invest in the business."); *Roeder v. Alleman (In re Davis)*, 120 B.R. 823, 826 (Bankr. W.D. Pa. 1990) (going concern standard applied even though debtor had discussed ramifications of bankruptcy with counsel); *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 B.R. 127, 131 (Bankr. D. Mass. 1989) ("Although quite weak after the closing, the Debtor was still able to continue its business operations without the aid of a bankruptcy court until the following August, and it has been operating under the umbrella of Chapter 11 since then. A going concern standard of valuation is therefore appropriate". . . ."); *In re Art Shirt*, 93 B.R. at 341 ("Normally, 'fair value' is the 'going concern' value or fair market price. . . . I emphasize [that] a business does not have to be thriving to receive going concern valuation." (citations omitted)); *In re Bellanca Aircraft Corp.*, 56 B.R. at 387 ("Despite Bellanca's increasing debt load and steadily deteriorating financial condition throughout 1979 and 1980, it is evident that until at least March 1980 the corporation was a going, though not thriving, concern. A fair valuation of its assets, therefore, must take into account whatever vestige of additional value might have inured to the business as a whole as a result of its then struggling existence."). Cf. *In re Payless Cashways, Inc.*, 290 B.R. at 705 ("the coalescence of . . . four factors—tightened credit; insufficient inventory; no DIP facility; and unavailable trade credit—put Payless to bed, and there was no realistic hope for recovery. And I find that those four factors coalesced on May 13, 2001. Until that date, Payless was a going concern." (footnote omitted)).

38. See, e.g., *In re Taxman Clothing Co.*, 905 F.2d 166, 170 (7th Cir. 1990) ("Caution should be taken not to consider the property as 'dead' merely because hindsight teaches that the debtor was traveling on the road to financial ruin."); *In re Longview Aluminum, L.L.C.*, 2005 Bankr. LEXIS 1312, at \*17-18; *In re Payless Cashways, Inc.*, 290 B.R. at 705. But see *In re Heilig Meyers Co.*, 319 B.R. at 458 ("Further evidence of debtors' operation as a going concern on May 25, 2000, is found in their ability to continue to function today, albeit under a reduced basis, over four years after having filed their petitions. A debtor's ability to continue to conduct business is evidence of its operation as a going concern. A debtor on its deathbed, by contrast, normally cannot conduct business long after making allegedly preferential transfers or filing its bankruptcy petition and is forced to liquidate." (citation omitted)); *In re DAK Indus., Inc.*, 170 F.3d at 1200 ("In this case, the bankruptcy court determined that DAK was a going concern during the preference period, relying primarily on the fact that DAK continued to conduct business under Chapter 11 protection for two and one-half years. In light of the amount of business transacted by DAK during the preference period and the years that followed, as well as DAK's ability to pay its operating expenses during the same period, this finding was not erroneous."); *Gillman v. Scientific Research Prods. Inc. of Del. (In re Mama D'Angelo, Inc.)*, 55 F.3d 552, 556 (10th Cir. 1995) ("We are mindful of the authority to the effect that fair valuation ordinarily must be made from the vantage of a going concern and that subsequent dismemberment should not enter the picture. But we 'may consider information originating subsequent to the transfer date if it tends to shed light on a fair and accurate assessment of the asset or liability as of the pertinent date.' Thus, it is not improper hindsight for a court to attribute current circumstances which may be more correctly defined as current awareness or current discovery of the existence of a previous set of circumstances. . . . Circumstances did not change between July and the November shut-down date; it simply took management a few months to 'discover' and become 'aware' of those circumstances that existed beginning in July." (citations omitted)).

39. See, e.g., *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*13 (court rejected solvency analysis of debtors' expert, who valued assets of going concern on liquidation basis); *In re Heilig-Meyers Co.*, 328 B.R. at 480 ("[T]he debtors failed to carry their burden of proving insolvency because Cleveland improperly based his valuation on liquidation values which ran counter to the requirement to treat the debtors as a going concern. The bankruptcy court properly assessed each asset's value as though

going concern status is at issue in the litigation, defense counsel also should consider whether helpful testimony can be elicited from the debtor's former senior management.<sup>40</sup>

#### D. THE VALUATION DATE REQUIREMENT

As any practitioner experienced in valuation knows, businesses or assets must be valued as of a certain date. Indeed, "[t]he date, or dates, at which the business is being valued is critically important because circumstances can cause values to vary materially from one date to another, and the valuation date directly influences data available for the valuation."<sup>41</sup> In avoidance litigation, the valuation/solvency date is the date of the transfer at issue.<sup>42</sup>

As in a business valuation, in a solvency analysis an expert only should consider information that was known or reasonably available on the valuation/solvency date:

The valuation date is the date to which the analyst's opinion of value applies. . . . The analyst should consider only the information that was known or 'knowable' as of that

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[it] was part of an operating economic unit. In sum, the fact that Heilig was a going concern added value to the company's assets that should not be ignored in determining its solvency. The bankruptcy court properly rejected any reliance on liquidation values in its analysis into the debtors' going concern value."); *In re Joy Recovery Tech. Corp.*, 286 B.R. at 77 ("the appropriate valuation method is fair market value. Therefore, the court will not credit the liquidation analysis performed by Peltz on behalf of the Trustee."); *Jones Truck Lines*, 83 F.3d at 258 ("Rather than present evidence of a negative going concern value on April 15, Jones relied on post-bankruptcy liquidation values of assets later sold by a broker. Jones also attacked its own financial statement, challenging the reported \$13,709,653 in equity because a planned conversion of debt to preferred stock never occurred, and arguing that liabilities were understated because a substantial liability contingent on Jones's withdrawal from the Teamsters Union Central States Pension Fund was not included. We are inclined to agree with FSLC that Jones's evidence on this issue was contrary to the principles of going concern valuation.").

40. See, e.g., *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*7 (court relied on deposition testimony of debtors' former senior officers, as well as contemporaneous documents, in determining that debtors were operating as going concerns on transfer date); *In re Heilig Meyers Co.*, 319 B.R. at 473 (testimony of debtors' employees was "useful to the determination of whether debtors should have been valued on a deathbed basis or as a going concern"); *In re Payless Cashways, Inc.*, 290 B.R. at 697-98 ("I found that Defendants had made a prima facie case that Payless was a going concern for all or part of the preference period [March 6-June 4, 2001]. Defendants presented evidence that Payless was open and doing business at all times prior to the bankruptcy filing. Mr. Witaszak testified, on behalf of management, that management believed its business plan was working and sales would improve."); *id.* at 703 ("Silverman relies on the facts that Payless' management missed projections for all of 2001 and that Payless was forced to liquidate within three months of its bankruptcy filing as proof that Payless was on its 'deathbed' during the preference period. Those are relevant facts, but they are not sole determinants of solvency. It is undisputed that Payless continued to operate throughout the preference period. Moreover, both Edward Zimmerlin, Payless' former Senior Vice President of Marketing and Merchandising, and Richard Witaszak, testified that they believed the company would be successful, and that they both bought stock in the company."); *Jones Truck Lines*, 83 F.3d at 258 ("There was ample evidence that Jones was a going concern on April 15, 1991, despite its financial troubles. Jones continued to operate, its officers were optimistic, and its managers and lenders continued to invest in the business.").

41. PRATT, REILLY & SCHWEIHS, *supra* note 23, at 26.

42. See, e.g., *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*1 n.3 ("To meet the elements of Bankruptcy Code § 547(b), the solvency of the debtor must be determined as of the date

time and nothing else. This is true even if the analyst knows that events that transpired since then would have a material impact on the value."<sup>43</sup>

The rationale for the valuation date requirement is simple and logical: "the purpose of determining solvency on the transfer date is to avoid valuing assets based on the intervening bankruptcy. . . . [B]ecause the sale is hypothetical, it must be based on the conditions at the time of the transfer and not at the time of bankruptcy."<sup>44</sup>

An important consequence of the valuation date requirement is that it generally precludes consideration of post-petition data when evaluating the pre-petition solvency of a going concern.<sup>45</sup> Thus, where a going concern premise of value

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of the transfer."); *In re WRT Energy Corp.*, 282 B.R. at 368 ("The relevant solvency valuation date for avoidance purposes is the date of the challenged transfer."); *In re Tri-Star Techs. Co.*, 260 B.R. at 325 ("this Court's focus should be on the state of the Debtor's solvency when the Debtor actually transferred value."); *In re Golden Mane Acquisitions, Inc.*, 221 B.R. at 967 ("Most courts agree that for purposes of section 547(b)(3), the solvency of a transfer[or] is to be determined as of the time of the transfer." (footnote omitted)); *In re R.M.L., Inc.*, 92 F.3d at 154 ("For purposes of § 548, solvency is measured at the time the debtor transferred value, not at some later or earlier time."); *In re Davis*, 120 B.R. at 825 ("The determination of insolvency is to be made at the time when the alleged preferential transfer occurred and not when the petition is filed. Evidence of insolvency on the date of the transfer is the critical issue and proof of insolvency on any other date is insufficient to prove this element."); 3 NORTON, *supra* note 20, § 57:10, at 57-58 ("the testing period for insolvency is at the time of the transfer").

43. REILLY & SCHWEIHS, *supra* note 12, at 251. See also *supra* note 42; *In re Commercial Fin. Servs., Inc.*, 350 B.R. at 541 ("For the purpose of a solvency analysis, . . . assets and liabilities must be valued based upon information known or knowable as of the date of the challenged transfer." (emphasis in original) (citations omitted)); *In re WRT Energy Corp.*, 282 B.R. at 407 ("Solvency valuations, including those undertaken by experts, generally must be based on conditions and standards as they existed at the time of the transaction at issue, not on hindsight.")

44. *In re Trans World Airlines, Inc.*, 203 B.R. at 896.

45. See, e.g., *In re Heilig-Meyers Co.*, 328 B.R. at 481 ("Throughout Judge Tice's opinion, the consistent approach is for the court to reject any value that takes into account post-petition events as one would expect when valuing the assets of a going concern."); *id.* at 483 ("Reliance on post-petition effects on the value of the debtors' assets and liabilities would run contrary to the legal precepts applicable in a going concern analysis."); *In re WRT Energy Corp.*, 282 B.R. at 407 ("[A] 'debtor's assets must be valued at the time of the relevant valuation . . . and not what the assets turn out to be worth at some later time after the intervening bankruptcy.'" (ellipses in original) (citation omitted)); *In re R.M.L., Inc.*, 92 F.3d at 155 ("The use of hindsight to evaluate a debtor's financial condition for purposes of the Code's 'insolvency' element has been criticized by courts and commentators alike."); *In re Total Technical Servs., Inc. and TTS, Inc.*, 150 B.R. at 900 ("Fair value is based upon information available to the parties during the preferential time period, and not upon information that only became available after the filing of the bankruptcy petition."); *In re Davis*, 120 B.R. at 825 ("The assets must be valued at what they are reasonably worth at the time of the allegedly preferential transfers and not what they turned out to be worth at some time after the bankruptcy intervened."); *In re Energy Coop., Inc.*, 109 B.R. at 824 ("In applying the balance sheet test, 'assets must be valued at what they are reasonably worth (at the time of the allegedly preferential transfers) and not at what they turned out to be worth at some time after the bankruptcy intervened.' . . . [C]ase law precludes hindsight, perfect though that vision may be, so the inquiry as to value needs greater analysis." (citation omitted)); *Roelmeyer v. Heller & Co. (In re Lackow Bros., Inc.)*, 752 F.2d 1529, 1532 (11th Cir. 1985) ("The fact that Creditor sold Debtor's collateral for 1.2 million dollars six months after the Chapter 11 petition was filed does not shed much light on what the collateral was worth nine months earlier on the ninetieth day before filing of bankruptcy. . . ." (emphasis in original)). Cf. *In re Coated Sales, Inc.*, 144 B.R. at 674 n.27 ("It is beyond peradventure that the filing for bankruptcy protection often affects the collectibility of receivables. . . ."); *In re Exide Techs.*, 303 B.R. 48, 66 (Bankr. D. Del. 2003) ("The stated purpose for Newman's numerous adjustments to the valuation methodologies were to bring value calculations in line with current market value. This is not appropriate when seeking to value securities of a reorganized debtor since the 'taint' of bankruptcy will cause the market to undervalue the securities and future earning capacity of the Debtor.")



applies, post-petition asset sales typically should *not* be used as evidence of the value of the debtor's assets.<sup>46</sup> Additionally, the fair value of a debtor's assets should be determined based on market conditions as they existed on the transfer date, not on some later date.<sup>47</sup> However, a court properly may consider information that was *knowable* on the valuation date—such as fraud or errors in the debtor's internal records—even if that information generally was not *known* at the time.<sup>48</sup> Of course, the difficulty may lie in ascertaining precisely where to draw the line between what information was and was not knowable. Courts have not been entirely consistent or clear in that regard, as some courts appear to employ hindsight and to rely on information that may not have been knowable on the valuation date.<sup>49</sup>

46. See *supra* note 45. See also *In re Heilig-Meyers Co.*, 328 B.R. at 480 (“[T]he debtors failed to carry their burden of proving insolvency because [their expert] improperly based his valuation on liquidation values [post petition sale transactions] which ran counter to the requirement to treat the debtors as a going concern. The bankruptcy court properly assessed each asset’s value as though [it] was part of an operating economic unit. In sum, the fact that Heilig was a going concern added value to the company’s assets that should not be ignored in determining its solvency.”). *But see infra* notes 49–50 and accompanying text.

47. See, e.g., *In re WRT Energy Corp.*, 282 B.R. at 407 (“Solvency valuations, including those undertaken by experts, generally must be based on conditions and standards as they existed at the time of the transaction at issue, not on hindsight.” (citations omitted)); REILLY & SCHWEIHS, *supra* note 12, at 29 (“The concept of fair market value also assumes prevalent economic and market conditions at the date of the particular valuation.”).

48. See, e.g., *In re Coated Sales, Inc.*, 144 B.R. at 668 (“[A] company’s assets must be valued at the time of the alleged transfer and not at what they turned out to be worth at some time after the bankruptcy intervened. . . . Nonetheless, the Court may consider information ‘originating subsequent to the transfer date if it tends to shed light on a fair and accurate assessment of the asset or liability as of the pertinent date (transfer date).’ This assures that the valuation is based in reality. . . . Thus, it is not improper hindsight for a court to attribute ‘current circumstances’ which may be more correctly defined as ‘current awareness’ or ‘current discovery’ of the existence of a previous set of circumstances. The finding of false accounts receivable, nonexistent inventory and illegal transfers must be taken into account in accurately determining CSI’s financial condition at the transfer date.” (citations omitted)); *Chem. Separations Corp. v. Rohm and Haas Co.* (*In re Chem. Separations Corp.*), 38 B.R. 890, 895–96 (Bankr. E.D. Tenn. 1984) (“the court may properly consider the existence of subsequently apparent estimating errors which caused the accrued costs on contracts and construction in progress to be inaccurately reflected at the time in question. . . . In the instant case the Price Waterhouse adjustments to the accrued costs on contracts and construction in progress were made to correct errors on the debtor’s internal records showing certain contracts as completed which were, in fact, not completed. The picture presented by the debtor’s internal records was not, then, an accurate portrayal of this item as of the dates of the transfers. Rather than reflecting any subsequent substantial or radical changes in the liability, the adjustments actually serve only to correct errors existing at the time of the transfers and to realistically portray the correct status of the liability.”).

49. See, e.g., *In re Winstar Comm’ns, Inc.*, 348 B.R. at 277 (Court permitted trustee’s expert to rely on sale of substantially all of debtor’s assets approximately one year after valuation date; “Lucent criticizes any reliance upon the actual sale price ultimately paid for Winstar’s assets during its bankruptcy. It argues this number represents a distress sale and a price significantly less than Winstar’s value on December 7, 2000. The sale price, although not the only or even the primary fact upon which Scherf’s valuation is based, is relevant. Contrary to Lucent’s characterization of the sale of Winstar’s assets, the sale was not an auction but rather as a going concern.”); *In re CXM, Inc.*, 336 B.R. at 761 (although court did not identify premise of value, court relied on section 363 asset sale; “The sale of substantially all of the Debtor’s assets shortly after the filing of a 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 solvency or lack thereof.”); *In re Golden Mane Acquisitions, Inc.* 221 B.R. at 971 & n.16 (“The opponents argue that the

Courts that rely upon subsequent data to prove insolvency may be employing (expressly or implicitly) the theory of retrojection, “whereby a trustee may meet his burden of proof on the issue of insolvency by showing that the debtor was insolvent at a reasonable time subsequent to the alleged transfer, accompanied by proof that the debtor’s financial situation did not change materially, during the intervening period.”<sup>50</sup>

The valuation date requirement limits the debtor’s ability to rely on post-petition asset sales—which almost never involve a true willing seller under no compulsion to sell—to attempt to establish the debtor’s insolvency.<sup>51</sup> Such sales also rarely

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best evidence of value of the real estate is the price obtained approximately seven months after the bankruptcy filing. Most courts would agree that evidence of such a sale is not only competent evidence in section 547(b)(3) considerations but is also pertinent evidence. For that reason the Court has considered that evidence and weighed it against the opposing evidence. ‘The admission in evidence of the price brought at the trustee’s sale lends probative force to the asset evaluation and is competent evidence to establish insolvency.’” (citations omitted); *In re R.M.L., Inc.*, 187 B.R. at 463 (“I accepted the Committee’s evidence which indicated that, pursuant to GAAS and GAAP, the subsequent events surrounding the collapse of the proposed Intershoe/Mellon [sic] should be treated as evidence of Intershoe’s financial condition as of August 31, 1991. Although events which drastically and unexpectedly change a company’s actual financial condition (such as a fire or other disaster) would not be the type of subsequent event that should evidence a company’s prior financial condition, I agreed with the testimony of the Committee’s experts that the failure of the proposed Mellon/Intershoe transaction is exactly the type of event that should be viewed as evidence of the Company’s prior financial condition.”); *id.* at 464 (“courts have concluded that subsequent events, such as actual collection rates for receivables, that may not technically be cognizable under GAAP and GAAS, may be considered by the bankruptcy judge in insolvency determinations. . . . Here the actual rate of realization on Intershoe’s assets are dwarfed by its liabilities. Although I acknowledge the ‘hindsight’ nature of this consideration, it merely buttresses the Committee’s already-sufficient evidence as to Intershoe’s then-present value.”); *Moody*, 971 F.2d at 1069 (“We find the \$5.65 million Jeannette received for PP&E in liquidating its divisions and subsidiaries particularly probative of the going concern value of Jeannette’s PP&E on July 31, 1981 because these components were sold as going concerns on something approaching a liquidation basis.”); *In re Tenn. Chem. Co.*, 143 B.R. at 476 (“Shell argues that the sale price of the manufacturing property in March, 1990 cannot be relevant to its value in March, 1989. The court does not agree. The value of the manufacturing property may have changed during the year before the sale. But this does not prevent the sale price from being evidence of the value one year earlier. It only means that the Court must consider events during the year to determine whether the sale price is good evidence of the property’s value at the year’s beginning.”); *In re Chem. Separations Corp.*, 38 B.R. at 895–96 (“Clearly, in evaluating assets such as accounts receivable, the courts assess the validity and collectibility of the accounts as of the critical date, yet may rely on hindsight gained from the success or failure of subsequent efforts to collect the accounts. . . . Certainly, the insolvency of the debtor must be determined as of the dates of the transfers and, in making that determination, both the worth of assets and the extent of liabilities must be evaluated at what they were at the time of the transfers and not at what they turned out to be after the intervention of bankruptcy. However, the court may consider information originating subsequent to the transfer date if it tends to shed light on a fair and accurate assessment of the asset or liability as of the pertinent date.”).

50. *In re Winstar Communications, Inc.*, 348 B.R. at 276 (citation omitted). See also *In re Coated Sales, Inc.*, 144 B.R. at 666 (“The courts have recognized . . . the difficulty in valuing the assets and liabilities of a debtor on the exact date of a preferential transfer. Thus, courts often utilize the well-established bankruptcy principles of ‘retrojection’ and ‘projection,’ which provide for the use of evidence of insolvency on a date before and after the preference date as competent evidence of the debtor’s insolvency on the preference date.” (citations omitted)); *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*8 n.16 (Although expert’s valuation date was two weeks prior to transfer date, court relied on expert’s conclusions because “there was no evidence of any material change in the Debtor’s financial condition between [the valuation date] and the Transfer Date . . .”).

51. See e.g., *In re Tenn. Chem. Co.*, 143 B.R. at 478 (“The court will assume that the Chapter 11 itself caused a drop in the value of the business. Likewise, the continued operating losses probably caused

provide for a market exposure period consistent with the fair market value standard.<sup>52</sup> A debtor may attempt to circumvent the valuation date requirement by arguing that post-valuation date information (including post-petition asset sales) should be considered because data that emerges during the hypothetical market exposure period, supposedly commencing on (and therefore extending after) the valuation date, is known and available. Any such argument should be rejected, however, because the valuation date is at the *end* of the hypothetical market exposure period, not at the beginning.<sup>53</sup> If a debtor's expert relies on post-petition asset sales (or other post-petition data) for purposes of evaluating the solvency of a going concern, the expert's conclusions may be challenged on that ground.<sup>54</sup>

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a drop in the value of the business. You can add the mounting bankruptcy costs as a reason for a drop in the value of the business. Potential buyers were likely to think that the bankruptcy trustee had to sell the business or shut it down. In light of these facts, the trustee's sale price for the manufacturing property may have been close to liquidation or forced sale value.”)

52. See *supra* note 32 and accompanying text.

53. See, e.g., *In re Trans World Airlines, Inc.*, 203 B.R. at 896 (“[T]he requirement that a solvency determination be made on the date of transfer must be reconciled with the fair market value requirement of a sale over a reasonable period of time. While it is generally accepted that assets must be valued at the time of the transfer, few courts have examined the purpose underlying this requirement. From a review of the case law on this point, it appears the purpose of determining solvency on the transfer date is to avoid valuing assets based on the intervening bankruptcy. Therefore, reconciling these points requires that the hypothetical sale over a reasonable period of time take into account the debtor's situation on the date of the transfer, and not the debtor's situation during the ensuing period of bankruptcy. Thus, while a 12 to 18 month time frame would realistically place the sale in the period of bankruptcy, because the sale is hypothetical, it must be based on the conditions at the time of transfer and not at the time of bankruptcy, as it would if one was realistically counting the 12 to 18 months. . . .”); REILLY & SCHWEIHS, *supra* note 12, at 252 (“This concept of time may appear to be at odds with some important valuation concepts . . . that assume adequate exposure in the market place. The temptation here is to allow consideration of information that may have become available within the exposure time appropriate to the subject property type after the valuation date. However, that is not the corollary to the definition. The valuation date is at the end of the appropriate market exposure period, not at the beginning.”). See also *In re WRT Energy Corp.*, 282 B.R. at 369 (“For purposes of a ‘fair valuation,’ the fair market value of the property must be measured by what the property would bring if actually sold on the market *at the time of the transfer*, assuming an informed, hypothetical willing seller and an informed, hypothetical willing buyer not under compulsion to buy or sell, and *having a reasonable amount of time to sell the property.*” (emphasis added)).

54. See, e.g., *In re Heilig-Meyers Co.*, 328 B.R. at 480 (“[T]he debtors failed to carry their burden of proving insolvency because [their expert] improperly based his valuation on liquidation values [post-petition sale transactions] which ran counter to the requirement to treat the debtors as a going concern.”); *In re Longview Aluminum, L.L.C.*, 2005 Bankr. LEXIS 1312, at \*20–21 (Court rejected trustee's expert's conclusion that aluminum smelter had no going concern value, even though smelter was closed on valuation date and never did reopen; on valuation date debtor's principals reasonably believed that smelter would reopen and become profitable); *In re Advanced Telecomm. Network, Inc.*, 321 B.R. at 333–36 (court rejected debtor's expert's inclusion of large liability based on consent judgment agreed to 10 months after valuation date); *In re WRT Energy Corp.*, 282 B.R. at 383 (“With the benefit of perfect hindsight, . . . [the Trust's expert] uses the unexpected failure of the Lac Blanc well in the fall of 1995 to write the CGC Notes off months earlier. Such use of hindsight is inappropriate in determining value of assets at a particular point in time.” (footnote omitted)); *Union Bank of Switzerland*, 2000 WL 178278, at \*10 (“The flaw in Hazelcorn's analysis is his reliance on information that was available *after* March 27, 1997 to conclude that Ward was insolvent as of that date. By improperly using this information, he created two critical adjustments in his valuation of Ward's assets and liabilities. . . . A debtor's assets must be valued at the time of the relevant valuation—here, as of March 27, 1997—and not at what the assets turned out to be worth at some time after the intervening bankruptcy.” (emphasis in original)).

Courts applying the *liquidation* premise of value, however, frequently do not adhere to the valuation date requirement and value the debtor's assets based on post-bankruptcy asset sales.<sup>55</sup> While the theoretical propriety of using information that was not available on the transfer date is debatable, the practice appears well established in the case law when the liquidation premise applies.

### E. VALUING THE ASSETS OF A GOING CONCERN

"To decide whether a firm is insolvent . . . , a court should ask: What would a buyer be willing to pay for the debtor's entire package of assets and liabilities? If the price is positive, the firm is solvent, if negative, insolvent."<sup>56</sup> While technically true, this observation understates the complexities involved in the valuation analysis. Although a detailed analysis of asset valuation is beyond the scope of this article—indeed, the subject could fill (and has filled) many texts—several recurring issues deserve mention.

First, courts generally will consider any recognized valuation methodology for purposes of valuing a debtor's assets. Depending on the facts of the case, this may include the income approach (such as discounted cash flow or capitalization of earnings), the market approach (such as comparable companies or comparable transactions) and/or the asset approach (which may include meaningful purchase offers or replacement costs).<sup>57</sup> Of course, defense counsel generally should steer

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55. See, e.g., *In re Heilig-Meyers Co.*, 319 B.R. at 457 ("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 Sunset Sales, Inc.*, 220 B.R. at 1016-17 (where debtor was on deathbed, court considered post-petition asset dispositions and amounts actually collected on accounts receivable); *In re Schwinn Bicycle Co.*, 192 B.R. at 489 (liquidation premise applied; "[t]he 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.* at 485 ("The best evidence as to value of Schwinn's assets in this case is the value obtained for the assets when they were actually marketed and sold during the bankruptcy, shortly after the petition for relief was filed.")

56. *In re Trans World Airlines, Inc.*, 180 B.R. at 411 n.28.

57. See, e.g., *In re Nellson Nutraceutical, Inc.*, 356 B.R. 364, 370 (Bankr. D. Del. 2006) ("There are three valuation methodologies utilized under standard valuation practice. Although the terms used to describe the methods vary, the methodologies themselves are standard. They are: (i) a discounted cash flow analysis or 'DCF'; (ii) a precedent transaction or comparable transaction analysis; and (iii) a publicly traded company or comparable company analysis."); *In re Commercial Fin. Servs., Inc.*, 350 B.R. at 535 ("there is no single method for assessing solvency or assigning a value to assets and liabilities for the purpose of determining solvency"); *In re Winstar Comm'ns, Inc.*, 348 B.R. at 274 ("There are three standard approaches to determine the fair value of assets: the market approach, the income approach and the asset approach. Although experts generally consider each of these approaches, not all of the approaches are appropriate or helpful in determining the proper measure of valuation. Indeed valuation, although employing broad principles of economics, is as much an art as it is a science. Each approach may yield a different result and which approach offers the best or better framework is a determination made in light of the facts of a case."); *In re Lids Corp.*, 281 B.R. at 540 ("Several different valuation methodologies are recognized as effective ways of determining the solvency of a company for purposes of section 547"; court considered adjusted balance sheet, market multiple, and comparable transaction); *In re Coated Sales, Inc.*, 144 B.R. at 670 ("Although a sale is fundamentally the best evidence of a property's value, a firm commitment to buy at a certain price is also considered probative."); ZUKIN, *supra*

their experts away from novel valuation theories and should consider a *Daubert/Kumho Tire*<sup>58</sup> challenge if the debtor's expert relies on unrecognized valuation methodologies or applies recognized methodologies inappropriately.<sup>59</sup> Regardless of the methodologies employed, "[t]he valuation of a company's assets is generally completed on a debt-free basis (without regard to capital structure)."<sup>60</sup>

Second, at least some courts have expressed a preference for the income approach.<sup>61</sup> "The income approach estimates the value of a company based on its earnings capacity."<sup>62</sup> The income approach may be particularly useful when the debtor was engaged in an expansion plan on the transfer date, as the value of the plan may be reflected in the debtor's projections.<sup>63</sup>

Third, experts frequently employ at least one valuation methodology that relies on projections of the debtor's future financial performance. As a result, solvency

note 12, ¶ 13.2[2][a], at 13-8 (discussing, *inter alia*, public company approach (including application of control premium) and discounted cash flow approach). *See also In re Commercial Fin. Servs., Inc.*, 350 B.R. at 529 n.3 ("in valuing assets and debts for the purpose of determining solvency, a court may adopt all, some or none of the discrete components of either party's expert's analysis, making findings as appropriate based upon the evidentiary foundation presented"). *But see In re Heilig-Meyers Co.*, 319 B.R. at 463 ("Very few courts have relied upon market or transaction multiple methodologies in determining whether a debtor was insolvent on the date of an alleged preferential transfer."); *In re Payless Cashways, Inc.*, 290 B.R. at 699 (rejecting comparable company approach); *In re Trans World Airlines, Inc.*, 180 B.R. at 417 ("Reliance on the replacement cost method for valuing aged limited use improved real estate is, as a general proposition, risky."); *In re Total Technical Servs., Inc. and TTS, Inc.*, 150 B.R. at 903 (purchase offer afforded minimal weight where no evidence was presented concerning details of offer).

58. *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993); *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (1999).

59. *See, e.g., In re Nellson Nutraceutical, Inc.*, 356 B.R. at 364 (excluding opinion of debtor's expert concerning debtor's enterprise value where expert used unprecedented methodology to determine terminal value under DCF analysis); *Chartwell Litig. Trust v. Addus Healthcare, Inc. (In re Med Diversified, Inc.)*, 346 B.R. 621, 626 (Bankr. E.D.N.Y. 2006) (granting defendants' motion *in limine* and excluding trustee's expert's testimony and report; "the deliberate, manifest, pervasive and systematic bias on Cimasi's part in applying the standard methodologies for estimating the total enterprise value of Addus warrants disqualifying him and his report on the principal ground of unreliability."); *Chartwell Litig. Trust v. Addus Healthcare, Inc. (In re Med Diversified, Inc.)*, 334 B.R. 89, 102-03 (Bankr. E.D.N.Y. 2005) (in fraudulent transfer action, rejecting as unreliable defendants' expert's use of "Black-Scholes Method" to value option to purchase 100% of shares of privately held company).

60. ZUKIN, *supra* note 12, ¶ 13.2[2][a], at 13-8.

61. *See, e.g., In re Med Diversified, Inc.*, 334 B.R. at 98 ("the leading authorities on business valuation ... recognize that the most reliable method for determining the value of a business is the Discounted Cash Flow ('DCF') method."); *In re Longview Aluminum, L.L.C.*, 2005 Bankr. LEXIS 1312, at \*18 ("The preferred method of valuing a business as a going concern is by performing a discounted cash flow analysis."); Lippe v. Bairnco Corp., 288 B.R. 678, 689 (S.D.N.Y. 2003) ("Many authorities recognize that the most reliable method for determining the value of a business is the discounted cash flow ('DCF') method."); *aff'd*, 99 Fed. Appx. 274 (2d Cir. 2004). *See also* REILLY & SCHWEIHS, *supra* note 12, at 154 ("regardless of what valuation approach is used, in order for it to make rational economic sense from a financial point of view, the results should be compatible with what would result if a well-supported discounted economic income analysis were carried out."); *id.* at 235 ("Going concern value tends to be based largely—and sometimes entirely—on income and cash flow analyses. Liquidation value often involves an analysis of individual asset values, so the emphasis is on balance sheet items....").

62. *In re Winstar Comm'n's, Inc.*, 348 B.R. at 278.

63. *See, e.g., Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 315 n.51 (Del. Ch. 2006) ("When the court determines that the company's business plan as of the [valuation date] included specific expansion plans or changes in strategy, those are corporate opportunities that must be considered part of the firm's value.").

disputes can involve a mini-battle over the reasonableness of the debtor's prior management's contemporaneous projections. While a debtor attempting to prove insolvency may have an incentive to denigrate those projections, at least some courts entertain a *de facto* presumption as to the reasonableness of management projections.<sup>64</sup> Indeed, a court may view with skepticism a debtor's litigation-driven effort to disparage its prior projections, especially when those projections had been provided to third parties:

Traditionally, this court has given great weight to projections of this kind because they usually reflect the best judgment of management, unbiased by litigation incentives. That is especially so when management provides estimates to a financing source and is expected by that source (and sometimes by positive law) to provide a reasonable best estimate of future results. Therefore, we have regarded with rightful suspicion attempts by parties who produced such projections to later disclaim their reliability, when that denial serves their litigation objective.<sup>65</sup>

Of course, the simple fact that projections were prepared contemporaneously by management does not necessarily mean that those projections are reasonable, and where a court concludes that the projections underlying an expert's analysis

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64. See, e.g., *In re Longview Aluminum, L.L.C.*, 2005 Bankr. LEXIS 1312, at \*24 ("Myhran's analysis of projected market rates is simply not supported by evidence sufficient to rebut the reasonableness of management's projections."); *id.* at \*27 ("Without a firm basis to replace management's cost projections with [the trustee's expert's], it is not possible to accept [the trustee's expert's] opinion. . . ."); *Cede & Co. v. JRC Acquisition Corp.*, No. Civ. A. 18648-NC, 2004 WL 286963, at \*2 (Del. Ch. Feb. 10, 2004) ("this Court prefers valuations based on management projections available as of the date of the merger and holds a healthy skepticism for post-merger adjustments to management projections or the creation of new projections entirely. Expert valuations that disregard contemporaneous management projections are sometimes completely discounted."); *Gray v. Cytokine Pharmaceuticals, Inc.*, No. Civ. A. 17451, 2002 WL 853549, at \*8 (Del. Ch. Apr. 25, 2002) ("In preparing his DCF analysis, Penny completely disregarded the cash flow projections that were prepared by PSI's management and relied on by Merrill Lynch. Instead, Penny made his own projections. . . . I cannot accept that Penny, with his limited experience with the Company, was better equipped to make future financial projections than PSI's management. Consequently, I find Penny's litigation-driven projections to be unreliable and, thus, disregard his DCF analysis."). See also *VFB LLC*, 2007 WL 942360, at \*6 ("True, earnings projections 'must be tested by an objective standard anchored in [a] company's actual performance,' but such a test applies to information about a company's performance available 'when [the projection is] made.' . . . A company's actual subsequent performance is something to consider when determining *ex post* the reasonableness of a valuation, but it is not, by definition, the basis of a substitute benchmark." (brackets in original) (citations omitted)); *In re Key3Media Group, Inc.*, 336 B.R. 87, 95-96 (Bankr. D. Del. 2005) (On motion to approve settlement, evaluating objector's argument that debtor did not receive reasonably equivalent value in prior acquisition transaction; "[t]he fact that EBITDA fell well short of projections, however, does not show that the forecasts made at the time of the purchase were unreasonable, especially when the subject assets were directly affected by unforeseen incidents, such as the terrorist attacks of September 11, 2001 or the economic woes which befell the internet industry. Predicting the operating performance of the Pulver assets was an exercise of the business judgment of the Debtors. Even a Debtor exercising the most cautious judgment, however, could not have been expected to foresee the occurrence of such events at the time of purchase, and then to incorporate the effects of those events in the valuation of the Pulver assets. The Debtors, therefore, would be faced with a difficult burden of showing that it was unreasonable assumptions, and not the effect of these catastrophic events, that led them to overvalue the Pulver assets." (citations omitted)), *aff'd*, No. 05-828-SLR, 2006 WL 2842462 (D. Del. Oct. 2, 2006); *infra* note 67.

65. *Del. Open MRI Radiology Assocs., P.A.*, 898 A.2d at 332 (footnotes omitted). See also *supra* note 64.

are of doubtful reliability, the court may reject the expert's analysis.<sup>66</sup> When the reasonableness of the debtor's contemporaneous projections is at issue, defense counsel should consider whether helpful testimony can be elicited from the debtor's former senior management or other knowledgeable persons.<sup>67</sup>

## F. APPROPRIATE TREATMENT OF LIABILITIES

Courts generally use the face value of debt, rather than any publicly traded market value or some other value.<sup>68</sup> Originally, the justification for using face

66. See, e.g., *In re Winstar Comm'ns, Inc.*, 348 B.R. at 278 (rejecting management's 10 year projections as "speculative at best."); *In re Heilig-Meyers Co.*, 319 B.R. at 463 (court rejected expert's DCF analysis because underlying projections were "of doubtful reliability"); *In re Lids Corp.*, 281 B.R. at 544 (rejecting comparable company analysis; "[w]e also find that Houlihan has improperly relied on Lids' projections to calculate value. Over the last few years, Lids has consistently failed to meet its projections; in 2000 alone, Lids' budget was revised three times to account for poor performance. Despite these revisions, Lids still missed its projections for 2000. Furthermore, the Houlihan Report assumed that after October 31, 2000, when Lids EBITDA was negative \$6,299,000, the company would nonetheless turn around. Houlihan relied on Lids' projections that at FYE January 27, 2001, its EBITDA would increase to negative \$3,456,000, and that at FYE January 26, 2002, its EBITDA would be positive \$5,513,000. There is no evidence to support the assumption that such a dramatic change would occur. Therefore, any conclusions based on these projections are unconvincing."); *In re Tenn. Chem. Co.*, 143 B.R. at 475-76 (court was skeptical about forecast that showed debtor making fast turnaround and which had been prepared in connection with possible sale of business to ESOP; "[c]onsidering the purpose of the forecast and how it was formulated, the court doubts the accuracy of its predictions. In any event, it was only a prediction based on events that might or might not happen. It does not detract from the court's conclusion that Tennessee Chemical's going concern value may not have been more than its liquidation value in early 1989."); *Murphy v. Meritor Savings Bank (In re O'Day Corp.)*, 126 B.R. 370, 405-07 (Bankr. D. Mass. 1991) (rejecting use of contemporaneous projections for purpose of evaluating adequacy of capital; "[t]he Trustee contends that the projections generated by Funston and Jones were 'woefully deficient' because they failed to properly consider O'Day's historical data, as well as its most recent financial trends. . . . [T]he court is persuaded that the projections generated by Jones and Funston were totally inconsistent with the historical figures . . . as well as the fiscal 1987 data. . . . [T]he projections employed by Funston and O'Day were imprudent. . . . [T]he Court concludes that O'Day was left with unreasonably small capital.").

67. See, e.g., *In re American Classic Voyages Co.*, 2007 WL 1237828, at \*10-11 (court relied on deposition testimony of debtors' former senior officers, as well as contemporaneous documents, in determining that debtors' contemporaneous "projections were reasonable when prepared"); *In re WRT Energy Corp.*, 282 B.R. at 412-13 (for purposes of adequacy of capital analysis, accepting contemporaneous projections and rejecting Trust's expert's projections prepared for litigation; "[i]n the case at bar, the court is faced with two separate types of projections. On the one hand, the court has projections as to WRT's anticipated performance and capital needs prepared by WRT itself, its secured lenders and underwriters, which projections were the basis for decision-making on the most important transactions in the company's history. On the other hand, the court has the calculations of Mr. Spilker, performed in anticipation of trial. . . . [A]ll of the professionals whose investment decisions were tied to a realistic view of the company prepared projections of its performance, evaluated the company's resources and endorsed WRT's ability to sustain its operations and become profitable. That endorsement was in the form of loans to and investment in WRT totaling over \$130 million."). See also *infra* note 85. Cf. *In re Coram Healthcare Corp.*, 315 B.R. 321, 340 (Bankr. D. Del. 2004) (confirming trustee's plan over competing plan submitted by equity; "[t]he Equity Committee's assertions that management's projections are flawed because they are inconsistent with historical and industry experience is inaccurate. We accept as credible the testimony of the Debtors' representatives who described in detail the process of preparing and vetting the projections.").

68. See, e.g., *In re Trans World Airlines, Inc.*, 134 F.3d at 196-97 ("We agree with TWA that we must consider the face value of TWA's publicly traded debt rather than the market value."); *In re Lids Corp.*,

value appeared to rest on the conclusion that the debtor was a going concern: "Because we treat [the debtor] as a going concern, we cannot consider the market's devaluation of [the debtor's] debt resulting from the possibility as of the date of the transfer that [the debtor] would cease operations and be unable to satisfy its promises."<sup>69</sup> Subsequent decisions clarified that liabilities should be valued at face regardless of whether the debtor was a going concern:

'If holders of claims are fully informed of the debtor's affairs and the asset values are less than the face amount of the claims, they would never value their claims at more than the value of the assets. Likewise, the fully informed debtor would never be willing to pay claimants more than claimants would be willing to take. Thus, the value of the claims would never exceed the value of the assets and insolvency could never occur.' We agree with this reasoning. If [defendant's] argument were correct, insolvency could never occur, which is an absurd result. Therefore, we conclude for purposes of determining whether a debtor is insolvent under section 547, the liabilities of the debtor must be valued at face value.<sup>70</sup>

Accordingly, absent unusual circumstances, it should be expected that a court applying the balance sheet test will value the debtor's liabilities at face value.<sup>71</sup>

"In calculating the debtor's balance sheet, the court should consider . . . only those debts that are valid under applicable state or federal law."<sup>72</sup> Thus, the mere fact that a liability appears on the debtor's balance sheet does not necessarily mean that the

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281 B.R. at 545-46 ("Debts are measured at face value because the language 'at a fair valuation' in section 101(32)(A) applies only to the valuation of assets; it does not apply to valuation of debts."); *In re Payless Cashways, Inc.*, 290 B.R. at 700 n.29 ("Despite some debate as to how to value assets, liabilities are valued at their face value. Therefore, when valuing individual assets, or conducting a balance sheet analysis of solvency, the fair market value of the assets is compared to the face value of the liabilities." (citation omitted)).

69. *In re Trans World Airlines, Inc.*, 134 F.3d at 196-97. See also *id.* at 196 ("We agree with TWA that we must consider the face value of TWA's publicly traded debt rather than the market value. This follows from our determination that we must treat TWA as a 'going concern.'"); *id.* at 197 ("Because our going concern methodology precludes us from devaluing TWA's debt based on creditors' perceptions of TWA's viability, a fair valuation of TWA's public debt is the face value of that debt."); *In re ORBCOMM Global, L.P.*, 2003 WL 21362192, at \*2 ("In [TWA], the Third Circuit concluded that the proper standard of valuation of the debt is face value, rather than market value, if the debtor is treated as a going concern.").

70. *In re ORBCOMM Global, L.P.*, 2003 WL 21362192, at \*3 (citation omitted).

71. See, e.g., *In re Winstar Comm'n's, Inc.*, 348 B.R. at 278 ("Absent some unusual circumstances not applicable here, the insolvency test anticipates that liabilities will be valued at their face value."). See also *In re Commercial Fin. Servs., Inc.*, 350 B.R. at 554 ("in performing a solvency analysis, liabilities must be valued from the perspective of the debtor, not from the perspective of the hypothetical investor assumed by the discount rate formulas, nor from the perspective of the creditor to whom the obligation is owed" (citation omitted)); *In re Heilig-Meyers Co.*, 319 B.R. at 456 ("The dollar sum of a debtor's contractual debts, such as bonds, credit lines and notes payable, are most often readily determinable by examining the debts' contractual terms."). But see *Mellon Bank, N.A.*, 945 F.2d at 648 ("The debtor's assets and liabilities are tallied at fair valuation to determine whether the corporation's debts exceed its assets"); *In re Grove Peacock Plaza, Ltd.*, 142 B.R. at 515 ("A debtor is insolvent for preferential purposes when the fair value of its liabilities exceeds the fair value of its assets.").

72. *Taylor v. Riverside-Franklin Props., Inc.* (*In re Taylor*), 228 B.R. 491, 502 (Bankr. M.D. Ga. 1998).



liability should be treated as a debt for purposes of the balance sheet test.<sup>73</sup> Appropriate treatment of contingent liabilities, as well as debt that is convertible into equity, will depend on the facts of the case. As to the former, courts typically evaluate the likelihood of the contingency occurring and whether the contingency is capable of reasonable estimation; as to the latter, courts may focus on the status of the convertible instrument on the valuation date or on the economics of conversion.<sup>74</sup> Such determinations should be based on information available on the valuation/solvency date.<sup>75</sup>

A debtor may attempt to characterize other balance sheet items, such as preferred stock, as debt. However, courts generally treat preferred stock (including mandatory redeemable preferred stock), as well as other instruments such as options or warrants, as equity.<sup>76</sup> When responding to a debtor argument that preferred stock (or some other instrument) should be treated as debt, it also may be helpful to review the debtor's plan. Treatment of preferred stock or other

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73. See, e.g., *In re Heilig-Meyers Co.*, 319 B.R. at 466 ("Both parties' experts assign a zero dollar amount to debtors' balance sheet item deferred income taxes because they do not believe it would result in an actual liability. The court adopts a zero dollar amount for deferred income taxes."); *id.* ("Debtors' expert Cleveland reduced accrued expenses by (\$2,073,369) to eliminate a reserve for impaired assets which he believed was a non-cash accounting entry. The court accepts Cleveland's determination that the reserve is an artificial liability that should be disregarded and uses Cleveland's appraisal . . . for accrued expenses."); *In re Tenn. Chem. Co.*, 143 B.R. at 473 ("the trustee's expert witness . . . testified that the deferred income and the deferred income tax were correctly shown as liabilities in the financial statement. However, he did not count them as debts because they would never have resulted in Tennessee Chemical having to pay out any money. The court agrees that they should not be counted as debts under the bankruptcy definition of insolvency."). See also *In re WRT Energy Corp.*, 282 B.R. at 390 ("The court does not agree with [the trustee's expert's] analysis. The question in this Insolvency Trial is not whether a journal entry should have been made, but whether a true liability existed.").

74. See, e.g., *In re Advanced Telecomm. Network, Inc.*, 321 B.R. at 335 ("[C]ontingent liabilities are not valued at their potential face amount; rather 'it is necessary to discount it by the probability the contingency will occur and the liability become real.' Further, the contingency must be capable of reasonable estimation. . . ." (citation omitted)); *In re WRT Energy Corp.*, 282 B.R. at 399 ("Under the Bankruptcy Code, for purposes of determining solvency, contingent liabilities should not be considered at face value, but rather should be discounted by the probability that the contingency will materialize."); *id.* at 400 ("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."); *In re Xonics Photochemical, Inc.*, 841 F.2d at 200 ("To value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real."); *In re Bellanca Aircraft Corp.*, 56 B.R. at 388 n.51 (court treated loan that was convertible into common stock as liability in case in which defendant/lender did not exercise conversion option). See also *supra* note 11.

75. See, e.g., *In re Advanced Telecomm. Network, Inc.*, 321 B.R. at 336 ("To retroactively add a previously omitted contingent liability to a company's balance sheet for insolvency purposes, one must, in effect, return in time to evaluate what the company would have known at that time. Using information the company then had available, the evaluator must assess the probability that the contingent liability would become real and then evaluate if the amount of the liability is capable of reasonable determination."); *In re WRT Energy Corp.*, 282 B.R. at 400 ("th[e] evaluation [of contingent liabilities] must be made as of the date of the valuation and without the benefit of hindsight.").

76. See, e.g., *In re Tenn. Chem. Co.*, 143 B.R. at 473 (rejecting trustee's expert's contention that preferred stock should be treated as debt for solvency analysis; "[t]he court will not count the

instruments as equity under a plan may bind the debtor for purposes of further proceedings.<sup>77</sup>

### G. APPLYING THE BALANCE SHEET TEST

Once the aforementioned analyses have been performed, application of the balance sheet test is straightforward and relatively simple. Assets are compared to liabilities. If liabilities exceed assets, then the debtor was insolvent; if not, then the debtor was solvent.<sup>78</sup>

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redemption price as a debt. Likewise, the court will not count the accrued dividends as a debt.”); *Joshua Slocum, Ltd. v. Boyle* (*In re Joshua Slocum, Ltd.*), 103 B.R. 610, 622–24 (Bankr. E.D. Pa. 1989) (court rejected trustee’s argument that mandatory redeemable preferred stock should be treated as debt for purposes of solvency analysis; “the redemption value of the Debtors’ ‘mandatorily’ redeemable stock should not be considered as a liability of the Debtors. Consequently, we conclude that none of the \$2,497,616.00 set forth on the Consolidated Balance Sheets of January 1, 1998 . . . should be included within the Debtors’ liabilities.”), *aff’d*, 121 B.R. 442 (E.D. Pa. 1989). *See also* *Harbinger Capital Partners Master Fund I, Ltd. v. Granite Broad. Corp.*, 906 A.2d 218 (Del. Ch. 2006) (concluding that redeemable preferred stock represented equity interest and accordingly that any holder of such stock had no standing to sue as creditor for purposes of fraudulent conveyance claim under New York law); *Carrieri v. Jobs.com Inc.*, 393 F.3d 508, 522 (5th Cir. 2004) (affirming lower courts’ decisions disallowing purported “claims” of equity interests; “[w]arrants with redemption provisions, such as those of the Carrieri Group, are equity interests until their expiration (or until the right to receive a cash payment properly matures on or before the petition date). Here, . . . the Carrieri Group’s Warrant Rights did not expire until 22 March 2004, well after the 15 March 2001 Petition Date and, thus, were properly characterized as ‘equity securities.’ Furthermore, the rights of shareholders to redeem stock are equity interests because they are not guaranteed the right to payment, as claims are, but rather are dependent on the solvency of the corporation.”); *Duel Glass and Warrant Holders v. Search Fin. Servs., Inc.* (*In re Search Fin. Servs. Acceptance Corp.*), Civ. A. 399CV0421G, 2000 WL 256889, at \*2–3 (N.D. Tex. Mar. 7, 2000) (court concluded that warrants with redemption provision were equity not debt); *Official Comm. Unsecured Creditors Color Tile, Inc. v. Blackstone Family Inv. P’ship, L.P.* (*In re Color Tile, Inc.*), Civ. A. 98-358-SLR, 2000 WL 152129 (D. Del. Feb. 9, 2000) (in fraudulent transfer action, concluding that preferred stock was equity not debt); *In re Revco D.S., Inc.*, 118 B.R. 468, 474 (Bankr. N.D. Ohio 1990) (“New York Life asserts it is a creditor as defined in §101(9)(A) of the Bankruptcy Code pursuant to the mandatory redemption provisions of the Preferred Stock and by reason of its claims for fraud in connection with its purchase of the Preferred Stock. . . . This Court concludes that New York Life’s assertion that it is a ‘creditor’ for purposes of prosecuting state fraudulent conveyance actions is unfounded. . . . [T]he mandatory redemption provision of convertible preferred stock is an interest and not a claim as New York Life asserts.”); 11 U.S.C. § 101(16)(C) (West 2004 and Supp. 2006) (“The term ‘equity security’ means warrant or right, other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest. . . .”).

77. *See, e.g.*, 11 U.S.C. § 1327(a) (West 2004 & Supp. 2006) (“The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan”); *In re Worldwide Direct, Inc.*, 334 B.R. 112, 129 (Bankr. D. Del. 2005) (“The confirmation of the Plan is binding and cannot now be collaterally attacked.”); *Fox v. Congress Fin. Corp.* (*In re Target Indus., Inc.*), 328 B.R. 99, 117 (Bankr. D.N.J. 2005) (“It is a well accepted principle that ‘a confirmation order is *res judicata* as to all issues decided or which could have been decided at the hearing on confirmation.’” (citation omitted)).

78. *See* 11 U.S.C. § 101(32)(A) (West 2004 & Supp. 2006) (“The term ‘insolvent’ means . . . financial condition such that the sum of such entity’s debts is greater than all of such entity’s property. . . .”). *See also In re Trans World Airlines, Inc.*, 134 F.3d at 198 (TWA was insolvent on transfer date because liabilities exceeded valuation of assets); REILLY & SCHWEIHS, *supra* note 12, at 340 (“The balance sheet test is passed if the sum of the value of the company’s assets is greater than the sum of the value of its liabilities.”).

## II. UNREASONABLY SMALL CAPITAL

### A. APPLICABLE TEST

An allegedly fraudulent transfer also may be avoided if, among other things, at the time of the transfer the debtor “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.”<sup>79</sup> “Unreasonably small capital” is not defined in the Bankruptcy Code (or the Uniform Fraudulent Transfer Act).<sup>80</sup>

In general, unreasonably small capital “refer[s] to the inability to generate sufficient profits to sustain operations.”<sup>81</sup> “Determining whether a firm has unreasonably small capital requires an objective assessment of the companies’ financial projections—[the] ‘critical question is whether the parties’ projections are reasonable.’”<sup>82</sup> Of course,

[e]valuation of cash flow projections must focus on information available at the time of the transaction, not on hindsight. The court should principally focus not on whether the projections were correct but on whether they were reasonable and prudent at the time they were made.<sup>83</sup>

79. 11 U.S.C. § 548(a)(1)(B)(ii)(II) (West 2004 & Supp. 2006).

80. See, e.g., *In re Longview Aluminum, L.L.C.*, 2005 Bankr. LEXIS 1312, at \*18 (“‘Unreasonably small capital’ is not defined in either § 548 or the UFTA.” (citation omitted)); *In re Taubman*, 160 B.R. 964, 986 (Bankr. S.D. Ohio 1993) (“The phrase ‘unreasonably small capital’ is not defined in the Bankruptcy Code. . . .”); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. at 137 (“The phrase ‘unreasonably small capital’ is not defined in either § 548 or the Uniform Fraudulent Conveyance Act.”).

81. *Moody*, 971 F.2d at 1070. See also *Peltz*, 279 B.R. at 744; *In re Longview Aluminum, L.L.C.*, 2005 Bankr. LEXIS 1312, at \*19 (“‘Unreasonably small capital’ encompasses difficulties which are short of insolvency but are likely to lead to insolvency at some time in the future.” (citations omitted)); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. at 137; *In re Joy Recovery Tech. Corp.*, 286 B.R. at 76 (“unreasonably small capital means something more than insolvency or inability to pay debts as they come due. Being left without adequate capital would mean that the transaction in issue put Joy on the road to ruin. To sustain his burden, the Trustee must show something more than a deteriorated balance sheet after the LBO or that Joy had difficulty paying its creditors.” (citation omitted)); *MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport Servs. Co.*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995) (“The [unreasonably small capital] test is aimed at transferees that leave the transferor technically solvent but doomed to fail.”); *In re Taubman*, 160 B.R. at 986 (“The phrase ‘unreasonable small capital’ is not defined in the Bankruptcy Code; thus, an appropriate analysis of this phrase involves examination of the debtor’s cash flow and available operating capital.”); *In re Pioneer Home Builders, Inc.*, 147 B.R. at 894 (“Although short of technical insolvency, a debtor’s unreasonably small capital structure is presumed to lead eventually to insolvency, which is why it serves as a grounds for treating the transfer in question as fraudulent vis-a-vis other unsecured creditors.”).

82. *Peltz*, 279 B.R. at 744. See also *Moody*, 971 F.2d at 1073 (“The critical question is whether the parties’ projections were reasonable. Because 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. However, reliance on historical data alone is not enough. To a degree, parties must also account for difficulties that are likely to arise, including interest rate fluctuations and general economic downturns, and otherwise incorporate some margin for error.”). For additional discussion of the use of projections in a solvency analysis, see *supra* notes 64–67 and accompanying text.

83. *In re WCC Holding Corp.*, 171 B.R. at 985 (citations omitted). See also *In re WRT Energy Corp.*, 282 B.R. at 411 (“The question is not whether cash flow projections were correct in hindsight but

As with the balance sheet analysis, the inquiry should focus on information known or reasonably available on the transfer date, although courts occasionally consider subsequent data.<sup>84</sup> Once again, testimony from former senior management or other knowledgeable persons concerning preparation of the projections at issue, and/or other relevant contemporaneous information, may be helpful.<sup>85</sup>

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rather whether they were reasonable and prudent when made.”); *id.* at 412–13 (relying on contemporaneous projections and rejecting projections prepared by Trust’s expert for purposes of litigation); *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 944 (“a court must consider the reasonableness of the company’s projections, not with hindsight, but with respect to whether they were prudent when made”); *Credit Managers Ass’n of S. Cal. v. Fed. Co.*, 629 F. Supp. 175, 186–87 (C.D. Cal. 1985) (“With 20-20 hindsight it is clear that Crescent’s cash flows did not work out as projected by GECC.... [T]he court’s task in determining whether Crescent had sufficient capital as evidenced by cash flow projections is not to examine what happened to Crescent, but whether the GECC projections, as modified, were prudent. The court finds that they were.”).

84. See, e.g., *In re WRT Energy Corp.*, 282 B.R. at 414 (“Adequacy of capital and belief as to ability to pay debts must be judged by what was reasonably believed at the time of the transactions and not on the basis of hindsight informed by the unforeseeable losses of the third and fourth quarter.”); *In re Fid. Bond and Mortgage Co.*, 340 B.R. at 294 (“The critical question for determining whether parties to a leveraged buy-out left a business with unreasonably small assets is whether it was *reasonably foreseeable* that an acquisition would fail. This requires analysis of whether the parties’ projections were reasonable. ‘[A] court must consider the reasonableness of the company’s projections, not with hindsight, but with respect to whether they were prudent when made.’” (emphasis in original) (citations omitted)); *id.* at 299 (“another factor to consider in an unreasonably small assets test is the length of time a company continued to operate and pay creditors after a disputed transfer.”); *In re Doctors Hospital of Hyde Park, Inc.*, 2007 WL 641399, at \*68 (“Defendant correctly points out that events subsequent to the transfer period may be considered. This debtor survived for three years before filing its bankruptcy, and that may be considered in evaluating whether a company had unreasonably low capital at the time of the transfers.”); *In re Joy Recovery Tech. Corp.*, 286 B.R. at 76 (“courts will not find that a company had unreasonably low capital if the company survives for an extended period after the subject transaction as Joy did.”); *Peltz*, 279 B.R. at 747 (“The Liquidating Trustee bases much of his position on the unreasonably small capital determination on the fact that USN did not meet its projections, and argues that its projections were unreasonable. He presents no evidence, however, that USN’s forecasting was any worse than any other fast growing CLEC in the dynamic marketplace, nor is there any evidence that USN had failed to take into account its high growth rate and the resulting degree of unpredictability when formulating its plans.”); *In re PWS Holding Corp.*, 228 F.3d 224, 234 (3d Cir. 2000) (“the Examiner analyzed whether the recapitalization left Bruno’s with unreasonably small capital. The critical question is whether the parties’ projections were reasonable at the time of the transaction.... Actual performance of the debtor following the transaction is evidence of whether the parties’ projections were reasonable.”); *In re WCC Holding Corp.*, 171 B.R. at 985 (“The sufficiency of WCC’s assets must be analyzed by inquiring into the reasonableness of cash flow projections given the circumstances on the date of transfer.”); *Moody*, 971 F.2d at 1073 (“Jeannette’s actual performance after the acquisition supports the district court’s finding that the parties’ projections were reasonable.”); *In re Suburban Motor Freight, Inc.*, 124 B.R. 984, 1000 (Bankr. S.D. Ohio 1990) (“while some courts have looked to the specific date of an alleged fraudulent transfer in determining the capital condition of a corporation, this Court believes that such an analysis would be shortsighted; the proper application of § 548(a)(2)(A)-(B)(ii) requires a court to examine a company’s capital throughout a reasonable period of time surrounding the precise date of the challenged transfer.”). See also *supra* note 83.

85. See, e.g., *In re Fid. Bond and Mortgage Co.*, 340 B.R. at 294–95 (“The record here established that the parties undertook a substantial amount of due diligence in preparing the Projections. The parties testified that they spent countless hours preparing and revising the Projections. Other witnesses who reviewed the Projections testified as to their belief that the assumptions underlying the Projections were reasonable at the time they were prepared. Despite this, the Debtor argues that the Projections were unreasonable because they did not accurately reflect the true nature of the companies being merged and did not adequately prepare for difficulties that were likely to arise.... The parties to the Mergers, however, understood that the Projections were not guaranteed and that market conditions could affect the financial condition of the companies.... Accordingly, while the examples of deviations

An analysis of adequacy of capital should take into account “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.”<sup>86</sup> Indeed, access to sufficient credit, *standing alone*, may be significant evidence of adequate capital.<sup>87</sup> Sources of operating funds is another topic on which

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from the Projections cited [by the Debtor] may have turned out to be correct, those changes do not outweigh the evidence which showed that the Projections were reasonable when made. . . .”); VFB LLC v. Campbell Soup Co., No. Civ. A. 02-137 KAJ, 2005 WL 2234606, at \*31 (D. Del. Sept. 13, 2005) (“All of the professionals involved in the Spin-off, as well as independent third parties that purchased VFI’s stock and, later, its bonds, believed that VFI’s assets were adequate to operate the businesses in which it was engaged. Because the most persuasive evidence runs directly contrary to its position, VFB has failed to carry its burden of proving by a preponderance of the evidence that VFI’s assets were unreasonably small for the business in which it was engaged.”), *aff’d*, 2007 WL 942360 (3d Cir. Mar. 30, 2007); Peltz, 279 B.R. at 746 (“The Liquidating Trustee offered no evidence that the USN Board or any senior manager believed that USN had unreasonably small capital on February 20, 1998. The evidence shows to the contrary. No USN document indicates that USN viewed itself as a distressed company in early 1988. Senior managers . . . purchased USN stock [before and after the transfer date]”); *id.* (“The issue before the court is whether USN’s expectations that it could again access the capital markets were unreasonable. Evidence regarding the statements and actions of USN and its financial advisors and the strong marketplace support for companies like USN indicate that it was not. No percipient witness or document suggests that in the time frame near February 20, 1998, USN should not plan and operate on the assumption that it would not have access to additional capital, if it needed it.”); *Credit Managers*, 629 F. Supp. at 183–84 (“Federal relies primarily on GECC’s analysis of Crescent’s cash flow and the testimony of GECC officials to prove that Crescent was not undercapitalized at the time of the buyout when GECC studied the company and decided to lend it \$7.5 million. Federal also relies on the testimony of Crescent’s top management personnel who invested their own money in Crescent and believed in May of 1982 that it was a viable entity with sufficient capital to generate income to cover the debt service and make a profit. Plaintiff counters this evidence with the opinion of its expert. . . . The court finds, based on the testimony of the GECC employees and the reports done by GECC both before and after the buyout, that Crescent, though heavily in debt, was not undercapitalized and had sufficient expected cash flow to stay in business.”). See also *Moody v. Sec. Pac. Bus. Credit, Inc.*, 127 B.R. 958, 998 (W.D. Pa. 1991) (“there is no reason for us to find that [the trustee’s expert’s] projections for Jeannette, made for the purposes of his testimony, years after the July 31, 1981 transaction, were any more reasonable than those made by Mr. Brogan or Security Pacific or than the sales projections made by Jeannette’s own management”), *aff’d*, 971 F.2d 1056 (3d Cir. 1992).

86. Peltz, 279 B.R. at 744–45 (citation omitted). See also *VFB LLC*, 2005 WL 2234606, at \*30 (“When considering if a business is inadequately capitalized, it is proper to consider the availability of credit.”); *In re Longview Aluminum, LLC.*, 2005 Bankr. LEXIS 1312, at \*37–38 (“[The trustee’s expert’s] opinion does not establish inadequate capitalization. . . . [The expert’s] opinion both underestimates Longview LLC’s borrowing capacity and ignores reasonably anticipated sources of operating funds. . . . Given Longview LLC’s reasonable prospect of generating positive cash flows as of February 26, 2001, its expected borrowing capacity would have been substantially higher.”); *In re Taubman*, 160 B.R. at 986 (“an appropriate analysis of [unreasonably small capital] involves examination of the debtor’s cash flow and available operating capital.”); *Moody*, 971 F.2d at 1073 (“it was proper for the district court to consider availability of credit in determining whether Jeannette was left with an unreasonably small capital.”); Bruce A. Markell, *Toward True and Plan Dealing: A Theory of Fraudulent Transfers Involving Unreasonably Small Capital*, 21 IND. L. REV. 469, 490 (1988) (“[B]orrowing against or selling unencumbered assets is only one of many commercially reasonable methods of raising cash. A company may seek additional equity capital either through capital contributions from existing owners or by the sale of equity interests to new investors. It may issue unsecured debt. If there is a senior blanket security interest, a new lender may lend more on the same assets secured by a junior lien, the existing lender may itself lend more, or the existing lender may subordinate its interest to a new lender.” (footnote omitted)).

87. See, e.g., *Moody*, 971 F.2d at 1072 (“We cannot say that Jeannette was left with an unreasonably small capital merely because after the leveraged buyout its sole source of operating capital was its line

testimony from former senior management or other knowledgeable persons may be helpful.<sup>88</sup>

Adequacy of capital “is of course a question of fact in each case.”<sup>89</sup> The test for unreasonably small capital is flexible and may depend on the industry or business at issue:

Adequate capitalization is . . . a variable concept according to which specific industry of business is involved. The nature of the enterprise, normal turnover of inventory rate, method of payment by customers, etc., from the standpoint of what is normal and customary for other similar businesses in the industry, are all relevant factors in determining whether the amount of capital was unreasonably small at the time of, or immediately after, the transfer.<sup>90</sup>

When analyzing adequacy of capital, it may be appropriate to evaluate financial ratios and to compare the debtor to similar companies, although ratios may not

of credit with Security Pacific.”) *But see* *Stone v. Ottawa Plant Food, Inc.* (*In re Hennings Feed and Crop Care, Inc.*), Adv. No. 01-7091, 2007 WL 1021973, at \*17 (Bankr. C.D. Cal. Mar. 30, 2007) (“Ottawa suggests that Hennings could have paid its bill if it had drawn down on the line of credit from the Bank, but that would not have changed whether excess debt was being incurred; it would have only changed the creditor to whom the debt was owed.”); *In re O’Day Corp.*, 126 B.R. at 408 (“Although Meritor emphasizes that the company had significant sums available to it under the revolver . . . and managed to stay in business for 22 months after the LBO, the Court is not persuaded that such evidence establishes the adequacy of working capital. Common sense dictates that an ability to borrow is not a substitute for operating profits.”).

88. *See, e.g., Peltz*, 279 B.R. at 745–46 (“While it was clear to USN management that it would need additional capital to continue to fund its business, the evidence indicates that all parties involved believed that USN could raise this capital from the capital markets. . . . The Liquidating Trustee offered no evidence that the USN Board or any senior manager believed that USN had unreasonably small capital on February 20, 1998. The evidence shows to the contrary. No USN document indicates that USN viewed itself as a distressed company in early 1998. Senior managers . . . purchased USN stock. . . . USN believed that it would be able to access the capital markets as late as July 1998 and thereafter. This belief was shared by senior executives with intimate knowledge of USN’s operating challenges and by USN’s financial advisors. The issue before the court is whether USN’s expectations that it could again access the capital markets were unreasonable. Evidence regarding the statements and actions of USN and its financial advisors and the strong marketplace support for companies like USN indicate that it was not.”); *Moody*, 971 F.2d at 1073 (“Defendants here relied on two sets of one-year projections, one prepared by Brogan and the other by Ngan. Brogan’s projections were based on a month-by-month analysis of Jeannette’s balance sheet, income statement, and resulting credit availability. Ngan’s projections were grounded in his interviews with Jeannette personnel and examination of the company’s financial records for the year and a half preceding the acquisition. The district court found these projections reasonable and prudent when made. We agree.” (citation omitted)).

89. 5 COLLIER, *supra* note 7, ¶ 548.05[3], at 548-49. *See also In re WRT Energy Corp.*, 282 B.R. at 411 (“Whether the amount of capital remaining in the hands of the debtor is unreasonably small for running the business is a factual question to be determined on a case-by-case basis.”); *In re Suburban Motor Freight, Inc.*, 124 B.R. at 994 (“Whether the amount of capital remaining in the hands of the debtor is unreasonably small is a question of fact.”); *id.* at 998–99 (“The phrase ‘unreasonably small capital’ is not defined in the Bankruptcy Code. Its meaning must, therefore, be ascertained upon a case-by-case review of the capital structure of a debtor’s business. . . . The term ‘unreasonably’ is relative and requires judicial consideration of the overall state of affairs surrounding the corporation and the challenged transfer itself. Courts’ inquiries must weigh the raw financial data against the nature of the entity and the extent of the entity’s need for capital during the time-frame in question.”); 3 NORTON, *supra* note 20, § 58.5, at 58-17 (“whether a debtor is left with unreasonably small capital will depend on the facts and circumstances of each case. The amount of the capital required generally depends on the risks of the business involved.”).

90. 5 COLLIER, *supra* note 7, ¶ 548.05[3], at 548–52 (footnote omitted).

tell the fully story.<sup>91</sup> At bottom, the inquiry is prospective:<sup>92</sup> “the test for unreasonably small capital is reasonable foreseeability,”<sup>93</sup> i.e., “was it reasonably foreseeable on the [transfer] date . . . that [the debtor] would have unreasonably small capital to carry out its business?”<sup>94</sup> The analysis is not necessarily static, as companies can adjust their expenditures to address revenue shortfalls and/or diminished access to capital.<sup>95</sup> It also is important to note that “a company may be adequately capitalized even if it is not ‘sufficiently well capitalized to withstand any and all setbacks to [its] business.’”<sup>96</sup>

The debtor’s expert may assert that capital is inadequate (or debts cannot be paid when they come due) because the debtor’s financial projections did not reflect sufficient cash to pay off principal balances on loans or notes when due. However,

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91. See, e.g., *In re Fid. Bond and Mortgage Co.*, 340 B.R. at 299 (“In addition to reviewing the reasonableness of the Projections, courts evaluating the unreasonably small assets test under fraudulent transfer laws also compare the company to others in the industry.”); *In re Joy Recovery Tech. Corp.*, 286 B.R. at 76 (“Joy compared favorably with other companies in its industry in terms of its working capital. . . . Joy post-LBO was still in the top 60% of firms in its market. . . .”); *Credit Managers*, 629 F. Supp. at 187 (“plaintiff’s own expert concedes that the negative implication of ratios can be overcome by a positive cash flow analysis.”).

92. See, e.g., *In re Doctors Hospital of Hyde Park, Inc.*, 2007 WL 641399, at \*80 (“The proper analysis . . . is ‘forward-looking, requiring consideration of liabilities the debtor ‘would incur’ or contemplated transactions for which the remaining assets were ‘unreasonably small.’”); Markell, *Toward True and Plan Dealing*, *supra* note 86, at 495 (“Initially, in order to determine what is ‘unreasonably small’ capital, the definition of ‘capital’ or ‘assets’ must be made clear. . . . Both the Code and the UFTA require that the ‘capital’ or ‘assets’ be adequate ‘in relation to the [transferor’s] business or transaction.’ This formulation forces a forward looking view; it requires a transferor to retain adequate wherewithal for future businesses or transactions.”).

93. *Moody*, 971 F.2d at 1073.

94. *Peltz*, 279 B.R. at 744. See also Markell, *Toward True and Plan Dealing*, *supra* note 86, at 499 (“But what is an ‘unreasonable’ amount? As noted in many cases, the exact amount varies with the particular case. This does not translate, however, into a toothless, relative, standard. Rather, the existing cases can be distilled into the following: capital remaining after a transfer is unreasonably small when the unpaid creditor/plaintiff can show its non-payment was a reasonably foreseeable effect of the transferor’s failure to retain, or failure to provide for, an adequate amount of resources from and after the transfer to satisfy the unpaid plaintiff/creditor’s claim.” (footnote omitted)).

95. See, e.g., *Peltz*, 279 B.R. at 747–48 (“In the Spring of 1998, USN adopted an aggressive budget as it continued in a high growth mode. It did so based on the continued assumption that it could raise new capital through a high-yield offering. That would fail, and thus its budgeting projections would also fail. However, had USN perceived that it would not have access to the additional capital required to fund its growth, it could have adjusted its operations to manage and preserve the considerable working capital that it had, instead of using that money to fund its growth. It could have continued to meet its debt obligations by taking steps such as refinancing its notes, raising money in the future through equity markets, or selling the company. But USN did not scale back its operations until months after the CT Tel closing (in the third quarter of 1998), because it was only at that point that USN realized that it would not have access to additional capital.” (footnotes omitted)).

96. *Moody*, 127 B.R. at 996. See also *id.* at 989 (“the fraudulent conveyance laws were not designed to insure creditors against all possible consequences of a company’s post-leveraged buyout errors in judgment or poor business practices. . . . Jeannette’s property was sufficient for it to carry on its business until it experienced an unforeseen dramatic decline in its orders and sales.”); *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 944 (“While a company must be adequately capitalized, it does not need resources sufficient ‘to withstand any and all setbacks.’” (citation omitted)); *Credit Managers*, 629 F. Supp. at 187 (“the law does not require that companies be sufficiently well capitalized to withstand any and all setbacks to their business. The requirement is only that they not be left with ‘unreasonably small capital’ at the time of the conveyance alleged as fraudulent.”).

loans and notes can be refinanced before they come due, even by companies that are experiencing financial or operating difficulties.<sup>97</sup> Thus, the inquiry should focus on the likelihood that the debtor could have obtained new or additional financing. Defense counsel should consider retaining an expert who has sufficient knowledge and/or experience to provide a credible opinion on that subject.

## B. THE CAUSATION REQUIREMENT

At least one court expressly has held that the unreasonably small capital test includes a causation requirement, i.e., that the transfer at issue must *cause* the condition of unreasonably small capital.<sup>98</sup> Thus, if the debtor *already had* unreasonably small capital before the transfer—a position occasionally taken by debtors, who may analyze the adequacy of their pre-petition capital over a period of time commencing before the transfer date—the debtor may fail to satisfy the adequate capital test.

In *In re Pioneer Home Builders*, the plaintiff sought to avoid certain transfers as allegedly fraudulent under the Bankruptcy Code and Texas law. Construing section 548(a)(2)(B)(ii) of the Bankruptcy Code and section 24.005(a)(2)(A) of the Texas Uniform Fraudulent Transfer Act (“TUFTA”), the court entered judgment for the defendant because “the Debtor already had unreasonably small capital before the transfers and the transfers did not cause the unreasonably small capital.”<sup>99</sup> As the Court explained:

At trial, representatives of the Debtor testified that the Debtor was having difficulty paying its debts as they came due *before* the transfers of the Collateral Property and the Collateral Notes. Thus, the transfers in question did not leave the debtor with unreasonably small capital—that was a problem the debtor had already. For avoidance purposes, both the Bankruptcy Code and TUFTA require that the disputed transfers *cause* the unreasonably small capital condition. The statutes require a finding that the capital remaining with the debtor as a result of the transfer is unreasonably small. Where a debtor already has unreasonably small capital, that the debtor subsequently engaged in transfers which worsened, but did not cause, its financial infirmities, will not subject those transfers to avoidance as fraudulent conveyances. This court holds, therefore, that the transfers of the Collateral Property and the Collateral Notes are not avoidable by the Debtor as fraudulent transfers since the Debtor had unreasonably small capital before any such transfers.<sup>100</sup>

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97. See, e.g., *Peltz*, 279 B.R. at 747 (“[USN] could have continued to meet its debt obligations by taking steps such as refinancing its notes, raising money in the future through equity markets, or selling the company”); *id.* (“the fact that a company may have operating difficulties at a point in time does not mean that it cannot reasonably expect to have access to traditional banking sources at the time of difficulty or at a later point in time.”); REILLY & SCHWEIHS, *supra* note 12, at 341 (for purposes of determining whether debtor has ability to pay debts as they come due, balloon payments on subordinated debt may be rescheduled or restructured, where appropriate).

98. See *In re Pioneer Home Builders, Inc.*, 147 B.R. at 894.

99. *Id.* at 895 n.8.

100. *Id.* at 894 (emphasis in original) (citations omitted). See also Markell, *Toward True and Plan Dealing*, *supra* note 86, at 499 (“the existing cases can be distilled into the following: capital remaining after a transfer is unreasonably small when the unpaid creditor/plaintiff can show its non-payment was



Accordingly, if the debtor's expert concludes that the debtor had unreasonably small capital prior to the transfer, or otherwise fails to address the causation requirement, the expert's opinion may be challenged on that ground.

### III. ABILITY TO PAY DEBTS AS THEY COME DUE

#### A. SUBJECTIVE NATURE OF THE INQUIRY

Section 548 of the Bankruptcy Code also provides that an allegedly fraudulent transfer may be avoided if, among other things, the debtor was unable to pay its debts as they came due.<sup>101</sup> Occasionally ignored in solvency litigation is the subjective nature of the section 548 test. To satisfy the ability to pay debts test, the debtor must demonstrate that, at the time of the transfer, the debtor "intended to incur, or believed that it would incur, debts that would be beyond its ability to pay as such debts matured."<sup>102</sup> This requires an analysis of the debtor's *subjective intent or belief*:

In proceeding under section 548(a)(1)(B)(i)-(ii)(III), the trustee must, however, show more than a chronological relation between the act of the debtor and the subsequently incurred debts. Proof must be adduced sufficient to justify the conclusion that the debtor's transfer or obligation was contemporaneous with an intent or belief that subsequent creditors will be injured, i.e., that the debtor will be unable to take care of them as their claims mature.<sup>103</sup>

Section 548(a)(1)(b)(ii)(III) rarely is litigated because of the subjective nature of the inquiry.<sup>104</sup> When a debtor fails to address its prior, subjective intent or belief as to its ability to pay debts, it may fail to satisfy section 548's ability to pay debts test.

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a reasonably foreseeable effect of the transferor's failure to retain, or failure to provide for, an adequate amount of resources from and after the transfer to satisfy the unpaid plaintiff/creditor's claim. An essential element of this formulation is the presence of a connection between the disputed transfer and non-payment of the creditor's claim." (footnotes omitted)); *id.* at 504 ("The last prerequisite to finding inadequate capital is that the transfer must directly lead to non-payment.").

101. 11 U.S.C. § 548(a)(1)(B)(ii)(III) (West 2004 & Supp. 2006).

102. 11 U.S.C. § 548(a)(1)(B)(ii)(III) (West 2004 & Supp. 2006).

103. 5 COLLIER, *supra* note 7, ¶ 548.05[4], at 548-52.1 (footnotes omitted). See also *In re Suburban Motor Freight, Inc.*, 124 B.R. at 994; *Sailstad v. Hendrickson (In re Clemente)*, 15 B.R. 937, 943 (Bankr. N.D. Ohio 1981); *In re Taubman*, 160 B.R. at 985; *id.* at 986 ("This prong of § 548(a)(2)(A)-(B) requires the court to undergo a subjective, rather than an objective, inquiry into a party's intent."); *In re WRT Energy Corp.*, 282 B.R. at 414-15 ("Section 548(a)(1)(B)(ii)(III) . . . protects future creditors from a debtor who transfers assets with the intent to hide them or impair the debtor's ability to pay debts as they arise or with the belief that inability to pay debts would likely result. The 'inability to pay debts' prong of section 548 is met if it can be shown that the debtor made the transfer or incurred an obligation contemporaneous with an intent or belief that subsequent creditors likely would not be paid as their claims matured."); *Morse Operations, Inc. v. Goodway Graphics of Va., Inc. (In re Lease-A-Fleet, Inc.)*, 155 B.R. 666, 675 (Bankr. E.D. Pa. 1993) (test is whether debtor "was aware that it was unable to pay future debts as they became due as a result of [the] transfers.").

104. See, e.g., *In re Suburban Motor Freight, Inc.*, 124 B.R. at 1000 n.14 ("There are few rulings on this particular prong of § 548(a)(2)(A)-(B), and it is rarely used by parties seeking to avoid a transfer as it appears to require the courts to undergo a subjective, rather than objective, inquiry into a party's intent.").

Courts may attempt to infer intent from the facts and circumstances, using a reasonable person standard.<sup>105</sup> Intent has been inferred where, for example, a debtor is running a Ponzi scheme.<sup>106</sup> Whether intent or belief is demonstrated directly or by inference, however, it still must be proven and may not be based on hindsight.<sup>107</sup> In order to disprove the existence or inference of any such intent or belief, it may be helpful to develop testimony from the debtor's former officers or principals.<sup>108</sup> Indeed, where the debtor's contemporaneous projections indicate

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105. See, e.g., *In re WRT Energy Corp.*, 282 B.R. at 415 ("While the statute suggests a standard based on objective [sic] intent, the courts have held that the intent requirement can be inferred 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."); 3 NORTON, *supra* note 20, § 58:6, at 58-14 ("This ground occurs when the debtor enters into a transaction for less than reasonably equivalent value, at a time when it intended or believed that it would incur debts beyond its ability to pay as they became due. In other words, a debtor cannot transfer property or incur obligations in anticipation of financial difficulties. . . . The debtor's intent or belief is determined from the facts surrounding the transaction, using a reasonable person standard. The question is simply whether the debtor intended or believed that it would incur debts beyond its ability to pay as they matured."). See also *Liebersohn v. Campus Crusade for Christ, Inc.* (*In re C.F. Foods, L.P.*), 280 B.R. 103, 117 (Bankr. E.D. Pa. 2002) ("[A]s Burry doled out charitable contributions or took in new investors, he must have realized that the Ponzi scheme would eventually fail, so that, ultimately, many debts could not and would not be paid"); *In re Taubman*, 160 B.R. at 986 ("The record is silent as to any expressed intention or belief by the Debtor to incur debts beyond her ability to pay; however, the record does offer facts and circumstances from which such an intention may be found."); *In re Suburban Motor Freight, Inc.*, 124 B.R. at 1001 ("Although the record is silent as to any express intention or belief on behalf of the Shareholders that Suburban would incur debts beyond its ability to pay, the record does offer facts and circumstances from which such intention reasonably may be inferred.").

106. See, e.g., *Rieser v. Hayslip* (*In re Canyon Sys. Corp.*), 343 B.R. 615, 650 (Bankr. S.D. Ohio 2006) ("given the undisputed evidence that Canyon was operating a Ponzi scheme from the time it commenced operations, the Court may find as a matter of law that the Debtor intended to incur debts beyond its ability to repay."); *In re C.F. Foods, L.P.*, 280 B.R. at 116 ("The test described in both PUFTA § 5104(a)(2)(ii) and Bankruptcy Code § 548(a)(1)(B)(ii)(III) is more easily met. Burry's operation of the Debtor's Ponzi scheme shows his subjective intent to incur debts beyond the Debtor's ability to pay as they became due."); *In re Taubman*, 160 B.R. at 986-87 ("The nature of a ponzi scheme renders the operator insolvent from the beginning. . . . As a result of the Debtor's continuous insolvency and operation of a ponzi scheme, the court finds that the Debtor intended to incur, or believed that she would incur, debts beyond her ability to pay such debts as they mature.").

107. See, e.g., *In re WRT Energy Corp.*, 282 B.R. at 414 ("Adequacy of capital and belief as to ability to pay debts must be judged by what was reasonably believed at the time of the transaction and not on the basis of hindsight informed by the unforeseeable losses of the third and fourth quarter."); *id.* at 415 ("the Trust has failed in its burden of proving a subjective intent on the part of WRT as of the dates at issue herein, to incur debts beyond its ability to repay as required under section 548(a)(1)(B)(ii)(III). Nor did the Trust produce sufficient facts and circumstances surrounding the transactions to enable the court to infer that the debtor's belief it would be able to pay its debts as they matured was unreasonable."); *In re Clemente*, 15 B.R. at 943 ("There was no proof to establish that any obligations were entered into with Clemente believing that he could not pay them. . . . The mere fact that Clemente listed creditors on his bankruptcy schedules does not prove that he incurred these debts knowing they were beyond his ability to pay them. The Court does not believe the evidence was sufficient to establish this point.").

108. See, e.g., *MFS/Sun Life Trust-High Yield Series*, 910 F. Supp. at 943 ("Certainly, the plaintiffs have adduced no evidence of an actual belief by the defendants that VDAS would be unable to pay its debts. Mr. Bergschneider and MAST purchased VDAS with the intent that it would prosper. Mr. Hirsch, Mr. DePalma, and Mr. Meli all retained interests in the company that were dependant upon its continued success."); *In re WCC Holding Corp.*, 171 B.R. at 986 ("To prevail under § 24.005(a)(2)(B) [of the Texas UFTA], the Trustee must prove that on the date of the challenged transfer, WCC intended to incur, or believed that it would incur, debts beyond its ability to pay as they became due. Here, the Trustee

that the debtor would have been able to pay its debts, it may be difficult for the trustee to prove knowledge or intent.<sup>109</sup>

## B. APPLICABLE TEST

The distinction between the ability to pay debts test and the unreasonably small capital test is not entirely clear, although the latter appears to be a more difficult test.<sup>110</sup> Indeed, a company that passes the adequate capital test likely will pass the ability to pay debts test as a matter of course.<sup>111</sup>

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has not demonstrated by a preponderance of the evidence that on the date of the transfer, April 18, 1998, WCC intended to incur debts beyond its ability to pay. Indeed, the evidence is directly contrary to this assertion. The shareholders invested substantial sums in WCC with the expectation of making a profit. They did not intend to incur excessive debts that would eventually lead to the loss of their \$1 million to \$2 million investment.”)

109. See, e.g., *In re Fid. Bond and Mortgage Co.*, 340 B.R. at 300 (“The final constructive fraud analysis under § 5104(a)(2) [of the Pennsylvania UFTA] is whether the debtor made the transfer or incurred the obligation without receiving reasonably equivalent value and intended to incur, or reasonably should have believed that it would, incur debts beyond the debtor’s ability to pay as they became due. Here, the parties to the Merger clearly did not intend to create a new entity that was unable to pay its debts. The best evidence of the parties’ belief that the Debtor would be able to pay its debts is found in the Projections, which I have already concluded are reasonable.”); *Moody*, 127 B.R. at 976 (“While we find that all of the parties were aware of the leveraged nature of the transaction, there is no evidence that before or after the July 31, 1981, transaction, Jeannette or any of the defendants ever intended to hinder, delay or defraud creditors, or believed that Jeannette would incur debts beyond its ability to pay as they matured. Projections prepared both before and after July 31, 1981, showed that the company could pay its debts and run its business in an ordinary manner. Those projections were reasonable and prudent at the time they were made. Based on those projections, those made by Mr. Brogan relating to availability, and the due diligence performed by Security Pacific, the parties involved all intended and believed Jeannette could pay its debts as they matured. We also find that no party to the July 31, 1981, transaction had an incentive to enter into that transaction if it had expected Jeannette to be unsuccessful.”)

110. See, e.g., *Moody*, 971 F.2d at 1070 (“We believe the better view is that unreasonably small capital denotes a financial condition short of equitable insolvency. . . . [A]n ‘unreasonably small capital’ would refer to the inability to generate sufficient profits to sustain operations. Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable solvency [sic].” (footnote omitted)); *Peltz*, 279 B.R. at 744; *In re Morse Tool, Inc.*, 148 B.R. at 132 (“Unreasonably small capital describes a condition short of equitable insolvency—the inability to pay obligations as they come due—because ‘an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they come due.’” (citing *Moody*, 971 F.2d at 1070)); *REILLY & SCHWEIHS*, *supra* note 12, at 342 (“The adequate capital test . . . is related to the cash flow test in that if a company has adequate capital, it will be able to pay its debts as they come due. . . .”). *But see In re C.F. Foods, L.P.*, 280 B.R. at 116 (“In general, the tests of paragraphs (a)(2)(i) and (a)(2)(ii) [of the Pennsylvania UFTA] should be viewed as addressing slightly different aspects of the same fundamental inquiry: whether the debtor is and, on a continuing basis, will be able to pay its debts as they become due. By definition, a debtor which reasonably should be able to pay its debts as they become due on a continuing basis should be deemed to have adequate assets in relation to its business or transaction, sufficient to satisfy the test of paragraph (a)(2)(i), and such debtor also should be deemed to satisfy the ‘reasonably should have believed’ test of paragraph (a)(2)(ii).” (quoting legislative history)).

111. See, e.g., *Moody*, 971 F.2d at 1075 (company passed adequate capital test; “[b]ecause we assume the notion of unreasonably small capital denotes a financial condition short of equitable insolvency, it follows that the transaction did not render Jeannette equitably insolvent either.”). See also *supra* note 110.

In general, the starting point for the ability to pay debts test is the debtor's contemporaneous projections; the reasonableness of such projections should be evaluated in the manner discussed above.<sup>112</sup> Thereafter:

[F]uture post-transaction debt payments...are computed and scheduled by due date. Then a projection of the amount of liquidity available to the company to meet its debt requirements is estimated. . . . To calculate a company's liquidity available for debt repayment, the analyst should project each of the following for the company for several periods after the transaction: (1) any excess cash on hand, (2) free cash flows earned during each period, and (3) the company's borrowing availability on each due date to pay its debts. A comparison would then be made between the amount of debt payments required during each period and the liquidity available to satisfy such requirements. A company will pass [the ability to pay debts] test in any projected period if it can pay its debts as they come due either through cash accumulated on its prior earnings or through free cash flow earned in the period, or by having enough borrowing availability to pay its debts.<sup>113</sup>

As with the adequacy of capital test, if principal payments on loans or notes come due during the projection period, it may be necessary to evaluate the likelihood that the debtor could have obtained new or additional financing.<sup>114</sup>

#### IV. CONCLUSION

A solvency dispute may involve up to three tests: the balance sheet test; the unreasonably small capital test; and the ability to pay debts test. The balance sheet test is by far the most commonly litigated measure of solvency.

Application of the balance sheet is not a simple accounting exercise, as the debtor's balance sheet is only a starting point. The debtor's assets should be valued using the appropriate premise of value and suitable valuation methodologies. In most cases, the parties' experts should consider only information that was known or reasonably available on the valuation/solvency date. Liabilities generally should be valued at face value. If liabilities exceed assets the firm is insolvent; if not, it is solvent. In many cases the debtor benefits from a presumption of insolvency, although the debtor bears the ultimate burden of proof.

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112. See *supra* notes 64–67 and 83–86 and accompanying text. See also REILLY & SCHWEIHS, *supra* note 12, at 342 (“Similar to what should be done in evaluating company projections for a discounted cash flow (DCF) valuation, the analyst should judge which scenarios are reasonable in light of the company's past performance, current economic conditions and future prospects.”).

113. REILLY & SCHWEIHS, *supra* note 12, at 341–42. See *also id.* at 342 (“As one projects further into the future, borrowing availability may also consist of the ability to relevel the company to take advantage of the prior debt repayments that have been made.”).

114. See *supra* note 97 and accompanying text. See also MFS/Sun Life Trust-High Yield Series, 910 F. Supp. at 943–44 (“The plaintiffs make much of the fact that in 1994 VDAS would be required to make a balloon payment on the principal owed to Security Pacific. But this fails to demonstrate VDAS' inability to meet its debts for several reasons. First, according to the VDAS budget, much of Security Pacific's senior debt would have been paid off by 1994. Second, the plaintiffs presented no credible evidence that VDAS would be unable to refinance its debt in 1994.”).

The unreasonably small capital and ability to pay debts tests generally are driven by contemporaneous projections of the debtor's future financial performance. The parties' experts should consider all reasonably anticipated sources of operating funds, as well as the debtor's ability to refinance debt balances before they come due. The adequate capital test may include a causation requirement, while the ability to pay debts test has a subjective component, requiring the debtor or trustee to prove that the debtor intended or believed that subsequent creditors likely would not be paid as their claims matured.

A final observation: the decision to contest insolvency is not one that should be made lightly. Indeed, the odds would appear to be stacked against you, as you probably are in bankruptcy court (often perceived to be debtor-friendly), it is a known fact that the debtor's business failed, you may have to overcome a presumption of insolvency, the debtor's old business records probably are a disaster, and most (if not all) of the debtor's former officers are long gone. Moreover, solvency fights can be time-consuming and expensive. With the right facts and a good expert, however, contesting insolvency is worth the effort. One last word of advice: when it comes to experts, you typically get what you pay for. Trying to save money may cost you in the end.

