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# Use of Assertions of Insolvency in Avoidance Actions to Rebut Financial Statements

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Under the Bankruptcy Code, a debtor may be able to avoid payments made within 90 days of the petition date. A voidable preference occurs when the debtor transfers an interest in property, to or for the benefit of a creditor, on account of an antecedent debt while the debtor was insolvent, within 90 days of the bankruptcy,<sup>2</sup> that allowed a creditor to receive more than it would have in a chapter 7 liquidation.<sup>3</sup> The debtor's insolvency is presumed within 90 days of the petition date, but is a rebuttable presumption.<sup>4</sup> If a creditor can successfully rebut the presumption, and a debtor cannot prove it was insolvent at the time of the transfer, no avoidable preference occurred.



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Section 548 of the Bankruptcy Code allows a trustee to avoid a transfer made within a year of the bankruptcy for which the debtor received less-than-reasonably equivalent value at a time when the debtor was insolvent or a transfer rendered the debtor insolvent.<sup>5</sup> Here too, the transferee has an opportunity to defend against an avoidance action by demonstrating that the debtor was not insolvent at the time of the transfer.

This article discusses two approaches creditors have taken when attempting to rebut the assertion or presumption of the debtor's insolvency in avoidance actions. Some creditors have sought to use publicly filed or internally prepared financial statements to show that the debtor's assets exceeded its liabilities. Other creditors have tried to convince courts that contingent

liabilities should not be counted when applying a balance-sheet test to determine solvency in an avoidance action. These two approaches have met with varying degrees of success.

## Balance-sheet Test for Insolvency

According to §547 of the Code, a debtor is presumptively insolvent within 90 days of the petition date, but insolvency is not defined in that Code section. However, in the general definitional section, the Code does define "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."<sup>6</sup> This is often referred to as the "balance-sheet" test and is generally a test courts use to determine solvency in avoidance actions.<sup>7</sup> Under this test, a debtor is insolvent if its assets exceed its liabilities. The question is how to define assets and liabilities and what should be included in that equation.

## Use of Pre-petition Financial Statements

In attempting to rebut an assertion or the presumption of insolvency, some creditors have used the debtor's own financial statements. For example, recently in *In re Waccamaw's Homeplace*,<sup>8</sup> the debtor sued a creditor seeking to recover approximately \$3.5 million as preference payments. In support of its solvency argument, the creditor offered into evidence the debtor's internally prepared monthly operating reports and a financial disclosure statement filed with the Securities and Exchange Commission (SEC),<sup>9</sup> all of which were prepared in accordance with GAAP.<sup>10</sup>

The bankruptcy court deemed the evidence insufficient to rebut the Bankruptcy Code's presumption of insolvency.<sup>11</sup> Judge Walsh noted that labeling the insolvency test under §101 as a "balance-sheet" test may be a misnomer<sup>12</sup> because financial statements prepared in accordance with GAAP do not record assets at fair market value.<sup>13</sup> Rather, such statements record assets at the historical purchase price with an annual reduction for depreciation.<sup>14</sup> Additionally, there may be nonrecorded liabilities that are not reflected in a GAAP balance sheet.<sup>15</sup> Judge Walsh was not

satisfied that the creditor had met its burden of rebutting insolvency in part because the creditor's witness conducted no meaningful assessment of the debtor's liabilities, including off-balance sheet liabilities (e.g., lease-rejection damages).<sup>16</sup>

In determining that the debtor in *Waccamaw* was insolvent,<sup>17</sup> Judge Walsh relied in part upon his earlier decision, *In re TWA*,<sup>18</sup> which also focuses on the elements of insolvency. In that case, the parties agreed that in an insolvency analysis under §101(32), balance-sheet numbers do not necessarily reflect the fair value of assets.<sup>19</sup> The parties disagreed because the creditor believed the debtor's approach was a liquidation valuation, not a going-concern valuation.<sup>20</sup> The debtor argued that the creditor's approach did not address the reality of converting no-cash assets into cash to pay creditors.<sup>21</sup>

The bankruptcy court suggested that, with few exceptions, balance-sheet asset numbers do not reflect the fair value of the assets.<sup>22</sup> Additionally, there were assets of substantial value that were not even listed on the asset side of the debtor's balance sheet.<sup>23</sup> The court cautioned that the balance sheet is merely the starting point for a solvency analysis.<sup>24</sup> The court reflected that financial statements prepared in accordance with GAAP do not record assets at fair market value and many nonrecorded liabilities usually surface in an insolvency analysis. Judge Walsh concluded that the creditor had seriously confused the analysis under the Bankruptcy Code definition of "fair valuation" with accounting presentations called for by GAAP.<sup>25</sup> He reiterated his view that 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.<sup>26</sup>

Judge E. Stephen Derby agreed with this approach in *In re Merry-Go-Round Enterprises Inc.*,<sup>27</sup> where the trustee moved to set aside preferential transfers. The defendants filed a motion for summary judgment, alleging that the debtors were not insolvent in the 90 days preceding the petition date.<sup>28</sup> Judge Derby pointed out that GAAP standards for asset valuation are not synonymous with the valuation standard set

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<sup>2</sup> The preference period is one year for insiders. 11 U.S.C. §547(b)(4)(B). However, the presumption of insolvency extends only to the 90-day period. 11 U.S.C. §547(f).

<sup>3</sup> 11 U.S.C. §547.

<sup>4</sup> 11 U.S.C. §547(f).

<sup>5</sup> 11 U.S.C. §548(a)(B)(i) and (ii).

<sup>6</sup> 11 U.S.C. §101(32)(A). For a discussion of going concern vs. liquidation value to determine solvency in avoidance actions, see Sage, Michael and Taruschii, Anna, "The Debtor's 'Insolvency' for Avoidance Actions," 22 No. 7, Bkrst. 1 (May 2005).

<sup>7</sup> See, e.g., *In re Labrum & Doak LLP*, 227 B.R. 383, 387 (Bankr. E.D. Pa. 1998) (courts use balance-sheet test for insolvency, comparing asset to debts).

<sup>8</sup> 2005 WL 1279038 \*1 (Bankr. D. Del. May 31, 2005).

<sup>9</sup> *Id.* at \*4.

<sup>10</sup> Generally Accepted Accounting Principles.

<sup>11</sup> 2005 WL 1279038 at \*4.

<sup>12</sup> *Id.* at \*3.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> *Id.* at \*4.

<sup>17</sup> *Id.* at \*3.

<sup>18</sup> 180 B.R. 389 (Bankr. D. Del. 1994), *rev'd*, 203 B.R. 890 (D. Del. 1996), *aff'd*, 134 F.3d 188 (3rd Cir. 1998).

<sup>19</sup> *Id.* at 405.

<sup>20</sup> *Id.* at 404.

<sup>21</sup> *Id.* at 404-05.

<sup>22</sup> *Id.* at 405.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 410.

<sup>26</sup> *Id.* (citations omitted).

<sup>27</sup> 229 B.R. 337, 343 (Bankr. D. Md. 1999).

<sup>28</sup> *Id.* at 340.

forth in §101(32A) of the Code.<sup>29</sup> The GAAP provide that contingent liabilities should not appear on a balance sheet unless they are probable and can be reasonably estimated.<sup>30</sup> However, Judge Derby believes that for bankruptcy purposes, a determination of insolvency requires the inclusion of all contingent liabilities, regardless of the respective degrees of probability.<sup>31</sup> Because Merry-Go-Round's balance sheets were presented in accordance with GAAP, the court could not assign a value to contingent liabilities and therefore could not decide the solvency issue on a motion for summary judgment.<sup>32</sup>

In light of the case law, in defending a preference action creditors' counsel should make sure they have more than a debtor's GAAP balance sheets when seeking to rebut the presumption of insolvency. Courts will typically require more comprehensive evidence that takes into account all assets and liabilities, including contingent liabilities.

## Valuing Contingent Liabilities

Another issue raised in the context of seeking to rebut the presumption of insolvency in preference actions is how to

value contingent liabilities. The Seventh Circuit discussed this issue in *In re Xonics Photochemical Inc.*,<sup>33</sup> which was originally a bankruptcy case that involved intra-affiliate obligations and the status of contingent liabilities. The debtor sought to set aside two payments as preferences, and the dispositive issue became the debtor's solvency.<sup>34</sup> Both the bankruptcy court and the district court concluded that the debtor had been insolvent at the time of the transfers.<sup>35</sup>

The Seventh Circuit was astounded that the parties apparently agreed that if the loan guarantee and the note the debtor cosigned were valid obligations, the debtor was insolvent at the time of the transfers.<sup>36</sup> The court found this proposition to be absurd because then every entity with contingent liabilities greater than its net assets would be insolvent.<sup>37</sup> The Seventh Circuit believed there is a compelling reason not to value contingent liabilities at their face amounts because by definition their contingent nature renders the liability uncertain.<sup>38</sup> Accordingly, valuing a contingent liability requires a discount by the probability that the

contingency will occur and the liability will become real.<sup>39</sup> Before a court can determine whether a firm's assets exceed its liabilities, a contingent liability (or asset) must be reduced to its present, or expected, value.<sup>40</sup>

The Third Circuit adopted the *Xonics* rationale in *In re TWA*<sup>41</sup> in which the debtor sought to recover as a preference a prepetition deposit made to stay enforcement of a judgment against the debtor. In connection with the insolvency, the debtor requested that the court consider the face value of the company's debt, rather than the lower market value urged by the creditor.<sup>42</sup> The debtor also sought to include approximately \$634 million in contingent liabilities and \$576 million in pension plan liabilities.<sup>43</sup> The bankruptcy court below had agreed with the debtor's conclusion that it was insolvent.<sup>44</sup> The bankruptcy court valued the debtor's public debt at market value and included the contingent and pension plan liabilities at the debtor's figures.<sup>45</sup> However, the bankruptcy

<sup>29</sup> This is the section that defines insolvency.

<sup>30</sup> 229 B.R. at 343.

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> 841 F.2d 198, 199 (7th Cir. 1988).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 200. See, also, *In re R.M.L. Inc.*, 92 F.3d 139, 156 (11th Cir. 1996) (to consider contingent assets, court must consider likelihood of event occurring).

<sup>39</sup> *Id.* See, also, *In re Chase & Sanborn Corp.*, 904 F.2d 588, 594 (11th Cir. 1990) (contingent liability cannot be valued at potential face amount).

<sup>40</sup> *Id.* (citations omitted). But see *In re Merry-Go-Round Enterprises Inc.*, 229 B.R. at 343 (determination of insolvency requires inclusion of all contingent liabilities regardless of degrees of probability).

<sup>41</sup> 134 F.3d 1888 (3d Cir. 1998).

<sup>42</sup> *Id.* at 192.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

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court considered the contingent liabilities in an amount discounted by the likelihood that TWA was on the verge of going out of business.<sup>46</sup> The district court held that the liabilities should not have been valued at face value and remanded with instruction to conduct a fair valuation of the debtor's liabilities.<sup>47</sup>

The Third Circuit agreed with the bankruptcy court that the public debt should have been valued at face value.<sup>48</sup> The Third Circuit also agreed that it was proper to consider contingent liabilities when considering insolvency.<sup>49</sup> However, the Third Circuit disagreed that dissolution costs of the debtor can be included in the equation.<sup>50</sup> Contingent liabilities should be limited to costs arising from foreseeable events that might occur while the debtor is a going concern.<sup>51</sup> Treating TWA as a going concern, the Third Circuit refused to include

<sup>45</sup> *Id.* at 192-93.

<sup>46</sup> *Id.* at 193.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 196. See, also, *Orbcomm Global L.P. v. Crenshaw*, 2003 WL 21362192 \*3 (Bankr. D. Del. 2003) (value public debt at face value for insolvency purposes).

<sup>49</sup> *Id.* at 197.

<sup>50</sup> *Id.*

as contingent liabilities \$816 million in dissolution costs that the bankruptcy had included in its calculation.<sup>52</sup>

In *Covey v. Commercial National Bank of Peoria*,<sup>53</sup> the Seventh Circuit discussed how to value contingent liabilities for a construction enterprise. The trustee sought to recover certain payments as fraudulent conveyances.<sup>54</sup> The Seventh Circuit repeated the *Xonic* court's holding that in determining the value of a contingent liability, a court must determine the probability that the liability will occur.<sup>55</sup> By way of example, the Seventh Circuit noted that all of an air carrier's planes might fall out of the sky or an electric utility's nuclear stations might melt down, creating stupendous liabilities; however, the probability of such occurrence is low.<sup>56</sup> Therefore, such contingent liabilities should not be included in a solvency analysis.<sup>57</sup> According to the Seventh Circuit, "Discounting a contingent liability by the probability of its occurrence is good economics and therefore good law, for solvency, the key to §548(a)(2), is an economic term."<sup>58</sup>

<sup>51</sup> *Id.* at 198. See, also, *In re W.R. Grace & Co.*, 281 B.R. 852, 858 (D. Del. 2002) (appropriate discount factor is derived from reasonable foreseeability of contingency coming to pass).

<sup>52</sup> *Id.*

<sup>53</sup> 960 F.2d 657, 658 (7th Cir. 1992).

<sup>54</sup> *Id.* at 659.

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

## Conclusion

Creditors have attempted to demonstrate a debtor's solvency to defeat avoidance actions. Generally, courts will not be willing to rely solely on GAAP financial statements or monthly operating reports to conclude that a debtor's assets exceeded its liabilities. Accordingly, bankruptcy litigators should be prepared to introduce additional evidence to demonstrate solvency. Several courts will determine the probability of a contingent liability occurring in deciding whether or not to discount such contingent liability when considering solvency. The lower the probability of the occurrence, the more likely the judge will be willing to discount the contingent liability. However, litigators should take into account that courts tend to value public debt at face value. ■

<sup>58</sup> *Id.* at 660. See, also, *Peltz v. Hatten*, 279 B.R. 710, 743 (D. Del. 2002) (in determining solvency, courts should examine whether off-balance sheet assets should be included in debtor's par value).

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