1997

From the Bankruptcy Courts: Can Low Market Value of Debt Securities Render a Corporation Solvent for Preference Purposes? A Surprising Decision From Delaware

Alan N. Resnick
Maurice A. Deane School of Law at Hofstra University

From the Bankrupcy Courts

*Alan N. Resnick**

Can Low Market Value of Debt Securities Render a Corporation Solvent for Preference Purposes? A Surprising Decision From Delaware

Suppose that a corporation has assets worth $100 million and liabilities that include $150 million (face amount) of outstanding publicly-held bonds. The corporation's other liabilities consist of $5 million in trade debt. Although it is current on interest payments, it is behind on most of its trade debt because of serious cash flow problems and declining sales volume. Because of its bleak financial condition, increasing competition, and negative publicity, its bonds have been trading at a discount and could be purchased on the market for only 60 percent of their face value. Suppose further that, during this period of impending doom, the corporation wires a late $100,000 payment on an old unsecured debt to its favorite and most loyal trade creditor, and then files a chapter 11 petition a few days later.

The likely reaction of an experienced—or even inexperienced—bankruptcy lawyer hearing these facts would be to identify the $100,000 payment as a preference that may be recovered under Section 547 of the Bankruptcy Code.[1] The late payment of an unsecured antecedent debt—clearly not paid in the ordinary course of business—within ninety days before bankruptcy should set off alarms and flashing lights for anyone interested in recovering the money for the benefit of the bankruptcy estate. But a transfer is not a voidable preference unless, among other requirements, the debtor is insolvent at the time of the transfer.[2] The term "insolvent" is defined in the Bankruptcy Code to mean, when the debtor is a corporation, "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."[3]

---

* Benjamin Weintraub Distinguished Professor of Bankruptcy Law, Hofstra University School of Law, Hempstead, N.Y.; Counsel to the firm of Fried, Frank, Harris, Shriver & Jacobson, New York, N.Y.; Reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States; member of the National Bankruptcy Conference. The views expressed in this article are the author's own.

[1] 11 USC § 547.

[2] 11 USC § 547(b)(3).

[3] 11 USC § 101(32). The Bankruptcy Code definition also provides that property transferred, concealed, or removed with intent to hinder, delay, or default creditors is to be excluded when determining whether an entity is insolvent.

This "balance sheet" test is significantly different than the definition of "insolvent"

Was this corporation "insolvent" when it paid the $100,000 debt? Because of a recent decision of the federal district court In re Trans World Airlines, Inc.,[4] it appears that there is now some support, at least in Delaware, for the position that this fictitious corporation—with $100 million worth of assets and $150 million in bond debt—was *not* insolvent under the Bankruptcy Code's "balance sheet" test and, therefore, that the payment could not be recovered as a preference.

The TWA Case

Eighty-eight days before Trans World Airlines (TWA) filed a bankruptcy petition in 1991, it deposited $13.7 million with the clerk of the district court in the Southern District of New York as security for payment of a judgment in favor of Travellers International AG (Travellers) and against TWA. The purpose of the deposit was to stay enforcement of the judgment pending an appeal. TWA, as a chapter 11 debtor in possession, commenced an adversary proceeding to recover the cash deposit, successfully arguing in the bankruptcy court that the deposit gave Travellers a preference under Section 547(b) of the Code.[5] In its decision, the bankruptcy court found that TWA was insolvent at the time of the cash deposit, in part because of the face amount of its outstanding debt securities.[6]

On appeal, the district court was faced with the issue of whether TWA was "insolvent" when the cash deposit was made.

Valuation of Assets

In determining whether TWA was insolvent at the time of the cash deposit, the bankruptcy court first focused on the asset side of the balance sheet. It engaged in a lengthy analysis of the meaning of the phrase "fair valuation" found in the definition of "insolvent," including an in-depth discussion of case law under both the former Bankruptcy Act and the present Code. The bankruptcy court then reached several general conclusions:

- ☐ The prevailing and proper approach to the valuation of assets of an operating company is to determine the "going concern value" of assets, rather than the foreclosure or forced-sale liquidation value.
- ☐ Balance sheet numbers prepared in accordance with Generally Accepted Accounting Principles (GAAP) do not re-

often found in other statutes, including Section 1-201 of the UCC which renders an entity insolvent if it either satisfies the Bankruptcy Code insolvency test, or "has ceased to pay its debts in the ordinary course of business or cannot pay its debts as they become due."

[4] 203 BR 890 (D. Del. 1996).

[5] The Official Unsecured Creditors' Committee intervened in the adversary proceeding as a party-plaintiff.

[6] 180 BR 389 (Bankr. D. Del. 1994).

flect the true going concern value of assets. As the bankruptcy court pointed out in a footnote, "[f]inancial 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."[7] Therefore, they may serve only as a starting point for the analysis, subject to additions and deletions based on expert testimony of appraisers and accountants.

☐ The proper way to determine the going concern value of assets is to predict the amount of cash that could be realized in a sale of the assets within a reasonable period of time. The bankruptcy court rejected the notion that the going concern value approach requires asset valuation on the assumption that they will not be sold, but will remain "in place" indefinitely to generate income for the debtor. "Like the preference creditor, other creditors can only benefit by being paid. Consequently . . . § 547(b)(3) insolvency analysis requires a determination of the amount of funds which could be generated by converting non-cash assets into cash."[8]

If a going concern valuation requires a prediction as to the cash that could be received in a hypothetical asset sale, then how does that approach differ from a forced sale or liquidation value approach? The difference is in the timing. The going concern approach is based on the proceeds of a hypothetical sale over a reasonable period of time, rather than immediately in a foreclosure-type setting. In this case, the bankruptcy court held that TWA's approximation of a twelve- to eighteen-month time period for an orderly sale of assets was reasonable.

Based on these principles, the bankruptcy court engaged in an asset-by-asset analysis—focusing on such non-cash assets as leased flight equipment, aircraft and spare engines, gates and slots, and maintenance facilities—to arrive at their fair market going concern value. The court concluded that the aggregate fair value of TWA's assets on the date of the transfer was approximately $3.1 billion.

On appeal, the district court agreed with the bankruptcy court's analysis and conclusions regarding the fair value of TWA's assets. The district court also addressed an apparent inconsistency between (1) the requirement that a going concern valuation must be based on a hypothetical sale that will take place within a reasonable time (twelve to eighteen months in this case) *after* the date on which the alleged preference took place and (2) the requirement that, under Section 547(b), a solvency determination must be made *on* the date of the

---

[7] 180 BR at 405, n. 22.

[8] 180 BR at 411.

transfer. But the district court found a way to reconcile these two requirements:

> 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. [footnote omitted]. 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 twelve to eighteen 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.[9]

Determining the Amount of Liabilities

Turning to the liability side of the balance sheet, both the bankruptcy and district courts agreed that contingent obligations must be included. In general, the amount of contingent obligations must be determined by multiplying the dollar amount of potential liability by the "probability that the contingency will occur and the liability will become real."[10]

The district court also agreed with the bankruptcy court's general approach of measuring TWA's liabilities within the context of a hypothetical sale of the business within a twelve to eighteen month period. For example, to determine the liabilities in connection with TWA's pension plan, medical and dental benefit plans, and estimated wind-down expenses, the bankruptcy court assumed that the business would be terminated. As the bankruptcy court wrote, "[i]f TWA were required to wind down its operations and convert non-cash assets to cash in a 12 to 18 month period, its operations would obviously terminate and the liabilities contingent on that event would then become fixed."[11] The district court held that, "[b]ecause the Bankruptcy Court found significant factual support for its finding that absent a major capital restructuring, TWA was likely to terminate its business, this Court cannot say that the finding was clearly erroneous."[12]

Valuing Bond Debt

But the two courts differed on whether, for the purpose of determining insolvency, TWA's publicly held bonds should be considered liabilities only to the extent of their fair market value, rather than for their full face value. The evidence

---

[9] 203 BR at 896.

[10] 180 BR at 427. Both courts cited In re Xonics Photochemical, Inc., 841 F2d 198, 200 (7th Cir. 1988), as authority for the proposition that contingent liabilities must be valued using a probability analysis.

[11] 180 BR at 427–428.

[12] 203 BR at 897–898.

indicated that, at the time of the alleged preference, TWA's debt obligations with respect to its bonds was approximately $1.77 billion (including face amount due on maturity plus accrued interest), but that these bonds could have been purchased on the market for only $663 million. In view of TWA's other liabilities, whether the prepetition cash deposit was a voidable preference depended on which of these two figures should be used in determining TWA's solvency.

The bankruptcy court focused on the language of Section 101(32), which bases the insolvency test on whether "the sum of such entity's debts is greater than all such entity's property, at a fair valuation." The word "debt" is defined in Section 101(12) to mean "liability on a claim." Clearly, TWA's liability to the holders of its debt securities would be for the full face amount of the bonds, plus any accrued interest, payable upon maturity.

The bankruptcy court also reasoned, from the phrasing of Section 101(32), that only property is to be valued at fair market value, not liabilities.

> Had Congress intended the meaning ascribed by Traveller's [i.e., the fair value approach applied to liabilities], it could have easily drafted language to so state. The section could have read: "the sum of such entity's debts, at a fair valuation, is greater than all of such entity's property, at a fair valuation," or "at a fair valuation, the sum of such entity's debts is greater than all of such entity's property."[13]

The bankruptcy court observed that it would produce an anomalous result if both assets and liabilities were valued at fair market value. Assuming that creditors are fully informed of the debtor's financial condition, and that asset values are lower than the face amount of the debtor's liabilities, creditors "would never value their claims at more than the value of the assets," and "the fully informed debtor would never pay claimants more than what 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."[14]

The bankruptcy court did not find persuasive Travellers' argument that the bond debt should be valued, for insolvency test purposes, at the public trading price because TWA, if it wanted to, could have bought the bonds at that price rather than pay the face amount at maturity. It also rejected Traveller's argument that the prevailing case law that requires use of a probability analysis with respect to contingent obligations[15] mandates the use of fair market value with respect to TWA's debt securities. A probability valuation analysis should be used with respect to contingent multi-obligor claims, such as liability on a guaranty where the debt has not yet matured. The court's role in those situations is to

[13] 180 BR at 423.

[14] 180 BR at 424.

[15] See, e.g., Mellon Bank, NA v. Metro Communications, Inc., 945 F2d 635 (3d Cir. 1991); In re Xonics Photochemical, Inc., 841 F2d 198 (7th Cir. 1988).

estimate the amount of the unliquidated claim. "They have no application here to the TWA publicly traded debt obligations."[16]

Based on this reasoning, the bankruptcy court held that the face amount of the bonds must be used in computing the total amount of liabilities for insolvency purposes.

District Court Rejects Face Amount Valuation

The district court disagreed with the bankruptcy court on whether the modifier "at fair valuation" found in § 101(32) should apply to debts as well as property. The district court relied on language in *Mellon Bank, NA v. Metro Communications. Inc.*,[17] where the Court of Appeals for the Third Circuit stated that "assets and liabilities are tallied at fair valuation to determine whether the corporation's debts exceed its assets."[18] The district court rejected the bankruptcy court's view that this quote from *Mellon Bank* must be limited to the context of that case, which involved the assessment of the debtor's portion of an obligation shared by others. The district court concluded that, since both property and debts must be tallied at fair valuation, the bond debt must be valued according to its fair value at the time of the preferential transfer. "[B]ecause the Court has concluded that liabilities should be fairly evaluated, the Court does conclude that the Bankruptcy Court's decision to value the public debt at face value was error."[19]

Conclusion

How would the district court in Delaware value the publicly-held debt in the case of the fictitious corporation discussed at the beginning of this article? If it is inappropriate to use the face value of the bonds in calculating the amount of debt—which is what the district court held in *TWA*—would that court value this liability based on the price at which the bonds were trading in the market place on the date of the preferential transfer?

Although the district court did not explain in detail how it would determine fair value, it appears that it probably would look to the market value of the bonds. If so, the district court probably would hold that the $100,000 payment in question was not a voidable preference. Assuming that the going concern value of assets was $100 million, that the $150 million in outstanding bonds were trading at 60 percent of their face value (for a fair market value of $90 million), and that other debts amounted to only $5 million, the corporation would have been solvent at the time of the payment. But if the public had a little more confidence in the corporation's financial future so that its bonds were trading at 70 percent of their face value (for a fair market value of $105 million) at the

[16] 180 BR at 424.
[17] 945 F2d 635 (3d Cir. 1991).
[18] 945 F2d at 648.

[19] 203 BR —.

time of the $100,000 payment, then, applying the district court's view in *TWA*, the corporation probably would have been insolvent and the $100,000 would be recoverable as a preference.

By not explaining exactly how it would fairly value TWA's debt securities, it is possible that the district court was leaving the door open to a method of valuation based on the probability that the bondholders will be paid at the end of the hypothetical sale of the debtor's assets within a reasonable time? That is, if it is likely that the proceeds of a "going concern" sale would produce cash sufficient to pay only 50 percent of the face amount of the bonds, would the district court approve an approach that values the bond debt at 50 percent of face value, regardless of their current trading price? If so, it would be difficult to imagine how any debtor could be considered insolvent because the "fair value" of the debtor's liabilities would never exceed the value of assets available to pay them.

The district court's decision in *TWA* could make it much more difficult for bankruptcy trustees and debtors in possession to recover preferences under Section 547(b) because of the difficulty in finding insolvency, at least when the debtor has outstanding debt securities trading publicly at a discount. In addition, because the term "insolvent" is used elsewhere in the Code, including in Section 548 on fraudulent transfers and Section 546(c) on a seller's right to reclaim goods, the ramifications of the *TWA* decision may extend well beyond preference disputes. It also remains to be seen whether the district court's holding will be applied to a debt that is not related to publicly traded debt securities but can be "fairly valued" based on the creditor's willingness to sell the claim to a third party or on the probability that the claim will be fully paid.