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BVR

Grounding Retrospective Solvency Analyses in Contemporaneous Information (2 of 3)

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Courts frequently use contemporaneous information to assess a debtor's solvency as of the date a disputed transfer was made or a disputed obligation was incurred. This is the 2nd of three papers that provides a business valuation practitioner's perspective on how to use contemporaneous information to assess the debtor's solvency on the relevant date. This paper addresses the use of contemporaneous actions (excluding stock and debt prices, which were addressed in the 1st paper) that can be used to assess whether a debtor was solvent or insolvent. This paper represents the views of the author and is not the official position of Duff & Phelps LLC.

Introduction

This is the 2nd in a series of three papers that provides a business valuation practitioner's perspective on how to ground retrospective solvency analyses in contemporaneous information. The 1st paper provided an overview of fraudulent conveyance and preference lawsuits and explained how contemporaneous market prices for the debtor's stock and debt securities are used to assess the debtor's solvency or insolvency as of a particular date. This 2nd paper addresses other contemporaneous indicators of a debtor's solvency or insolvency as of a particular date. The 3rd paper will address the solvency analyses (Balance Sheet Test, Adequate Capital Test, and Ability to Pay Debts Test) performed by testifying experts retained in connection with a litigation.

Contemporaneous Actions of Knowledgeable Insiders and Outsiders

Contemporaneous indicators of a debtor's solvency or insolvency are not limited to market prices for the debtor's stock and debt securities. The contemporaneous actions (or inactions) of knowledgeable insiders and outsiders are also important indicators of a debtor's solvency or insolvency as of the transfer date. Simply put, contemporaneous parties frequently make decisions that suggest a debtor was either solvent or insolvent as of, or near, the transfer date. Retrospective solvency analyses must address these contemporaneous decisions.

This is an important observation, because it means the principles in cases such as *Vlasic*, *Iridium*, *TOUSA*, and *Idearc*[1] are not limited to debtors that have publicly traded securities. There are likely many other debtors that did not have publicly traded securities that nevertheless had other contemporaneous indicators of solvency or insolvency. As discussed in more detail below, the courts' findings in many cases focused on these contemporaneous indicators of solvency or insolvency.

Relevant actions from Vlasic *and* Iridium *that suggest the debtor was solvent*

Messrs. Schwartz and Bryan highlight the ''avenues of proof'' that the District Court relied upon in *Vlasic* that were not related to the market prices for the debtor's publicly traded stock (shown in Table 1).[2] These authors highlight this information to demonstrate that:

> [c]ourts can and should take greater advantage of the full panoply of types of market evidence relied upon by the United States District Court in [*Vlasic*], and ordinarily equally available to the finder of fact in other business valuation disputes—even in cases where, unlike [*Vlasic*] and *Iridium*, the company to be valued has no publicly traded securities. Such market evidence includes the

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[1]See the 1st paper in this series for an overview of these matters.
[2]Michael W. Schwartz and David C. Bryan, ''*Campbell*, *Iridium*, and the Future of Valuation Litigation,'' *Business Lawyer* 67(2012):939. The authors also show that the Court in *Iridium* found similar contemporaneous indicators of solvency. These authors also published a follow-up paper in the May/June 2013 issue of *The Value Examiner* titled ''Expert Testimony in BV Cases Should Be the Exception, Not the Rule.''

Table 1
Avenues of Proof and Examples Used in *Vlasic*[3]

Avenue of Proof	Examples
Contemporaneously expressed views and actions of executives familiar with the business	''The District Court concluded: 'That seasoned executives familiar with the businesses that came to constitute VFI chose to join VFI demonstrated that thoroughly knowledgeable people believed the Spin-off would be a successful venture.''' [4]
Actions of contemporaneous creditors	The disputed transfer was financed by banks that concluded the debtor was creditworthy. The debtor remained a viable credit for almost two years after the disputed transfer date, as evidenced by lenders' actions, credit ratings, and the near–par value trades of the debtor's debt securities.
Contemporaneous views of business and financial experts	Contemporaneous valuations were performed. They were generally consistent with the stock market's valuation of the debtor around the transfer date. ''As the District Court found, 'such contemporaneous evidence of fair market value has the advantage of being untainted by hindsight or post-hoc litigation interests.''' [5]
Contemporaneous business planning documents	The debtor's projections were consistent with a solvency determination. The debtor's employee compensation plan created an incentive for the development of ''conservative and realistic'' projections because ''70% of [management's] compensation depended on [the debtor] achieving at least 90% of the [projected] results.'' [6]
Other contemporaneous assessments of enterprise value by management and outside professional advisors	Post–transfer date valuations showed the debtor remained solvent for two years after the transfer date. Perhaps the most relevant of these valuations was contained in a letter written by the debtor's CEO over a year after the spin-off. This letter to his shareholders discussed ''negative information about [the debtor] that had come to light in the intervening period. Had this information been known at the time of the spin-off, [the debtor's] CEO concluded, the market would have valued the enterprise at $1.15 billion (rather than $1.6 billion)—more than twice the amount of VFI's debt at the time of the spin-off.'' [7] This valuation explicitly addressed most, if not all, of the plaintiff's allegations that the market was misinformed on the spin-off date. Recall (from the 1st paper in this series) that the Court found all relevant information was disclosed within six months of the transfer date.
The dog that did not bark	''It is also highly probative if the party attacking the transaction is unable to proffer evidence that the values its trial experts would assign to the business after-the-fact were values identified by actual, real-time participants in, or witnesses to, the transaction.'' [8] The plaintiff did not show any insider or outsider who contemporaneously acted as if the debtor was insolvent as of the transfer date. ''The District Court stated, in rejecting the plaintiff's principal trial expert: 'If anyone actually making decisions at the time held the utterly bleak view espoused by [the expert], I have seen no evidence of it.''' [9]

contemporaneous actions of company executives and directors, who make career and investment decisions based on their views of value; the contemporaneous actions and views of lenders, creditors, investors, and other market participants; and the contemporaneous views of expert advisors expressed at or near the valuation date.[10]

Messrs. Schwartz and Bryan proffer that:

> [t]his evidence is of extremely high probative value: it reflects what real people with close knowledge of the business and a real financial stake in the enterprise actually did at the time of the valuation. It is thus immune both from the criticism that the actors had inadequate knowledge of the business, and from the criticism that they were swept up in some sort of 'tulip craze' in the public markets. As Judge Easterbrook aptly put in a related context: ''[S]elf-interest concentrates the mind, and people who must back their beliefs with their purses are more likely to assess … value … accurately than are people who simply seek to make an argument. Astute investors survive in competition; those who do not understand the value of assets are pushed aside.

[3]Messrs. Schwartz and Bryan explain that the bankruptcy court in *Iridium* also considered ''contemporaneous insider and knowledgeable outsider evidence. Notably, in addition to Iridium's market capitalization, the court looked to and relied on: Iridium's own contemporaneous projections of its future cash flows; analyses performed by investment bankers and accountants at the time of the challenged payments, confirming their belief in Iridium's cash flow forecasts; contemporaneous views of sophisticated Wall Street firms that underwrote Iridium's equity and debt offerings; valuation work performed by experts at the time the transactions were undertaken, rather than in hindsight for purposes of litigation; and Iridium's demonstrated ability to obtain financing to make the challenged transfers by accessing substantial bank loans and the capital markets.'' Schwartz and Bryan, op. cit.: 946.

[4]Schwartz and Bryan, op. cit.: 944. The District Court's finding is cited to *Vlasic*, 2005 WL 2234606, *4.

[5]*Id*. at 945. The District Court′s finding is cited to *Vlasic*, 2005 WL2234606, *13.

[6]*Id*. The District Court's finding is cited to *Vlasic*, 2005 WL 2234606, *14.

[7]*Id*. The authors summarize the District Court's findings in *Vlasic*, 2005 WL 2234606, *26.

[8]*Id*. at 945–946.

[9]*Id*. The District Court's finding is cited to *Vlasic*, 2005 WL 2234606, *29.

[10]*Id*. at 939.

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Table 2
Avenues of Proof and Examples Used in *Bachrach Clothing*

Avenue of Proof	Examples
Contemporaneously expressed views and actions of executives familiar with the business	The debtor's CFO certified that the debtor was solvent on the transfer date. The buyer made an additional $5 million investment in the debtor after the transfer date.
Actions of contemporaneous creditors	A lender extended a $7 million credit line to the debtor on the transfer date. A lender extended a $20 million credit line several weeks after the transfer date.
Contemporaneous views of business and financial experts	The buyer, ''a sophisticated investor, believed the $8 million [purchase] price was attractive.''[11]
Contemporaneous business planning documents	There was a contemporaneous agreement among the parties that the debtor ''had at least $9 million in working capital six months after the sale.''[12]
Other contemporaneous assessments of enterprise value by management and outside professional advisors	The debtor's CEO had ''interest in investing in the company after the sale occurred.''[13]
The dog that did not bark	''No one, including [the buyer], an auditor, investment banker, or anyone else, ever indicated or complained that the [seller's] sale to [the buyer] rendered [the debtor] insolvent or undercapitalized.''[14]

> There is no similar process of natural selection among expert witnesses and bankruptcy judges.''[15]

Recent solvency-related case that focused on ''the real world''

A recent bankruptcy court decision (*Bachrach Clothing*[16]) focused extensively on the debtor's contemporaneous indicators of solvency. This result occurred despite the fact that this debtor did not have publicly traded stock or debt. Thus, it could be argued that this court followed the general principles articulated by Messrs. Schwartz and Bryan in their paper published in *The Business Lawyer*.[17]

The disputed series of transactions in *Bachrach Clothing* was related to a leveraged buyout. The seller transferred an unleveraged debtor to the buyer, the buyer caused the debtor to incur debt, and then the buyer caused the debtor to transfer some of the proceeds from the debt raise to the seller. The debtor subsequently filed for bankruptcy and sought to recover the proceeds that were transferred to the seller in connection with the leveraged buyout.[18]

In *Bachrach Clothing,* the Court focused on ''real world events,'' which were also characterized as ''contemporaneous market data,'' when it determined that the debtor was not insolvent on the transfer date.[19] Notably, the Court implicitly addressed each of the ''avenues of proof'' identified by Messrs. Schwartz and Bryan in their paper (see Table 2). Thus, some may argue that the Court could have found that the debtor was not insolvent without the assistance of testifying experts.

Nevertheless, the Court focused on the ''battle of the testifying experts'' too. The defendant's expert's enterprise valuation was over six times greater than the plaintiff's expert's valuation of the debtor. The difference in the proffered discount rate was the primary driver of this chasm in valuations, as both experts used the same projections for the discrete projection period. The discount rate-related dispute is addressed in Chapter 15 of *The Lawyers Guide to Cost of Capital,* which will be published by the American Bar Association in 2014.

Debate over use of testifying experts in certain valuation-related lawsuits

There is a debate among some practitioners as to whether expert testimony should automatically be considered in certain valuation-related cases. In their

[11] *Id*. The Court also observed that a Big 4 accounting firm's ''due diligence revealed the $8 million purchase price was below book value.'' *Bachrach Clothing*, 480 B.R. 820, 867.
[12] *Id*.
[13] *Id*.
[14] *Id*.
[15] *Id*. at 942–943. Judge Easterbrook's finding is cited to *In re Central Ice Cream Co*., 836 F.2d 1068, 1072 n.3 (7th Cir. 1987).
[16] In re: Bachrach Clothing, 480 B.R. 820 (Bank. N.D. Illinois, E.D., 2012).
[17] Messrs. Schwartz and Bryan briefly discuss this case in their follow-up paper titled ''Expert Testimony in BV Cases Should Be the Exception, Not the Rule'' in the May/June 2013 issue of *The Value Examiner*.
[18] The Court ultimately found that this series of transactions should not be collapsed, which rendered moot the plaintiff's allegation that the debtor was insolvent. *Bachrach Clothing*, 480 B.R. 820, 859. Nevertheless, the Court (perhaps in anticipation of an appeal) addressed the plaintiff's allegation that the debtor was insolvent.
[19] *Bachrach Clothing*, 480 B.R. 820, 867.

paper published in *The Business Lawyer,* Messrs. Schwartz and Bryan propose that valuation-related expert testimony should not automatically be considered in cases where there is ''reliable, contemporaneous market evidence of value.''[20] The authors believe that *Vlasic, Iridium,* and *Bachrach Clothing* are cases that fit this description. *The Business Lawyer* published a rejoinder paper in 2013, written by Messrs. Stark, Williams, and Maxwell.[21] The authors of the rejoinder paper believe that parties should be allowed to automatically proffer valuation-related experts even in cases such as *Vlasic* and *Iridium* (and presumably *Bachrach Clothing*). The key issues addressed in *The Business Lawyer* papers are (1) the relevance of the courts' findings in *Vlasic* and *Iridium* and (2) what to do at the conclusion of fact discovery.

Relevance of the Courts' Findings in *Vlasic* and *Iridium*

A core debate in *The Business Lawyer* papers is the potential characterization of the federal courts' findings in *Vlasic* and *Iridium* as ''landmark'' decisions.[22] Messrs. Schwartz and Bryan consider *Vlasic* and *Iridium* to be ''landmark'' decisions. Messrs. Stark, Williams, and Maxwell, on the other hand, contend that *Vlasic* and *Iridium* are ''well-reasoned and important decisions'' but do not represent a ''groundbreaking moment in law.''[23] They contend that these decisions ''are not so much precedential 'landmarks' as clear and emphatic applications of a proposition long accepted in the law: In certain circumstances, market data may be quite compelling—even dispositive—valuation evidence.''[24] A discussion on whether these cases are in fact ''landmark'' decisions is beyond the scope of this paper.

What to Do at the Conclusion of Fact Discovery

The above discussion matters because Messrs. Schwartz and Bryan seek to extract ''the full potential'' of these potentially ''landmark'' decisions ''to make valuation litigation fairer and less expensive.''[25] Simply put, Messrs. Schwartz and Bryan view these decisions (and similar decisions that followed) to be a game changer that should affect the process used by parties that seek to sponsor valuation-related expert testimony.

Messrs. Schwartz and Bryan explain that there is ''a major procedural hurdle to achieving the full benefits of the [*Vlasic*] and *Iridium* approach to corporate valuation: the deeply ingrained judicial practice of allowing bankruptcy litigants routinely to hire and present expert valuations.''[26] They observe that ''[t]here seems, in short, to be a *de facto* presumption operating in bankruptcy litigation that litigants in valuation disputes are entitled to retain and proffer valuation experts regardless of the state of the non-expert record.''[27] They contend the de facto presumption that expert testimony can always be proffered is wasteful (in terms of time and money) in cases that are ultimately decided based on findings from the fact record.

Messrs. Schwartz and Bryan contend that the state of the non-expert record matters, and they propose that parties should take a deep breath at the end of fact discovery. In place of the current practice that quickly transitions from fact discovery to expert discovery, they propose that:

> the full effectuation of [*Vlasic*] and *Iridium* would be best achieved by requiring a party wishing to call a valuation expert to make a motion by the close of fact discovery affirmatively showing that the trier of fact cannot reach a reasoned decision about value by relying on market evidence in the fact record. No longer should it be a matter of course that, as is now common practice, expert reports are filed within a short time after fact discovery has closed, automatically putting into motion a costly sequence of expert reports and depositions, followed by rebuttal reports and more depositions, and setting the stage for a substantial commitment of valuable trial time—all for a species of evidence that may be wholly unnecessary to a just and reasoned decision of the case.[28]

Messrs. Stark, Williams, and Maxwell, on the other hand, are defenders of the status quo. They essentially argue that the current process works well and that the cost savings from the motion requirement proposed by Messrs. Schwartz and Bryan are not likely to be large for two reasons. First, they contend that ''massive valuation trials are a very rare occurrence, more the remote exception than the rule.''[29] Second, they observe that testifying experts are often retained well before the close of fact discovery, as they often assist attorneys with the development of the fact record.[30]

A debate of *The Business Lawyer* papers on the merits is beyond the scope of this paper. However, there is an important issue addressed in those papers that is within the scope of this paper. That issue is the characterization of a debtor as distressed or not distressed.

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[20]Schwartz and Bryan, op. cit.: 951. The authors state that contemporaneous market evidence is not limited to the prices of publicly traded stock and debt because it includes the types of evidence that is addressed in Table 1.

[21]Robert F. Stark, Jack F. Williams, and Anders J. Maxwell, ''Market Evidence, Expert Opinion, and the Adjudicated Value of Distressed Businesses,'' *Business Lawyer* 68(2013):1039.

[22]Schwartz and Bryan, op. cit.: 939 and Stark, Williams, and Maxwell, op. cit.: 1051.

[23]Stark, Williams, and Maxwell, op. cit.: 1051.

[24]*Id.* at 1052.

[25]Schwartz and Bryan, op. cit.: 940.

[26]*Id.* at 941.

[27]*Id.*

[28]*Id.* at 952.

[29]Stark, Williams, and Maxwell, op. cit.: 1057.

[30]*Id.* at 1057.

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Messrs. Stark, Williams, and Maxwell focus particularly on the valuation of distressed businesses in their paper. These authors acknowledge that ''[t]rading volumes and price levels [of a debtor's stock and debt securities] can readily reflect enterprise worth, especially respecting *healthy* companies that enjoy wide analyst coverage and/or highly liquid trading in their stock [emphasis added].''[31] However, they contend that findings in cases such as *Vlasic* and *Iridium* ''cannot be extrapolated'' in particular to cases that address ''distressed businesses.''[32] They also contend that ''expert testimony is often needed to assist the trier of fact in assessing the reliability, relevance, and credibility of pricing information at the time a company is in financial distress.''[33]

The focus on distress is often relevant when performing a prospective valuation of a bankrupt debtor but it is not always relevant when performing a retrospective valuation. In fact, every debtor that is subject to a fraudulent conveyance or preference lawsuit was, by definition, *not* bankrupt on the transfer date. The defendant will often argue that the debtor was not distressed on the transfer date either.

It is possible that some (perhaps many) proponents of the position taken by Messrs. Stark, Williams, and Maxwell will agree with the proposal by Messrs. Schwartz and Bryan for cases in which the debtor was not demonstrably distressed. As a practical matter, some cases will be relatively straightforward (e.g., *Vlasic*), whereas other cases will have more nuanced fact records (e.g., *Tronox*[34]). The proposal made by Messrs. Schwartz and Bryan, if executed properly, would not allow expert testimony in the straightforward cases but would allow expert testimony in the more nuanced cases.

Extrapolation of These Concepts to *Bachrach Clothing*

The unique situation that led to the fraudulent conveyance lawsuit in *Bachrach Clothing* suggests to this author that the approach advocated by Messrs. Schwartz and Bryan should prevail in this particular instance. This is not a case in which impaired creditors were allegedly misled when they lent the money to the debtor. This is a case in which the so-called creditor was the private *equity* sponsor (aka, the buyer) who structured the disputed transaction. This unusual result occurred because the buyer converted its equity investment into secured debt shortly before it put the debtor into bankruptcy, which placed the buyer at the top of the waterfall.[35] The buyer then caused the debtor to agree not to sue the buyer.[36] Finally, the buyer caused the debtor to file a fraudulent conveyance lawsuit in an attempt to recover the proceeds that were paid to the seller. A trade creditor ''succinctly described [the buyer's] successful tactics'' as follows:

> … It appears that [the buyer] is attempting to take two bites from the same apple. If [the debtor] became profitable they would profit from their investment. If it failed [the buyer] would get all their money back as secured creditors.[37]

It is not surprising that the Court focused on what happened in the ''real world'' in this situation. The buyer was the sponsor of the disputed transaction and did not make any credible allegations that it was misled by the buyer. Thus, the Court was faced with a ''bizarro world'' case in which the *equity* sponsor of a leveraged buyout would be the primary recipient of any recovery on fraudulent conveyance claims, which are generally supposed to be for the benefit of impaired *creditors*.

Extrapolation of These Concepts to Other Matters

There are other instances in which expert testimony may be relevant even when there are ample contemporaneous indicators of solvency or insolvency. This paper will address two types of examples. First, it will address a situation in which there was conflicting contemporaneous evidence (*TOUSA*). Second, it will address a situation in which the contemporaneous evidence on the surface consistently suggested that the debtor was solvent but the Court nevertheless found that the debtor was insolvent (*Tronox*).

Other relevant actions of knowledgeable insiders and outsiders that may suggest the debtor was solvent

Contemporaneous actions of knowledgeable insiders and outsiders are not limited to the examples present in the courts' opinions for *Vlasic*, *Iridium*, and *Bachrach Clothing*. For example, indicators of a debtor's solvency or insolvency can be shown by actions taken (or not taken) by a debtor's

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[31] *Id*. at 1062.
[32] *Id*.
[33] *Id*. at 1064.
[34] *Tronox* is discussed later in this paper.

[35] The Court explained that ''[o]nce [the buyer] decided to stop funding [the debtor,] it 'papered over' its equity investment by having [name omitted] sign the note …. By purchasing the [name omitted] note and increasing [the debtor's] debt to cover the additional $3 million contribution with a back-dated note, [the buyer] converted most of its capital contribution into a secured claim. Shortly after [the buyer] elevated its investment to a position ahead of [the debtor's] unsecured creditors, [the buyer's] principals decided to pull the plug on [the debtor]. [The debtor] filed bankruptcy a few weeks later ….'' *Bachrach Clothing*, 480 B.R. 820, 845.
[36] The Court explained that the buyer ''controlled [the debtor's] bankruptcy so effectively that [the debtor's] Chief Restructuring Officer … had no idea why he agreed not to sue the [buyer].'' *Bachrach Clothing*, 480 B.R. 820, 849.
[37] *Bachrach Clothing*, 480 B.R. 820, 849–850.

management team. Did the management team buy stock in the debtor? Did the management team sell its stock in the debtor at the 1st opportunity? Did the management team participate in a deferred compensation plan (and risk becoming an unsecured creditor upon a subsequent bankruptcy filing)? None of these actions on their own, or in combination, are dispositive. However, one may suspect that the management team of a debtor that was clearly insolvent would (1) not buy stock, (2) sell stock at the 1st opportunity, and (3) not participate in a deferred compensation plan at all or beyond the amount that is subject to company match.

Another indicator of a debtor's solvency or insolvency is the contemporaneous actions taken by the debtor's creditors. The courts and practitioners tend to focus on the relative ''big'' decisions that are made related to a large loan.[38] However, there are a substantially greater number of relatively ''small'' decisions that are made in the ordinary course of business. For example, vendors sell products and service providers perform their services on credit. In these instances counterparties choose to extend credit to the debtor, which they presumably would not do if they believed the debtor was insolvent.[39]

Consider a vendor that sells products to the debtor every month on terms that require payment within thirty days. Assume the debtor filed for bankruptcy two years after the transfer date. The vendor in this example chose to extend credit to the debtor over *twenty* separate times between the transfer date and the bankruptcy filing (i.e., 2 years $\times$ 12 months/year = 24 months). It is often difficult to argue that this vendor believed the debtor was insolvent during this entire two-year period.

Contemporaneous valuation analyses

Contemporaneous valuation analyses performed by 3rd parties are sometimes more formal than the ones produced in *Vlasic* and *Iridium*. Examples of such analyses include solvency and fairness opinions.

Solvency opinions

As the name suggests, a solvency opinion reflects an opinion that the debtor was solvent as of a particular date. A solvency opinion can be issued by a firm contemporaneous with a transaction.[40] For the purposes of this paper, a contemporaneous solvency opinion is referred to as a ''prospective'' opinion (versus a ''retrospective'' opinion that is proffered in litigation). Prospective solvency opinions are obtained as part of a proactive risk management practice and can support board decisions across a broad range of transactions and circumstances. These opinions are often obtained by boards in an attempt to mitigate the risk that the debtor's fiduciaries, in good faith, approved a transaction that subsequently becomes subject to a preference, or fraudulent transfer, lawsuit. Thus, a well-supported prospective solvency opinion can help to independently establish that the debtor was solvent when the transfer occurred.

The presence of a prospective solvency opinion does not automatically mean that a court will find the debtor was solvent as of the date that opinion was rendered. As discussed in more detail below, courts have sometimes questioned the reliability of prospective solvency opinions. Similarly, the lack of a prospective solvency opinion does not necessarily suggest that the parties believed the debtor was insolvent on the transfer date. Interestingly, the lack of a prospective solvency opinion may suggest that the parties believed the debtor was comfortably solvent. A prospective solvency opinion costs money, and the costs may outweigh the expected benefits when everyone thinks the debtor is comfortably solvent. Thus, the probability that a prospective solvency opinion will be procured is likely negatively correlated with the debtor's financial condition.[41] To

[38]There is logic to this approach because it is often (but not always) illogical for a creditor to knowingly lend ''new'' money to an insolvent debtor. However, there are at least four notable exceptions. First, a lender may be willing to lend ''new'' money to an insolvent debtor if the loan is over-secured. However, the lender (assuming it is not an insider) needs to be reasonably sure that the debtor will not subsequently file for bankruptcy within ninety days in order to avoid a possible preference lawsuit. Second, an existing lender may be willing to make a ''defensive'' loan in which the expected loss on the ''new'' money is more than offset by the expected gain on the outstanding loan(s). For example, the lender may conclude that the debtor is worth more outside of bankruptcy than in bankruptcy and may be willing to contribute ''new'' money to preserve the value of its existing claims on the debtor. Third, a lender may be willing to lend ''new'' money at a sizable expected loss on the debt component if the debt is convertible into equity. In this instance, the expected value of the conversion option (which is effectively a call option) may be substantially greater than the expected loss on the debt component of the security. Finally, some lenders may be willing to lend ''new'' money to potentially insolvent debtors through so-called ''Happy Meal'' loans, which are named after McDonald's hamburger-and-toy combo. The lender in these types of loans (which are convertible into equity) is given the right to easily borrow shares from the debtor, which enables it to short the debtor's stock. The *Wall Street Journal,* in a page-1 paper, explained that the lenders (hedge funds) ''can make money if the companies' shares rise in value by converting their bonds into more-valuable stock. If the stock falls, their short positions often can more than make up for any losses on the bonds.'' The *Wall Street Journal*'s analysis ''shows that share prices of 19 of the 24 companies had fallen 200 trading days after deals, by an average of 53%.'' ''Cash Poor Companies Feed Hunger for 'Happy Meal' Bonds,'' *The Wall Street Journal* (19 August 2013).

[39]This is admittedly an oversimplification. Some creditors may knowingly extend credit to an insolvent debtor under the assumption that they can reduce their exposure upon further signs of financial distress (but they risk being the defendant in a preference lawsuit if they are successful). Other creditors may feel they have no choice but to continue to provide credit to the debtor (sometimes there is a prisoner's dilemma, wherein the collective support of creditors is in the individual creditor's self-interest). Another subset of creditors may believe that their transactions are safe harbored and therefore not at risk from a preference lawsuit.

[40]As a practical matter, the due diligence and reporting of such opinions, along with the underlying support, are completed prior to the debtor entering into a binding agreement or closing of the transaction.

[41]Said differently, the probability that a very creditworthy debtor will procure a solvency opinion is relatively low, whereas the probability that a debtor of questionable creditworthiness will procure a solvency opinion is relatively high.

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demonstrate this concept, a prospective solvency opinion was not procured in *TOUSA* (as discussed in more detail below) until after one of the debtor's lenders suggested the debtor was in the so-called ''zone of insolvency.''

A party seeking to establish that a debtor was insolvent on the transfer date should search for evidence that the debtor sought to procure, but was unable to obtain, a prospective solvency opinion from a reputable provider.[42] This concept is discussed in more detail below in the discussion related to *ASARCO*.

Contemporaneous solvency opinions are not limited to those that are provided by 3rd-party firms. Perhaps the most relevant form of a prospective solvency opinion is sponsored by a senior member of the debtor's management team. It is common for lenders to require a senior member of the debtor's financial management team to make a solvency representation in the formal credit agreement. It is also common for lenders to require a solvency representation in subsequent waivers and amendments to the formal credit agreement.[43]

The relevance of solvency representations is often debated among the parties in a fraudulent conveyance or preference litigation. The defendant will often argue that the solvency representations are very compelling contemporaneous indicators of solvency. Conversely, the plaintiff will often try to dismiss the relevance of the contemporaneous solvency representations. The plaintiff will often argue that the representations were simply a boilerplate portion of the credit agreement and that the person who made the representation was not qualified and/or informed enough to credibly make the representations.

Fairness opinions

A fairness opinion is also obtained by boards as part of a proactive risk management practice and can support board decisions across a broad range of transactions and circumstances. These opinions are often obtained in an attempt to mitigate the risk that the debtor's fiduciaries, in good faith, approved a transaction that subsequently becomes subject to a lawsuit alleging that the terms of the transaction were not fair to certain shareholders. A fairness opinion is often provided by a financial advisory firm to the board of directors and states that the terms of the transaction are ''fair from a financial point of view'' to the shareholders of the company that procured the fairness opinion.[44]

A fairness opinion does not explicitly affirm the solvency of the debtor. However, a fairness opinion can be used as a de facto Balance Sheet Test for the debtor, which is relevant for solvency analyses.[45] This is so even for situations in which only the seller (and not the buyer) receives the fairness opinion. This observation is relevant because sellers are more likely than buyers to procure fairness opinions.[46,47]

It may not be clear why a fairness opinion has any bearing on a solvency analysis. More specifically, there

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[42]It would be easier to establish that the debtor was insolvent if the fact record included a contemporaneous insolvency opinion. However, a debtor is unlikely to procure an insolvency opinion in connection with a transaction it executed. Simply put, it would typically be illogical for a debtor to procure an opinion that indicated its board approved a transfer that was likely a fraudulent transfer or preference payment and/or a breach of fiduciary duty and/or an illegal dividend, etc.

[43]The subsequent solvency representations arguably establish a ''line in the sand'' that retrojection arguments cannot cross. More specifically, it is difficult for a plaintiff to argue that the debtor's subsequent bankruptcy filing was foreseeable on the transfer date when a senior member of the debtor's management team represented that it was solvent *on*, and at a point in time *after*, the transfer date.

[44]Steven M. Davidoff, Anil K. Makhija, and Rajesh P. Narayanan, ''Fairness Opinions in Mergers and Acquisitions.'' Chap. 26 of *The Art of Capital Restructuring: Creating Shareholder Value Through Mergers and Acquisitions*. Eds. H. Lent Baker, Halil Kiymaz. Hoboken, NJ: Wiley, 2011. The authors observe that a fairness opinion ''is not an appraisal'' and that it ''does not specify a set value or presume to be a determination of price …. Instead, a fairness opinion is the opinion of a financial or other advisor that a specified transaction is within a range of values encompassing financial 'fairness.' A more specific definition of fairness in these circumstances is almost never proposed or spelled out.'' *Id*. at 484. The authors further observe that ''To date, there is no agreed-upon standard definition among academics, practitioners or standard-setters of what fairness is in any circumstance'' and that ''[l]iability concerns have driven the fairness opinion structure and form.'' *Id*. at 485. Thus, providers of fairness opinions ''have eschewed definitional fairness since elaboration provides further facts and conclusions upon which to challenge the opinion's validity or preparation or to otherwise assert under the federal securities (and other disclosure-based laws) that it is a statement of fact rather than opinion.'' *Id*. at 485.

[45]The Balance Sheet Test compares the fair value of the debtor's assets with the debtor's liabilities. See the 3rd paper in this series for a more detailed description of the Balance Sheet Test.

[46]Researchers have observed that sellers almost universally procure fairness opinions, whereas buyers do not universally procure fairness opinions. For example, one study (Cain and Denis, 2009) of 582 negotiated public transactions between 1998 and 2005 revealed that sellers procured a fairness opinion 96% of the time, whereas buyers only procured a fairness opinion 28% of the time. The authors explain that the Delaware Supreme Court's decision in *Smith v. Van Gorkom* was a prominent precedent and that other entwinements of Delaware law led to the de facto legal requirement for sellers to obtain fairness opinions. Delaware law is prominent because ''[t]he majority of U.S. publicly listed corporations are organized in the State of Delaware and governed by its laws. Moreover, the law of Delaware carries enormous weight in corporate law matters in the other states. Thus, in the aftermath of *Van Gorkam*, the fairness opinion became a de facto if not legal requirement throughout the United States for targets [sellers] in a corporate control transaction.'' Davidoff et al., op. cit.: 486.

[47]The Court in *Smith v. Van Gorkom* found that the seller's board was grossly negligent in part because ''there was no call by the Board … for any valuation study or documentation of the $55 price per share as a measure of the fair value of the Company in a cash-out context.'' The Court explicitly stated that ''We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law.'' *Smith v. Van Gorkom*, 488 A.2d 858, 876 (Supr. Ct. Del. 1985). Messrs. Davidoff, Makhiha, and Narayanan explain that ''any reading of the opinion suggested that [procurement of] a fairness opinion was not necessarily'' a requirement for the seller's board to establish that it did not breach its duty of care. Nevertheless, ''later Delaware court opinions would provide further support for'' the inference that the procurement of a ''thoroughly prepared valuation study or fairness opinion'' would ''satisfy the board's duty of care and to be duly informed as to corporate value'' as well as ''establish sufficient basis to rely on 8 Del. C. § 141(e).'' Davidoff et al., op. cit.: 486.

are three arguments that can be made to dismiss the relevance of fairness opinions in a solvency analysis. First, fairness opinions are frequently provided to the seller, not the buyer or debtor. Second, it is easy for a firm to issue a fairness opinion to the seller when the buyer pays too much (and overburdens the debtor with debt in the process). Third, the wide range of values included in fairness opinions suggests that the valuation analysis is not very precise and thus not very reliable.[48] Each of these arguments is addressed below.

A fairness opinion issued to a seller can be relevant when assessing the debtor's solvency because the fairness opinion is often based on a valuation of the debtor. For example, consider the sale of a seller's subsidiary to a buyer (who pays in cash) in a leveraged buyout. A fairness opinion issued to the seller, buyer, or debtor in this situation would value the same business: the business being sold by the seller and bought by the buyer. This business is the debtor. At the end of the day, a fairness opinion (provided to the board of the seller, buyer, or debtor) is an opinion that is supported by an underlying valuation analysis.[49] In an paper that summarizes his study of fairness opinions, Gilbert Matthews included the following excerpt from Vice Chancellor (now Chief Justice of Delaware's Supreme Court) Strine:

> [C]ourts must be candid in acknowledging that the disclosure of the banker's 'fairness opinion' alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability.
> The real informative value of the banker's work is not in its bottom-line conclusion, but in the valuation analysis that buttresses that result …. [A] minority stockholder engaging in the before-the-fact decision whether to tender would find it material to know the basic valuation exercises that [the investment banker] undertook, the key assumptions that they used in performing them, and the range of values that were thereby generated.[50]

The binary nature of solvency analyses makes it possible to consider fairness opinions issued to a seller even in situations in which the buyer overpaid. This is an important observation because the plaintiff in most fraudulent conveyance lawsuits will argue that the buyer overpaid.

Let us consider an example in which a debtor pays $3 billion for a business enterprise that is only worth $2 billion. It would be easy for a firm to issue a fairness opinion to the seller in this situation. Perhaps the business enterprise valuation range would be $1.8 to $2.2 billion, which is significantly less than the $3 billion selling price. But now let us assume that the debtor had $1 billion of debt after this transaction was consummated. The buyer may have overpaid in this situation (by $1 billion) but the debtor is still solvent under the Balance Sheet Test because its business enterprise is worth $2 billion, while it only has $1 billion in debt. This may be a ''bad'' deal for the buyer but it has to be a ''really bad'' deal for the debtor's creditors before the debtor becomes insolvent.[51] This explains why a *relative* analysis such as a fairness opinion to a seller when the buyer overpays is still relevant for assessing an *absolute* analysis such as the solvency of the debtor.

It is common for fairness opinions to include a wide range of values.[52] This wide range of values could limit the utility of fairness opinions in the context of assessing the fairness of a transaction. However, this wide range of values *increases* the utility of fairness opinions in the context of assessing the solvency of a debtor. This result occurs for two reasons. First, a wide range of values results in lesser ''low'' values and greater ''high'' values. The end result is a de facto sensitivity analysis. Any debtor that passes the Balance Sheet Test at the ''low'' end of this wide range has effectively passed a downside sensitivity test. Second, to the extent one argues that there is bias in the analysis; the bias is more likely to result in ''lower''

[48]See Gilbert Matthews, ''Valuation Methods in Fairness Opinions: An Empirical Study of Cash Transactions,'' *Business Valuation Review* 31(2012):55–74 for a discussion regarding the wide range of valuation in fairness opinions.

[49]Messrs. Davidoff, Makhija, and Narayanan explain that the ''meat'' of the fairness opinion is in the ''board book'': ''A well-advised board will review this book in connection with their receipt of a fairness opinion and question the bankers as to their derivation of fairness. The fairness opinion's meaning and worth, if any, lies in these actual analyses.'' Davidoff et al., op. cit.: 485.

[50]Matthews op. cit.: 56. This excerpt is from *In re Pure Resources, Inc. Shareholder Litigation*, 808 A.2d 421, 449 (Del. Ch. 2002).

[51]I was once given the following advice: A seller procures a fairness opinion to make sure the seller gets a good deal and a solvency opinion to make sure the seller does not get too good of a deal when the purchase price is financed with a lot of debt. As discussed in this paper, a fairness opinion indirectly addresses the Balance Sheet Test. However, many practitioners will argue that a fairness opinion does not address the Adequate Capital or Ability to Pay Debts tests. For example, a debtor that passes the Balance Sheet Test by a small amount may not have enough of an ''equity cushion'' to be deemed adequately capitalized. Other practitioners will argue that the contemporaneous financing of the debt often establishes that the debtor was deemed by contemporaneous investors to be adequately capitalized and able to pay its debts.

[52]Gilbert Matthews, ''Valuation Methods in Fairness Opinions: An Empirical Study of Cash Transactions,'' *Business Valuation Review* 31(2012):55–74. The author has a section titled ''Commentary: Wide spreads of inputs limit the utility of DCF as a fairness standard.'' Mr. Matthews explains in this section that ''[t]he wide valuation ranges that are used in fairness opinions are of limited utility in assessing fairness. If the price offered to shareholders is near the low end of a wide range, how is that fact an indicium of fairness? Are wide ranges used to make it easier to fit a transaction price within a range? The credibility of fairness opinions is deleteriously affected by wide valuation ranges.''

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values, not ''higher'' values.[53] This occurs because the fairness opinion provider's bias, to the extent it exists, is likely to *under*state the value of the debtor.[54] Any debtor that passes the Balance Sheet Test under this skew toward ''lower'' values would pass the Balance Sheet Test by a greater margin under results that are not skewed.

Relevant actions in TOUSA *that suggest the debtor was insolvent*

The discussion so far has been focused on contemporaneous indicators of solvency. This occurred because we have focused on (1) cases in which the debtor was found to be solvent and (2) the contemporaneous opinions of financial advisors that are likely to lead to direct (or indirect) solvency determinations. Recall that debtors are unlikely to procure opinions from financial advisors that indicate the debtor was insolvent when its board approved the disputed transaction.

The discussion will now address contemporaneous indicators of insolvency. We will first discuss *TOUSA*, which was the only case in the 1st paper that used contemporaneous market prices for the debtor's securities to establish that the debtor was insolvent on the transfer date.

The fact pattern in *TOUSA* was substantially different than the fact patterns in *Vlasic, Iridium,* and *Idearc*. There were multiple contemporaneous indicators of insolvency in *TOUSA,* whereas there were multiple indicators of solvency in the other matters.

However, the fact pattern in *TOUSA* was also very similar to the fact patterns in *Vlasic*, *Iridium*, and *Idearc*. Contemporaneous actions taken by knowledgeable insiders and outsiders were generally consistent with the market data in all of these cases. Thus, the court could have theoretically arrived at its conclusion in *TOUSA* without (1) knowledge of the market prices for claims on the debtor or (2) expert testimony sponsored by the plaintiff or defendant regarding the debtor's enterprise value on the transfer date.

Interestingly, all of the contemporaneous indicators did not universally support a determination that the debtor was insolvent in *TOUSA*. As mentioned earlier, a prospective solvency opinion was procured, and the defendant argued this fact established that the debtor was solvent on the transfer date. The court ultimately did not rely on the contemporaneous solvency opinion for the reasons mentioned below. Thus, *TOUSA* is a case in which expert testimony may have been helpful, as the court was presented with conflicting contemporaneous indicators of solvency and insolvency.[55]

The fact pattern in *TOUSA* addresses an issue identified by Messrs. Stark, Williams, and Maxwell in their paper. These authors ''hope to spark deeper and more thoughtful scholarly discussion over when and what forms of market evidence should be deemed probative and persuasive to courts adjudicating the value of distressed business enterprises.''[56] In *TOUSA,* the Court was forced to choose between (1) the market price for the debtor's securities that indicated the debtor was insolvent and (2) the contemporaneous solvency opinion that indicated the debtor was solvent.

There is no choice that is correct every time. Some (perhaps most) will argue that the market price for the debtor's securities is more relevant. However, the Delaware Chancery Court's practice of focusing more on independent valuations sponsored by experts than on the transaction terms in so-called ''appraisal'' cases could suggest that the contemporaneous solvency opinion (assuming it was deemed to be reliably prepared) may be more relevant.[57]

Non-Valuation-Related Topics

There were several actions taken *prior* to the transfer date by knowledgeable *insiders* that suggested the debtor may have been insolvent prior to and at the transfer date. The debtor's CEO painted a bleak picture to the debtor's

[53]This discussion is not meant to suggest that fairness opinion providers produce biased analyses. This discussion is only meant to highlight that any allegation of bias in the analysis (which is presumably the point of anyone who argues that a fairness opinion provided to the seller is irrelevant for assessing the buyer's and debtor's perspective) would logically suggest that the values were too ''low,'' not too ''high.''

[54]Some researchers believe that fairness opinion providers deliver ''valuations that favor the completion of deals.'' Davidoff et al., op. cit.: 490 (citing to Cain and Denis, 2009). This bias, to the extent it exists, suggests that fairness opinions provided to sellers systematically *under*state the debtor's value (to establish that the deal price is ''high'' relative to the benchmark), whereas fairness opinions provided to buyers systematically *over*state the debtor's value (to establish that the deal price is ''low'' relative to the benchmark). Such a bias would suggest that most fairness opinions understate the value of the debtor because most fairness opinions are provided to the seller, not the buyer. Thus, this bias, to the extent it exists, reinforces the merit of using most contemporaneous fairness opinions to establish that a debtor was solvent under the Balance Sheet Test.

[55]One could say that the conflicting contemporaneous evidence in *TOUSA* is consistent with Messrs. Stark, Williams, and Maxwell's view that ''[i]n the end, the views and actions of 'knowledgeable insiders' and 'knowledgeable outsiders' are simply one side's factual evidence, no more, no less. They do not supplant other forms of evidence and do not, in and of themselves, provide any basis for excluding contrary evidence.'' Stark, Williams, and Maxwell, op. cit.: 1049.

[56]Stark, Williams, and Maxwell, op. cit.: 1042.

[57]The customary focus on expert-prepared valuations over the transaction terms is perhaps best demonstrated by the Delaware Chancery Court's recent decision in Huff Fund Investment Partnership v. CKx, Inc., No. 6844-VCG (Del. Ch. Nov 1, 2013). This case has garnered a lot of attention because the Court focused on the merger price and not the expert valuations, which was unusual for the Delaware Chancery Court in an ''appraisal'' case and was justified by the Court based on case-specific reasons.

board[58] and a bleaker picture to the debtor's largest shareholder.[59] The debtor's CFO wrote an e-mail to himself stating that the debtor ''*will* fail'' to satisfy covenants in its bond indentures ''into late 2008 or 2009. Not even close.''[60] The debtor's CFO further stated, ''[a]s CFO, and in light of all this market uncertainty, I have absolutely no desire to fly this plane too close to the ground, achieve some from [sic] of consensual settlement today and crash within the upcoming year. That would be a [expletive removed].''[61]

There were also several actions taken *prior* to the transfer by knowledgeable *outsiders* that suggested the debtor may have been insolvent prior to and at the transfer date. For example, some of the debtor's bondholders warned that the company would be entering the zone of insolvency and that the proposed transfer might result in the debtor's subsequent bankruptcy filing.[62] Additionally, a 3rd party performed a bankruptcy waterfall analysis, with the implication being that bankruptcy was being considered as an option.[63] Finally, the credit rating agencies rated the subordinated bonds at Ca (Moody's) and CCC− (Standard and Poor's [S&P]). The Court observed that, according to Moody's, ''[o]bligations rated Ca are highly speculative and are likely in, or very near, default.''[64] The Court also observed that, according to S&P, a credit rating of CCC− denotes ''[i]n the event of adverse business, financial or economic conditions … an obligor is not likely to have the capacity to meet its financial commitment on [an] obligation.''[65]

Contemporaneous Solvency Opinion

While a contemporaneous (prospective) solvency opinion was obtained in connection with the disputed *TOUSA* transaction, the Bankruptcy Court concluded that this opinion was not a persuasive indicator of the debtors' solvency on the transfer date.

The Bankruptcy Court found the background that led to the procurement of the solvency opinion to be relevant. A contemporaneous bondholder complained via a letter that the proposed transaction might result in a fraudulent transfer. The administrative agent for the proposed transaction demanded the procurement of a solvency opinion after receiving this letter.[66]

The Bankruptcy Court found it relevant that the solvency opinion provider did not address the subsidiary guarantors' solvency. The solvency opinion provider was only asked to address the consolidated enterprise's solvency. It may be reasonable to conclude that the solvency opinion provider was asked to answer the wrong question.[67]

[58]''At the June 20, 2007 Board meeting, at which the Board approved the July 31 Transaction, [the debtor's CEO] informed the Board that the U.S. housing market was at the lowest point since 1991 …. A PowerPoint presentation to the Board described the economic reality facing the company. The 'selling season and housing recovery [are] not what we hoped when we prepared the budget.' TOUSA was liquidating assets at the bottom of the market; pursuing a '[v]alue-destructive' strategy through the Transeastern settlement'; had limited access to capital markets; had undertaken financing on a 'very short leash'; and had '[l]ittle room for errors' because the company was '[f]lying too low to the ground.''' *TOUSA,* 422 B.R. 783, 794.

[59]The debtor's CEO sent TOUSA's largest shareholder's advisor a memo entitled ''Strategic Alternatives'': ''In a bullet-point summary at the outset captioned 'The TE settlement leaves TOUSA in a very difficult position,' [the debtor's CEO] observed that, as a result of the Transeastern settlement, TOUSA would be '[o]ver-leveraged,' '[w]ithout access to the capital markets,' in the midst of a 'serious housing correction,' at the 'wrong time' to be '[f]orced to reduce assets,' '[i]n need of a significant equity infusion,' and '[u]nable to survive should housing conditions degrade further or the housing correction lengthen appreciably.' [The debtor's CEO's] memorandum foresaw that a '[s]tay the [c]ourse strategy—even when coupled with the company's de-leveraging plan—would, among other things, leave TOUSA unable to service its $1 billion of bond debt, at a 'competitive disadvantage,' with '[c]apital [c]onstraints' that would allow '[b]arely enough 'oxygen' to survive,' with '[l]ittle room for error [and] increased risk of crashing and burning,' [l]imited ability to re-invest in the business,' and '[a]lways on the brink of default.' The '[e]nd [r]esult' of the strategy, [the debtor's CEO] acknowledged, would be '[i]ncreased risk of failure and inability to withstand worsening business conditions.''' One of the seven ''cons'' listed in the debtor's CEO memorandum of the proposed transaction was ''[l]iquidation or bankruptcy risk.'' *TOUSA,* 422 B.R. 783, 794–795. The Court observed that the debtor's CEO circulated a similar memorandum before TOUSA's board approved the transaction.

[60]*TOUSA,* 422 B.R. 783, 793.

[61]*Id.* at 793–794.

[62]''On May 16, Debtwire reported that TOUSA bondholders had warned that the company would be entering the 'zone of insolvency' if it took on the new financing to settle with the Transeastern Lenders, and that '[s]ome holders of Technical Olympic's secured debt, and a portion of other Transeastern mezz lenders, believe that the proposed settlement could force the company into eventual bankruptcy.''' *TOUSA,* 422 B.R. 783, 796.

[63]''[An investment bank] prepared a bankruptcy waterfall analysis for TOUSA in February 2007, and [one of TOUSA's senior financial advisors] suggested in early 2007 that the company needed a Chief Restructuring Officer.'' *TOUSA,* 422 B.R. 783, 792.

[64]*TOUSA,* 422 B.R. 783, 831.

[65]*Id.*

[66]''As TOUSA's financial condition deteriorated in the spring of 2007, its bondholders sounded an alarm. On April 18, 2007, counsel for [the contentious bondholder], a major investor in TOUSA bonds, delivered a letter to TOUSA's Board highly critical of the proposed Transeastern settlement. The letter observed that the settlement would swap an unsecured liability of parent corporation TOUSA for the secured liability of TOUSA and its subsidiaries; noted that the settlement might put TOUSA into the 'zone of insolvency' and the financing might be a 'fraudulent transfer;' and warned that the proposed refinancing could 'destroy the financial flexibility the Company will require to survive if the current housing slump becomes a protracted one' …. TOUSA immediately sent the [the contentious bondholder's] letter to [the administrative agent] which, in response, demanded on April 27, 2007 that TOUSA provide a solvency opinion as a condition of closing the July 31 Transaction. [TOUSA] acknowledged that [the administrative agent's] request was precipitated by the [contentious bondholder's] letter.'' *TOUSA,* 422 B.R. 783, 839.

[67]Interestingly, the defendant in *Tronox* focused on this legal entity point and cited the bankruptcy court's findings in *TOUSA*. The Court did not agree with the defendant in *Tronox* and noted that the appellate court in *TOUSA* did not address the legal entity point.

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The plaintiff made three procedural challenges in an attempt to cast doubt on the credibility of the contemporaneous solvency opinion. First, the plaintiff argued that the opinion provider did not have relevant industry experience.[68] Second, the plaintiff focused on the opinion provider's contingent fee arrangement, which suggests (according to the plaintiff) a bias toward a solvency determination.[69] Third, the plaintiff argued that the opinion provider arrived at its opinion in a short period of time, which suggested a lack of due diligence.[70] The Bankruptcy Court agreed with the plaintiff's characterization of these circumstances.

The Court also agreed with the plaintiff's three technical challenges that casted doubt on the reliability of the contemporaneous solvency opinion. First, the plaintiff argued that the financial projections used in the opinion provider's analysis were based on management's forecasts and that management's forecasts were unreliable.[71] Second, the plaintiff argued that the opinion provider did not sufficiently ''stress test'' (i.e., consider the downside scenarios of) the financial projections.[72] Third, the plaintiff argued that the opinion provider used a market multiple of earnings before interest, taxes, depreciation, and amortization (EBITDA) that was inappropriate for valuing a business in the debtor's industry (homebuilding).[73]

It is noteworthy that the Court found the financial forecasts provided to the solvency opinion provider did not reflect the full contemporaneous views of the debtor's management. The Court found that the debtor's management's outlook at the time was more pessimistic than the projections given to the solvency opinion provider.[74]

While the discussion above is informative, the procedural history of this case should be taken into account. This case focused on reasonably equivalent value (and not solvency) issues on appeal. The discussion above is included to provide some insight into the types of arguments a plaintiff may make, and a court may find compelling, in its attempt to discredit a contemporaneous solvency opinion.

Relevant actions in ASARCO *that suggest the debtor was insolvent*

We will now discuss a case involving a debtor that did not have any publicly traded securities in which the Court

[68]''[The administrative agent's] Commitment Letter required a solvency opinion from a 'nationally recognized, independent financial advisory firm that has substantial experience in providing solvency opinions in connection with transactions similar to the Transactions contemplated hereby'. But [the solvency opinion provider] had not provided a solvency opinion for a home builder since some time before 2005. Yet, despite [the solvency opinion provider's] apparent lack of experience, TOUSA did not consider any firm other than [the ultimate solvency opinion provider].'' *TOUSA,* 422 B.R. 783, 839.

[69]''The [solvency opinion provider's] solvency opinion was a contingent fee arrangement: TOUSA agreed to pay $2 million if [the solvency opinion provider] ultimately opined that TOUSA would be solvent immediately following the July 31 Transaction; but if [the solvency opinion provider] could not so opine, TOUSA would pay [the solvency opinion provider] only its time charges and reimburse its costs. These ultimately amounted to less than half of the $2 million fee which was paid …. [the solvency opinion provider's] lead partner on the solvency opinion engagement, [name omitted], described the $2 million as a 'premium' based on the riskiness of the assignment.'' *TOUSA,* 422 B.R. 783, 839–840.

[70]''[The solvency opinion provider] reached its bottom line opinion in remarkable speed. [The solvency opinion provider's] retention was finalized on June 15, 2007. By the time TOUSA's Board meeting on June 20, 2007, [the solvency opinion provider] had already indicated that it expected to deliver a favorable opinion. Indeed, in providing counsel to the TOUSA Board at the June 20 meeting, [an investment bank] assumed that TOUSA would be solvent based on the fact that TOUSA had 'received a solvency opinion from [the solvency opinion provider]'—even though the [solvency opinion provider's] opinion supposedly would not be completed for more than a month thereafter. On June 22, 2007, in response to [name omitted] request to read [the solvency opinion provider's] solvency opinion, [name omitted] emailed '[solvency opinion provider's] Final Solvency Opinion' to him. By June 27, 2007, a draft solvency opinion was in circulation.'' *TOUSA,* 422 B.R. 783, 840.

[71]The subheadings of the Court's opinion include the following: ''The [solvency opinion provider's] Opinion relied on projections provided entirely by TOUSA management, not from a 'bottoms up' analysis of TOUSA's business''; ''TOUSA did not revise the assumptions it provided to [the solvency opinion provider] even though it knew that the market was continuing to decline''; and ''To make matters worse, TOUSA did not even provide [the solvency opinion provider] with its honest assessment of its prospects.'' *TOUSA,* 422 B.R. 783, 840–842.

[72]The Court found that ''[j]ust as [the solvency opinion provider] relied on TOUSA's outdated assumptions for its base case model, [the solvency opinion provider] also used TOUSA's assumptions for the 'downside' models'' and that ''TOUSA designed its downside to include little real stress.'' The Court found that ''Because [the solvency opinion provider] blindly relied upon TOUSA's unsupportable financial projections, [the solvency opinion provider's] opinion that TOUSA was solvent as of July 31, 2007 is not credible. Even minor reductions in the [Average Selling Price] assumptions in [the solvency opinion provider's] discounted cash flow analysis would have resulted in a finding of insolvency. If the unrealistic [Average Selling Prices] in TOUSA's projections were reduced by merely 4.8% in each of [the] projected periods, it would have led to a finding of insolvency. Similarly, if the *only* change to the projections were to reduce the [Average Selling Price] assumption in the final year of the projections by 8%, it also would have led to a finding of insolvency [emphasis in original].'' *TOUSA,* 422 B.R. 783, 842–843.

[73]*TOUSA,* 422 B.R. 783, 843.

[74]Recall that one of the Court's findings was ''To make matters worse, TOUSA did not even provide [the solvency opinion provider] with its honest assessment of its prospects.'' *TOUSA,* 422 B.R. 783, 842. The Court found that ''[b]y the time [the solvency opinion provider's] opinion was issued, [TOUSA's CEO] no longer believed (if he ever did) the assumptions TOUSA had given to [the solvency opinion provider]. On August 4, 2007, [TOUSA's CEO] traveled to Porto Carras, Greece to visit … [the] chairman of TOUSA's Board of Directors and the largest shareholder of TOUSA's parent company. At that meeting, [TOUSA's CEO] presented his actual views of the state of the homebuilding industry. What he described to [TOUSA's chairman and largest shareholder] as the ''best case''—sales recovering in ''mid/late 2008'' and deliveries recovering in ''early/late 2009''—is itself more pessimistic than the ''base case'' (*i.e.,* likeliest) model that the company had provided to [the solvency opinion provider] only eight days earlier. [TOUSA's CEO] even described a scenario in which deliveries would not recover until mid to late 2010. A draft of the Porto Carras presentation, reflecting the same critical assumptions, was prepared at least a week *before* the [the solvency opinion provider's] solvency opinion was finished. But [TOUSA's CEO] sent [the solvency opinion provider] neither the Porto Carras presentation nor the facts contained in it [emphasis in original].'' *TOUSA,* 422 B.R. 783, 842.

found that the debtor was insolvent. Thus, the Court's finding in this case could not have been directly, or indirectly, influenced by contemporaneous market prices for the debtor's stock and/or debt securities.

ASARCO LLC, Southern Peru Holdings, LLC v. Americas Mining Corporation (''*ASARCO*'')[75] is a noteworthy matter in part because the plaintiff failed to establish that the debtor did not receive reasonably equivalent value[76] (which often would make the debtor's insolvency irrelevant) yet successfully convinced the same court that the transfer was a fraudulent conveyance under the actual intent provision.[77] As the name suggests, the actual intent provision pertains to the incurrence of debt or transfers that were made with the actual intent to hinder, delay, or defraud a debtor's creditors. The finding of actual intent suggests that there were contemporaneous indicators of insolvency as of the transfer date.

There were many contemporaneous indicators of insolvency. Six in particular stand out. First, the debtor's outside counsel concluded that the debtor was in the zone of insolvency, if not actually insolvent.[78] Second, the debtor's outside counsel, in the words of the Court, ''predicted this very lawsuit'' would be filed.[79] Third, the independent members of the debtor's board of directors did not consent to the transaction and resigned from the board.[80] Fourth, a 3rd party informed the debtor that it could not provide a prospective solvency opinion for the proposed transaction.[81] Fifth, the debtor had ''numerous past due obligations'' and opened a new bank account to stop creditors that sought to ''garnish or attach ASARCO's accounts,'' which the Court found to be ''persuasive evidence of [the defendant's] intent to hinder and delay ASARCO's creditors.''[82] Sixth, the debtor's auditors issued a going concern qualification in the years leading up to, and including, the transfer date.[83]

ASARCO is a good example of a case that would likely not require valuation-related testimony if the motion requirement proposed by Messrs. Schwartz and Bryan was put into place. This is so because the Court's findings were based almost entirely on the fact record summarized above.[84] Notably, the defendant did not even proffer a testifying expert for the Balance Sheet Test.[85]

Relevant actions in Tronox *suggest the debtor was solvent, yet the debtor was found to be insolvent*

Saving the most interesting (and recent) case for last, we will now discuss *Tronox*.[86] This case is noteworthy because the debtor had many contemporaneous indicators of solvency, yet it was nevertheless found to be insolvent. It is also interesting because a bankruptcy court judge in the Southern District of New York (the same venue as *Iridium*) placed more weight on expert analyses prepared in litigation than on contemporaneous analyses and actions. The Court in *Tronox* essentially found that the plaintiff did enough to prove that the debtor was insolvent, while the defendant did not do enough to establish that the contemporaneous indicators of solvency were grounded in reliable information. Notably, the Court found that this transfer was a fraudulent conveyance under both the constructive fraud and actual intent provisions.

The *Tronox* discussion in this paper consists of three parts. First, it addresses the ''avenues of proof'' that are not based on market prices, which is the subject of this paper. Second, it addresses the traditional market-based indicators of solvency because this case was published

[75] *ASARCO LLC v. Americas Mining Corp*., 396 B.R. 278 (Dist. Ct. 2008).

[76] ''Since the Court finds that ASARCO received reasonably equivalent value for the SPCC shares transferred on March 31, 2003, ASARCO's constructive fraudulent transfer claim fails and there is no need to reach the second prong regarding whether ASARCO was insolvent.'' *ASARCO*, 396 B.R. 278, 364.

[77] ''After considering the statutory badges of fraud and the other circumstantial evidence presented by both sides in this case, the Court determines that AMC entered into the challenged transaction with full knowledge that ASARCO's creditors would be hindered or delayed as a result. Therefore the Court finds that AMC had actual intent to hinder or delay ASARCO's creditors and is liable for actual fraudulent transfer ….'' *ASARCO*, 396 B.R. 278, 394. Interestingly, one of the ''statutory badges of fraud'' was the debtor's insolvency. *ASARCO*, 396 B.R. 278, 373.

[78] ASARCO's outside counsel sent a memo to ASARCO's Restructuring Committee ''that detailed the Committee's duties and obligations.'' ASARCO's outside counsel (based in part on contemporaneous analyses by others) concluded in this memo, issued prior to the transaction, ''that ASARCO was in the 'zone of insolvency,' if not actually insolvent and that the Board owed fiduciary duty to ASARCO's creditors.'' ASARCO's outside counsel also told ASARCO's Board that ''… it is well settled that the fact that ASARCO may be receiving reasonably equivalent value in exchange for the sales of the SPCC shares is immaterial to the question of intent and voidability in a fraudulent transfer lawsuit alleging actual intent to hinder, delay, or defraud ASARCO's creditors.'' *ASARCO*, 396 B.R. 278, 311–312.

[79] *ASARCO*, 396 B.R. 278, 312.

[80] ''Ultimately, on March 26, 2003, [the two independent board members] did resign from the Board and withdrew their consent from the entire transaction …. On March 31, 2003, AMC/Grupo closed on the transaction …. The transaction was approved by the remaining board members of ASARCO without dissent, primarily because the dissenting board members had resigned and the remaining board members were all affiliated with AMC/Grupo.'' *ASARCO*, 396 B.R. 278, 313.

[81] ''Midway through 2002, [the debtor's outside counsel] noted that [a reputable firm that provides prospective solvency opinions] could not render a solvency opinion for ASARCO and if one was needed, AMC/Grupo would have to hire another firm.'' *ASARCO*, 396 B.R. 278, 306.

[82] *ASARCO*, 396 B.R. 278, 386.

[83] *ASARCO*, 396 B.R. 278, 397.

[84] Valuation-related expert testimony was central to the Court's findings for the Reasonably Equivalent Value Test. However, those findings were effectively rendered moot (in the context of the fraudulent transfer claims) because of the Court's finding that there was actual intent to defraud, hinder, or delay the debtor's creditors.

[85] *ASARCO*, 396 B.R. 278, 404.

[86] In re: Tronox Incorporated, et al, 2013 WL 6596696 (Bkrtcy. S.D.N.Y.) (Dec 12, 2013).

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after the 1st paper in this series (which focused on these indicators) was finalized. Third, it shows how this case was superficially similar to *Vlasic* and *Iridium* but was ultimately found to be similar to *ASARCO*.

Avenues of Proof

Management testimony

All of the fact witnesses at trial that were employed by the debtor testified that they believed the debtor was solvent and not doomed to fail on the transfer date.[87] This is ordinarily a compelling indicator of a debtor's solvency. Simply put, every one of these witnesses essentially testified that there was no intent to hinder, delay, or defraud the debtor's creditors.

Nevertheless, the Court did not place much (if any) weight on this testimony for two reasons. First, the Court observed that there was some deposition testimony that contradicted this view.[88] Second, the Court focused on the contemporaneous evidence (or in this case, the lack thereof) that underlies the contention that the debtor was solvent.

This lawsuit was about the spin-off of a company from its parent company. The spun-off company was saddled with all of its former parent company's legacy liabilities, which included environmental-related claims.

The focus of this case was the valuation of environmental-related (and other legacy) liabilities and the spin-off's expected effect on these creditors as of the spin-off date. The legacy claimants did not get to ''choose their debtor'' as their claims were transferred, without their consent, to the relatively weaker spun-off company. Such a transfer is not a fraudulent conveyance if (1) it was not made with the intent to hinder, delay, or defraud creditors and (2) the spun-off company was solvent on the spin-off date.

The Court essentially found that the defendant could not ''show its work'' when it asserted that there was a grounded contemporaneous belief that the debtor was solvent on the transfer date. The defendant asserted that the debtor was solvent but did not produce (1) a contemporaneous valuation of the environmental-related liabilities or (2) a contemporaneous assessment of the spin-off's effect on these creditors. The defendant's inability to produce these analyses (i.e., to ''show its work'') was deemed by the Court to be a ''major failure of proof.''[89]

[87] *Id.* at *45.
[88] *Id.* at *45–*46.
[89] *Id.* at *47.

Prospective solvency opinion

A prospective solvency opinion was obtained prior to the spin-off. Interestingly, the firm that provided the prospective solvency opinion in *Tronox* was the same firm that explicitly rejected the opportunity to provide a prospective solvency opinion in *ASARCO*. Unlike *TOUSA*, the prospective solvency opinion in *Tronox* was consistent with the market prices for the debtor's securities. Ordinarily, this fact pattern would be a compelling contemporaneous indicator of solvency.

However, the Court did not place any weight on the contemporaneous solvency opinion in *Tronox*. The Court essentially ignored the contemporaneous solvency opinion because the firm that provided the opinion did not perform an independent analysis of ''the critical issue in this case—the amount of [the debtor's] contingent liabilities.''[90] The Court arrived at this conclusion, in part, by focusing on the language contained in the opinion. The amount used for contingent liabilities, according to the opinion itself, ''was identified to us and valued by responsible officers of the [debtor], upon whom we have relied without independent verification; no other contingent liabilities have been considered.''[91] The managing director from the firm that provided the opinion also confirmed, at his deposition, that his firm ''used as [the debtor's] anticipated contingent liabilities the reserve in [the debtor's] financial statements.''[92]

The Court found that the reserve in the debtor's balance sheet for these liabilities was biased low, for purposes of a solvency analysis, for two reasons. First, the generally accepted accounting principles (GAAP) reserve was less than expected value due to the Statement of Financial Accounting Standards (SFAS 5) ''probable and reasonably estimable'' standard. All liabilities that do not meet the ''probable and reasonably estimable'' standard have a reserve of zero even if the expected value of these liabilities is substantially greater than zero.[93] Second, the debtor's application of the accounting rules led to a further downward bias in the reserve.[94] More specifically, the debtor misapplied the GAAP standard because it did not begin to assess a liability until a complaint was received by a 3rd party.[95] It is for these reasons that the Court stated the following: ''there was no dispute at trial

[90] *Id.* at *30.
[91] *Id.*
[92] *Id.*
[93] A liability can be not probable and/or reasonably estimable yet still be quite large. For example, a 10% probability of incurring a $10 billion liability is not probable, yet the liability is still valued (prior to considerations for the time value of money) at $1 billion.
[94] *Tronox*, 2013 WL 6596696, *41–*42.
[95] A liability can be probable and reasonably estimable even if a formal action has not yet been undertaken.

that a reserve for contingent liabilities in a financial statement has no probative value in determining liabilities or solvency for fraudulent conveyance purposes.''[96]

To summarize the discussion above, the Court found that the prospective solvency opinion provider did not perform any analysis on the most relevant topic.[97] This explains how the Court can simultaneously (1) state that ''there is no substitute for a solvency analysis''[98] yet (2) place no weight on the ''solvency analysis'' contained in the prospective solvency opinion.

Potential offer to acquire the debtor

Tronox is unique among the cases discussed in this paper because there was an attempt to sell the debtor shortly before the transfer date. On the one hand, an offer (especially a binding offer) can provide a compelling contemporaneous indicator of solvency. On the other hand, a nonbinding offer is … nonbinding, which can greatly mitigate the relevance of this potential contemporaneous indicator of solvency.

The defendant argued that in particular, one potential buyer's offer to acquire the debtor was ''[u]nassailable [e]vidence of [s]olvency.''[99] The defendant argued that this potential buyer performed a substantial amount of due diligence on all aspects of the debtor's business, which included environmental-related liabilities.[100] The defendant asserted that this potential buyer's ''valuation of the [debtor's b]usiness was ultimately and powerfully manifested in its November 20, 2005 fully-funded, signed offer for $1.3 billion, which the record shows was final and binding.''[101]

The Court did not share the defendants' view of this offer. The Court stated that the defendants ''overstate the nature and significance of the [potential buyer's] bid.''[102] The Court made three observations to support its finding. First, the defendant's investment banker ''concluded that the [potential buyer's] bid contained open items and that critical parts of the contract remained to be negotiated.''[103] Second, ''[a]dditional disclosures had to be made, triggering [the potential buyer's] rights of termination if they were inaccurate.''[104] Third, the bid contained indemnities for environmental and tort liability that the defendant had previously rejected. It is for these reasons that the Court questioned whether the potential buyer was ever, in the defendant's mind, a serious bidder. Consistent with this view, the defendant's CEO testified that we were ''convinced [we] didn't have a real opportunity [with this potential buyer.]''[105]

The defendant also tried to use the potential buyer's due diligence files to support a contemporaneous valuation of the debtor's environmental-related liabilities. Recall that the defendant did not produce such an analysis. The defendant's testifying solvency expert ''built his analysis of [the debtor's] solvency around [the potential buyer's] calculations as to the legacy liabilities ….''[106]

The Court did not share the defendant's view of these due diligence files either. The Court found that ''the record is inadequate to give [the potential buyer's] analysis of [the debtor's] environmental and tort liabilities the weight the defendants demand.''[107] The Court observed that very few documents associated with this potential buyer's analysis of these liabilities was submitted into evidence. Notably, this potential buyer was within the court's subpoena power, but neither the defendant nor the plaintiff called on a witness from this firm to testify at trial. Thus, this is another example in which the defendant was unable to ''show the work'' that went into the contemporaneous analyses.

''Mordant humor''

The discussion of the fact record so far has focused on why the defendant was unable to demonstrate that contemporaneous actions and analyses established that the debtor was solvent. The discussion has not yet explained how the contemporaneous record supported a finding that there was actual intent to hinder, delay, or defraud the debtor's creditors.

It is possible that contemporaneous ''mordant humor'' played a role in the Court's finding in this matter. The Court focused on the following ''mordant humor'' that was expressed by the contemporaneous investment bank's principal witness:

> During the negotiations leading up to the spinoff, [this investment banker] more than once drew a picture of a pot containing a flower ([the spun-off business]) and a weed (the legacy liabilities) strangling the flower. [This investment banker] explained that ''the problem is, there is a weed at the base of this flower and it is going to choke off the company's ability to be prosperous.''[108]

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[96] *Tronox*, 2013 WL 6596696, *30.
[97] The Court also stated that ''there is no evidence that [the prospective solvency opinion provider] was even aware of the importance of the legacy liabilities to the [debtor's] solvency. *Tronox*, 2013 WL 6596696, *30.
[98] *Tronox*, 2013 WL 6596696, *42.
[99] *Id*. at *43.
[100] *Id*. at *43.
[101] *Id*.
[102] *Id*.
[103] *Id*.
[104] *Id*.
[105] *Id*.
[106] *Id*. at *44.
[107] *Id*.
[108] *Id*. at *25.

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Traditional Market-Based Indicators

The defendant argued that the price for the debtor's securities indicated that the debtor was solvent on the transfer date. The Court acknowledged that the debtor's ''ability to issue unsecured bond debt and stock in the IPO is Defendants' strongest indication of solvency based on the market.''[109]

Nevertheless, the Court dismissed the relevance of these contemporaneous indicators of solvency for two reasons. We will address both of these reasons below.

Potential exception

The Court in *Tronox* chose to dismiss the contemporaneous market indicators of solvency in part because the debtor in *Tronox* had a substantial amount of environmental-related liabilities. Simply put, it appears that the Court in *Tronox* (and *W.R. Grace*) carved out an exception to the standard practice of relying on otherwise-reliable contemporaneous market data. The Court in *Tronox* stated:

> In the *W.R. Grace* case, the fulcrum issue relating to insolvency was the size of its asbestos liability. In the instant case, it is the size of Tronox's environmental liability. In both cases, the market as a whole, *no matter how efficient or inefficient*, cannot be relied on to determine solvency or insolvency. In this case, as further discussed below, there is no substitute for a solvency analysis (emphasis added).[110]

The Courts' findings in *Tronox* and *W.R. Grace* raise an interesting question. The Court in *Iridium* was generally deferential to the market for the valuation of a speculative business. The Courts in *Tronox* and *W.R. Grace* would ignore the market (even if it was perfectly efficient) for the valuation of a business that had a substantial amount of asbestos-related or environmental-related liabilities. Should courts defer to the market when assessing hard-to-value assets but ignore the market when assessing hard-to-value liabilities? There does not appear to be a valuation-based reason for inconsistent treatment of market data.

Others have identified the ramifications of the *W.R. Grace* (and, by extension, *Tronox*) decisions. For example, Gregory Horowitz observed the following:

> [*W.R. Grace*] represents a potentially enormous exception to the principle that a company is solvent if judged to be so by an efficient and well-informed market. There was no suggestion in [*W.R. Grace*] that [the debtor] had withheld any material information known to it about its asbestos liability at the time of the transaction; indeed, Judge Wolin accepted for sake of argument that [the debtor's] contemporaneous liability estimates were reasonable and made in good faith. The ruling nonetheless stands for the proposition that future events may demonstrate that, by virtue of existing but unknowable liabilities, a company was insolvent at any point in time. If so, there is no way parties to a transaction could be confident of each other's solvency, and parties must always enter into transactions—or at least transactions that might be argued to be for less than reasonably equivalent value—at risk of future insolvency-based challenges.[111]

[109] *Id.* at *39.
[110] *Id.* at *42.

Market was misled

Unlike the Court in *W.R. Grace*, the Court in *Tronox* found that material information was withheld from the market. Thus, the Court's findings in *Tronox* would still hold if the exception was not applied. The Court's focus on this topic provides a road map for plaintiffs in other matters that cannot dismiss the relevance of contemporaneous market data as a result of the exception.

Inflated projections

The Court agreed with the plaintiff's characterization of the financial projections that were disclosed to the market as inflated ''sell-side'' projections.[112] The Court focused on two points. First, the process used to develop the projections deviated from the debtor's historical practice, in response to direction from the defendant's CFO, which resulted in a substantial increase in projected profitability.[113] Second, the projections were stale because they were created in February and not updated to reflect the decline in the market between February and the November registration date. Notably, the defendants' own industry expert admitted that the projections were ''particularly insupportable'' as of the November registration date.[114]

Inadequate disclosure

The Court found ''[t]he record is clear that the financial statements omitted certain critical contingencies and potential liabilities.''[115] The key contingency related to

[111] Gregory A. Horowitz, ''Market Pricing in Solvency Valuation and Testing.'' In *Contested Valuation in Corporate Bankruptcy*: A Collier Monograph, Robert J. Stark et al., eds. (2011).
[112] *Tronox,* 2013 WL 6596696, *39.
[113] For example, projected EBITDA increased by 77% in 2008 and by 65% in 2009 as a result of this change. These percentages are based on data from *Tronox* at *39. The Court observed that the average forecasted EBITDA using these sale prices ''far exceeded'' the debtor's actual EBITDA that it previously earned in ''peak'' and ''very strong'' years.'' *Tronox,* 2013 WL 6596696, *39.
[114] *Id.*
[115] *Id.* at *40.

a contract for a sale of land. The financial forecast included $154 million of projected proceeds related to this sale (to reflect the debtor's 30% interest in property valued at $515 million). However, there was no disclosure ''that the contract was merely the economic equivalent of an option, in that it gave the purchasers the right to walk away for $2 million in liquidated damages (less than 1% of the purchase price).''[116] The key potential liability related to a Federal Superfund site in which the Environmental Protection Agency demanded reimbursement and interest of approximately $350 million. The Court found that there was ''no disclosure whatsoever'' of the potential liability associated with this site.[117]

Comparison to *Vlasic, Iridium,* and *ASARCO*

The defendant argued that the contemporaneous indicators of solvency in *Tronox* were ''far stronger'' than they were in *Vlasic* and *Iridium*.[118] Taken at face value, the defendant was correct for the reasons discussed above.

Nevertheless, the Court ultimately compared *Tronox* to *ASARCO*, in part for the reasons discussed above. The Court acknowledged that the fact pattern in *Tronox* was not as egregious as it was in *ASARCO* but still found that there was actual intent to hinder, delay, or defraud creditors.[119] Notably, the Court focused on the ''mordant humor'' discussed above in its comparison of *Tronox* with *ASARCO* when it stated that:

> although ASARCO was in a worse cash squeeze at the time of the fraudulent conveyance, Tronox was no better capitalized, as capital adequacy looks at the long term ability of an enterprise to sustain its liabilities. The weed that would ultimately choke Tronox, [the contemporaneous investment banker] recognized, was its legacy liabilities.[120]

[116] *Id.* The defendant's vice president for strategic planning told the defendant's CEO and CFO that '''there would probably be no IPO if Tronox were not able to forecast receipt of the proceeds from [these] land sales.'' The purchasers ultimately (after the transfer date) ''terminated the transaction and walked away.''

[117] *Id.*

[118] The defendants asserted ''[i]n this trial, the enormous body of contemporaneous market evidence of solvency was far stronger than in [*Vlasic*], *Iridium*, and *CarCo—all* of which found for defendants on solvency.'' The bankruptcy court (also in the SNDY) in *Car Co* granted the defendants' ''motion to dismiss where 'the contemporaneous market information concerning the involvement of other sophisticated parties in the transaction' rendered constructive fraudulent conveyance implausible.'' *Tronox,* 2013 WL 6596696, *38.

[119] The Court stated ''[t]he facts of this matter resemble, if any other case, the ASARCO decision, despite Defendants' contention at closing argument that the facts in the ASARCO decision 'could not be further from the present case.' Certainly ASARCO was more obviously *in extremis* when the parent there transferred to itself its subsidiary's 'crown jewel' assets and attempted to isolate them 'from risk of exposure to the government and other creditors.''' *Id.* at *33. It is noteworthy that the opinion contains 29 references to *ASARCO*.

[120] *Id.* at *57.

Summary observations for contemporaneous indicators of solvency or insolvency

There were many contemporaneous indicators of solvency in the decisions in which the plaintiff failed to meet its burden of proof obligation. Conversely, there were many contemporaneous indicators of insolvency in the decisions in which the plaintiff was able to meet its burden of proof obligation. Many of these cases do not appear to be ''close calls.''

Some practitioners may argue that this result is not surprising because a court has an incentive to ''cherry pick'' facts that are consistent with its findings. A natural extension of this argument is that there may have been other facts that are inconsistent with the court's rulings.

Setting aside one's views of the final selection of facts that make it into a court's opinion, the facts discussed in many of the aforementioned cases appear to be overwhelming. It is hard to argue that a credible fact was missing in cases such as *Vlasic,* in which the plaintiff could not produce any witnesses that thought the debtor was doomed to fail and the debtor's CEO wrote a letter to shareholders that essentially said ''if we knew then what we know now we still would have been solvent on the transfer date.'' It is also hard to argue that a credible fact was missing in a case such as *ASARCO,* in which all signs pointed toward insolvency.

Nevertheless, some cases may be ''closer calls,'' and other cases may not be what they appear to be on the surface. For the reasons discussed above, *Tronox* is an example of the latter. These are the cases in which valuation-related expert testimony is more relevant.

Notwithstanding the discussion above, there is an important role for business valuation professionals to play in cases across the spectrum. The marshalling of evidence through fact discovery is often a collaborative effort among attorneys and subject matter experts. Valuation professionals should make sure that important documents are reviewed and analyzed and that relevant questions are asked of fact witnesses during depositions to ensure that the fact record is adequately developed.

Application of the Stock and Debt Approach for Private Companies

The use of the Stock and Debt Approach for publicly traded companies appears to be well-established practice for assessing the solvency of a debtor as of the relevant date. Leading academics and several Courts have extolled the virtues of this approach. See the 1st paper in this series for further discussion.

However, the relevance of the Stock and Debt Approach for companies that do not have publicly traded

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equity as of the relevant date could be debated. Some practitioners argue that the Courts' findings in cases like *Vlasic*, *Iridium*, *TOUSA,* and *Idearc* are not applicable when the debtor's stock is not publicly traded. Therefore, some practitioners may argue that the Stock and Debt Approach is limited to a relatively small number of disputed transactions. Nevertheless, the Stock and Debt Approach often maintains many of its virtues even in instances in which the debtor's stock is not publicly traded.

The common denominator in many alleged fraudulent transfer lawsuits is contemporaneous financing that provides the source of funds. For example, consider the lenders in *Vlasic*. These lenders provided $500 million of new money to the debtor knowing that the cash would be distributed to Campbell (i.e., they knew that the former parent would get the cash while the debtor would get the obligation to repay the lender). These lenders presumably would not have extended the loan to the debtor (which was non-recourse to Campbell) if they believed the fair value of the debtor's assets was less than its liabilities. Similarly, these lenders presumably would not have extended the loan to the debtor if they believed the debtor was inadequately capitalized or had the inability to pay its debts.[121]

Do lenders care if the borrower's equity was private or publicly traded? It is likely that most, if not all, lenders do not care. Therefore, the lenders' decision to extend credit is often a powerful contemporaneous indicator of solvency that is not dependent on the debtor's equity being publicly traded.

This is not to say that the fair value of a debtor's equity is irrelevant. It is, after all, one of the two components in the Stock and Debt Approach. The lenders' decision to extend credit will often indicate that the debtor was solvent when the loan closed. The fair value of the debtor's equity will often establish the *degree* of the debtor's solvency, which could be characterized as the size of the debtor's *solvency cushion*. The degree of the debtor's solvency may be technically irrelevant in some instances (e.g., it does not matter if the debtor was solvent by a little or a large amount under the Balance Sheet Test). However, the size of the debtor's solvency cushion could be relevant in other instances (e.g., for assessments of the Adequate Capital Test).[122]

Interestingly, the fair value of equity can often be objectively determined based on contemporaneous market information even when the debtor's stock is not publicly traded. Consider leveraged buyouts and recapitalizations. These transactions often have private equity sponsors that acquire a portion, or all, of the debtor's equity on the relevant date. The prices paid in these transactions reflect a market clearing price between a willing buyer and a willing seller based on information that was known by the parties on that date. The basis for these values is therefore no different than the basis for a publicly traded stock price.[123] Some practitioners may even argue that the private equity sponsor did more due diligence and/or had access to more insider information than the typical market participant that buys and sells publicly traded shares. Private equity transaction value indicators cannot be summarily dismissed simply because this value indication is not a publicly traded stock price.

The frequency of post–transfer date observations is an advantage that publicly traded stocks have over private equity–backed transactions. Some practitioners may argue that the Court in *Vlasic* could not have performed its assessment of the debtor's contemporaneous valuation after the disclosure of certain information if its stock was not publicly traded. This is a fair observation. However, it should only go so far. Some debtors (such as the debtor in *Vlasic*) have debt that is publicly traded; this can be the case even when the debtor's stock is not publicly traded. The publicly traded debt price as of the post–transfer date disclosure can be a contemporaneous indicator of solvency (although not of the degree of solvency). Many

[121]For full context, the Court found that ''[i]t appears that the Banks did not conduct an independent investigation of the performance of the VFI Businesses,'' as they instead ''relied heavily on 'pro forma' financial statements and projections supplied by Campbell.'' Setting aside one's view on this fact pattern, the Court found that the lenders ultimately performed pertinent due diligence no later than shortly after the transfer date (in connection with an amended credit agreement) as they ''exhaustively examined VFI's finances'' in a ''contentious process.'' The end result of this due diligence was a determination that VFI was a BB-rated company, which was equal to or better than 60% of the consumer packaged goods in the United States. *Vlasic*, 2005 WL 2234606, *12–*13.

[122]The availability of public debt and equity values also allows for the finder of fact to address situations in which the debtor's debt securities are trading above or below par in part because of a decrease or increase in interest rates after the issuance of the security. Debt values are negatively correlated with interest rates; therefore, debt values decrease/increase when interest rates increase/decrease (holding everything else constant). The effect of interest rate changes on the upside is generally muted (i.e., the debtor can often refinance or repay the debt obligation under certain situations). The effect of interest rate changes on the downside can be greater (i.e., the creditor generally has few levers to pull to effectuate a refinancing at current market rates). This observation is relevant because debt trading below par could be due to below current market interest rates, which is bad for creditors but good for the debtor. The value of this asset (i.e., the intangible associated with the below current market interest rates) is incorporated in the value of the debtor's equity.

[123]One exception (discussed in the 1st paper in this series) is the possibility that a control premium should be added to the publicly traded stock price.

debtors will also have contemporaneous valuations of debt and/or equity that are performed in the ordinary course of business. These valuations will reflect contemporaneous analyses that are unaffected by hindsight or by arguments made in the fraudulent conveyance lawsuit. Some of these valuations will even be reviewed by external parties (e.g., valuations that flow through the financial statements and are therefore audited or reviewed by the debtor's auditor[124]) and therefore potentially have another indicia of reliability.

Consider two debtors that are identical in every way but one: debtor 1 has publicly traded equity and private debt, while debtor 2 has private equity and publicly traded debt. Some practitioners may argue that the Stock and Debt Approach can be better applied to debtor 1 than to debtor 2. That may be true if the goal is to establish the size of the debtor's solvency *cushion* and the debtor's equity value is substantial. However, the Stock and Debt Approach can often be more easily applied to debtor 2 when its debt is issued, or trades, at terms consistent with a viable entity. There is no credible argument (assuming there are no credible ''fraud on the market'' arguments) that can be made to dismiss this contemporaneous indicia of solvency for debtor 2, given that solvency is a binary test designed to test the financial condition of a debtor from the debtor's *creditors*' perspective. Conversely, it will be very difficult to argue that debtor 2 was solvent if its debt was trading at terms consistent with an unviable entity.[125] Any practitioner who wants to focus only on publicly traded equity misses this central tenet of solvency analyses.

Closing Thoughts

As discussed above, there are often several indicators of a debtor's solvency or insolvency in the ordinary course of business that become part of the fact record. Management may invest in the debtor or defer their compensation at the risk of becoming an unsecured creditor in the event of a subsequent bankruptcy filing. Alternatively, management may reduce its economic exposure to the debtor at the first chance it gets. Internal and external assessments and valuations are performed, which can be consistent with solvency or insolvency determinations. Creditors extend existing loans or provide new money if the entity is viewed to be viable or refuse to work with the debtor when the entity is viewed to not be viable.[126] These indicators of solvency or insolvency have nothing to do with the public or private nature of the debtor's equity securities. Practitioners who ignore this information do so at their own peril.

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[124]See AU Section 328 (Auditing Fair Value Measurements and Disclosures). The purpose of AU Section 328 ''is to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements.'' According to this guidance, ''[t]he auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP …. Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available in the circumstances.'' This guidance recognizes that some valuations are harder to perform and/or more relevant than others. Thus, AU Section 328 states: ''[b]ecause of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditors planned audit procedures can vary significantly in nature, timing, and extent. For example, substantive tests of the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data … (b) developing independent fair value estimates for corroborative purposes … or (c) reviewing subsequent events and transactions.'' Sometimes the audit procedures are performed by a valuation specialist. AU Section 328 states that ''[t]he auditor should consider whether to engage a specialist and use the work of that specialist as audit evidence in performing substantive tests to evaluate material financial statement assertions.'' Most importantly, the auditor will sometimes address the very questions that are asked in fraudulent conveyance litigation. For example, AU Section 328 states ''[w]hen testing the entity's fair value measurements and disclosures, the auditor evaluates whether: (a) [m]anagement's assumptions are reasonable and reflect, or are not inconsistent with, market information … (b) [t]he fair value measurement was determined using an appropriate model, if applicable, [and] (c) [m]anagement used relevant information that was reasonably available at the time.''

[125]There may be some examples in which the debtor's debt securities can be distressed yet the debtor remains solvent under the Balance Sheet Test. One can hypothesize a scenario in which a debtor has a very large haircut on its debt yet its market capitalization exceeds the cumulative haircut on its debt. Consider a debtor financed by loans that are covenant light, with a paid-in-kind toggle, minimal principal amortization, and which have a relatively long time until maturity. This describes some loans that were entered into prior to the most recent credit crisis. This debtor was presumably solvent when the transaction was entered into (i.e., the lenders presumably would not knowingly lend to an insolvent debtor). However, this debtor may subsequently become insolvent yet remain outside of bankruptcy for a sustained period due to its shareholder-friendly loan terms. The positive market capitalization when the debt is trading at a large haircut is due to ''option value.'' The debtor in this example passes the Balance Sheet Test but may or may not pass the Adequate Capital or Ability to Pay Debts tests. The standard of value may be very relevant in this instance. A sale-based standard (i.e., analogous to fair market value) would focus on the Balance Sheet Test because a sale of the debtor's assets that brings in enough proceeds to pay off all of the debtor's liabilities should also be consistent with the passing of the Adequate Capital and Ability to Pay Debts tests. A value-in-place–based standard (i.e., analogous to fair value in Delaware cases), on the other hand, would presumably focus on the Adequate Capital and Ability to Pay Debts tests because the ''option value'' is essentially value transferred by the debtor's creditors to the debtor's shareholders. The creditors in this situation are not expected to receive a full recovery, which is why their securities trade (and will be expected to continue to trade) at steep discounts to par.

[126]This may be an oversimplification, as some existing creditors will prefer to work with the debtor even when the debtor is insolvent. One such example is a debt exchange offer, in which creditors accept a weaker security in exchange for giving the debtor a better chance at remaining outside of bankruptcy. This out-of-court restructuring is viewed as a better alternative to a bankruptcy filing that could result in greater losses for these creditors.

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