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Feature

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Assessing Fraud

Insights from Selected Voidable Transfer-Related Matters

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Debates over fraud take center stage in many voidable transfer-related lawsuits. This presumably occurs because it is often difficult to credibly argue that the debtor was rendered insolvent by a transfer that was contemporaneously financed by lenders. A compelling argument can be made that a creditor (especially when it has no preexisting exposure to the debtor) does not knowingly lend to an insolvent debtor.[1] The best way to dismiss the relevance of these contemporaneous loans is to establish that the lenders would not have lent the money if they knew about the true state of the debtor's financial condition.

A recent article in the *ABI Journal* addressed the need to assess fraud's effect on a debtor's financial condition.[2] The authors wholeheartedly agree with the article's premise that the effect of alleged fraud should be assessed and that quantifying it is often challenging. However, there are some situations where an analysis of alleged fraud can be relatively straightforward. This article addresses some of these situations.

Line in the Sand

Voidable transfer-related lawsuits can be influenced by hindsight because the debtor filed for bankruptcy. The analysis should be devoid of hindsight because the only solvency-related issue that matters is the debtor's financial condition as of the transfer date(s). However, all parties involved in the lawsuit know that the debtor subsequently became insolvent, which may cast doubt on solvency determinations as of transfer date(s).

Many practitioners directly or indirectly use hindsight. Sometimes, this use of hindsight truly confirms what was known or knowable. In other instances, this use of hindsight is inappropriate because it includes information that was not known or not knowable as of the transfer date(s).

Defendants may want to exclude hindsight. The debtor was typically viewed as solvent on the transfer date(s) as evidenced by lenders' willingness to finance the transfer(s). The debtor ultimately became insolvent, as evidenced by the bankruptcy filing that triggered the voidable transfer-related lawsuit. Defendants sometimes have little to gain by focusing on hindsight.

On the other hand, plaintiffs may want to consider hindsight for the opposite reasons. Their end goal is to effectively project backward in time (*i.e.*, retroject) the debtor's bankruptcy filing to the earlier transfer date(s). Absent a clearly unforeseeable event that was the proximate cause of the debtor's bankruptcy filing, a credible argument can occasionally be made that the debtor's bankruptcy was foreseeable as of the earlier transfer date(s).

However, when allegations of fraud are involved, there are instances where defendants may want to focus on certain hindsight. Perhaps the seminal case is *VFB v. Campbell Soup Co.* ("*Campbell*").[3] The defendant successfully used hindsight to draw a line in the sand after the transfer date, which retrojection of the debtor's bankruptcy filing could not cross.

Campbell

The dispute stems from the spin-off of Vlasic Foods International (VFI) from Campbell Soup Co. VFI effectively borrowed $500 million from third-party lenders and transferred the proceeds to Campbell on March 30, 1998, to effectuate the spin-off.[4] VFI subsequently filed for bankruptcy less than three years later. The plaintiffs (collectively,

1 Many voidable transfer lawsuits stem from (1) leveraged buyouts (LBOs) where most of the pre-LBO debt is refinanced, or (2) spin-offs where most of the debt is new as of the spin-off date.

2 Dr. Israel Shaked, Brad Orelowitz and Edward S. Weisfelner, "Judging Fraud: The Case of Relying on Wrong Information," XXXV *ABI Journal* 8, 18-19, 57-58, August 2016, *available at* abi.org/abi-journal.

3 *Campbell*, 482 F.3d 624 (3d Cir. 2007). One of the authors worked on the *Campbell* matter.

"VFB") sought to recover the $500 million on fraudulent transfer grounds.

Contemporaneous market data, if reliable, clearly demonstrated that VFI was solvent on the spin-off date. VFI's $500 million in debt was presumably worth $500 million (because it was funded on the transfer date) and its market capitalization exceeded $1.1 billion. Thus, VFI had more than $2 of equity for every $1 of debt. Not surprisingly, VFI had an investment-grade (BBB) credit rating.

VFB argued that the contemporaneous indicators of solvency, such as its security prices and credit rating, were irrelevant because they were allegedly predicated on fraudulent information. VFB ignored all debtor-specific market evidence (*e.g.*, VFI's market capitalization) and relied solely on expert witness testimony. VFB's testifying experts opined that VFI was insolvent on the transfer date.

The district and appellate courts employed a parsimonious approach: Assess contemporaneous market participants' views when they were undoubtedly fully informed. The Third Circuit questioned whether the market was ever not fully informed, holding that it was "difficult to understand how Campbell's sales and earnings manipulation could have seriously misled the public markets about the Division's prospects,"[5] and concluding that the "truth of VFI's situation had become clear" by September 1998.[6]

Both courts observed that VFI's financial condition in September 1998 was strong and established that VFI was solvent on the earlier transfer date. VFI's market capitalization remained higher than the face value of its debt, meaning that it had more than $1 of equity for every $1 of debt. VFI also had a BB credit rating, which was "equal to or greater than that of 60% of the consumer packaged goods companies in the United States."[7] VFI was undeniably solvent after clear disclosure of issues that VFB alleged were not disclosed on the transfer date.

VFI's financial condition, independent of the disclosure issues, deteriorated between March 1998 and September 1998.[8] Thus, VFB could not credibly argue that the September 1998 market indicators were not representative of what was known or knowable as of March 1998. If VFI had been solvent in September 1998, it was undoubtedly solvent in March 1998 when its financial condition was stronger.

The authors believe that the principles used in *Campbell* could also be applied in similar situations, including instances where debt was valued at less than par.[9] A chart can be constructed to show when contemporaneous market participants believed VFI became insolvent. The analysis subtracts the "debt haircut" (difference between market and par value) on VFI's debt from VFI's market capitalization. The result is the "solvency cushion." A debtor is solvent when market capitalization is greater than the debt haircut. Conversely, a debtor is insolvent when market capitalization is less than the debt haircut.[10]

As shown in Figure 1, VFI's market capitalization (the blue bar) exceeded its debt haircut (the orange bar) through early 2000.[11] This data, if reliable (VFB also alleged there were some issues with bond offering disclosures in 1999), suggests that VFI remained solvent through early 2000.[12]

Limiting Damages

What happens when only some creditors were defrauded? Should all creditors participate in a voidable transfer-related recovery or only the defrauded creditors? These questions are important when considering the effect of alleged fraud on a debtor's financial condition in a voidable transfer-related lawsuit.

The standard answer is that all creditors participate in the recovery, whether they were defrauded or not. However,

4 *Id.* at 627. "Technically, what happened in the present case was that the banks extended *Campbell* credit under a loan agreement that provided that the rights and obligations under the agreement would be assumed by the subsidiary upon transfer of the Division." (emphasis in original, referring to debtor and not case name).

5 *Id.* at 632.

6 *Id.*

7 *Campbell*, 2005 WL 2234606 *13 (D. Del. 2005).

8 *Campbell*, 482 F.3d 624, 632 (3d Cir. 2007) ("Nobody contends that VFI was worth more in September 1998 than at the end of March 1998.").

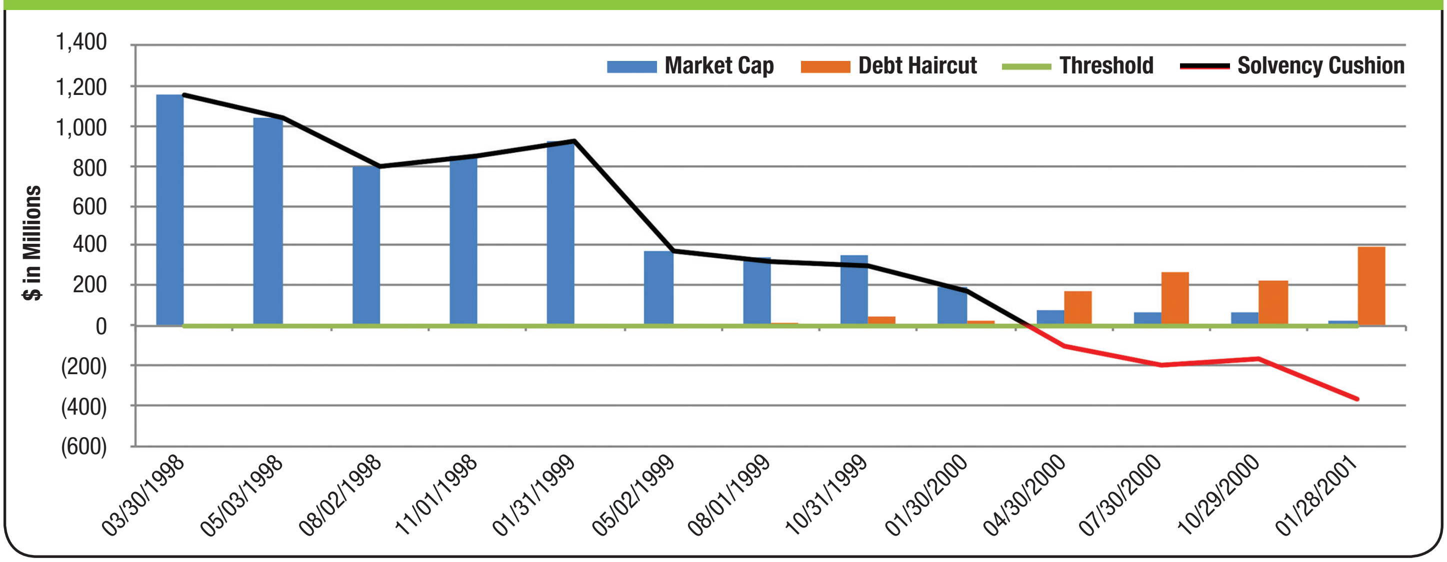
9 Michael Vitti, "Grounding Retrospective Solvency Analyses in Contemporaneous Information: Part I," *Business Valuation Review* (2013), 32(4), 186-211.

10 *Id.* This calculation is biased toward an insolvency determination as it excludes (1) value associated with employee stock options and (2) a control premium, to the extent it is applicable.

11 Bond prices are available from June 1999 through VFI's bankruptcy filing; bank debt prices are not available. For purposes of this analysis, the authors assumed that bank debt was valued at the same discount to par as bond debt. This assumption results in biased low values because the senior bank debt maintains its value better than the junior bond debt. However, as a practical matter, the bank debt price assumption appears to be irrelevant within the context of Figure 1 because VFI would tip into insolvency at the same point in time (April 30, 2000) in this quarterly analysis, even if the bank debt traded as high as 97 cents (while the bond debt traded at 63.75 cents) on the dollar.

12 Figure 1 charts data as of VFI's fiscal quarter-ending dates.

Figure 1: Market's Assessment of VFI's Solvency over Time



it could be said that the creditors who were not defrauded should not be able to participate in certain voidable transfer-related recoveries. As a practical matter, creditors in this situation are looking to the recipient of the transfer to repay the loan. However, the recipient of the transfer did not guaranty the loan, so it does not necessarily follow that the recipient of the transfer should have to repay the debtor's obligation, especially if the lenders received adequate disclosure when they made the loan.

There is at least one instance where a court deviated from the standard treatment: *Crescent*. The defendant

> argued that the trust's fraudulent-transfer claims should be limited to the amount of the nonbank claims (alleged to be approximately $250 million) as it would be an absurd windfall to permit banks that were complicit in the alleged fraudulent transfer and had already obtained all that they had bargained for — ownership of Crescent — to recoup an additional $961 million.[13]

There were no credible allegations of fraud in *Crescent*, and the "complicit" creditors took ownership of the company through the bankruptcy process. Judge Sam Sparks observed:

> To allow the Trust to step into the lenders' shoes and set aside the billion-dollar transfer as fraudulent would bail out the lenders who knew the terms of their own deal and have never asserted they were defrauded in any way.[14]

The defendant in *Crescent* was successful in limiting the recovery to just the nonbank creditors. In the March 2014 *ABI Journal* article, its authors observed that "Duke lost what the court characterized as 'the battle on Section 544(b),' [but] it still won 'the war' under § 550(a)."[15]

Crescent appears to stand for the proposition that you should not characterize all contemporaneous market data as unreliable when some creditors are allegedly defrauded, but others are not. The contemporaneous indicators of solvency should be reassessed given the new information related to the alleged fraud for the innocent creditors, but not for the complicit creditors.

Case-Specific Decision Tree

Assessment of an alleged fraud's effect on a voidable transfer-related lawsuit is often case-specific. There are certain situations, such as those described in this article, where the assessment can be generalized. However, there are many other situations where the classic "it depends" answer applies.

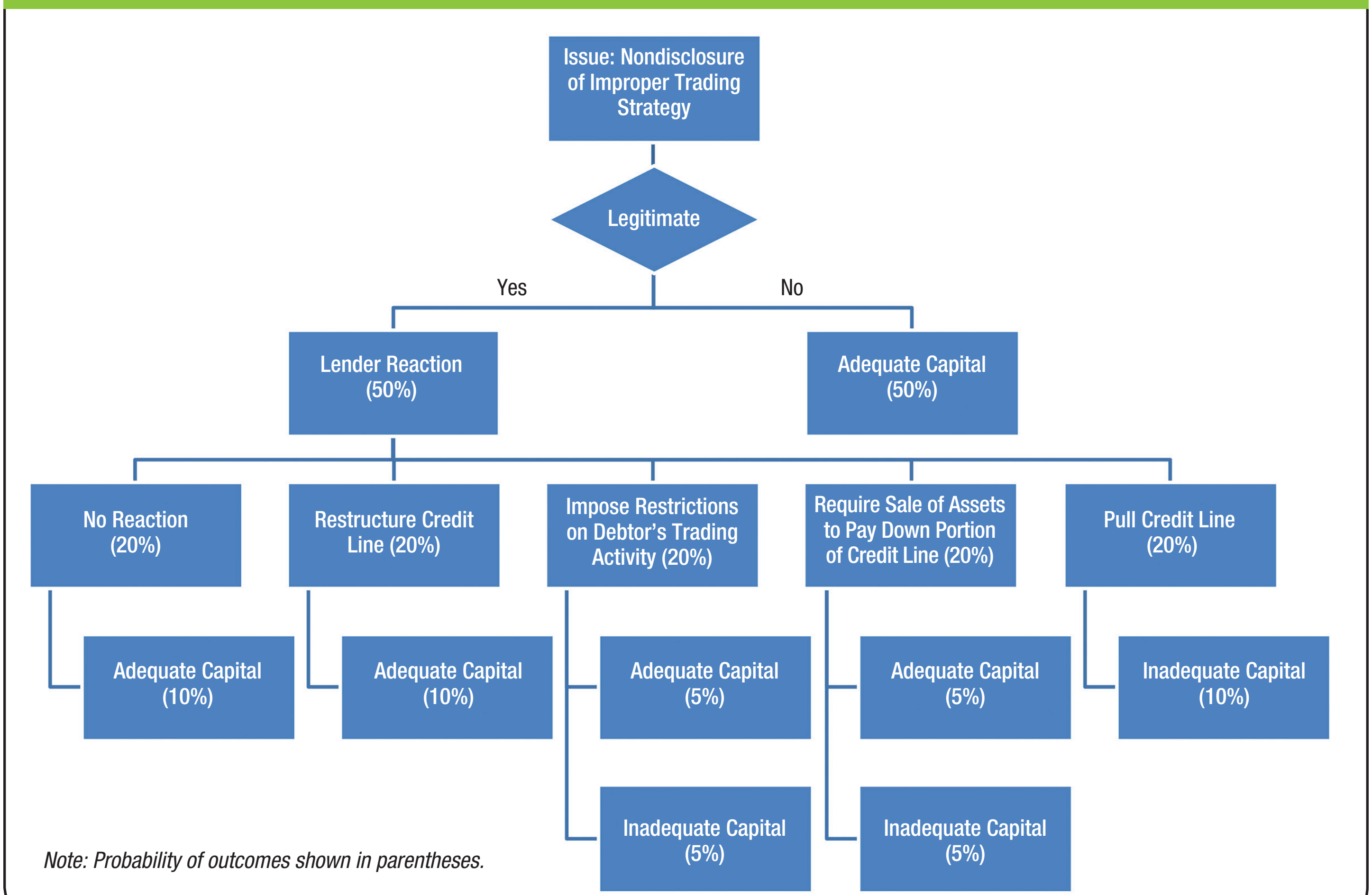
Key questions often must be assessed on a case-by-case basis. What is the effect of alleged fraudulent activity on a particular case? Sometimes it is massive; other times

13 Gerard G. Pecht and Bob B. Bruner, "Limiting Fraudulent-Transfer Damages to the Amount of 'Innocent' Creditor Claims," XXXIII *ABI Journal* 3, 56-57, March 2014, *available at* abi.org/abi-journal.

14 *Cresent Res. Litig. Trust v. Duke Energy Corp.*, 500 B.R. 480 (W.D. Tex. Oct. 4, 2013). Both of the authors worked on the *Crescent* matter.

15 *See* Pecht and Bruner, fn.13.

Figure 2: Range of Possibilities with "Flip-of-the-Coin" Probability



Note: Probability of outcomes shown in parentheses.

it is minor. How is the effect of alleged fraudulent activity assessed? Sometimes it is based on grounded analyses, whereas at other times it is based primarily on speculation. Adverse parties will likely have very different views on these questions.

The Third Circuit's nonprecedential decision in *Semcrude*[16] suggests that some analyses might be inherently too speculative given the facts of the case. The plaintiff alleged the debtor's lenders would have pulled the loan if the debtor had disclosed its allegedly improper trading strategy. The defendant argued that the debtor's trading strategy was not improper and *was* disclosed. The Third Circuit concurred with the lower courts, which

> reasoned that the Trustee's argument rested upon conjecture biased by hindsight such that it was not reasonably foreseeable that SemGroup would lose access to credit when it made the challenged equity distributions.[17]

The issues in *Semcrude* can be analyzed in the form of a decision-tree. Finance practitioners use decision trees to identify potential paths (*e.g.*, "branches") that stem from various decisions and assign probabilities to these paths to arrive at one expected value. The first question for the *Semcrude* matter is whether the trading activity was improper and undisclosed. If the answer is "no," there is no issue. If the answer is "yes," the next question is: What would the lenders be expected to do upon finding out about the improper trading activity? The lender reaction could range from "no reaction" to "pull the credit line." An analysis can be performed to assess the probabilities at each decision point and arrive at an aggregate probability of "inadequate capital" outcomes. Figure 2 depicts a range of possibilities with a "flip-of-the-coin" probability for each decision (50/50 for two possible outcomes, 20/20/20/20/20 for five possible outcomes).

This admittedly oversimplified decision-tree analysis arrives at an output: 20 percent probability that disclosure of the allegedly improper trading strategy results in inadequate capital. How does one interpret this data if one assumes that the underlying probabilities are reasonable? For context, observe the historical default curves for rated debt. New issues are frequently rated as low as "B" and are rarely rated "CCC" or lower. This observation suggests that a "line in the sand" can be drawn somewhere between the "B" and "CCC" levels. Standard & Poor's reports that the average B- rated firm defaults less than 10 percent of the time within one year and about 30 percent of the time within five years. Standard & Poor's further reports that the average CCC/C firm defaults almost 30 percent of the time within one year and greater than 50 percent of the time within five years.[18] This appears to be a relevant context for interpreting the results of the decision-tree analysis.

Some may believe that this type of analysis is inherently too speculative to be reliable in any situation. Others may believe that certain situations exist where the decision-tree analysis can be performed in a grounded, nonspeculative manner. As a practical matter, decision-tree analyses are used in various contexts (*e.g.*, to assess real options), so the challenge is applying this tool in different — but arguably no less speculative — circumstances.

Conclusion

Assessing the effect of allegedly fraudulent activity on a debtor's solvency in a retrospective assessment is often difficult. The numerous case-specific issues make it hard to use a "one-size-fits-all" approach.

However, there are some instances where the effect of allegedly fraudulent activity can be addressed in a systematic manner that renders the need for additional analyses irrelevant (*e.g.*, as described in *Campbell* and *Crescent*). Similarly, there are some instances where the effect of fraudulent activity may require the need of additional analyses that appear too speculative (*e.g.*, as described above in *Semcrude*). abi

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16 *In re Semcrude LP*, No. 14-4356 (3d Cir. April 28, 2016).
17 *Id.*
18 Standard & Poor's, "2015 Annual U.S. Corporate Default Study and Rating Transition," Table 13.