

# Insolvency

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# Elements of a Preference Claim

Section 547 states in relevant part:

“(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
- (3) made while the debtor was insolvent;

# Elements of a Preference Claim (cont.)

(4) made—

- (A) on or within 90 days before the date of the filing of the petition;  
or
- (B) between ninety days and one year before the date of the filing of petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

- (A) the case were a case under chapter 7 of the title;
- (B) the transfer had not been made; and
- (C) such creditor received payment of such debt to the extent provided by the provisions of this title.”

## In essence, a preference claim is:

- A transfer of the debtor's interest in property made within 90 days before the filing of the petition
- to a creditor on account of an antecedent debt
- made while the debtor was insolvent.

# Elements of a Fraudulent Transfer Claim

Section 548 states in relevant part:

“(a)

- (1) The trustee may avoid any transfer . . .of an interest of the debtor in property . . .that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily—
  - (A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

# Elements of a Preference Claim (cont.)

(B)

- (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
- (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
- (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or
- (IV) Made such transfer to or for the benefit of an insider, or incurred obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.”

# In essence, a constructive fraudulent transfer claim is

- A transfer of a debtor's interest in property made within two years before the filing of the petition for which the debtor did not receive reasonably equivalent value
- while the debtor was insolvent, or
- which transfer left the debtor inadequately capitalized, or
- which transfer left the debtor unable to pay its debts as they became due.

# Presumptions under Section 547 of the Bankruptcy Code-90 Day Insolvency Period

- Section 547(f) provides “[f]or purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.” 11 U.S.C. §547(f).
- This creates a rebuttable presumption that the debtor is insolvent in the 90 days leading up to the petition date.



# No insolvency presumptions under Section 548 of the Bankruptcy Code

- In contrast, there is no explicit presumption of insolvency of the debtor for purposes of claims brought under Section 548 of the Bankruptcy Code

# Definition of Insolvency:

- Section 101 of the Bankruptcy Code defines “insolvent” in relevant part to mean:
- “With reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation, exclusive of
  - i. Property transferred, concealed or removed with intent to hinder, delay, or defraud such entity’s creditors; and
  - ii. Property that may be exempted from property of the estate under section 522 of this title;”

# What is the applicable law for determining insolvency?

## Actions brought under Section 544 of the Bankruptcy Code

- Section 544(b) allows a trustee to step into the shoes of a creditor with a viable cause of action against the debtor and avoid any transfer of the debtors' property that is voidable under "applicable law."
- Applicable law in each state generally refers to the Uniform Fraudulent Transfer Act ("UFTA") or the Uniform Fraudulent Conveyance Act ("UFCA")\* as adopted by that state.

\*Although the majority of states have adopted the UFTA and a few minority have retained the UFCA, some states have not adopted either the UFTA or the UFCA.

# The Definition of Insolvency under the UFTA: Not Paying Debts

- Under the UFTA, a debtor who is not generally paying its debts as they become due is presumed to be insolvent. UFTA §2(b).
- The advisory notes to the UFTA note that the presumption was established to assist creditors who might have trouble obtaining records of the debtor, and often those records are incomplete.
- Furthermore, as the advisory notes say “insolvency is most cogently evidenced by a general cessation of payment of debts.”

# The Definition of Insolvency under the UFCA: Fair Saleable Value

- Under the UFCA, a debtor is deemed to be insolvent when the “fair salable value” of its assets exceeds its “probable liability on his existing debts as they become absolute and matured.” UFCA §2(1)
- “FSV” means the value that can be obtained if the assets are sold with reasonable promptness in an existing, as opposed to theoretical, market.
- Therefore, a debtor may be insolvent when the value of the debtor’s assets exceeds the value of his liabilities, but the assets are illiquid and the liabilities are short-term.
- This definition is considered to be more creditor friendly than the “fair valuation” standard under the Bankruptcy Code.

# Burden of Proof under Section 547

- Because there is a rebuttable presumption of insolvency for preference actions if the transfer is made within ninety days of the Petition Date, a creditor defending a preference action has to produce “some evidence” that the debtor was solvent at the time the transfer was made.\*
- Once the creditor rebuts the presumption of insolvency, the burden shifts back to the trustee to affirmatively demonstrate that the debtor was indeed insolvent when the transfer was made.\*
- The ultimate burden of proof lies with the trustee, to prove, by a preponderance of the evidence that the debtor was insolvent at the time of the transfer.\*

\*5-547 Collier on Bankruptcy P547.13

# Burden of Proof under Section 548

- Trustee bears the burden of proof of the elements of a voidable transfer by a preponderance of the evidence.
- The burden of proof never shifts. See *Smith v. Litchford & Christopher, P.A. (In re Bay Vista of Va., Inc.)*, 428 B.R. 197, 221 (Bankr. E.D. Va. 2010).
- Once the trustee establishes the prima facie case, the defendant must show that it gave value to the debtor and acted in good faith in order to rebut the trustee's evidence.

# How do you know if a debtor is insolvent?

- Ultimately, whether an entity is insolvent is a fact specific inquiry.
- “The Bankruptcy Court has broad discretion when considering evidence to support a finding of insolvency. Insolvency is a question of fact.” *Lawson v. Ford Motor Co. (In re Roblin Indus.)*, 78 F.3d 30 \*10 (2d. Cir. 1996) (internal citations omitted)



# Insolvency Tests

- Although insolvency is a fact specific inquiry, there are generally three tests used to determine whether an entity is insolvent.
  1. Balance Sheet Test
  2. Cash Flow Test
  3. Adequate Capital Test

# Insolvency Tests: Balance Sheet Test

- Traditional test: when a corporation “has liabilities in excess of the reasonable market value of the assets held.” See *Trenwich Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n.74 (Del. Ch. 2006)
- Narrow view: when a corporation has “a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued.” See *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004).
- Commentators have criticized the narrow view as improperly importing the “no reasonable prospect” standard from Delaware receivership law.

# Insolvency Tests: Balance Sheet Test

- What “is the appropriate time frame under which a hypothetical sale of assets must take place to achieve a valuation that is ‘fair’ for a going concern”? *Travellers Int’l, AG v. TWA (In re TWA)*, 134 F.3d 188, 194 (3d Cir. Del. 1998).
- Overwhelming number of cases hold that a “fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time.” *In re TWA*, 134 F.3d at 194 (citing multiple cases)
- A reasonable time period should be viewed from the perspective of the creditors, who on one hand want enough time to avoid a forced sale of assets, but on the other hand do not want too much time to lapse such that the creditor would receive less satisfaction of its claim because of the time value of money *Id.* at 195.

# Insolvency Tests: Cash Flow Test

- Case law is not clear whether this test is a forward looking test or limited to the present moment.
- The forward-looking version of the test asks whether the company will be able to pay its debts as they become due in the near future. *Blackmore Partners, L.P. v. Link Energy L.L.C.*, 2005 WL 2709639, \*3 (Del. Ch. 2005) (unpublished opinion).
- The present moment version of the test asks whether the debtor is currently paying its debts as they become due in the ordinary course. *U.S. Bank N.A. v. U.S. Timberlands Klamath Falls, L.L.C.*, 864 A.2d 930, 978 (Del. Ch. 2004) (however, court applied test in a forward looking manner).

# Insolvency Tests: Adequate Capital Test

- This test is intended to determine whether a company is left with adequate capital to operate after it engages in the transaction in question.
- Even if the company was not insolvent at the time of the transaction, the transaction might render the company insolvent.