

# Proper Structuring on the Front End

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# VALCON 2016

## Best Practices to Mitigate Fraudulent Transfer Risks

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## Legal Standards

## Constructive Fraud

Under the Bankruptcy Code

- Trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, if the debtor: received less than reasonably equivalent value; and
  - (i) was 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 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 such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business." § 548(a)(1)(B)
- Trustee also authorized to avoid transfers voidable under state fraudulent transfer law. § 544(b)

**Statute of limitations:**

Transfer or obligation must have been made or incurred on or within 2 years before the petition date.

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Legal Standards  
(Cont'd)

## Constructive Fraud

In New York

- Conveyance of property or incurrence of an obligation is fraudulent if made without fair consideration (not disproportionately small to market value of transferred property, and in good faith); and
  - (1) Transferor is insolvent at the time of the conveyance, or will be rendered insolvent by the transfer in question; or
  - (2) As a result of the transfer in question, transferor will be left with unreasonably small capital (i.e., technically solvent, but doomed to fail); or
  - (3) As a result of the transfer in question, transferor intends or believes it will incur debts beyond its ability to pay as they mature.

N.Y. D.C.L. §§ 273-275

**Statute of limitations:**

Claims must be brought within six years from the date of the fraud or conveyance.

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Legal Standards  
(Cont'd)

# Constructive Fraud

## In Delaware

- A transfer made or obligation incurred by a debtor is fraudulent as to
  - (1) A creditor, whether the creditor's claim arose before or after the transfer was made or the obligation was incurred, if the debtor:
    - (a) Made the transfer or incurred the obligation . . . without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor:
      - (i) Was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
      - (ii) Intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due . . . ; and
    - (2) A creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor:
      - (a) Was insolvent as a result of the transfer or obligation; or
      - (b) The "transfer was made to an insider for antecedent debt, the debtor was insolvent at that time, and the insider had reasonable cause to believe that the debtor was insolvent."

**Statute of limitations:**

Claims must be brought within the later of four years after the transfer was made or obligation incurred.

Claims must be brought within one year after the transfer was made or obligation incurred.

6 Del.C. §§ 1304(a)(2), 1305(a), 1305(b)

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Legal Standards  
(Cont'd)

# Actual Fraud

## Under the Bankruptcy Code

- Trustee may avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor . . . if the debtor . . . 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."

§ 548(a)(1)(A)

- Trustee also authorized to avoid transfers voidable under state fraudulent transfer law.

§ 544(b)

**Statute of limitations:**

Transfer or obligation must have been made or incurred on or within 2 years before the petition date.

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Legal Standards  
(Cont'd)

## Actual Fraud

In New York

- Every conveyance made and every obligation incurred with actual intent . . . to hinder, delay, or defraud either present or future creditors, is fraudulent as to both present and future creditors.”

N.Y. D.C.L. § 276

**Statute of limitations:**

Claims must be brought within the later of six years after the date of the fraud or conveyance, or two years from the date the fraud should have been discovered.

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Legal Standards  
(Cont'd)

## Actual Fraud

In Delaware

- A transfer made or obligation incurred by a debtor is fraudulent as to a creditor . . . if the debtor made the transfer or incurred the obligation with actual intent to hinder, delay or defraud any creditor of the debtor.

6 Del.C. § 1304(1)

**Statute of limitations:**

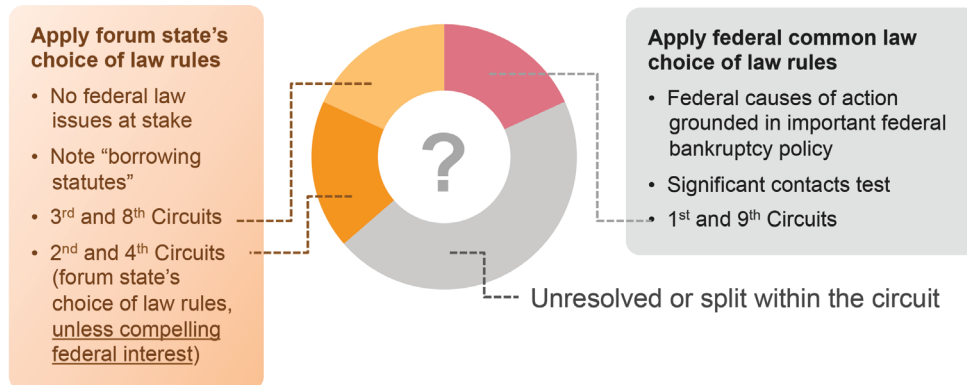
Claims must be brought within the later of four years after the transfer was made or obligation incurred, or one year from the date the transfer or obligation was or could reasonably have been discovered by the claimant.

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## Legal Standards (Cont'd)

### Choice of Law

- Arises primarily with state law fraudulent conveyance claims brought under § 544(b).
- Two step process:
  - (1) Do federal or state choice of law rules govern?
  - (2) Based on those choice of law rules, which state's substantive laws apply?
- Circuits are split on the first question:



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## Legal Standards (Cont'd)

### Pleading Fraudulent Conveyance

- **Constructive fraud claims** must satisfy Rule 8(a).  
 The complaint need only provide a "short and plain statement of the claim showing that [the claimant] is entitled to relief."  
 But, "[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements" are insufficient to survive a motion to dismiss.
- **Actual fraud claims** must satisfy a heightened pleading standard under Rule 9(b).  
 The complaint must: "(1) specify the statements that the plaintiff contends were fraudulent, (2) identify the speaker, (3) state where and when the statements were made, and (4) explain why the statements were fraudulent."  
Relaxed particularity requirement for trustee plaintiffs: "A trustee is generally afforded greater liberality in pleading fraud, since he is a third-party outsider to the debtor's transactions," but the trustee must still go beyond merely identifying the allegedly fraudulent transfers
  - Bankruptcy courts in both New York and Delaware take this approach.

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## Legal Standards (Cont'd)

### Proving Constructive Fraud

- Must show lack of fair consideration (a.k.a. reasonably equivalent value):
  - (1) Lack of Fair Consideration (New York)
    - (i) Two-part test:
      - (a) Fair equivalency of consideration – turns on the facts of each case. In bankruptcy context, courts examine financial consequences of the entire restructuring from the standpoint of the debtor's creditors (not the purchaser) as of the time of the transfer (i.e., has the net effect of the transfer has depleted the bankruptcy estate?).
      - (b) Good faith – lack of good faith if any of the following are true: (1) there was no honest belief in the propriety of the activities in question; (2) there was an intent to take unconscionable advantage of others; or (3) there was an intent to, or knowledge of, the fact that the activities in question will hinder, delay, or defraud others.
  - (2) Lack of Reasonably Equivalent Value (Bankruptcy Code, Delaware)
    - (ii) Totality of the circumstances test, including:
      - (a) whether transaction was at arm's length,
      - (b) whether transferee acted in good faith, and
      - (c) degree of difference between fair market value of asset transferred and price paid.

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## Legal Standards (Cont'd)

### Proving Actual Fraud

- Must prove transferor intent with clear and convincing evidence; or by establishing the existence of several "badges of fraud."
- **New York:** the following circumstances are "so commonly associated with fraudulent transfers that their presence gives rise to an inference of intent:"
  - Lack or inadequacy of consideration.
  - Close relationship between parties (not arms-length).
  - Transferor's retention of possession, benefit or use of property transferred.
  - Transferor's insolvency before and/or after transfer.
  - Existence or cumulative effect of a pattern or series of transactions or course of conduct after incurring debt, onset of financial difficulty, or threat of suit from creditors.
  - General chronology of events under inquiry.
  - Questionable transfer outside the usual course of business.
  - Secrecy, haste or unusualness of transaction.

#### Presumptions:

Lack of fair consideration gives rise to a rebuttable presumption of fraudulent intent.

Conveyances to close relatives or insiders apparently lacking in fair consideration give rise to a presumption of fraudulent intent, as do Ponzi scheme payments.

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## Legal Standards (Cont'd)

### Proving Actual Fraud

- **Delaware:** the court will consider, among other factors, whether:
  - Transfer or obligation was to an insider;
  - Debtor retained possession or control of property transferred after the transfer;
  - Transfer or obligation was disclosed or concealed;
  - Before transfer was made or obligation was incurred, debtor had been sued or threatened with suit;
  - Transfer was of substantially all the debtor's assets;
  - Debtor absconded;
  - Debtor removed or concealed assets;
  - Value of consideration received by debtor was reasonably equivalent to value of asset transferred or amount of obligation incurred;
  - Debtor was insolvent or became insolvent shortly after transfer was made or obligation was incurred;
  - Transfer occurred shortly before or shortly after a substantial debt was incurred; and
  - Debtor transferred the essential assets of the business to a lienor who transferred the assets to an insider of the debtor.

#### Presumptions:

Once claimant establishes that a conveyance was to a close relative or insider and unsupported by fair consideration, and collusion is difficult to prove, a rebuttable presumption arises and the transaction is presumed to be fraudulent.

Transferee then has the burden to show the solvency of the transferor to avoid a finding of fraud.

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### Insolvency Determinations - When

- Leveraged buyouts
  - Collapsed transactions
- Intercompany guaranties
- Inadequate capitalization
- Overcollateralization
- Spinoffs
- Substantial asset sales
- Dividend recapitalizations

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## Insolvency Determinations - How

- Standard of insolvency
  - sum of entity's debts is greater than all of entity's property, at a fair valuation (the "balance sheet test")
- Limitations of GAAP
  - historical costs
  - probable and reasonably estimable
  - ASC 450 – contingent liabilities
  - Reserve limitations
- There is no generally accepted accounting principle for analyzing the insolvency of a company. *Arrow Elec., Inc. v. Justus (In re Kaypro)*, 218 F.3d 1070, 1076 (9<sup>th</sup> Cir. 2000)

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## Insolvency Determinations

- Contingent liabilities
  - Environmental
  - Pension
  - Litigation
  - Long-term leases
  - Long-term contracts
  - Disputed claims may not be contingent
  - Unknown claims may not be contingent
- Contingent Assets

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## Insolvency Determinations - Standards

### Reasonableness test

- Diamond Power Int'l, Inc. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co.), 274 B.R. 230 (Bkcty. E.D.La. 2002)
  - Objective reasonableness of contemporaneous estimate applied
  - Included in GAAP financials but GAAP not basis for decision
  - Hindsight approach rejected
- Failure of burden of proof
- Not binding for any other purpose

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## Insolvency Determinations - Standards

### Hindsight rule

- Official Comm. of Asbestos Personal Injury Claimants v. Sealed Air Corp. (In re W.R. Grace & Co.), 281 B.R. 852 (Bkcty. D. Del. 2002)
    - Subsequent historical information may be used to determine an accurate calculation of the liability for insolvency calculation
    - Use of hindsight to estimate disputed claim
  - Also determines that mass tort liabilities are not contingent
- Criticized by courts and commentators

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## Insolvency Determinations - Standards

### Probability discount rule

- Covey v. Commercial Nat'l Bank of Peoria, 960 F.2d 657 (7th Cir. 1992) (refining standard of In re Xonics Photochemical, Inc., 841 F.2d 198 (7th Cir. 1988))
  - Face amount of liability x probability of contingency occurring = value of contingent liability
- Mellon Bank, N.A. v Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L., Inc.), 92 F.3d 139 (3rd Cir. 1996)
- Advanced Telecomm. Network, Inc. v Allen (In re Advanced Telecomm. Network, Inc.), 490 F.3d 1325 (11th Cir. 2007)

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## Insolvency Determinations - Standards

### Monte Carlo simulation

- Lyondell Chemical Co. v. Occidental Chemical Corp., 608 F.3d 284 (5th Cir. 2010)
  - Range of outcomes analyzed based on projections of management or expert to estimate likelihood of various outcomes
- Tronox Inc. v. Kerr McGee Corp. (In re Tronox Inc.), 503 B.R. 239 (Bkcty. S.D.N.Y. 2013)

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## Going-Concern vs. Liquidation Value

- Going-concern premise of value is typically viewed as the fair market value standard
- Liquidation premise of value usually viewed as a forced sale or distressed value standard
- Financial advisors typically state the use of the going-concern premise of value in retainer agreements.
- Relevant Cases
  - Doctors Hospital of Hyde Park, Inc. v. Desnick (In re Doctors Hospital of Hyde Park, Inc.), Adversary No. 02 A 00363, 2007 WL 641399, at \*63 (Bankr. N.D. Ill. Mar. 2, 2007) (“Generally, fair valuation reflects the price that a willing buyer would pay in an arm’s length transaction.”); In re
  - Winstar Comm’ns, Inc., 348 B.R. at 274 (“Fair valuation is generally interpreted as fair market value, that is the amount a hypothetical willing buyer would pay to a willing seller, rather than a distressed or liquidation value.”); In re
  - CXM, Inc., 336 B.R. at 760–61 (“‘Fair valuation’ for purposes of § 101(32) is generally defined as the going concern or fair market price ‘[u]nless a business is on its deathbed.’ Under those circumstances a liquidation value should be used to value the assets.” (citation omitted)); In
  - Heilig-Meyers Co., 328 B.R. at 477–78 (“Fair value, in the context of a going concern, is determined by the fair market price of the debtor’s assets that could be obtained if sold in a prudent manner within a reasonable period of time to pay the debtor’s debts.” (citation omitted));
  - In re Payless Cashways, Inc., 290 B.R. at 703 (“As a going concern a company’s assets should be measured at market value rather than at distress value.”);

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## Going-Concern vs. Liquidation Value

- WRT Energy Corp., 282 B.R. at 369 (“‘[F]air valuation... means a fair market price that can be made available for payment of debts within a reasonable period of time, and ‘fair market value’ implies a willing seller and a willing buyer.’ For purposes of a ‘fair valuation,’ the fair market value of the property must be measured by what the property would bring if actually sold on the market at the time of the transfer, assuming an informed, hypothetical willing seller and an informed, hypothetical willing buyer not under compulsion to buy or sell, and having a reasonable amount of time to sell the property.” (citation omitted));
- Daley v. Chang (In re Joy Recovery Tech. Corp.), 286 B.R. 54, 77 (Bankr. N.D. Ill. 2002) (“The first step in this analysis is to determine whether valuation should be on a fair market or liquidation basis. Fair market value is defined as the value that a willing buyer would pay for the assets as a going concern.”);
- Trans World Airlines, Inc., 134 F.3d at 193–94 (Applying going-concern premise; “[t]he cases generally direct us to look at ‘market value’ rather than ‘distress value,’ but then also caution that the valuation must be analyzed ‘in a realistic framework’ considering amounts that can be realized ‘in a reasonable time’ assuming a ‘willing seller’ and a ‘willing buyer.’” (citations omitted)).

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## The Role of the “Balance Sheet” in Determining Solvency

- Wait, little to do with value? Tell me it isn’t so.
- GAAP/IFRS not indicative of value
- What about the “adjusted balance sheet”?
  - Adjusts individual balance sheet line items to “fair market value”
  - Valuations of individual assets do not necessarily reflect the enterprise value of the company
  - Might be appropriate for certain asset-holding companies (e.g. externally managed funds of various asset classes)

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## Red Flags

- Multiple sets of projections —
  - Upon which one should the financial advisor rely?
  - Does the financial advisor need to reconcile the projections?
- Operational reorganizations and transaction synergies (buy-out)
- Restricted access to portfolio company, all communications through equity sponsor
- Prior bankruptcy filing—was it a balance sheet or operational issue?
- Management’s experience in operating a highly-leveraged company
- The company is unable to generate basic reports from its accounting and other systems
- Financial advisors must carefully analyze any savings associated with roll-ups and if the various companies “talk” to each other and share systems
- Customer concentrations
- Projected and persisting margins and growth rates materially better than competitors

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# EXAMINATION OF ADEQUATE CAPITAL

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## Tests of Solvency

Three tests of solvency:

- Assets exceed liabilities (the “Balance Sheet” test)
- Ability to pay debts
- Adequate capital

Adequate capital is the “least bright line” of the solvency tests

- Seeks to determine whether the company has sufficient capital to operate in the manner intended by management

Contemporaneous projections, where they exist, are typically considered to represent management’s intent

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## Measuring Capital

Capital is the means by which a company is financed. Capital, and thus its sufficiency, can be measured in multiple ways:

- Equity “cushion”
- Operating cash flow
- Access to capital
  - Borrowing capacity
  - Monetization of assets

These interrelated measures of capital differ by emphasis on:

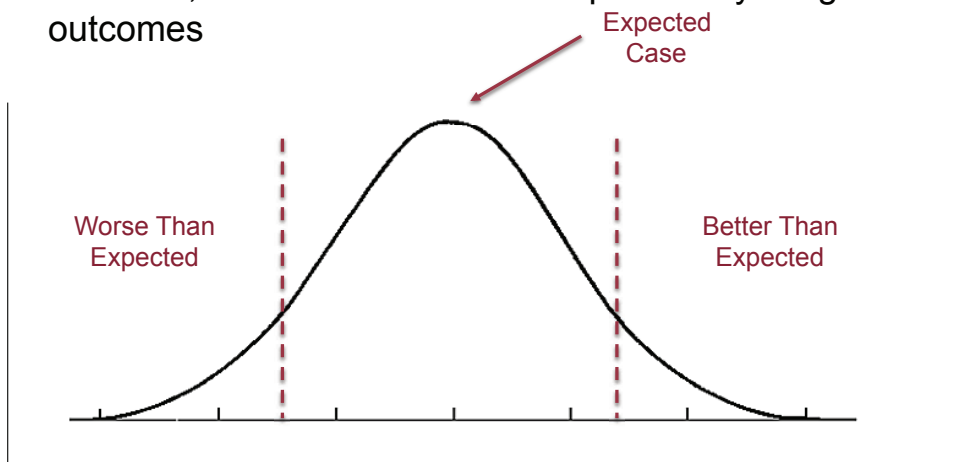
- Financial leverage
- Ability to fund operating expenses and working capital
  - Ability to fund debt service links to ability to pay debts test
- Ability to fund long-term assets and investments for anticipated growth

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## Role of Projections to Assess Capital

Projections are (or should be) an “expected case” – the “most probable” outcome

However, there is a distribution of probability-weighted outcomes



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## Sensitivity Analysis

Measures of capital must be accessed over a distribution of projected outcomes to ensure adequacy.

If capital is adequate for the “expected case” then it is usually not necessary to assess adequacy under “better than expected” cases (i.e., the right-hand side of the curve)

Is capital adequate for “worse than expected” cases (i.e., the left-hand side of the curve)?

- What is a reasonable way to determine downside cases?
- Need capital be adequate under all possible downside cases?

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## Reasonable Downside Case

The construction of a reasonable downside case is specific to fact and circumstance. May assume:

- Occurrence of a discrete event(s), or
- More generalized under-performance, relative to management projections

Emphasis for downside case may differ:

- For discrete events: timing of event(s) and quantification of impact (e.g., When will it occur? How much will it cost?)
- For underperformance: how volatile are key drivers for the projections (e.g., how will sales volume perform under an extended downturn?)

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## Downside Case: Underperformance

### Common key drivers:

- Sales volume                      Commodity prices
- Sales price per unit              Variable costs
- Cost of materials                Fixed costs

### Common measures of volatility

- Time series: How have these variables performed overtime?
- Cross sectional: How are these variables performing for peer group?
- Forward curve: What contemporaneous information exists to indicate how these variable will perform in the future

Remember to consider relationship between key drives (e.g., sales volume may impact sales price)

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## Limiting Exposure to Fraudulent Transfer Claims

### 1. Due Diligence – Financial Condition

- Consolidated and by Entity
  - Fair value of assets and liabilities
  - Pre and post transaction determinations
- Solvency Opinion(s), Solvency Certificates, Projections (internal and advisors), Legal Opinions (?)

### 2. Structure – Loan to Entity with Collateral

- Identity of Interests
- Indirect Benefits
- Issues with Guaranties & Corporate Groups, LBOs, Asset-based

### 3. Structure – Law of Jurisdiction

### 4. Loan Documentation – Careful Drafting

- Representations (supported by board resolutions/minutes), loan covenants, financial covenants, conditions precedent, savings clauses, net worth guaranties, subrogation and contribution rights

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## Best Practices

### 1 – Financial condition due diligence

- Financial projections by management and advisor(s) (expert), including GAAP basis and market balance sheet
- Lender insolvency analysis of each borrower, guarantor, grantor as well as on consolidated basis (Tousa)
- Solvency certificates of management, and expert solvency opinions

### 2 – Transaction structuring considerations

- Tie loans to assets – reasonably equivalent value
- Loan proceeds tied to actual operating use by borrower

### 3 – Loan documentation

- Borrowing base formula and certificates
- Financial covenants
- Board resolutions supported by board minutes
- Savings clauses

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## Other Lessons and Observations

### CFO Solvency Certificates

- Conflicts of interest
  - Transaction participant
  - Save face
  - Analyzing own projections
- Cost
  - Modest relative to board member liability
  - Fraudulent transfer cases costly—a solvency opinion may help mitigate cost or litigation altogether
- Easier to evaluate subject company concurrent with the transaction instead years later in a retrospective analysis.
- Content
- Underlying analytics
  - Inexperience could result in misapplied methodologies/logic
- Extra set of eyes
  - Do not want to drink your own Kool-Aid
- Willingness of company to allow independent solvency analysis—“nothing to hide”
- Qualifications
  - Generally, company CFOs have not been trained in conducting solvency analysis
  - Relatively small universe of finance professionals have significant experience in providing such opinions.

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## Other Lessons and Observations

### CFO Solvency Certificates-Relevant Cases

- *Waccamaw's HomePlace*, 325 B.R. at 530 (rejecting solvency testimony of defendant's CFO as "superficial at best and insufficient to overcome the presumption");
- *Peltz v. Worldnet Corp. (In re USN Comm'ns, Inc.)*, 280 B.R. 573, 585 n.19 (Bankr. D. Del. 2002) ("Defendant has presented no expert testimony to rebut the presumption of Debtor's insolvency. . . . [T]he issue here is whether Plaintiff should be forced to proceed with the burden of proving Debtor's insolvency for the purposes of § 547(b) where the *only* evidence submitted by Defendant to rebut the § 547(f) presumption of insolvency is the Form 8-K. I find that he should not." (emphasis in original)).
- *Brandt v. Samuel, Son & Co., Ltd. (In re Longview Aluminum, L.L.C.)*, Case No. 03 B 12184, 2005 Bankr. LEXIS 1312, at \*17 (Bankr. N.D. Ill. July 14, 2005) ("It is generally accepted that whenever possible, a determination of insolvency should be based on seasonable appraisals or expert testimony.");
- *Miller & Rhoads, Inc. Secured Creditors' Trust v. Robert Abbey, Inc. (In re Miller & Rhoads, Inc.)*, 146 B.R. 950, 956 (Bankr. E.D. Va. 1992) ("Numerous cases have held that the schedules are not dispositive or controlling and that courts should rely upon more accurate evidence, such as current appraisals, opinion testimony or actual sales of the assets in determining insolvency." (citation omitted)).