A determination of insolvency can avoid the prior transfer of certain debtor assets or the prior assumption of certain debtor liabilities. Making that determination will require an understanding of the major valuation methods.

LEGAL COUNSEL can represent many different parties in a bankruptcy proceeding, including the debtor in possession ("DIP"), the unsecured creditors committee, the secured auditors committee, an individual secured creditor, the bankruptcy trustee (if any), a party doing business with the DIP (e.g., a joint venturer, a party buying assets from the bankruptcy estate), and others. Many of these parties (and, of course, the finder of fact) may have concerns regarding any fraudulent transfers that the debtor entity entered into. These transfers often explain the reason for the debtor’s bankruptcy filing, affect the value of the assets in the bankruptcy estate, and affect the ability of the DIP to implement an effective plan of reorganization.

Legal counsel often retain valuation analysts to perform solvency or insolvency analyses during a bankruptcy proceeding. Legal counsel often have to retain the valuation analyst, instruct the analyst as to the appropriate assignment, review and understand the analyst’s
conclusions, defend the analyst during deposition and trial testimony, review and critique opposing valuation expert analyses and reports, and cross-examine opposing experts during deposition and trial.

These solvency or insolvency analyses often relate to claims of fraudulent conveyance, preference items, or other objectionable debtor entity actions or transfers. For example, legal counsel for the bankruptcy trustee, the DIP, or a creditor may attempt to recover a debtor entity’s fraudulent transfer under the provisions of the U.S. Bankruptcy Code section 548, 11 U.S.C §548 (for purposes of this article, section of the Bankruptcy Code will be referred to by United States Code citation). Of course, legal counsel may pursue fraudulent transfer remedies if any of these parties can prove that the debtor had actual intent to hinder, delay, or defraud the creditors. In the more common fraudulent conveyance claim, legal counsel must demonstrate that the debtor entity either: (i) was insolvent on the date that the objectionable transfer was made or the objectionable obligation was incurred; or (ii) became insolvent as a result of that objectionable transfer or obligation.

According to 11 U.S.C. §547, a transfer may be voided if it was made while the debtor is insolvent. So, legal counsel will work with the valuation analyst to assess the debtor entity’s solvency or insolvency in order to include the transferred assets back into the bankruptcy estate or exclude the assumed liabilities from the bankruptcy estate.

This article summarizes what legal counsel should consider when retaining a valuation analyst to determine if the debtor entity was insolvent. Bankruptcy Code section 548, 11 U.S.C. §548 provides for three tests to determine if a subject debtor transfer or obligation may be avoided:

- The balance sheet test (i.e., if the debtor liabilities exceed the fair value of the debtor assets);
- The cash flow test (i.e., if the debtor incurred debts that are beyond the debtor’s ability to repay as those debts mature); and
- The capital adequacy test (i.e., if the debtor engaged in a business or transaction for which any property remaining with the debtor was unreasonably small capital).

This particular discussion focuses on the first section 548 insolvency test, i.e., the balance sheet test.

**INSOLVENCY AND THE BALANCE SHEET TEST**

**Valuation Procedures**

Applying the balance sheet test, the valuation analyst typically performs a two-step procedure to
conclude whether the debtor entity is insolvent. In the first procedure, the valuation analyst concludes the appropriate premise of value to use in the fair value valuation. In the second procedure, the valuation analyst estimates (and compares) the values of the debtor assets and the debtor liabilities.

In the first procedure, the valuation analyst concludes the highest and best use (“HABU”) of the subject debtor entity. Based on the conclusion of this HABU analysis, the analyst concludes whether it is appropriate to value the debtor assets on either a value in continued use, going-concern basis premise of value or a value in exchange, orderly disposition basis premise of value. This HABU conclusion determines the premise of value. In all cases, the analyst will conclude the fair value standard (or definition) of value.

In the second procedure, the valuation analyst concludes the fair value of the debtor entity assets (both tangible assets and intangible assets), based on the selected premise of value. Then, the valuation analyst concludes the value of all of the debtor entity liabilities (both recorded liabilities and contingent liabilities). This balance sheet valuation should specifically consider: any asset reductions (e.g., cash payments to creditors, cash dividends/distributions to stockholders, sales or other transfers of tangible assets) related to the objectionable transaction; and any liability increases (e.g., leases, loans, or other obligations) related to the objectionable transaction. Next, the valuation analyst compares the fair value of all of the debtor assets to the value of all of the debtor liabilities.

Finally, if the fair value of the debtor total assets exceeds the value of the debtor total liabilities, then the debtor “passes” the balance sheet test — and the debtor entity is solvent under the balance sheet test. Alternatively, if the value of the debtor total liabilities exceeds the fair value of the debtor total assets, then the debtor “fails” the balance sheet test — and the debtor entity is insolvent under the balance sheet test.

A common definition of the fair value standard of value (particularly with regard to the going concern premise of value) is the price (in terms of cash) that a hypothetical willing buyer would pay and that a hypothetical willing seller would accept in the arm’s-length sale of the subject property, within a reasonable time period and with neither property being under compulsion to transact.

The selected standard of value basically answers the question: value to whom? The fair value standard of value contemplates a sale between an unidentified, hypothetical willing seller and an unidentified, hypothetical (and unrelated) willing buyer.

The selected premise of value answers this question: How will the parties considered in the standard of value come together to structure the transaction? Will the hypothetical buyer buy (and the hypothetical seller sell) a going concern business, or an in-place assemblage of tangible and intangible assets, or (through a voluntary liquidation) a bundle of tangible assets only?

Legal counsel should realize that in the fair value valuation, the analyst may have to exercise professional judgment as to what constitutes the length of the “reasonable period of time” in the fair value definition. The courts have generally defined a reasonable time period as the amount of time that “a typical creditor would find optimal: not so short a period that the value of goods as substantially impaired via a forced sale, but not so long a time that a typical creditor would receive less satisfaction of its claim, as a result of the time value of money and typical business needs, by waiting for the possibility of a higher price.” See In re Trans World Airlines, 134 F.3d 188, 195 (3d Cir. 1998); cert. denied, 523 U.S. 1138 (1998); In re Roblin Indus. Inc., 78 F.3d 30, 35 (2d Cir. 1996) (“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.”); see Matter of Lamar