Insolvency defined:

- The Code defines "insolvent" as a condition where the sum of an entity's debts are greater than the value of it's assets at "**fair valuation**." 11 U.S.C. § 101(32)(B)
- **Fair valuation** is intended to estimate the price that a willing buyer would pay in an arm's length transaction for the debtor's entire package of assets and liabilities for a going concern

Value is hard to discern and often a point of contention

Would you have invested?

Microsoft Corporation, 1978

Determining Insolvency

- The balance sheet is the starting point, not the end point of the analysis. Book value does not equal “fair value”
- Accounting has archaic rules that can often keep significant value (such as Coke’s secret formula) off of the balance sheet.
- Incompetent or fraudulent accounting practice can often make the balance sheet look much healthier than it actually is.
- Defendants in avoidance actions often see value that is highly subjective as to both existence and amount.
- Adjust every element of the balance sheet, including assets or liabilities not recorded or improperly stated, to fair value for every time period under consideration.

Accepted Methods of Valuation

- Income Approach
  - Conversion of expected future economic benefits (income, cash flow, etc.) to present value.
- Market Approach
  - Comparison of subject company to historical transactions from private databases or public markets
- Asset Approach
  - Build-up of appraisals of the existing individual assets and liabilities of the company.

Income Approach

- Theoretically the most correct approach, widely used in financial markets and well accepted in court proceedings
- Requires evaluation of financial markets and assessment of market, industry, and specific company risks.
- Based on expectations and projections of the future. Difficult to use in start-ups, high-growth companies, or situations in extreme flux.
- Results are highly sensitive to the facts used and assumptions made.

Market Approach

- Market is the final arbiter of value, most judges and juries are familiar with market methods (think of shopping for a new house)
- Often difficult to find sufficiently comparable companies
- Adequate information about companies being used for comparison is usually not available
- Need to be able to focus on specific factors that drive or detract from value

Asset Approach

- Easy to understand
- Valuation of intangible assets, contingent liabilities may be considered speculative.
- Piece-by-piece approach is of questionable relevance when valuing a going concern operation.
- Least relevant method when valuing companies with high-growth potential, significant intellectual property, important contractual rights, or significant goodwill.

The art and science of valuation

- The value of a company is dependent on the assets in place and the benefit streams being generated at the time of the valuation. Since we are talking about distressed companies, those assets likely are not generating enough cash to pay the liabilities that are encumbering them.
- In healthy companies, a large component of the value is often the company's growth prospects and anticipated profitability. In a distressed company, growth and profitability are often non-existent or negative.

Inherent conflict

- The valuation of a company should be premised upon its future earning capacity, free of impact of specific distress or past mismanagement.
- See, e.g., Consolidated Rock Products Co., v. Du Bois, 312 U.S. 510, 526 (1941)
- However, the more speculation (as to future results) a valuation contains, the more it needs to be discounted (i.e. lower valuation) and the more the valuation is likely to be ruled inadmissible by the court.

Value is determined by the market and by identification of risk

- The risks potentially impacting a company's anticipated benefit stream are evaluated by considering factors such as the quality of the management team and operations, the company's ability to execute on its business plans, financial strength and ability to finance its planned activities, the probability of survival, political factors, industry factors, competitive factors, the longevity of customers, and the size of the market.
- These often include factors that led to the company's distress. To the extent that success factors are missing or impaired, the company's value will be lower.

Problems in Valuing Distressed Companies

- Management is often in denial or clueless, and possibly committing fraud
- Cost-of-capital models are for going concern entities. Distressed firms have severely restricted access to capital and often only at vulture prices.
- There are often considerable disagreements as to whether the declines can be reversed
- Context is particularly significant when valuing distressed companies

Characteristics of companies in decline

- Declining working capital, sales, margins, and profits.
- Increased aging of receivables, payables, and inventory
- Disruptions in operations due to shortages, quality problems, etc. lead to increasing customer dissatisfaction
- Mismatch between strategic needs and available capital
- Low employee morale, high or key turnover
- Lack of timely and accurate information
- Management is more reactive than proactive

These would all negatively impact the analysis of value

Inability to pay debts

- In determining a debtor's insolvency for purposes of avoiding a transfer under § 548(a), the ability to pay debts as they mature is irrelevant if the insolvency is clearly demonstrated under the balance sheet test
- Since balance sheet solvency is often arguable, inability to pay debts is often used as a supplemental or alternative argument.

Ability to pay debts as they become due

- A company can appear solvent on the balance sheet, but still not be able to pay its bills as they become due. Evidence of this includes:
  - Aged accounts payable, Cash consistently overdrawn, Checks being held before mail
  - Vendors accepting steep compromises for either more immediate payment or more security
  - Churning of vendors, vendors constantly being replaced
  - Difficulty sourcing required materials, being forced to pay COD or CIA
  - Decreases in gross margin due to higher sourcing costs, decreases in both quality and quantity of inventory due to availability restrictions
  - Excess labor costs due to spurts in production when materials arrive sporadically
  - Significant delay in routine required payments that generate slow responses to non-payment, such as trust fund taxes and pension obligations.
  - Large amounts of cancelled customer orders or product returns
  - Management acting reactively instead of proactively
  - Higher than normal stress levels in employees, significant turnover in management ranks
  - Lawsuits filed for non-payment
  - Internal chaos

Debtor (Trustee) Avoiding Powers

- Background of 11 U.S.C. §§547 and 548 including a discussion of the policy underlying the preference laws.
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- Who may be the Plaintiff?
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- An overview of the defenses that may be asserted if your client is sued.
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- Strategies for defending/settling cases under § 547 and § 548 (or like State laws).