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Solving Insolvency

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When retained to testify as an expert witness before the New York Stock Exchange (NYSE) arbitration panel, I expected the assignment to consist of a straightforward determination of whether a member brokerage firm had been insolvent at the time of a failed transfer of a large block of securities. Instead, I found that the facts that might support a conclusion that the defendant was clearly insolvent—the fulcrum of the plaintiff 's case—could be interpreted in ways that would support a finding of solvency or insolvency, depending on the definition that the NYSE chose to rely on. This, in essence, was my testimony, which neither the arbitration panel expected, nor my client wanted to hear. However, it was a true representation of the facts, and in some ways encouraged the parties to settle the case. The conundrum existed at the time primarily because of the many precedent court decisions that had slightly modified the definition of insolvency to address the circumstances of a particular case.

Ten years have passed, and today multiple definitions of insolvency are still being referred to by advisors, creditors, and debtors—all of whom tend to cite the one that suits their purpose. For example, a creditor that has successfully defended against a preference or fraudulent transfer claim by arguing that a company was not insolvent under the Bankruptcy Code, might later pursue a derivative action against the company's directors under the assertion that the company was insolvent under Delaware law. Even shareholders who make use of the bankruptcy code to protect their company's assets from creditors may find it necessary to subsequently argue against insolvency (determined under a different premise) in an effort to retain proceeds from a pre-petition leveraged stock sale transaction.

Such scenarios are possible because uncertain and multiple standards of solvency are applied depending on the jurisdiction, premise of value, whether evidence of fraud exists, and the latest court precedents. Parties to an insolvency action can be surprised if they do not clearly understand and anticipate the definitions that the court will apply to arrive at a decision. The implications of insolvency vary, depending on which of three definitions are used. Commonly referred to as the balance sheet test, the cash flow test, and adequate capital test, a debtor may be required to pass only one, two, or perhaps all three to be considered solvent.

In one variation, the Uniform Commercial Code applies a cash flow and balance sheet test to define insolvency as when the debtor:

1) has ceased to pay debts in the ordinary course of business, or
2) cannot pay debts as they become due, or
3) is insolvent within the meaning of the federal bankruptcy law.

For purposes of pursuing a derivative claim under Delaware's corporate law, insolvency may be defined and interpreted differently than it is in other jurisdictions.[1] For example, the 2007 Delaware Supreme Court's *Gheewalla* decision appears to have added a qualification to the traditional balance sheet test for insolvency, which was articulated as: "A deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof."[2] This modification to the balance sheet test appears to suggest that failure of some form of an adequate capital test would also be necessary in order for a company to be considered insolvent. The *Gheewalla* decision also indicated that if a company becomes insolvent, the directors' duty to shareholders and creditors might shift to one of protecting the interests of only creditors.[3]

The Federal Bankruptcy Code introduces additional complexities by defining insolvency as the "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation…"[4] This is essentially a balance sheet test, except that the values of both assets and liabilities are determined using market-based measures, and not necessarily financial reporting standards. Case law generally interprets "fair valuation" for purposes of preference actions under Section 547 of the Bankruptcy Code to mean fair market value.

Before the balance sheet test can be applied to determine solvency, the premise of value must first be agreed upon. Assets of a business are valued under the anticipated condition, or premise, under which they are likely to be sold. These include in-use as part of a going concern, as part of an assemblage of assets, in-exchange under an orderly liquidation, or forced liquidation. In Chapter 11 cases, courts have historically required going concern values, although this is changing as recent fair value accounting pronouncements of the Financial Accounting Standards Board (FASB) have effectively modified the definition of reorganization value by way of modifications to Statement of Position 90-7.

AICPA Statement of Position 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code (SOP 90-7) was issued in 1990 to provide guidance on financial reporting for entities that file petitions with the bankruptcy court and expect to reorganize as a going concern under Chapter 11 of Title 11 of the U.S. Code. It has remained the primary guidance for financial reporting by entities in reorganization since that time. Under SOP 90-7, entities meeting certain criteria are required to adopt Fresh-Start Accounting (FSA), under the assertion that the emerging company is a new and different successor entity. Since historical costs and accounts of the predecessor company are no longer representative of contracts that have been renegotiated, all assets (and now liabilities) should therefore be reported at their current fair value.5

Paragraph 38 of SOP 90-7 requires, in part, that the reorganization value of the emerging entity be allocated to the entity's assets in conformity with the procedures specified by FASB Statement No. 141, Business Combinations. In December 2008, FAS 141 was significantly modified and replaced with FAS 141(R), which expands the list of assets and liabilities that must be valued under the fair value standard. Consequently, companies that might appear to be insolvent under Generally Accepted Accounting Principles could be solvent under the UCC or the Bankruptcy Code.

Since most actions taken to recover assets in a bankruptcy involve a determination of whether the debtor was insolvent at the time of transfer, the business and its assets must be valued at various points in time. A creditor's understanding of the new valuation requirements and acceptable methodologies have become a critical determinant of how much is recovered from a distressed debtor. This is because the recent fair value accounting pronouncements are used to determine and negotiate asset values in various bankruptcy motions, such as adequate protection, fraudulent transfers, avoidable preferences, equitable subordination, and confirmation of a reorganization plan. Even in out-of-court settlements, both debtors and creditors will want to gauge the attractiveness of any proposed modification or settlement using the same fair value standard.

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1 Delaware's Fraudulent Transfers Act, Title 6, Delaware Code § 1302(a)-(b) defines insolvency as: (a) A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets, at a fair valuation; or (b) A debtor who is generally not paying debts as they become due is presumed to be insolvent.

2 The additional language was adopted from the Court of Chancery's decision in Geyer v. Ingersoll Publications Co., 621 A.2d 784, 789 (Del. Ch. 1992), in which the Delaware Court of Chancery explained that a corporation is insolvent if "it has liabilities in excess of a reasonable market value of assets held." and the Court of Chancery's prior decision in Production Resources Corp. v. NCT Group, Inc. 863 A.2d 772, 782 (Del. Ch. 2004).

3 North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d. 92 (Del. 2007), in which the Delaware Supreme Court ruled that the fiduciary duties of directors of an insolvent corporation continue to be owed to the corporation, although in the case of an insolvent corporation, creditors, as the remaining economic stakeholders in the corporation, gain sufficient standing to pursue derivative claims for directors' breaches of fiduciary duty to the corporation. The decision clarifies that creditors may not bring any claim against directors for a breach of fiduciary duty that occurs while a solvent corporation is still in the "zone of insolvency," the parameters of which the Court did not define.

4 Section 101(32)(A)

5 Gregory R. Marsh, "Valuation in Bankruptcy," New York Law Journal, April 28, 2008: S4-S11.