

# AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for the Insolvency Professional

## Determining Insolvency in Preference and Fraudulent Conveyance Actions

Written by:

Sharyn B. Zuch

Wiggin & Dana LLP; Hartford, Conn.  
szuch@wiggin.com

Richard P. Finkel, CPA, CFE, CIRA  
Blum Shapiro Litigation Consulting  
Group LLC; West Hartford, Conn.  
rpf@blumshapiro.com

Was the debtor insolvent at the time of the transfer? This is often the threshold issue in preference and fraudulent conveyance actions. It is therefore necessary in many cases to determine insolvency at a specific point in time, prior to the bankruptcy filing.



Sharyn B. Zuch

For corporations, §101(32) of the Bankruptcy Code adopts a traditional balance-sheet definition of insolvency, a "...financial condition such that the sum of such entity's debts is greater than all of such entity's property, at fair valuation..." (emphasis added). "Fair valuation" is not defined in the Bankruptcy Code, but case law defines it as the amount that can be realized from the conduct of an orderly sale of the debtor's assets in an open market within a reasonable time frame, not liquidation value.<sup>1</sup> To determine insolvency, the debtor's assets and liabilities should be valued at fair value, "unless a business is on its death bed."<sup>2</sup> The bankruptcy court may consider subsequent events, but the debtor's

assets and liabilities must be valued as of the time of the transfer, not at what they ultimately were worth in the bankruptcy.<sup>3</sup> In addition, §101(32)(A)(1) requires that the company's assets be valued exclusive of any "property transferred, concealed or removed with the intent to hinder, delay or defraud" creditors.

### The Presumption of Insolvency



Richard P. Finkel

In preference actions, §547(f) gives the trustee (or the debtor-in-possession (DIP)) a presumption of insolvency for the 90 days immediately preceding the bankruptcy filing. This presumption of insolvency is rebuttable.<sup>4</sup> Section 547(f) does not change the burden of proof, which remains with the trustee; it just shifts the burden of going forward with the evidence.<sup>5</sup> In a preference action against an insider in which the transfer occurred more than 90 days before the date of filing, there is no presumption of insolvency, and the trustee must establish insolvency on the date of the transaction. There is also no presumption of insolvency in avoidance actions for constructive fraud brought under §548(a)(1)(B).

### The Burden of Proof

Insolvency is a question of fact that the trustee must prove by the preponderance of the evidence.<sup>6</sup> The preponderance standard means that the trustee must persuade the bankruptcy court that the proposition sought to be proven—that the debtor was insolvent on the date of the transfer—"is more likely true than not."<sup>7</sup> If a creditor meets the presumption of insolvency with credible

evidence, then the burden of introducing evidence of insolvency shifts to the trustee.<sup>8</sup> The trustee will typically rely on testimony of an accountant, appraiser or business valuation expert to establish the fair value of the debtor's assets and liabilities at the time of the transfer in question.<sup>9</sup> If the transfer occurred in the middle of an accounting period and there is no record of the value of the debtor's assets and liabilities on that date, the determination of insolvency is difficult at best.

The debtor's financial statements for the reporting period closest to the transfer date provide a good place to start, but they are historical statements of value, *i.e.*, book value, and must be converted to fair value. The book value of assets such as property and equipment are recorded at cost, less accumulated depreciation. The fair value of such assets does not depend on how fast they have been depreciated on the company's books, but on what they are worth in the current market. Assets such as inventory should be adjusted based on age, liquidity and market conditions, and accounts receivable should be discounted for collectibility. Likewise, liabilities should be reduced to their expected or present value before a determination can be made regarding whether a company's assets exceed its liabilities.<sup>10</sup>

Table 1 illustrates a typical balance sheet for a closely held corporation. The first column represents historical value and indicates, based on these values, that the company is solvent by \$1,219,000.

Each asset and liability on the historical balance sheet must be analyzed and adjusted to fair value, if applicable. In this example, accounts receivable and inventory have been reduced to their realizable values. Prepaid expenses and other assets are assumed to have no net realizable value. Property and equipment have been reduced to appraised market value. On the liability side, accrued expenses have been reduced to reflect only those accruals that would actually require

<sup>1</sup> See, e.g., *Foley v. Briden (In re Arrowhead Gardens Inc.)*, 32 B.R. 296, 299 (Bankr. D. Mass. 1983), *aff'd*, 776 F.2d 379 (5th Cir. 1985); see, also, *Coated Sales Inc. v. First Eastern Bank N.A. (In re Coated Sales Inc.)*, 144 B.R. 663, 667 (Bankr. S.D.N.Y. 1992) ("[f]air value is not synonymous with a forced sale"); *Beckman v. Von Christerson (In re CSI Enterprises Inc.)*, 220 B.R. 687, 692 (Bankr. D. Colo. 1998).

<sup>2</sup> *In re Arrowhead Gardens Inc.*, 32 B.R. at 299; *In re Coated Sales Inc.*, 144 B.R. at 668.

<sup>3</sup> *In re Coated Sales Inc.*, 144 B.R. at 668; *Gillman v. Scientific Research Products Inc. (In re Mama D'Angelo Inc.)*, 55 F.3d 552, 856 (10th Cir. 1995).

<sup>4</sup> *Lawson v. Ford Motor Co. (In re Roblin Industries Inc.)*, 78 F.3d 30, 34 (2nd Cir. 1996).

<sup>5</sup> See, e.g., *Total Technical Services Inc. v. Whitworth (In re Total Technical Services Inc.)*, 150 B.R. 893, 899 (Bankr. D. Del. 1993).

<sup>6</sup> *Matson v. Strickland (In re Strickland)*, 230 B.R. 276, 282 (Bankr. E.D. Va. 1999). See, also, *Murphy v. Nunes (In re Terrific Seafoods Inc.)*, 197 B.R. 724, 731 (Bankr. D. Mass. 1996).

<sup>7</sup> *Arrow Electronics Inc. v. Justus (In re Kaypro)*, 230 B.R. 400, 412 (BAP 9th Cir. 1999), *aff'd in part, rev'd in part, and remanded (on other grounds)*, 218 F.3d 1070 (9th Cir. 2000).

<sup>8</sup> *In re Roblin Industries Inc.*, 78 F.3d at 34-35.

<sup>9</sup> Tax returns and actual sales of assets may also be used. See *In re Strickland*, 230 B.R. at 283. Securities and Exchange Commission (SEC) filings are also a starting point for valuation. See, e.g., *In re Total Technical Services Inc.*, 150 B.R. at 900.

<sup>10</sup> *In re Xonics Photochemicals Inc.*, 841 F.2d 198, 200-201 (7th Cir. 1988).

payment by the company in an orderly liquidation. Taking these adjustments into consideration, the company is insolvent by \$164,000.

### Inference of Insolvency by Retrojection

In a case where the debtor's financial position is unascertainable on the date of a challenged transfer, a number of courts have permitted the trustee to infer insolvency on a particular date by a method known as "retrojection." The "retrojection rule" provides that "if a debtor was insolvent on the first known date and insolvent on the last relevant date, and the trustee demonstrates the absence of any substantial or radical changes in the assets or liabilities of the debtor between the two retrojection dates, then the debtor is deemed to be insolvent at all intermediate times."<sup>11</sup> The retrojection method has also been described this way:

A [debtor's] insolvency on a transfer date may be shown by using company books and a later inventory and by working backwards though a ledger to reflect sales, purchases [and] returns after the critical date...a trustee must be able to show absence of substantial or radical changes in assets or liabilities of the bankrupt between (retrojection dates).<sup>12</sup>

Some courts, however, have been reluctant to infer insolvency using this method going back more than a few months before a proven date of insolvency.<sup>13</sup>

### Practice Pitfalls

In presenting the evidence of insolvency to the bankruptcy court, the trustee (or DIP) should always bear in mind that he has the burden of proof; a tie on the issue of insolvency goes to the transferee. For instance, judgment was entered for the defendants in *Parlon v. Claiborne (In re Kaylor Equipment Rental Inc.)*, 56 B.R. 58, 63 (Bankr. E.D. Tenn. 1985). The trustee sought to avoid the debtor's \$15,000 in payments to two of its three owners as fraudulent transfers under §548(a)(2) of the Bankruptcy Code.

At trial, the only disputed issue was the corporation's solvency on the date of the transfers. The trustee offered some documentary evidence of insolvency at the time of the transfers, but the debtor's records were inconclusive. The trustee failed to introduce expert testimony to rebut the

<sup>11</sup> *In re Strickland Inc.*, 230 B.R. at 284. See, also, *In re Terrific Seafoods Inc.*, 197 B.R. at 731.

<sup>12</sup> *In re S&W Exports Inc.*, 16 B.R. 941, 947 n.2 (Bankr. S.D.N.Y. 1982), quoting *Haynes & Hubbard Inc. v. Stewart*, 387 F.2d 907 n.1 (5th Cir. 1967); see, also, *In re Mama D'Angelo*, 55 F.3d at 554-555.

<sup>13</sup> See, e.g., *Washington Bancorporation v. Hodges (In re Washington Bancorporation)*, 180 B.R. 330, 333-335 (Bankr. D. D.C. 1995).

**Table 1**

**XYZ Corporation  
Balance Sheet  
As of December 31, 20XX**

Assets	Historical Value	Adjustments	Fair Value
<b>Current Assets</b>			
Cash and cash equivalents	\$ 50,000	\$ -	\$ 50,000
Accounts receivable-net	950,000	(275,000)	675,000
Notes receivable-stockholders	75,000	-	75,000
Inventories	725,000	(200,000)	525,000
Prepaid expenses	125,000	(125,000)	-
Other current assets	8,000	(8,000)	-
Total Current Assets	<u>\$ 1,933,000</u>	<u>\$ (608,000)</u>	<u>\$ 1,325,000</u>
<b>Property and Equipment</b>			
Machinery and equipment	\$ 750,000	\$ (450,000)	\$ 300,000
Vehicles	50,000	(25,000)	25,000
Furniture and fixtures	250,000	(150,000)	100,000
Leasehold improvements	850,000	(850,000)	-
	1,900,000	(1,475,000)	425,000
Less accumulated depreciation	650,000	(650,000)	-
Net property and equipment	<u>\$ 1,250,000</u>	<u>\$ (825,000)</u>	<u>\$ 425,000</u>
<b>Other Assets</b>			
Deposits	20,000	-	20,000
Total Other Assets	<u>\$ 20,000</u>	<u>\$ -</u>	<u>\$ 20,000</u>
<b>Total Assets</b>	<b><u>\$ 3,203,000</u></b>	<b><u>\$ (1,433,000)</u></b>	<b><u>\$ 1,770,000</u></b>

**Table 2**

**XYZ Corporation  
Balance Sheet  
As of December 31, 20XX**

Liabilities and Equity	Historical Value	Adjustments	Fair Value
<b>Current Liabilities:</b>			
Accounts payable	\$ 900,000	\$ -	\$ 900,000
Accrued expense	75,000	(50,000)	25,000
Notes payable	50,000	-	50,000
Income taxes payable	9,000	-	9,000
Total current liabilities	<u>\$ 1,034,000</u>	<u>\$ (50,000)</u>	<u>\$ 984,000</u>
<b>Long Term Liabilities:</b>			
Notes payable	<u>\$ 950,000</u>	<u>\$ -</u>	<u>\$ 950,000</u>
Total Liabilities	<u>\$ 1,984,000</u>	<u>\$ (50,000)</u>	<u>\$ 1,934,000</u>
<b>Stockholders' Equity:</b>			
Common stock	\$ 25,000	\$ -	\$ 25,000
Retained earnings	1,194,000	(1,383,000)	(189,000)
Total Stockholders' Equity	<u>\$ 1,219,000</u>	<u>\$ (1,383,000)</u>	<u>\$ (164,000)</u>
<b>Total Liabilities and Equity</b>	<b><u>\$ 3,203,000</u></b>	<b><u>\$ (1,433,000)</u></b>	<b><u>\$ 1,770,000</u></b>

defendants' certified public accountant (CPA), who testified that all of the debtor's debts could have been paid in full had the debtor's assets been sold on the date of the transfers. The trustee lost his case, despite introducing some evidence of insolvency, because he failed to carry his burden of proof at trial. The bankruptcy court hinted that the outcome might have been different if the trustee had offered expert testimony demonstrating a substantial change in the financial condition of the company between the date of the transfers and the date of filing, or if the trustee had used a valuation expert to establish that the debtor's asset valuation on the date of the transfers exceeded fair market value<sup>14</sup> and should have been adjusted downward.

On the other hand, the trustee should not rely on "conclusory" expert testimony alone. In *Orix Credit Alliance Inc. v. Harvey (In re Lamar Haddox Contractor Inc.)*, 40 F.3d 118, 122 (5th Cir. 1994), the Fifth Circuit reversed the preference judgment entered in favor of the chapter 11 estate representative because the "conclusory opinion testimony" of the estate's CPA was insufficient to establish the debtor's insolvency on the dates of the transfers. The accountant testified that he had no idea of the fair value of the debtor's heavy equipment, its major asset. The estate representative introduced no other testimony, nor financial records from which the court could determine the fair value of the debtor's assets. Ironically, the accountant actually had in his possession the debtor's financial statements and general ledger. These financial records could have been used as a starting point for determining fair value, but counsel did not introduce them into evidence, and the Fifth Circuit found that the estate representative failed to carry his burden of proof.

## Conclusion

Proving insolvency can be difficult, especially if the transfer in question took place between accounting periods. The use of credible experts such as accountants, appraisers and business valuation professionals can be critical to the ultimate outcome of a proceeding involving the determination of insolvency. ■

*Reprinted with permission from the ABI Journal, Vol. XX, No. 9, November 2001.*

*The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 8,400 members, representing all facets of the insolvency field. For more information, visit ABI World at [www.abiworld.org](http://www.abiworld.org).*

<sup>14</sup> See, also, *Pembroke Dev. Corp. v. Commonwealth Sav. & Loan Ass'n. (In re Pembroke Dev. Corp.)*, 124 B.R. 398, 402 (Bankr. S.D. Fla.), which held that a loan-modification agreement was not a preference because the debtor failed to introduce any evidence, such as appraisals or opinion testimony, that the actual value of the debtor's real property was worth substantially less at the time of the transfer.