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Valuing Forbearance In Fraudulent Transfer Actions

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As a business descends into financial distress, it commonly enters into discussions with its creditors concerning a viable path forward to stave off a bankruptcy filing or liquidation. Either as the first step in a series of agreements or as part and parcel of a larger out-of-court restructuring, creditors often agree to forbear from pursuing collection remedies against the company or the collateral for a period. In return, the company may transfer money or property to the creditors—transfers that may or may not reduce the company's obligations—or incur additional debt. If, in a subsequent bankruptcy proceeding, the estate representative sues a given creditor for a fraudulent transfer based on the receipt of the money or property or a fraudulent incurrence of the additional obligation, then the creditor may well defend by claiming that the forbearance provided "value" to the debtor. Perhaps in conjunction with other benefits received by the debtor, the creditor will argue that it gave "reasonably equivalent value" and thus may defeat the fraudulent transfer action. In the resolution to that litigation, the creditor's liability may turn on whether and to what extent a court ascribes value to the forbearance. Below we discuss the legal and financial framework for addressing that question.

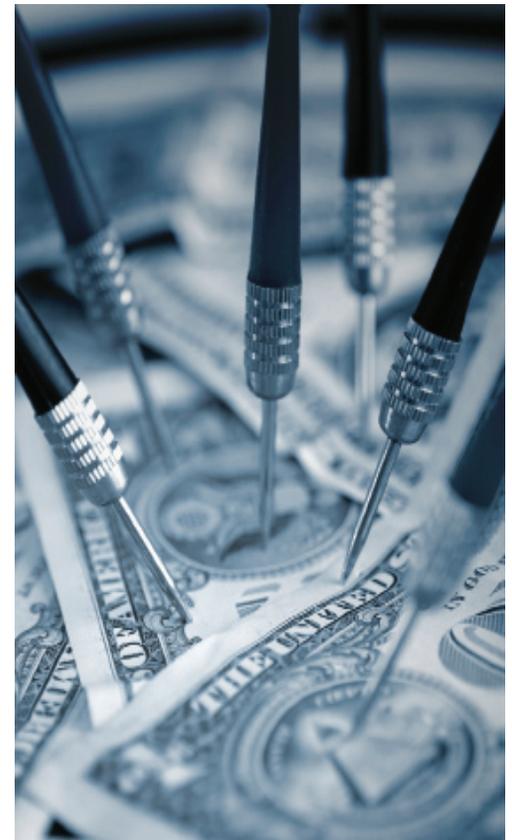
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The Legal Introduction

Section 548(a)(1)(B) of the Bankruptcy Code—the constructive fraudulent transfer section—states in relevant part that a trustee may avoid any transfer...of an interest of the debtor in property, or any obligation...incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily...received less than a reasonably equivalent value in exchange for such transfer or obligation and...was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation...¹

Section 548(d)(2) defines value as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." "Value has been defined as that which provides an economic benefit, either direct or indirect, to the debtor."² However, whether the value provided in a given case rises to the level of "reasonably equivalent value" requires a more searching inquiry. "There is no fixed mathematical formula for determining reasonably equivalent value; rather, the determination depends on all the facts of each case."³

Courts have routinely recognized that forbearance can comprise a component of reasonably equivalent value with respect to a fraudulent transfer analysis.⁴ Two relatively recent cases, however, show that courts at times reach a summary conclusion with respect to valuing



forbearance without readily providing significant detail around the attendant calculations. These decisions demonstrate that forbearance provides legitimate benefits to the debtor, but they do not necessarily illuminate the path for parties that may face the issue in the next case.

In *In re Positive Health Management*, the debtor operated a pain management clinic in a building over which First National Bank held a security interest.⁵ The debtor, however, was

not directly obligated on the mortgage debt to the bank; rather, the bank had a contractual relationship with a different entity.⁶ Nevertheless, the debtor made prepetition transfers directly to the bank, which then did not pursue foreclosure or other collection efforts against the property.⁷ After the debtor filed for bankruptcy, the Chapter 7 trustee sued the bank to avoid the payments as fraudulent transfers.⁸

After a trial to the bankruptcy court, the trustee argued to the district court that the bank had received \$367,681.35 in prepetition payments, but the fair market rental value of the premises was only \$253,333.33.⁹ Thus, the bank only “gave value” to the extent of the rental value, and the difference between the payments and the rental value—the difference was \$114,348.02—should be avoided as a fraudulent transfer. The court disagreed, finding that the record at trial showed that the debtor had received value for the use of the building—that is, the rental value—and additional value in the form of the bank’s forbearance from foreclosing on the property.¹⁰ That forbearance allowed the debtor “to engage in ongoing business operations to generate continued cash flow.”¹¹ Thus, while the court did not provide a detailed analysis, it necessarily concluded that the forbearance provided reasonably equivalent value to offset the \$114,348.02 in payments above and beyond the rental value.

In *In re Propex*, the debtor had entered into a prepetition secured credit agreement with various lenders.¹² Thereafter, on Jan. 26, 2007, the parties amended the credit agreement by waiving the debtor’s obligations to comply with certain financial covenants for the fourth quarter of 2006 and relaxing the covenants for 2007 and the first quarter of 2008.¹³ In exchange, (i) the debtor made a \$20 million payment, and (ii) the interest rate on the credit facility was increased.¹⁴ After the debtor filed for bankruptcy, the committee brought suit alleging that the amendment was a fraudulent transfer because the debtor received less than fair consideration for the cash payment and interest rate increase.¹⁵

On a motion to dismiss, the court quickly concluded that the debtor had received reasonably equivalent value as a matter of law with respect to the \$20 million cash payment because that payment satisfied antecedent debt on a dollar for dollar basis.¹⁶ That conclusion is clearly correct as an application of black letter law. But the court also had to consider the other aspect of the transaction—the interest rate increase.

With respect to the interest rate increase, the court found that the waiver of the financial covenants for the fourth quarter of 2006 and the relaxing of the covenants for the next five quarters constituted reasonably equivalent value as a matter of law for the increase in interest rate.¹⁷ The committee argued that the waiver and covenant relaxation had no value, as there was no chance that the debtor could comply with the financial covenants (even as modified).¹⁸ The court disagreed:

[T]he lenders could have declared Propex in default, demanded immediate payment on all its obligations, and pursued all the remedies available to them by virtue of the default. By agreeing to forbear and to relax the financial covenants, the lenders gave Propex “‘breathing room’—an opportunity to avoid default, to facilitate its rehabilitation, and to avoid bankruptcy.” The court holds that that opportunity constitutes reasonably equivalent value for the interest rate increase as a matter of law, irrespective of the fact that “[t]he ‘breathing room’ turned out to be short-lived.”¹⁹

Interestingly, the court decided this issue on a motion to dismiss. It did not, however, set forth in its opinion how it valued the interest rate increase, on the one hand, or the “breathing room,” on the other. Other courts may not be as willing to reach such conclusions without more quantitative analysis on the relative valuations.²⁰ We thus turn to how valuation theory and methodology assist in determining the value of forbearance.

The Financial Introduction

Greek orator Antiphon noted more than 2,000 years ago that “the most costly outlay is time.” Hundreds of years later Benjamin Franklin transformed this into its common form when he wrote: “Remember that time is money. He that idly loses five shillings’ worth of time loses five shillings, and might as prudently throw five shillings into the sea.” Indeed, perhaps in no time in history has the adage “Time is Money” been more true than today.

However, if time is money, can the two be equated mathematically? Indeed, fundamental to valuation theory is the concept that an asset’s value must incorporate the risks inherent from the passage of time. Value, generally, is the present value of expected future cash flows. To arrive at that present value, one must apply reasonable financial theory to compensate for the passage of time and the expectation

that there is risk in the outcomes that may be achieved in the future.

In the context of distressed businesses, there are often strategic risks that are faced and critical decision points. The results of these decisions may result in businesses surviving or failing. The efforts to restructure a business can involve many parties working together to preserve what value may exist in the business, or can be realized from its liquidation or sale. For lenders, one common consideration is forbearance—simply defined as “a refraining from the enforcement of something (as a debt, right, or obligation) that is due.”²¹ However, conceptually, if the lender provides a business with forbearance, it must receive something in exchange of reasonably equivalent value. This, of course, raises the question: What is the value of forbearance. From the perspective of the debtor, one could ask “What would a buyer pay for this option in the market?” or “What would the company pay to secure this option?”²² Of course, the answer involves a complex analysis of specific facts and circumstances. A complete review of the methods utilized and information considered for such an analysis is certainly beyond the scope of this article. However, certain concepts and calculations are worth considering.

One of the complexities in determining the value of forbearance is that one must consider several perspectives and several potential outcomes. Put simply, the value of forbearance could be conceptualized as the difference between the present value of expected future cash flows if forbearance is provided and the same in the circumstance where forbearance is not provided. One could certainly interpret the opinions of the court in *In re Positive Health Management* and *In re Propex*, above, as reflective of this perspective. While the courts did not offer a mathematical or financial method to determine this value, they suggest that had the forbearance not been extended, the circumstances would have been very different, suggesting that value could be measured by the difference.

For these situations, valuation techniques can be employed that consider the decision-tree of reasonable outcomes. Decision tree valuation techniques can be employed in a wide array of circumstances, each having certain similarities:

- Real options²³
- Valuation of claims arising out of litigation
- Valuation of contingent assets/liabilities

For each of these, the valuation practitioner typically considers certain assumptions or inputs to the calculation of value. While the specifics of

each methodology may include or exclude certain factors, generally, the practitioner considers:

- The different events that are likely to occur under certain scenarios
- The time it will take for these scenarios to develop
- The probability of the expected outcomes in each scenario
- The cash flow associated with each of the potential outcomes
- The risks associated with the receipts of those cash flows

The facts and circumstances often surrounding forbearance lead naturally to the use of decision tree valuation techniques due to the multiple potential outcomes and restructuring events that may arise with or without forbearance. For example, in the circumstance where forbearance is not received by the company the following factors may apply:

- The business is able to make other arrangements and is able to survive—Probability: 10 percent
 - The business is then able to take advantage of certain circumstances allowing it to achieve superior profitability—Probability: 5 percent
 - The business continues to struggle achieving only modest profitability—Probability: 95 percent
- The business is unable to remain solvent and pay debts as they become due, resulting in filing for bankruptcy protection—Probability: 90 percent

Contrast this to the following set of outcomes if forbearance is provided:

- The business is able to survive without any further financial accommodations—Probability: 75 percent
 - The business is able to capitalize on certain circumstances and is able to achieve superior profitability—Probability: 40 percent
 - The business continues to struggle achieving only modest profitability—Probability: 60 percent
- The business is able to survive but requires further financial accommodations in 6 months—Probability: 25 percent
 - The business further restructures and is able to survive with modest profitability—Probability: 80 percent
 - The business is unable to further restructure and is required to file for bankruptcy protection—Probability: 20 percent

As illustrated in the scenarios above, typically the first step in developing an analysis using

decision-tree valuation techniques involves estimating the amounts and timing of the future cash flows estimated under multiple scenarios. These amounts are discounted to a present value utilizing a rate of return consistent with the risk inherent in the projected cash flows. The present value of the total cash flows in each scenario is then weighted based on the probability of each scenario occurring, as projected.²⁴ In the scenarios above there is a significant amount of additional information that would be required to reasonably estimate the value of forbearance to the debtor. However, the application of this framework could result in a reasonably certain estimate of the value of forbearance, if applied correctly utilizing reasonable inputs. The scenarios above illustrate, as is common with distressed business, the significance of the decisions that affect the business' chance of survival and profitability.

The decision tree framework described above provides for flexibility not typically found in the Discounted Cash Flow Method. However, decision tree valuation techniques can also require additional assumptions which can be challenging to quantify. In addition, there are practical limitations to the number of possible scenarios that can either be modeled or reasonably estimated. As such, one must carefully weigh the benefits of additional flexibility with the challenges and complexity of the resultant financial models.

Conclusion

Courts have made clear that forbearance has value. Further they have stated that forbearance is an element of consideration when reviewing reasonably equivalent value for purposes of fraudulent transfers. That said, the published opinions have provided little guidance as to the specific factors considered in valuing forbearance or specific methods that are to be applied. However, the essential characteristics of forbearance are similar to other circumstances in which valuation theory is commonly applied. In these circumstances, such as the valuation of claims arising out of litigation (often considered a contingent asset or liability), decision-tree valuation methodologies are employed to assess the value of assets based on the probabilities, cash flows and risks of cash flows associated with certain expected outcomes. This analysis is certainly complex and requires a careful analysis of available facts in any matter, however, the value of

forbearance can be determined if sensible inputs are applied reasonably.

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1. 11 U.S.C. §548(a)(1)(B) (emphasis added).
2. *Barber v. Iverson* (In re *Iverson*), 2008 WL 2796998, at *5 (Bankr. C.D. Ill. July 21, 2008) (citing *Liste v. John Wiley & Sons* (In re *Wilkinson*), 319 B.R. 134, 138 (Bankr. E.D. Ky. 2004), aff'd 196 Fed. Appx. 337, 2006 WL 2380887 (6th Cir. 2006)).
3. *First State Bank of Red Bud v. Official Comm. of Unsecured Creditors* (In re *Schaefer*), 2011 WL 1118666, at *4 (S.D. Ill. March 28, 2011) (citing *Barber v. Golden Seed*, 129 F.3d 382, 387 (7th Cir. 1997)).
4. E.g., *In re Schaefer*, 2011 WL 1118666, at *5. See also *Geron v. Palladin Overseas Fund* (In re *AppliedTheory*), 330 B.R. 362, 363-64 (S.D.N.Y. 2005) (discussing *Cuevas v. Hudson United Bank* (In re *M. Silverman Laces*), 2002 WL 31412465 (S.D.N.Y. Oct. 24, 2002) and holding that forbearance plus the transfer of a lien equates to reasonably equivalent value as a matter of law with respect to a creditor that provided a cash loan and reasoning that the fact-based analysis used by other courts in similar circumstances is unnecessary).
5. *Williams v. BBVA Compass Bank* (In re *Positive Health Mgmt.*), 2012 WL 3929900 (S.D. Tex. Sept. 7, 2012) (hearing case after bankruptcy court had submitted proposed findings of fact and conclusions of law to district court).
6. Proposed Findings of Fact and Conclusions of Law Regarding Trustee's Complaint for Avoidance of Transfers and Related Relief at 14, *Williams v. BBVA Compass Bank* (In re *Positive Health Mgmt.*), 2012 WL 3929900 (S.D. Tex. Sept. 7, 2012) (No. 4:11-cv-03436), ECF No. 1.
7. *In re Positive Health Mgmt.*, 2012 WL 3929900, at *1.
8. *Id.*
9. *Id.* at *3. Given that the debtor was not obligated on the mortgage debt to the bank, the payments could not fall within the definition of "value" as payment of antecedent debt.
10. *Id.*
11. *Id.*
12. *The Official Comm. of Unsecured Creditors of Propex v. BNP Paribas* (In re *Propex*), 415 B.R. 321, 323 (Bankr. E.D. Tenn. 2009).
13. *Id.* at 323-24.
14. *Id.* at 324.
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.* at 325.
19. *Id.* (quoting *Cuevas v. Hudson United Bank* (In re *M. Silverman Laces*), 2002 WL 31412465, at *6 (S.D.N.Y. Oct. 24, 2002)).
20. See, e.g., *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston* (In re *Exide Techs.*), 299 B.R. 732, 748 (Bankr. D. Del. 2003) (denying a motion to dismiss and stating: "The value of the forbearance may constitute reasonably equivalent value, but only based on a showing of what the value of the forbearance was."); see also, e.g., *Stillwater Nat'l Bank and Trust Co. v. Kirtley*, 299 B.R. 626, 638 n.50 (10th Cir. BAP, 2003) (stating with respect to forbearance that "[i]ndirect benefits that cannot be quantified do not constitute value.>").
21. "Forbearance" Merriam-Webster.com, Merriam-Webster, 2012 (Web, Nov. 16, 2012).
22. Note that the value of this forbearance may be perceived differently by the creditor and debtor, depending on the circumstances.
23. Such as decisions to expand geographically, invest in a new manufacturing line or lay off employees to achieve greater capacity.
24. See generally Tom Copeland, Vladimir Antikarov, *Real Options—A Practitioner's Guide* (New York: Cengage Learning, 2003); Steven Kam, Annika Reinemann, Caroline Puiggali, Jason Ruiz, "The Valuation of Litigation," *Valuation Strategies* 2-11 (March/April 2006).