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## Defending Avoidance Actions with Solvency: What Does the Market Say?

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Recent bankruptcy decisions have highlighted the role of market evidence in measuring the solvency of bankruptcy debtors.

Debtors in bankruptcy (and trustees or unsecured creditors' committees acting on behalf of a bankruptcy estate) often invoke the Bankruptcy Code's avoidance powers--generally, the fraudulent transfer and preference provisions--to demand the return of certain payments and other transfers made before a bankruptcy filing, typically for redistribution to the unsecured creditors of the bankruptcy estate on a *pro rata basis*. In most cases, however, the recipient of the payment or other transfer will be required to return it only if the debtor was insolvent at the time of the payment or transfer. If the debtor was solvent and could pay all of its creditors in full, then redistribution of the payment or transfer would not serve its intended purpose of achieving equal treatment of creditors. See, e.g., 11 U.S.C. §§ 547(b)(3) and 548(a)(1)(B)(ii).

Bankruptcy case law is replete with analyses of whether a debtor was insolvent at the time of a transfer or payment. The case law employs a variety of different methods to determine solvency, based on varying circumstances.<sup>[i]</sup> Among these methods, there is an emerging trend for determining the solvency of debtors whose securities trade in robust public markets--courts are increasingly looking to the market capitalization of the debtor at the time of the transfer or payment as a measuring stick to determine its solvency.

### The *Iridium* Decision

Last August, in a preference and fraudulent transfer action seeking the recovery of more than \$3.7 billion, the United States Bankruptcy Court for the Southern District of New York emphasized that "a company's stock price is often the best data point for determining the company's value," and therefore its solvency. *Statutory Comm. of Unsecured Creditors on behalf of Iridium Operating, LLC, et al. v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283, 346 (Bankr. S.D.N.Y. 2007) (Peck, J.).<sup>[ii]</sup> Relying largely on market data, the court found that the creditors' committee had failed to prove that Iridium was insolvent in the years prior to its bankruptcy filing and subsequent liquidation. The court reached this conclusion based largely on the fact that Iridium's stock continued to trade in the market at positive values until just months before its bankruptcy filing. Accordingly, the alleged

preferential and fraudulent transfers were not recoverable.

### The *eToys* Decision

The Delaware bankruptcy court recently signaled its agreement with this approach, substantially relying upon the market capitalization of the now-liquidated *eToys, Inc.*, in holding that *eToys* was solvent at the time of an allegedly fraudulent transfer that occurred just a few months before the company filed for bankruptcy. See *EBC I, Inc., f/k/a eToys, Inc. v. America Online, Inc. (In re EBC I, Inc.)*, Adv. Pro. No. 03-50003 (Bankr. D. Del. January 10, 2008) (Walrath, C.J.). As in *Iridium*, the Delaware court's consideration of "objective evidence from the public equity and debt markets" was pivotal in rendering the transfer unrecoverable.<sup>[iii]</sup>

### The *VFB* Decision

The New York and Delaware bankruptcy courts both explicitly followed the valuation rationale adopted by the Court of Appeals for the Third Circuit when evaluating a different fraudulent transfer defense--reasonably equivalent value--in *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (2007). In *VFB*, the Third Circuit decided that the prepetition debtor had received "reasonably equivalent value" in exchange for \$500 million in debt it incurred to purchase certain company divisions from its parent company as part of a leveraged spin-off. Explaining that "[m]arket capitalization is a classic example of . . . an anchored projection," the court found that "absent some reason to distrust it, the market price is a more reliable measure of . . . stock[] value than the subjective estimates of one or two expert witnesses." *Id.* at 631, 633. In considering the weight to be given to the expert and market evidence, the court considered the reliability of the New York Stock Exchange, "one of the most efficient capital markets in the world." *Id.* at 629. Since the market price of the debtor following the acquisition suggested that the value of the companies it acquired exceeded the \$500 million the debtor had borrowed in connection with the acquisition, the Third Circuit affirmed the district court's determination that the debtor received reasonably equivalent value in the transaction.

Although solvency, and not reasonably equivalent value, was the defense at issue in *Iridium* and *eToys*, both the New York and Delaware courts followed the Third Circuit in finding the market capitalization valuation method appropriate, and contrary expert testimony less helpful. In *Iridium*, the New York court found that the opinion of *Iridium*'s expert witness was inconsistent with "contemporaneous market evidence, including *Iridium*'s stock price," and that the market evidence was, by contrast, "untainted by hindsight or post-hoc litigation interests." See *Iridium*, 373 B.R. at 346, 351. Likewise, in the recent *eToys* decision, the Delaware court rejected *eToys*'s argument that "it was inappropriate to include any value for intangibles because the balance sheet should include only tangible assets that are readily saleable" in liquidation, largely because *eToys* offered no reason to distrust the market data that the defendant AOL's expert witness had relied upon.<sup>[iv]</sup>

The *VFB* decision, together with the *Iridium* and *eToys* decisions, suggest the ascendancy of the principle set forth by the Supreme Court 20 years ago: "The market is performing a substantial part of the valuation process . . . . [It is] acting as the unpaid agent of the investor, informing him that given all the information available to it, *the value of the stock is worth the market price.*" *Basic Inc. v. Levinson*, 485 U.S. 224, 244 (1988) (emphasis added) (internal citation omitted).

## The Bottom Line

The VFB, *Iridium*, and *eToys* decisions evidence the emergence of a "market cap" approach to valuation analysis in bankruptcy avoidance actions involving publicly traded debtors. The courts in these cases were unwilling to ignore the fact that the debtors' equity securities were trading at positive values at the time of the transfers, even though the debtors were required to file for bankruptcy shortly thereafter. In other words, the courts were unwilling to assume that the markets were "imperfect" and incorrect simply because the debtors filed for bankruptcy within as little as a few months after the alleged transfers were made.

These decisions demonstrate an alternate path to proving solvency--which is a full defense to preference actions and certain fraudulent transfer actions--that may be viable even when other evidence of solvency is difficult to obtain or inconclusive. While market evidence is not likely to be conclusive in all cases, the courts' reliance on market evidence in the recent *VFB*, *Iridium* and *eToys* decisions may lead to an enhanced role for market evidence in similar cases in the future.

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[i] See, e.g., *In re American Classic Voyages Co.*, 367 B.R. 500, 514 (Bankr. D. Del. 2007) (adopting a discounted cash flow analysis in determining that the debtor was solvent); *In re Lids Corp.*, 281 B.R. 535 (Bankr D. Del. 2002) (considering the adjusted balance sheet, market multiple, and comparable transaction methodologies in determining the debtor was insolvent under 11 U.S.C. § 547(b)(3)).

[ii] WilmerHale is counsel to the debtor in *Iridium*. It did not, however, represent a party in this adversary proceeding.

[iii] WilmerHale was counsel to the prevailing party, defendant AOL LLC (f/k/a America Online, Inc.), in this case.

[iv] There may of course be cases, such as those in which market manipulation is alleged, in which courts would necessarily conclude that market-based data did not correctly reflect actual valuation.

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## Authors



**George W. Shuster Jr.**

PARTNER

✉ [george.shuster@wilmerhale.com](mailto:george.shuster@wilmerhale.com)

☎ +1 212 937 7232



**Philip D. Anker**

PARTNER

Co-Chair, Bankruptcy and  
Financial Restructuring Practice  
Group

✉ [philip.anker@wilmerhale.com](mailto:philip.anker@wilmerhale.com)

☎ +1 212 230 8890