Defending Against Bankruptcy Avoidance Actions

Complex Financial Litigation

Christopher Horvay
John Levitske
Bob Musur
James Sullivan

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Meet the Faculty

Panelists

Christopher Horvay - Raines Feldman Littrell LLP

Bob Musur - Bodmer Price & Light, LLC

James Sullivan - Seyfarth Shaw LLP

Moderator

John Levitske - HKA Global, LLC

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Meet The Faculty

Christopher Horvay - chorvay@raineslaw.com

With more than 36 years experience, Christopher J. Horvay has represented senior creditors and asset-based lenders in complex litigation, workout and bankruptcy matters across the country. His practice also involves the representation of asset-based lenders in the documentation of complex loan transactions and in litigation disputes as well as the representation of creditor committees and liquidation trustees in litigation relating to fraudulent conveyances. Chris has consistently been recognized as an Illinois Super Lawyer since 2006, as well as an Illinois Leading Lawyer for the last two years in commercial bankruptcies and workouts.

Chris's recent creditor representations include senior secured lenders in Clark Retail Enterprises and United Airlines, significant landlord interests in K-Mart Corporation, and as special counsel to plaintiffs in Price v. Phillip Morris. He also served as debtor's counsel in a number of significant business bankruptcy cases, including Ben Franklin Stores in the Northern District of Illinois. Read More

Bob Musur - rmusur@bodmerprice.com

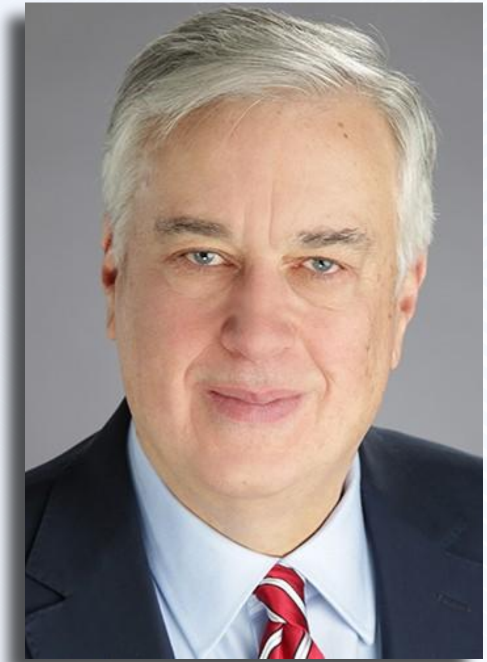
Robert has over 30 years of business valuation experience for companies operating in a number of industries, including consumer, technology, media and manufacturing. He has performed these valuations for business combinations, acquisitions and tax purposes.

James Sullivan - jmsullivan@seyfarth.com

James' primary practice focus is corporate restructuring and bankruptcy, distressed situations, and complex commercial disputes. He brings over 25 years of experience representing corporate debtors, banks, secured and unsecured creditors, creditors' committees, trustees, and distressed investors in large Chapter 11 cases as well as in out-of-court restructurings.

On the transactional side, James acts as outside general counsel to some of his clients, guiding such clients on a host of corporate and transactional matters. James also regularly counsels investors in acquisitions and dispositions of businesses, distressed assets, real estate, and other assets. In addition, he frequently represents borrowers and lenders in matters involving corporate and acquisition financing. Many of James’ clients are based outside the United States, and he regularly guides them on issues relating to doing business in the United States. Read More

John Levitske – JohnLevitske@hka.com



John Levitske, CPA/ABV/CFF/CGMA, ASA, CFA, CIRA, MCFLC, MBA, JD, HKA Global

John Levitske is a partner with HKA and a member of the firm's Forensic Accounting and Commercial Damages group, where he provides business valuation, forensic accounting, and commercial damages expert services. With more than 35 years of experience, John has served as senior advisor to companies,legal counsel, executives, and investors regarding business valuation, financial, accounting, and damages issues in complex commercial matters such as shareholder disputes, bankruptcy disputes, M&A transaction disputes, corporate alter ego disputes, and other business disputes. He has provided expert advice when disagreements or uncertainties arose regarding quantifications of value, price, or economic damages of a business or stakeholder interest in a business. John works across all industries and is experienced with both private and public companies. Read More

About This Webinar

Defending Against Bankruptcy Avoidance Actions

- When a business faces bankruptcy, the financial ripples often extend far beyond the debtor itself. In many cases, the debtor or bankruptcy trustee may initiate legal actions to recover money or property transferred by the debtor before filing for bankruptcy. These “avoidance actions” are designed to ensure equitable treatment of creditors but can place significant burdens on those targeted.
- This webinar provides valuable insights to help you protect a company’s interests and navigate the complexities of bankruptcy avoidance litigation effectively.

About This Series

Complex Financial Litigation

- This webinar series focuses on the legal and financial realities that accompany unanticipated adverse events, soured business relationships, and failing organizations.

- Whether you are a general litigator, business owner, aspiring shareholder, or insurance claims analyst, this webinar series will help you to understand and prioritize key concepts associated with business breakups, shareholder disputes, claims for lost profits, and bankruptcy avoidance actions.

Episodes In This Series

#1 Common Issues and Strategies in Business Breakups

Premiere Date: 1/30/2025

#2 Nuts & Bolts of Lost Profit Cases

Premiere Date: 3/6/2025

#3 Resolving Shareholder Disputes

Premiere Date: 4/09/25

#4 Defending Against Bankruptcy Avoidance Actions

Premiere Date: 7/9/25

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Legal Context for Avoidance Actions

- A debtor or its duly-empowered successor (e.g., chapter 7 trustee, chapter 11 trustee, liquidation trustee pursuant to a plan) is able to enlarge the estate with cash recovered from certain recipients of transfers from the debtor by what are collectively called "avoidance actions."

- Avoidance actions are causes of action under the Code and the Code combined with state law, by which the transfer is "avoided" and the property that had been transferred (usually money) recovered by the debtor or trustee for the benefit of all creditors of the estate. The defeated transferee usually gets an unsecured claim for the amount avoided and recovered.

- Avoidance actions include actions to avoid and recover preferential transfers and actions to recover fraudulent transfers.

Common Avoidance Actions

- Preferential Transfers
- Fraudulent Transfers
- Constructive Fraud Transfers

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Preferential Transfers

- Under section 547 of the Code, the debtor or trustee may avoid and recover transfers of debtor's property made within the 90 days immediately preceding the bankruptcy case (within one year before if transferee was an insider), where such transfers were made to or for the benefit of a creditor, on account of antecedent debt, while the debtor was insolvent, and which enabled the creditor to receive more than it would have in a chapter 7 liquidation of the debtor.

- These are the elements the debtor or trustee must prove to avoid the transfer. The Code adds a presumption that the debtor was insolvent during the 90 day period. If transferee rebuts the presumption and debtor or trustee cannot prove that debtor was insolvent at the time of the transfer (or the transferee proves debtor's solvency at that point), then the transfer is not an avoidable preference.

- See 11 U.S.C § 547(b), (f), and (g).

Fraudulent Transfers

- Section 548 of the Code provides for debtor or trustee avoidance and recovery of intentionally fraudulent transfers and constructively fraudulent transfers that were made by the debtor within two years prior to the beginning of the bankruptcy case. To avoid an intentionally fraudulent transfer, the debtor or trustee need not prove that the debtor was insolvent at the time – though proving that would help.

Fraudulent Transfers *(cont'd)*

- To avoid a constructively fraudulent transfer, the debtor or trustee must prove that the debtor did not receive "reasonably equivalent value" for the transfer, and that the transfer either:
  - ➢ Was made while the debtor was insolvent or made the debtor insolvent, or
  - ➢ Left the debtor with unreasonably small capital, or
  - ➢ Was made with debtor's intent or belief that it would incur debts beyond debtor's ability to pay them.
- Point: the debtor or trustee usually try to prove insolvency at the time of the transfer, but there are other proof options.
- See 11 U.S.C. § 548(a).

Constructive Fraudulent Transfers

- A constructive fraudulent transfer includes a transfer of the debtor's property:
    - ➢ That was made by the debtor within 2 years before the date of the filing of the petition,
    - ➢ For which the debtor received less than a reasonably equivalent value, and
    - ➢ The debtor was insolvent on the date that such transfer was made or became insolvent as a result of such transfer.
        - ✔ See 11 U.S.C. § 548(a)(1)(B).
- There is no presumption of insolvency applicable to constructive fraudulent transfer causes of action.

Fraudulent Transfers – State Law Considerations

- Section 544(b) of the Code allows the debtor or trustee to “stand in the shoes” of a creditor holding an allowable unsecured claim, and thus to sue transferees of property from the debtor to avoid and recover such transfers as fraudulent transfers under state law.
- Most states have adopted the Uniform Fraudulent Transfer Act. Its intentional fraudulent transfer and constructive fraudulent transfer provisions do not differ in important ways from section 548 of the Code for our purposes, except that the UFTA adds a presumption of insolvency if the debtor is generally not paying its debts as they become due.
- In both sets of laws, the proof of the debtor’s insolvency at the time of the transfer can be the linchpin of the avoidance action. Actions under state law usually benefit from a “look-back” period exceeding the two-year period set in section 548 of the Code.

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The Bankruptcy Code Defines "Insolvent"

- The Code defines "insolvent" as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."

- The Code defines "debt" by reference to its extremely expansive definition of "claim," so that, for measuring insolvency, debts include (among other things) contingent and unliquidated claims against the debtor. "Property" of the debtor is anything that is "property" under applicable state law.

- "Fair valuation" is not defined in the Code.

  - See 11 U.S.C. § 101(5), (12), and (32).

  - *"'Fair value' is not defined by the U.S. Bankruptcy Code, but is often interpreted by U.S. bankruptcy case law as 'Fair Market Value'."* (Association of Insolvency & Reorganization Advisors, "Standards for Distressed Business Valuation," p. 26.)

Avoidance / Insolvency Valuations

- Balance Sheet Test: A company is insolvent if its debts exceed its assets on a fair value basis.

- Adequate Capital Test: A company is engaged in (or is about to engage in) a business or a transaction for which it has unreasonably small capital

- Cash Flow Test: A company is incurring debts that would be beyond its ability to pay as such debts matured

Balance Sheet Test

- The Balance Sheet Test determines whether a company's asset value exceeds its liabilities on a fair value basis as of some particular date. The balance sheet test is passed if the sum of the fair value of a company's assets exceeds its liabilities (including contingent liabilities, etc.). With regard to the balance sheet test, the assets of a company are to be valued on a fair value basis.

- "Fair Value" is not defined in the Bankruptcy Code.

- Determine the enterprise value (debt-free value) as a going concern as of the date is determined.

- Subtract the value of the company's liabilities (including contingent liabilities) from the enterprise value.

- Balance sheet test is passed if the company's enterprise value is greater than the sum of the value of its liabilities.

Balance Sheet Test *(cont'd)*

- Factors considered in the analysis:
  - ➢ Historical and projected financials
  - ➢ Industry and business environment
  - ➢ Selected company and transaction analysis
  - ➢ Discounted cash flow analysis
  - ➢ Capital structure and debt obligations
  - ➢ Non-operating assets and identified contingent liabilities
- Frequently Used – easy to understand.
- If Company fails the balance sheet test, there may be no reason to conduct more tests…depending on the evidence.

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Adequate Capital and Cash Flow Tests

- The Adequate Capital and Cash Flow tests are intended to analyze a company's robustness to the general economic uncertainty that all businesses face.

- That is, given its capital structure, can a company survive if its actual performance is slightly below its projections, or if it takes slightly longer to achieve certain assumed changes in the business?

Adequate Capital Test

- Determines if a business entity was engaged in a business or a transaction for which it had unreasonably small capital.
- Intended to determine whether a company is likely to survive, assuming reasonable business fluctuations in the future.
- Analyze the company's robustness to the general economic uncertainty that all businesses face.
- Ratio Analysis
- Often applies industry benchmarks

Cash Flow Test

- Analyze the company’s ability to generate free cash flow to meet obligations to the creditors.

- Project capital required to operate the business and debt capacity and financial flexibility.

- Allows to evaluate the company’s capital adequacy and financial flexibility, which might include cash from operations, additional borrowings, reduced capital expenditures, asset sales, or a combination thereof.

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Date of Insolvency

- A debtor or its duly-empowered successor (*e.g.*, chapter 7 trustee, chapter 11 trustee, liquidation trustee pursuant to a plan) is able to enlarge the estate with cash recovered from certain recipients of transfers from the debtor by what are collectively called "avoidance actions"

- Avoidance actions are causes of action under the Code and the Code combined with state law, by which the transfer is "avoided" and the property that had been transferred (usually money) recovered by the debtor or trustee for the benefit of *all* creditors of the estate. The defeated transferee usually gets an unsecured claim for the amount avoided and recovered

- Avoidance actions include actions to avoid and recover *preferential transfers* and actions to recover *fraudulent transfers*

Why Date of Insolvency Matters

- The Bankruptcy Code defines “insolvency” as a “financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, …. (Emphasis added.) 11 U.S.C. § 101(32)(A).
- This quasi-balance sheet test for insolvency necessitates a valuation of the debtor’s property as of the relevant date.
- Premises of Value Used in Avoidance Actions:
  - ➢ Liquidation Value: may be appropriate if it is more likely than not that the business will fail within the reasonably foreseeable future.
  - ➢ Going Concern Value: may be appropriate if the business is operating as a going concern.

Key Cases Regarding Insolvency

- *In re Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988) (on valuing contingent liabilities at the face amount multiplied by the probability that liability will become due)
- *Statutory Comm. Of Unsecured Creditors v. Motorola, Inc. (In re Iridium Operating LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007) (market data preferred, under facts of the case, to reconstituted projections)
- *Ogle v. JT Miller, Inc. (In re HDD Rotary Sales, LLC)*, Adv. No. 13-03031 (Bankr. S.D. Tex. Oct. 15, 2013) (evaluating retrojection analysis of debtor's insolvency at time of transfers)
- *Whyte v. C/R Energy Coninvestment II, L.P. (In re SemCrude, L.P.)*, Adv. No. 10-51808 (Bankr. D. Del. June 10, 2013)(valuation on a going concern basis, discussing in detail the Income Approach, Market Approach, and Asset-Based Approach)
- *Richardson v. Checker Acquisition Corp. (In re Checker Motors Corporation)*, 2013 WL 3279791 (Bankr. W.D. Mich. June 10, 2013)(holding that contingent multiemployer pension liability can be considered in valuation of insolvency under UFTA but not under Code section 548)

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