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TEMPORARY INSOLVENCY AND OTHER COMPLICATIONS PRESENTED BY COVID-19 IN FRAUDULENT CONVEYANCE CLAIMS

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Introduction

The economic turmoil and uncertainty caused by the COVID-19 pandemic present new challenges to analyzing insolvency in fraudulent conveyance claims. This article examines these challenges, including situations in which a company may be considered insolvent only temporarily due to highly fluctuating expectations about the economic recovery.

Background

The coronavirus (COVID-19) pandemic continues to wreak havoc on major economies around the world. As the impact of the crisis works its way through the financial system, bankruptcy filings are rising. In the U.S., many household names like Chesapeake Energy (a fracking pioneer), Hertz (a global car rental company), and J.C. Penny (a department store chain) have already filed for bankruptcy[1], and many more companies are expected to follow suit in the coming months.[2]

The increase in the number of companies filing for bankruptcy since the onset of the COVID-19 pandemic will undoubtedly lead to a rise in the number of fraudulent conveyance claims, as was the case after the 2008 Financial Crisis. A fraudulent conveyance, or fraudulent transfer, is defined as a transfer of a debtor's assets to a third party in an attempt to avoid debt repayments. A trustee chosen to administer the debtor's estate may avoid (or set aside) a fraudulent transfer that was made within 2 years of the date of the filing of a bankruptcy petition in Federal Court.[3]

As a fraudulent conveyance claim typically requires valuing a debtor's assets, in the context of the COVID-19 pandemic, a number of valuation issues will arise such as (1) availability of reliable cash flow projections at or around the valuation date, (2) heightened stock price volatility that may lead to materially different values of assets depending on the choice of the valuation date, and (3) lack of reliable transactional data due to cancelled or postponed M&A activities. Navigating these challenges will require a reasoned and measured approach.

There are two types of fraudulent conveyances:[4]

- An actual fraudulent transfer occurs when a debtor transfers its assets to a third party, or incurs an obligation, with the intent to hinder, delay or defraud creditors.

- A constructive fraudulent transfer occurs when a debtor receives less than a "reasonably equivalent value" in exchange for the asset transferred (or obligation assumed) and the debtor is insolvent on the date of the transfer,or becomes insolvent as a result of such transfer. Other conditions considered in place of insolvency are:

  - The debtor was engaged in business or a transaction, or was about to engage in business or a transaction, which would leave the debtor with an unreasonably small amount of capital;
  - The debtor intended to incur, or it is believed that the debtor would incur, debts that would be beyond the debtor's ability to repay; or,
  - The debtor made such transfer to, or for the benefit of, an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.[5]

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Bankruptcy trustees and creditors may file fraudulent transfer claims against equity holders and other third parties, for example, to recover some or all of the debtor's assets transferred or avoid transactions that left debtors with large amounts of debt.

How is insolvency determined?

One of the key considerations in a constructive fraudulent transfer claim is whether the debtor was insolvent at the date of the transfer or became insolvent as a result of such transfer. A company is considered insolvent if the fair value of its liabilities exceeds the fair value of its assets. Valuation experts are often engaged to assist counsel and courts with the determination of fair value in such cases.

Prior to reaching a conclusion on whether a company is insolvent, a company's assets are generally presumed to be used in its highest and best use and as part of a going concern business. There are three common valuation methods to value a going concern business: the income-based approach; market-based approach; and asset-based approach.

The income-based approach utilizes a projection of the debtor's cash flows and discounts these amounts to the present using an appropriate discount rate in order to determine fair value. The market-based approach, on the other hand, utilizes public trading data and earnings multiples of both comparable companies and precedent transactions in order to arrive at a determination of fair value. Finally, the asset-based approach estimates the market value of each of the company's assets, usually adjusting them from their book value, and subtracts the market value of the company's liabilities to arrive at a valuation conclusion. The asset-based approach is more common in a valuation of investment holding companies, or in a liquidation rather than going-concern scenario.

How does the COVID-19 pandemic impact the valuation of a business and the assessment of its insolvency?

The coronavirus pandemic presents a number of challenges to valuing businesses. As discussed in more detail below, the timing of the alleged fraudulent transfer could have an outsized impact given the rapidly changing market conditions. Furthermore, it may be difficult to establish reliable projections of the future cash flows of the company. The availability of reliable data, whether it is transaction multiples or analyst estimates, will likely be reduced. A discussion of how each of these factors could impact the specific valuation methodologies used to determine value, and consequently potential insolvency, is set out below.

Income-based approach

The starting point for any discounted cash flow analysis is a reliable set of projections as this will form the basis of a valuation using the income-based approach. Prior to the COVID 19 pandemic, it was generally easier for companies' management to create a reliable set of projected cash flows. However, during the current crisis, this has become substantially more difficult. This is exhibited by a growing number of companies which have suspended earnings guidance amidst the coronavirus pandemic. As of April, only about 1 in 5 companies in the S&P 500 continued to provide quarterly guidance.[6] Much about the disease is still unknown, and its effect on the global economy has been observed on an

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unprecedented scale. While companies will likely have or develop internal projections in bankruptcy proceedings, their reliability and relevance must be carefully examined and scrutinized.

The second component of a discounted cash flow analysis is determining the appropriate discount rate. This involves estimating the cost of the debtor's equity and debt, both of which can be challenging in a crisis. Consider, for example, the recent performance of high yield bonds, which can be viewed as indicative of the cost of debt of "riskier" companies such as those nearing bankruptcy. At the peak of market stress in March 2020, benchmark high-yield rates increased to more than 11%, which was nearly double where they started the year at 5.3%.[7] On the heels of substantial intervention by the Federal Reserve, including the Fed's outright purchase of high-yield debt, yields have fallen back down to around 6% by July 2020.

Given that the cost of debt assumption will have a material impact on the discount rate calculation, the timing of an allegedly fraudulent transfer could have a large impact on the valuation conclusion. Other inputs to the discount rate, such as the appropriate beta or equity risk premium, would be equally difficult to estimate in the post COVID-19 environment, further complicating the valuation analysis.

Market-Approach – Comparable Companies

One type of market-based approach that could be used in a valuation analysis involves observing the trading multiples of a selected group of comparable companies, such as forward looking EBITDA multiples (enterprise value / projected EBITDA), and applying these multiple to the subject company's own operating metrics. This valuation approach is dependent on both the trading prices of the companies selected, as well as estimates of future earnings.

U.S. equity markets experienced a steep decline earlier this year, with some industries experiencing declines of more than 50% in less than a month. Much of these declines have since reversed and in some industries (such as technology) stock price performance is now positive for the year. The performance of various S&P 500 industry groups from December 30, 2019 to June 30, 2020 is presented in the graph at the top of the next page.

The impact of the coronavirus on financial markets presents several challenges when assessing fraudulent conveyance claims. One possible scenario that may arise from the global pandemic is a company's "temporary" insolvency. For example, a company that was insolvent in March 2020 may no longer be insolvent in the following months due to the recovery in market prices and earnings expectations of the comparable companies used in the valuation. Therefore, understanding how the choice of the valuation date impacts the overall insolvency analysis becomes increasingly important and relevant in these volatile market conditions. Given the fraudulent conveyance claims will be pursued and heard well after the recovery in market prices, it may be difficult to argue that a company was insolvent in March 2020, if for example, the company's share price and those of comparable companies quickly recovered in the following months.

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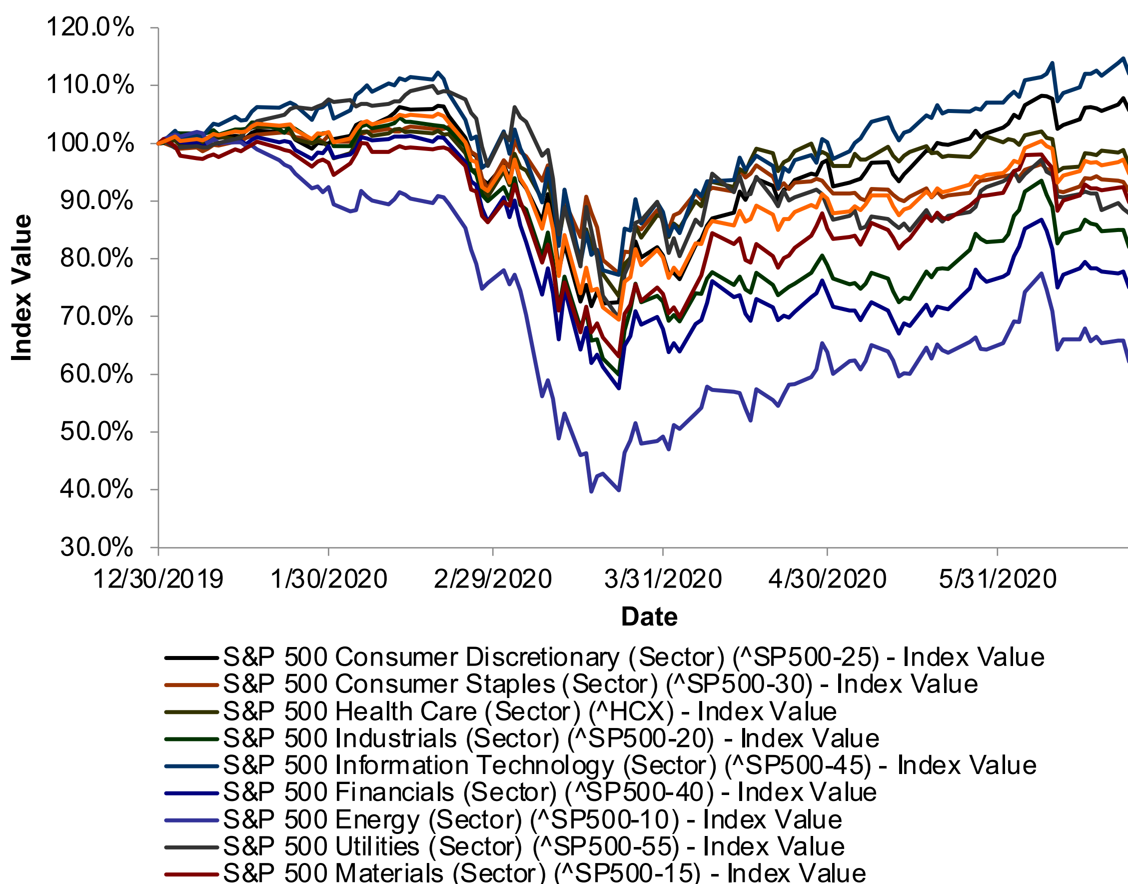
Performance of Various S&P 500 Industry Groups (December 30, 2019 – June 30, 2020)



Market-Approach – Precedent Transactions

A second type of market-based valuation approach involves observing the price paid in precedent transactions for similar companies in the past and using data from these transactions to determine the fair value of the subject company. For example, the price paid in the precedent transactions is compared to the target company's historical and projected earnings to calculate implied transaction multiples, which can then be used to value the subject company.

Since the COVID-19 outbreak, many M&A transactions have been cancelled or postponed, including Xerox Holdings Corp's hostile bid for HP Inc. and Sycamore Partners' purchase of L Brands, Inc. among others.[8] As fewer deals are completed, the number of precedent transactions one can use with this valuation method will be limited. Furthermore, the applicability of transaction multiples from transactions that closed prior to the COVID-19 outbreak may be called into question if applied to the valuation of a company on a post-COVID-19

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valuation date. Lastly, for transactions that have closed post-COVID-19, the reliability of transaction multiples will also need to be carefully considered. Significant changes in either analyst estimates and the value of stock-based consideration could lead to substantial changes in transaction multiples between the announcement of a merger and its closing.

In addition, the panic in financial markets in March 2020 led to increased funding stress, as discussed above with reference to the dramatic increase in high-yield debt rates. Depending on the particular facts and circumstances of a transaction being analyzed, this could warrant additional scrutiny. If, for example, the seller was experiencing a degree of financial distress and was compelled to sell assets or the whole business, the transaction may not meet the definition of fair market value.[9] In summary, the lack of relevant and complete transactions priced at fair market value would add to the difficulty of valuing the debtors' assets using this methodology.

Conclusion

With the coronavirus disease pandemic continuing to take a toll on the economy, many more businesses are expected to file for bankruptcy in the coming months and years. Business transactions that took place prior to and during the bankruptcy proceedings will be scrutinized, with many asking the question whether the company was already insolvent at the time of the transaction, or became insolvent as a result of the transaction, which may give way to a fraudulent conveyance claim. A proper assessment of the fair value of assets is required to determine the company's solvency and that analysis typically requires that the valuation be performed with information that was known or knowable on the valuation date. The practical reality, however, is that a valuation confirming a company's insolvency might be contradicted shortly thereafter as a result of dramatically improved market conditions. How the trier of fact incorporates that potential outcome into its decision-making process will be on a case by case basis, but any analysis performed should reconcile any major changes in a company's valuation, particularly over short periods of time.

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[1]https://www.forbes.com/sites/hanktucker/2020/05/03/coronavirus-bankruptcy-tracker-these-major-companies-are-failing-amid-the-shutdown/#300634a13425
https://fortune.com/2020/06/29/companies-filing-bankruptcy-2020-during-coronavirus-pandemic-covid-19-economy-industries/
[2]https://www.nytimes.com/2020/06/18/business/corporate-bankruptcy-coronavirus.html
[3]11 U.S. Code § 548. See for example: https://www.law.cornell.edu/uscode/text/11/548. Note that the statute of limitations can vary by state, however, in Federal Court the limit is two years.
[4]https://www.law.cornell.edu/uscode/text/11/548
[5]https://www.law.cornell.edu/uscode/text/11/548
[6]https://www.cnbc.com/2020/04/17/pandemic-has-companies-dropping-earnings-guidance-and-some-say-it-should-be-nixed-altogether.html
[7]https://fred.stlouisfed.org/series/BAMLH0A0HYM2EY
[8]https://www.bloomberg.com/news/articles/2020-05-08/dead-delayed-renegotiated-deals-and-fights-over-them-pile-up
[9]The generally accepted definition of Fair Market Value is: "The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."
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