

American Bankruptcy Institute, 22nd Annual Spring Meeting
Preference Defense: Solvency as a Barrier to Recovery
Alan Holtz, Managing Director
Ernst & Young Corporate Finance LLC
April 16, 2004

I. Preferential Transfers and Insolvency

Preferential transfers are defined under 11 USC §547. A trustee or debtor-in-possession must prove each of five elements in order for a transfer of a debtor's interest in property to be deemed a preference. This paper discusses §547(b)(3), insolvency of the debtor, and §547(f), the presumption of insolvency assuming all other required elements are met.

According to §547(b), the trustee may avoid any transfer of an interest in the debtor in property made on or within 90 days of the petition date while the debtor was insolvent. If the transferee is an insider, the relevant time period is extended to one year before the petition date.

Insiders of a corporation include directors, officers, a "person (corporation) in control of the debtor," relatives of the aforementioned, affiliates or insiders of an affiliate. This is a broad list, and therefore the list of potential defendants to a preference action could include subsidiaries not in bankruptcy, joint ventures and special purpose entities.

As mentioned, the trustee or debtor-in-possession has the burden of proving that a specific transfer met each of the five required elements. However, according to §547(f), the debtor is presumed to be insolvent during the 90 days immediately preceding the petition date.

Zeta Consumer Products Corp. v. Equistar Chemical, LP

In re: Zeta Consumer Products Corp. 291 B.R. 336 (Bankr. D. N.J. 2003)

The debtor is presumed insolvent during the 90 days immediately preceding the date of the filing of the petition (the Preference Period). See *11 U.S.C. § 547(f)*. The presumption will suffice to prove insolvency during the Preference Period if the creditor does not present some evidence showing that the debtor was solvent during that time. If the creditor comes forward with some evidence of solvency, the trustee or debtor-in-possession loses the benefit of the presumption and must prove the debtor's insolvency by a preponderance of the evidence. See *Clay v. Traders Bank of Kansas City*, 708 F.2d 1347, 1351 (8th Cir. 1983) (presumption affords initial benefit but ultimate burden remains on trustee to prove insolvency); *In re Total Technical Servs., Inc.*, 150 B.R. 893, 899 (Bankr. D. Del. 1993) (same).

No such presumption exists for transfers made prior to the 90-day preference period.

Cynthia Lee Traina, Trustee v. Walter J. Blanchard, Jr. et al.

In re: Linda V. Mayer (U.S. Dist. E. La. 1999) LEXIS 15608

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While the debtor is presumed insolvent during the ninety-day period preceding bankruptcy from which the trustee can seek to void all transfers, the same is not so for the time between ninety days and one year preceding the filing of a bankruptcy petition during which only transfers to insiders may be voided. To void transfers during that approximately nine-month period, the trustee must affirmatively prove the debtor's insolvency. Thus, no presumption of insolvency operates. See *In the Matter of Lamar Haddox Contractor, Inc.*, 40 F.3d 118, 121 (5th Cir. 1994). See also *In re Fanchon M. Perry*, 158 B.R. 694, 697 (Bankr. N.D. Ohio 1993); *In re Charles David Cochard*, 157 B.R. 449, 451 (Bankr. E.D. Mo. 1993).

Insolvency is defined in §101(32) of the Code as the “financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation.” This definition was cited in 1988 by the House of Representatives as “the traditional bankruptcy balance sheet test of insolvency.”¹

II. Fair Valuation and the Balance Sheet Test

While the definition on its face appears simple and straightforward, it has been the subject of much debate and many court decisions. When applying the “bankruptcy balance sheet test,” the courts look to two issues: (i) the premise of value and (ii) the definition of “fair valuation.”

WRT Creditors Liquidation Trust v. WRT Bankruptcy Litigation Master File Defendants

In re: WRT Energy Corporation 282 B.R. 343 (Bankr. W. La. 2001): LEXIS 1951

Courts generally conduct a two-step analysis to determine whether a debtor is insolvent under the balance sheet test. *Union Bank of Switzerland v. Duetsche Financial Services Corp.*, 2000 WL 178278, at 9 (S.D.N.Y. February 16, 2000) (citing *In re Taxman Clothing Co.*, 905 F.2d 166, 169-70 (7th Cir. 1990)). First, the court determines whether it is proper to value the debtor's assets on a "going concern" basis or a "liquidation" basis. Second, the court conducts a "fair valuation" and assigns a value to all the debtor's assets and liabilities as of the date of the challenged transfer. These assets and liabilities are tallied, and if debts exceed assets at fair valuation as of the date of the challenged transfer, the debtor is "insolvent" within the meaning of the balance sheet test. See *id.*; section 101(32).

The premise of value is the situation or circumstance under which a fair valuation is to be made. For purposes of this paper, we will discuss liquidation and going-concern. Under the premise of

¹ H.R. No. 100-11, 100th Cong. 2d Sess. 5-6 (1988).

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liquidation, the value of the assets of the debtor is determined by the amount which is expected to be obtained upon a forced or distressed sale. This premise is valid in the context of a preference action if the debtor is in imminent danger of failure, or "on its deathbed" on the date of the transfer.

In re: Taxman Clothing Co., Inc., Appeal of Arthur Winer, Inc.
905 F.2d 166 (U.S. App 7th Cir. 1990)

The point of peril is reached when the firm's ability to continue as a going concern -- a concern that can cover its costs -- is in doubt because its expected costs are greater than its expected revenues. In legal and accounting terms, this means when its liabilities exceed its assets. A liability is a capitalization of expected costs, an asset a capitalization of expected revenues. Because not all expected revenues and expected costs are capitalized, a balance sheet (the schedule of assets and liabilities) does not always yield an accurate [*170] picture of a firm's condition. A firm could be solvent in balance-sheet terms yet be in danger of imminent failure. Bankruptcy law ignores these subtleties in the interest of having a clear rule: balance-sheet solvency determines [**8] whether the payments to creditors in the present case were voidable preferences. *11 U.S.C. § 101(31); Briden v. Foley*, 776 F.2d 379, 382 (1st Cir. 1985); *Ackman v. Walter E. Heller & Co.*, 307 F. Supp. 958, 969 (S.D.N.Y. 1968).

* * *

We grant that going-concern value is not the proper standard if the business is "on its deathbed." *In re Utility Stationery Stores, Inc.*, *supra*, 12 B.R. at 176.

Edward M. Wolkowitz, Chapter 7 Trustee v. American Research Corporation, et al.

In re: DAK Industries, Inc. 195 B.R. 117 (Bankr. C. Ca. 1996)

The going-concern value is not the proper standard, however, if the business was "on its deathbed" or if its liquidation was clearly imminent when the transfers were made. *Id.* This sometimes becomes a difficult factual issue because the determination of whether the business was on its "deathbed" is frequently made *after* the business has succumbed to its financial ills. However, "caution should be taken not to consider property as 'dead' merely because hindsight teaches that the debtor was traveling on the road to financial ruin." *In re Taxman Clothing*, *supra* at 170 quoting 2 Collier on Bankruptcy.

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A going-concern is defined as a “commercial enterprise actively engaging in business with the expectation of indefinite continuance.”² As stated the Edward M. Wolkowitz v. American Research Corporation matter cited above, there is significant case law that potential preferential transfers be evaluated under the going-concern premise. This view was shared by the U.S. Bankruptcy Court for the District of Delaware.

Lids Corporation v. Marathon Investment Partners, LP
In re: Lids Corporation 281 B.R. 535 (Bankr. D. Del. 2002)

As long as liquidation in bankruptcy is not clearly imminent on the Valuation Date, the company must be valued as a going concern. See e.g., *In re Trans World Airlines, Inc.*, 134 F.3d 188, 193 (3d Cir. 1998).

Once the premise of value is established, and for this paper we will assume the going-concern premise applies, the next step of the analysis is determination of a “fair valuation.”

Lids Corporation v. Marathon Investment Partners, LP
In re: Lids Corporation 281 B.R. 535 (Bankr. D. Del. 2002)

“...assets should be valued at the sale price a willing and prudent seller would accept from a willing and prudent buyer if the assets were offered in a fair market for a reasonable period of time.”

Travellers International, AG v. Trans World Airlines, Inc.
In re: Trans World Airlines 134 F.3d 188 (3d Cir. 1998)

In the century that has passed since the enactment of the Bankruptcy Act of 1898, the courts have offered various statements describing how to achieve a fair valuation of assets for a going concern. The cases generally direct us to look at “market value” rather than “distress value,” but then also caution that the valuation must be analyzed “in a realistic framework” considering amounts that can be realized “in a reasonable time” assuming a “willing seller” and a “willing buyer.”

* * *

The reasonable time should be an estimate of the time that a typical creditor would find optimal: not so short a period that the value of the goods is substantially impaired via a forced sale, but not so long a time that a typical creditor would receive less satisfaction of its claim, as a result of the time value of money and typical business needs, by waiting for the possibility of a higher price.

² Black’s Law Dictionary (7th ed. 1999).

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As discussed previously, the “bankruptcy balance sheet test” is recognized as the appropriate test for solvency under §547(b). The “bankruptcy balance sheet test” is not the same as the determination of net worth using the assets and liabilities presented on the debtor’s financial statements. Financial statement balance sheets are prepared in accordance with Generally Accepted Accounting Principles (“GAAP”), the purpose of which is fair presentation of financial statements, not “fair valuation” in a bankruptcy context. Therefore, it is important that financial statements be used only as a starting point for determining a fair valuation. Assets and liabilities must be adjusted as appropriate to reflect the economic value of the entity, and recent changes in GAAP financial reporting, such as treatment of goodwill, should be considered.

In re: J. Howard Marshall, et ux.
300 B.R. 507 (Bankr. C. Cal. 2003)

Section 101(32)(A) makes two modifications to the usual balance sheet insolvency test. First, the test requires the revision of balance sheet values to their "fair valuation." In contrast, a balance sheet prepared according to generally accepted accounting principles provides asset values at historical cost less any applicable depreciation or amortization. The "fair valuation" standard requires an adjustment in balance sheet values from historical cost to present market values. Second, the § 101(32)(A) definition excludes property that would otherwise appear on a balance sheet, but that is exempt under § 522 (providing exemptions for individual debtors).

Lids Corporation v. Marathon Investment Partners, LP
In re: Lids Corporation 281 B.R. 535 (Bankr. D. Del. 2002)

It is well established that although GAAP is relevant in section 547 solvency analysis, it is not determinative. See e.g., *Arrow Electronics, Inc. v. Justus (In re Kaypro)*, 230 B.R. 400, 413 (B.A.P. 9th Cir. 1999) ("There is no generally accepted accounting principle method for analyzing the insolvency of a company Although such principles are relevant, they are not controlling in insolvency determinations"); *In re Sierra Steel, Inc.*, 96 B.R. 275, 278 (B.A.P. 9th Cir. 1989) ("although GAAP are relevant, they are not controlling in insolvency determinations"); *In re Lease-A-Fleet, Inc.*, 155 B.R. 666, 679 (Bankr. E.D. Pa. 1993) ("Courts are not required to rely upon GAAP standards when determining the issue of insolvency"); *In re Joshua Slocum, Ltd.*, 103 B.R. 610, 623-24 (Bankr. E.D. Pa. 1989) ("While GAAP principles do not control this court's determination of insolvency, we are inclined to accord weight to a company's treatment of its assets and liabilities according to GAAP").

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III. Asset and Enterprise Valuation

A “fair valuation” of the debtor’s assets and liabilities can be measured in several ways. This paper addresses individual asset valuation, typically used in a liquidation scenario, and enterprise valuation.

Individual asset valuation involves the revaluation of individual assets and liabilities from a cost-basis balance sheet value to fair market value or other standard of value. One approach is called the asset accumulation method. This method begins with a cost-basis balance sheet that is then adjusted for the fair market value of assets. Adjustments should include the value of intangible assets, contingent assets, and off-balance sheet and contingent liabilities. Challenges of this method include difficulty in determining the value of certain intangible assets and intellectual property on a discrete basis (NPV of a patent license, derivative foreign exchange contracts, and purchased intangibles and goodwill). This method is also time consuming and may be cost prohibitive, as it requires individual appraisals and valuations of each asset and liability.

Enterprise valuation approaches value the enterprise as a whole on a going-concern basis. Approaches to enterprise valuation include the market approach and income approach. Each approach has its own benefits and challenges.

The market approach compares the debtor entity to other comparable entities for which financial information is available. This approach assumes a rational and efficient market in which similarly situated entities are valued similarly. Two valuation methods used in this approach are the market multiple and the comparable transaction methods. The market multiple method applies pricing multiples (i.e., total enterprise value/revenue) derived from comparable entities to the debtor entity’s financial data to determine value. The comparable transactions method applies transaction multiples derived from M&A transaction data for comparable entities to the debtor entity’s financial data in a manner similar to the market multiple method. Several challenges exist when applying these methods. The selection of comparable entities and appropriate multiples should be done with great care in order to accurately reflect the debtor’s financial position relative to the market. The financial statements of comparable entities may need to be adjusted for comparison purposes. And finally, the economic environment and market conditions at the valuation date must also be considered.

The income approach to valuation defines the value of an enterprise to be equal to the present value of future income to be generated by the enterprise. Two methods used in this approach are the discounted cash flow (“DCF”) method and the income capitalization method. The DCF method is based upon projections of annual cash flow generation in the future. The income capitalization method is similar, however, this method assumes constant annual growth or decline or a constant annual income stream. Challenges to using these methods include

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appropriateness of growth and income projections, especially in troubled company situations, and the selection of an appropriate discount rate.

Finally, in calculating the debtor's enterprise value, the use of premiums and/or discounts may be appropriate. Premiums and discounts have historically been applied to take into consideration unique circumstances of the entity being valued. Premiums may be applied to reflect synergies of cash flows and other benefits to be ascribed from a purchase (control premiums). Discounts may be applied to reflect liquidity of shares, or lack thereof, held by minority owners (minority discounts). The application of such discounts and premiums has received limited attention in the past. Today, these premiums and discounts are more highly scrutinized, requiring demonstration of applicability and the specific identification of identifying factors to justify use.

John S. Pereira, Trustee v. Marshall S. Cogan, et al.

In re: Trace International Holdings, Inc. 294 B.R. 449 (U.S. Dist. S. N.Y. 2003)

By contrast, after obtaining the figure based on price per share, Stryker added in all but two of the Valuation periods,* a premium reflecting the control position represented by Trace's ownership of a large block of Foamex shares. The "control premium" represents the benefits associated with a control position, including the ability to make decisions that increase cash flow of the controlled or controlling person, declare dividends, raise capital through borrowing or the issuance of shares in the public or private markets, hire and fire management, determine the strategic direction of a company, make investments, liquidate or dispose of assets, and others.

* In those two periods, the first and second quarters of 1998, a public offer by Trace at a premium to the market was outstanding for all of the shares of common stock of Foamex then outstanding and not already owned by Trace. Stryker concluded that a premium for control was reflected in the NASDAQ trading prices of Foamex's common stock in these two periods as a result. Accordingly, he calculated the value of the asset solely by calculating the number of shares held by Trace by the then-market price of a single share trade publicly at the close of the relevant trading day.

To determine the magnitude of the control premium to apply in each period in which he applied a control premium to the value of the Foamex shares, Stryker considered a database of merger and acquisition transactions and offers maintained by MergerStat, a source regularly relied upon by valuation professionals, that reflected marketplace purchases of or offers to purchase control of companies categorized in the same three-digit Standard Industrial Classification Code as Foamex is categorized, between 1990 and 1999. Stryker observed 33 purchases or offers to purchase in the appropriate database. Based on market prices for the target companies' respective common stocks thirty days before the announced offer, the average offer was at a premium to market of 52%, and the median premium was 39%. Of the 32 mergers, only 22 actually closed,

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and all of them involved the sale of 100% of the target company's stock. Stryker did no analysis to determine why a control premium was being offered in the listed transactions and did not look at any information about the transactions except from the single page generated by MergerStat.*

* For his rebuttal report, Stryker performed a second MergerStat analysis to find transactions involving the sale of 40-50 blocks of stock. MergerStat contained ten such transactions for the period between 1993 and 1998, but none of these transactions were in Foamex's SIC code and only eight closed. Stryker did not look at any information concerning the transactions beyond what was listed on the single-page report and he did nothing to determine why a control premium was being offered in the listed transactions.

Blake testified, and further findings of fact set forth in the following paragraphs confirm, that Trace could not have obtained a control premium for its block of Foamex stock. Blake testified that a purchaser would only be interested in acquiring Trace's 44 to 46% block of Foamex stock at a premium if the purchaser were able to make a change to Foamex to increase its cash flow. Blake credibly testified that due to Foamex's cost structure, inability to raise sales prices and historic financial performance, a potential purchaser would not expect to be able to increase the cash flows from Foamex, and that Trace did not enjoy a lot of benefits that a control owner would normally enjoy. In this case, there were significant loan covenant restrictions regarding compensation and dividends, as well as a provision providing an automatic default if there was a change in Foamex's principal shareholder. The ability to exercise the prerogatives of control through Trace's 44 to 46% block was severely restricted by Foamex's debt structure and its financial performance.

In support of this finding, Michael Glassman, an investment banker for Beacon, who rendered investment banking advice to a special committee of Foamex board in connection with the Foamex going-private transaction, testified that a purchaser of Trace's share of Foamex would not pay a control premium.

In further support of this finding, Stryker agreed with Blake that ability to increase cash flows is primarily determinative in whether a control premium should be applied. However, Stryker never identified what a potential purchaser of Trace's block of Foamex stock could do to increase cash flow. Furthermore, Stryker never researched or identified any specific improvements that a buyer could make in Foamex's cash flow. Nor has Stryker identified any synergies or redundancies that a potential purchaser would use or reduce to increase cash flow. Stryker also ignored the change of control provisions in Foamex's private and public debt covenants.

In short, Stryker inadequately supported his conclusion that Trace's block of Foamex stock could be sold at a premium. Furthermore, Stryker's reliance on the MergerStat reports is incomplete and without adequate support. As a result, it is

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inappropriate to apply a control premium for Trace's interest in Foamex. Instead, the application of a 15% discount is reasonable, and Blake's application of that discount is both credible and reliable for the valuation of Trace's holdings in Foamex.

IV. Debt Valuation

Debt is defined by §101(12) of the Code as a “liability on a claim.” A “claim” is further defined in §101(5) as “a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or the right to an equitable remedy for breach of performance if such breach gives rise to a right of a payment.”

This broad definition has also been the subject of debate and considerable case law. In *Travellers International AG v. Trans World Airlines, Inc.*, the value of debt was of issue. The Bankruptcy Court ruled that TWA’s public debt should be valued based upon the fair value of the debt at the time of the transfers. The ruling was appealed to the U.S. District Court for the District of Delaware, which found that the modifier “fair valuation” included in the definition of insolvent in §101(32) applied equally to debts as it did to property. This decision was appealed to the 3rd Circuit which reversed, stating that debts should be valued based on face value as the modifier did not apply.

Travellers International, AG v. Trans World Airlines, Inc.
In re: Trans World Airlines 203 B.R. 890 (U.S. Dist 1996) and
134 F.3d 188 (3d Cir. 1998)

Because our going concern methodology precludes us from devaluing TWA's debt based on creditors' perceptions of TWA's viability, a fair valuation of TWA's public debt is the face value of that debt. See *Covey v. Commercial Nat'l Bank*, 960 F.2d 657, 660 (7th Cir. 1992) (holding that valuation of debt must be made from the perspective of the debtor, rather than the perspective of a third party creditor).

Contingent liabilities have also been an issue of debate and case law.

Lids Corporation v. Marathon Investment Partners, LP
In re: Lids Corporation 281 B.R. 535 (Bankr. D. Del. 2002)

Unlike assets, debts are measured at their face value and not at market value. See *Trans World Airlines*, 134 F.3d at 196 (publicly traded debt is measured by face value, not market value). Debts are measured at face value because the language

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"at a fair valuation" in section 101(32)(A) applies only to the valuation of assets; it does not apply to valuation of debts. *Id. at 196.*

Contingent liabilities must also be included in the total debt. However, "contingent liabilities must be limited to costs arising from foreseeable events that might occur while the debtor remains a going concern." *Id. at 198.* Contingent liabilities do not include costs associated with liquidation or dissolution of the debtor because such costs inherently contradict the going concern classification of the debtor. *Id.* Therefore, when conducting a balance sheet analysis, the fair market value of the assets is compared to the face value of the liabilities, including contingent liabilities.

V. Defense Considerations

When defending a preference action on the basis of solvency, the subjectivity involved in performing a valuation should be used to one's advantage. Consideration should be given to the use of multiple valuation approaches. If insolvency under a liquidation scenario is alleged, argument might be made for a going concern valuation. Alternative going-concern scenarios and redefinition of the business to put its assets to the highest and best use should also be considered. In both the Lids Corporation and Payless Cashways cases, the debtor entity was redefined to present likely scenarios under the going-concern premise.

Lids Corporation v. Marathon Investment Partners, LP
In re: Lids Corporation 281 B.R. 535 (Bankr. D. Del. 2002)

Scenario One: Sale of Assets Over a Reasonable Period of Time
Scenario 3: Hypothetical Sale of Profitable Stores

As there are numerous approaches to performing a going concern valuation, each of them should be explored in an effort to demonstrate solvency. Assumptions can be varied, as necessary and appropriate, such as the discount rate used, comparable companies or transactions selected and premiums or discounts applied.

If financial data is unavailable, consider events that may have changed the solvency picture between transactions or valuation dates such as catastrophic events, stock market fluctuations, competitive innovations in the marketplace and economic issues. One method to do this is retrojection. Retrojection is best described by reference to the Toy King Distributors case.

In re: Toy King Distributors, Inc.
256 B.R. 1 (Bankr. M. D. Fla. 2000)

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Alternatively, the court can determine solvency or insolvency using retrojection analysis when the debtor's financial condition is unascertainable as of the relevant dates. *Murphy v. Nunes (In re Terrific Seafoods, Inc.)*, 197 B.R. 724, 731 (Bankr. D. Mass. 1996). The retrojection rule provides that when 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 bankruptcy between the retrojection dates,' the debtor is deemed to have been insolvent at all intermediate times." *Id.* (quoting *Foley v. Briden (In re Arrowhead Gardens, Inc.)*, 32 B.R. 296, 300 (Bankr. D. Mass. 1983)). This rule allows the court to conclude that a debtor is insolvent even when there is a deficiency of evidence as to financial status during some of the time period at issue. The theory is that if a debtor is insolvent on one date and insolvent on a later date and there are no intervening circumstances that would suggest otherwise, the court can conclude that the debtor was insolvent during the entirety of the intervening period, even in the absence of specific financial information. *Id.*

VI. Solvency: Preferential v. Fraudulent Transfers

Finally, be aware of the difference in the treatment of solvency under §547 and §548 of the Code. Where §547 requires the debtor to be insolvent at the time of the transfer for the transfer to be deemed preferential, fraudulent transfer requirements under §548 are more broad. In addition to insolvency at the time of the fraudulent transfer, §548 also considers alternatives of insolvency as a result of the transfer, deepening insolvency (inadequate capital/inability to pay debts as they come due), and zone of insolvency (fluctuations into and out of solvency). The defense of fraudulent transfers has its own challenges, the discussion of which will be saved for another day. However, it is important to understand the distinguishing characteristics as well as the similarities of both of these avoidance powers.

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Preference Defense

Solvency as a Barrier to Recovery

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April 16, 2004

Overview

- Preferential Transfers and Insolvency
- Fair Valuation and the Balance Sheet Test
- Asset and Enterprise Valuation
- Debt Valuation
- Defense Considerations
- Insolvency: Preferential vs. Fraudulent Transfers

Preferential Transfers and Insolvency

- 11 USC §547
 - Transfers made while the debtor was insolvent
 - Transfers made on or within 90 days of the petition date
 - If an insider, transfers made up to one year before the petition date
 - Insolvency presumed during the 90 days immediately preceding the petition date

Preferential Transfers and Insolvency

- Insiders

- Insiders of a corporation include directors, officers, “person in control of the debtor,” relatives of the above, and affiliates or insiders of an affiliate
 - subsidiaries not in bankruptcy
 - joint ventures
 - special purpose entities

Preferential Transfers and Insolvency

- Presumption of Insolvency

- shifts the burden of going forward with evidence of solvency within the 90-day period to the transferee
- if the transferee produces evidence of solvency, the burden returns to the trustee to prove insolvency
 - Zeta Consumer Products Corp. v. Equistar Chemical, LP
In Re: Zeta Consumer Products Corp.
291 B.R. 336 (Bankr. D. N.J. 2003)
- no presumption of insolvency prior to the 90-day period
 - Cynthia Lee Traina, Trustee v. Walter J. Blanchard, Jr., et al.
In Re: Cynthia V. Mayer
(US Dist. E. La. 1999) LEXIS 15608

Insolvent Defined

- 11 USC § 101(32)

“financial condition such that the sum of such entity’s debts is greater than all of such entity’s property, at a fair valuation.”

This test is “the traditional bankruptcy balance sheet test of insolvency.”

– H.R. No. 100-11, 100th Cong. 2d Sess. 5-6 (1988).

Fair Valuation – “Two Step Analysis”

- Liquidation v. Going-Concern Value
- Fair valuation under the “Balance Sheet” test
 - WRT Creditors Liquidation Trust v. WRT Bankruptcy Litigation Master File Defendants
In Re: WRT Energy Corporation
282 B.R. 343 (Bankr. W. La. 2001):LEXIS 1951

Fair Valuation - Premise of Value

- Liquidation Value

Value of assets obtainable upon a “forced sale” or “distress sale”

Imminent danger of failure as of the date of the transfer, “on its deathbed”

–In the Matter of Taxman Clothing Co., Inc.

Appeal of Arthur Winer, Inc., et al.
905 F.2d 166 (U.S. App 7th Cir. 1990)

–Edward M. Wolkowitz, Chapter 7 Trustee v. American Research Corporation, et al.

In re: DAK Industries, Inc.
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- Going-concern Value

A “going-concern” is a commercial enterprise actively engaging in business with the expectation of indefinite continuance.

–Black’s Law Dictionary
(7th ed. 1999)

“As long as liquidation in bankruptcy is not clearly imminent on the Valuation Date, the company must be valued as a going concern.”

–Lids Corporation v. Marathon Investment Partners, LP

In Re: Lids Corporation
281 B.R. 535 (Bankr. D. Del 2002)

Fair Valuation Defined

- “Fair valuation”

“... assets should be valued at the sale price a willing and prudent seller would accept from a willing and prudent buyer if the assets were offered in a fair market for a reasonable period of time.”

- Lids Corporation v. Marathon Investment Partners, LP
In Re: Lids Corporation
281 B.R. 535 (Bankr. D. Del 2002)

Fair Valuation Defined

- Fair Valuation of a going concern is:
 - “market value” rather than “distress value,” but ... the valuation must be analyzed “in a realistic framework” considering amounts that can be realized “in a reasonable time” assuming a “willing seller” and a “willing buyer.”
 - A “reasonable time” is defined as:
 - “an estimate of the time that a typical creditor would find optimal: not so short a period that the value of the goods is substantially impaired via a forced sale, but not so long a time that a typical creditor would receive less satisfaction of its claim, as a result of the time value of money and typical business needs, by waiting for the possibility of a higher price.
 - Travellers International, AG v. Trans World Airlines, Inc.
In Re: Trans World Airlines, Inc.
134 F.3d 188 (3d Cir. 1998)

The “Balance Sheet” Test

- The “Balance Sheet” test is recognized as the appropriate test for solvency under §547
 - Balance Sheets reflect the “Book Value” of assets prepared in accordance with GAAP, the purpose of which is fair presentation of financial statements; Recent changes in GAAP should be considered
 - The test should be based on “fair valuation” not GAAP
 - In Re: J. Howard Marshall, et ux.
300 B.R. 507 (Bankr. C. Ca. 2003)
 - Assets and liabilities should be adjusted to reflect economic value of the entity
 - Lids Corporation v. Marathon Investment Partners, LP
In Re: Lids Corporation
281 B.R. 535 (Bankr. D. Del 2002)

Asset and Enterprise Valuation

Individual Asset Valuation

- Revaluation of individual assets and liabilities from a cost-basis balance sheet to fair market value¹

- Asset-Based Approach

- Asset Accumulation Method

1. or other standard of value where appropriate.

Enterprise Valuation

- Values the enterprise as a whole

- Market Approach

- Market Multiple Method
 - Comparable Transaction Method

- Income Approach

- Discounted Cash Flow Method
 - Income Capitalization Method

Asset Valuation - Asset-Based Approach

- Asset Accumulation Method
 - Begins with the cost-basis balance sheet
 - Adjusts for the fair market value of assets and the face value of liabilities
 - Includes valuation of intangible assets and contingent assets
 - Includes off-balance sheet and contingent liabilities

Challenges:

- Difficulty in valuing assets on discrete basis
 - NPV of a patent license
 - Derivative foreign exchange contracts
 - purchased intangibles and goodwill
- Time consuming and may be cost-prohibitive

Enterprise Valuation – Market Approach

Assumes a rational and efficient market in which similarly situated entities are valued similarly

- **Market Multiple Method**
 - Applies pricing multiples derived from comparable entities to the subject entity's financial data
- **Comparable Transactions Method**
 - Applies transaction multiples derived from M&A transactions for comparable entities to the subject entity's financial data

Challenges:

- Selection of comparable entities
- Selection of appropriate multiples
- Comparable entities' financial statements may need to be adjusted for appropriate comparison to the subject entity
- The economic environment should be considered

Enterprise Valuation – Income Approach

Value of an enterprise is equal to the present value of future income to be generated by the enterprise

- Discounted Cash Flow Method
 - Based upon projections of cash flow generation in the future
- Income Capitalization Method
 - Assumes constant annual growth (or decline) or a constant annual income stream

Challenges

- Appropriateness of growth and income projections
- Selection of a discount rate

Premiums and Discounts

Historically applied to take into consider unique circumstances of the subject entity

Today, it is important to demonstrate why a premium or discount is applicable by specifically identifying factors which justify its use

- John S. Pereira, Trustee v. Marshall S. Cogan, et al.
In Re: Trace International Holdings, Inc.
294 B.R. 449 (U.S. Dist S. N.Y. 2003)

- A discount for minority interest is really a liquidity discount
- Control premiums should not be applied simply based on percentage of ownership but to show synergies of cash flows and other benefits to be ascribed from the purchase

Debt Valuation

- “Debt” - 11 USC § 101(12)
 - reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or the right to an equitable remedy for breach of performance if such breach gives rise to a right of a payment.
 - Debt valued at face value not fair market value (Ex. public debt)
 - Travellers International AG v. Trans World Airlines, Inc.
Re: Trans World Airlines, Inc.
203 B.R. 890 (U.S. Dist 1996)
134 F.3d 188 (U.S. App. 1998)
 - Example: contingent liabilities
 - Lids Corporation v. Marathon Investment Partners, LP
In Re: Lids Corporation
281 B.R. 535 (Bankr. D. Del 2002)

Defense Considerations

- Consider the use of multiple valuation approaches
- Consider alternate scenarios and restructuring
 - Redefine the business to its highest & best use
 - Lids Corporation v. Marathon Investment Partners, LP
In Re: Lids Corporation
281 B.R. 535 (Bankr. D. Del. 2002)
- Retrojection – Consider events that may have changed the solvency picture between transactions or valuation dates
 - catastrophic events (9/11, weather events)
 - stock market fluctuations
 - competitive innovations in the marketplace
 - economic issues (restriction of supply, tariffs)
 - In Re: Toy King Distributors, Inc.
256 B.R. 1 (Bankr. M. D. Fla. 2000)

Insolvency:

Preferential v. Fraudulent Transfers

Preferential Transfers §547

- Insolvent at the time of the transfer

Fraudulent Transfers §548

- Insolvent at the time of the transfer or as a result of the transfer
- Fluctuation in and out of solvency
 - Zone of insolvency
- Inadequate capital/inability to pay debts as come due
 - Deepening Insolvency
 - “Liquidity” and “equity” tests

**Ordinary Course Defense
&
The “Floating Lien”**

**By
Howard S. Cohen, CPA, CFE
Parente Randolph, LLC**

Special Acknowledgment to: Klehr, Harrison, Harvey, Branzburg & Ellers, LLP for their research assistance

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I. The Ordinary Course of Business Defense

If a creditor is unable to derail a preference action by attacking the definition of a preferential transfer pursuant to 11 U.S.C. § 547(b) and the five prong test to be proven thereunder, then the next step is to look for an affirmative defense to the preferential transfers pursuant to 11 U.S.C. § 547(c). “If a creditor can qualify under any one of the exceptions, then he is protected to that extent.” *Report of the Committee on the Judiciary, Bankruptcy Law Provision*, H.R. Rep.No. 595, 95th Cong., 1st Sess. 177 (1977) at p. 373.

The most prevalent of any of the affirmative defenses is what is known as the “ordinary course of business defense” found in § 547(c)(2). Courts are most often required to determine whether the preferential transfers occurred in the ordinary course of business between the debtor and creditor.

The ordinary course defense of § 547(c)(2) requires an avoidance defendant to prove three elements by a preponderance of the evidence, namely that the otherwise preferential transfer was --

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms.

11 U.S.C. §547(c)(2).

Courts characterize subsections (A) and (B) as comprising a "subjective" component of the ordinary course defense, and regard subsection (C) as an "objective" standard. It is the burden of the creditor, the one against whom recovery is sought, to prove the non-avoidability of a preferential transfer. *See* § 547(g); *In re Molded Acoustical*, 18 F.3d 217, 221, n.5 (3d. Cir. 1994). It is further the creditor’s burden to satisfy each of the three prongs of § 547(c)(2) separately and independently as the three subparts of § 547(c)(c), specifically (A), (B) and (C), are meant to be read conjunctively in the statute. *See J.P. Fyfe, Inc. of Florida v. Bradco Supply Corp.*, 891 F.2d 66 (3d Cir. 1989); *In re Molded Acoustical*, 18 F.3d at 223.

A. Payment of a debt incurred in ordinary course (§ 547(c)(2)(A))

Usually, payments which qualify as “preferential payments,” are made for debts incurred in the “ordinary course.” An exception may be a situation where the payment is for long-term debt pursuant to a “catch-up” payment plan or any other type of “extraordinary” debt, which occurs from time to time in a business.

A creditor must be prepared to describe why a debt is ordinary and not extraordinary. Even some long-term debt payments may be deemed ordinary if regularly used in the industry.

Each case will be decided on its own facts. *See In re R.M.L., Inc.*, 195 B.R. 602, 613 (Bankr.M.D.Pa. 1996) (Section 547(c)(2)(A) was met by making a factual finding that the debt was incurred by virtue of a sufficiently ordinary practice in business.)

B. Made in ordinary course of business of debtor and creditor (§547(c)(2)(B))

The second prong of the ordinary course defense, and the other part of the "subjective" component of the defense (together with subsection (A)), is the requirement that the preferential transfer be made in the ordinary course of business or financial affairs of the debtor and the creditor. The sole emphasis under subsection (B) is the extent to which the parties' conduct varied from their normal course of doing business prior to the preference period.

There is no precise legal task or mathematical formula that can be applied to determine whether payments by a debtor during the 90-day preference period were "made in the ordinary course of business". Rather, courts engage in a factual analysis. *See In re Fulghum Construction Corp.*, 872 F.2d 739 (6th Cir. 1989); *Lovett v. St. Johnsbury Trucking*, 931 F.2d 494 (8th Cir. 1991). The cornerstone of this element of a preference defense is that the creditor needs to demonstrate some consistency with other business transactions between the debtor and the creditor. *Id.*

C. Made in ordinary course of business in the industry (§547(c)(2)(C))

The third prong of the "ordinary course" analysis must be satisfied separate and apart from the § 547(c)(2)(B) analysis. As of last year, all Federal Circuit Courts expressly required that avoidance defendants show that the terms of preferential payments received fall within some loosely defined industry standard. The Third Circuit, and subsequently the Fourth Circuit, have gone beyond the straight forward objective test used by other circuits, and have added a "sliding scale window" to allow the defendant a greater variance from the industry norm based on various factors involving the historical relationship of the parties.

The law is quite clear that a creditor cannot rest on its own history with its own customers to prove an industry standard but must come forward with particularized evidence in the industry, which is much broader than its own practices. *In re Cherrydale Farms*, 2001 WL 1820323 (Bankr. D. Del. Feb. 20, 2001) (J. Walsh) specifically states that:

"The emerging legal view is that §547 (c)(2)(C) requires objective proof that the disputed payments are 'ordinary' in relation to the prevailing standards in the creditor's industry. [citation omitted] As a practical matter this prevents the creditor from satisfying § 547 (c)(2)(C) indirectly by using its own relationship with the debtor to prove the existence of a unified industry standard. [citation omitted] Because courts following this view require the creditor to reference some external data, usually relating to the practices of its competitors, the creditor's failure to proffer

evidence exclusive of its own cause of dealing with the debtor is fatal.”

Id. at *5. See also *In re Midway Airlines, Inc.*, 69 F.3d at 797-98 (“Reliance solely on the experience of the creditor renders ineffectual the important dichotomy between the subjective requirements of 11 U.S.C. § 547(c)(2)(A)-(B), which can be satisfied through proof of the parties’ own dealings, and the objective requirement imposed by 11 U.S.C. § 547(c)(2)(C), which requires reference to some external datum.”)

D. Approaches among the Circuits

Notwithstanding their universal interpretation of § 547(c)(2)(C) being a separate and distinct element of the ordinary course of business defense that is analyzed from an objective standpoint, some court have used different approaches as to how a creditor can prove this third prong of the defense.

1. **Second Circuit** - “If the terms in question are ordinary for industry participants under financial distress, then that is ordinary for the industry . . . A creditor taking such steps should not be viewed as taking more than ‘unusual action’ when it does no more than follow usual industry practice. . . .” *In re Roblin Industries, Inc.*, 78 F.3d 30, 42 (2nd Cir. 1996).

2. **Third Circuit** – “when the parties have had an enduring, steady relationship, one whose terms have not significantly changed during the pre-petition insolvency period, the creditor will be able to depart substantially from the range of terms established under the objective industry standard inquiry and still find haven in subsection C.” *Molded Accoustical*, 18 F.3d 217, 226 (3d. Cir. 1994).

3. **Fourth Circuit** – sweeping, broad industry evidence will not suffice to satisfy the third prong of § 547(c)(2)(C). As explained in the Fourth Circuit case of *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044 (4th Cir. 1994):

“Suppose an industry where member businesses typically extend credit. If those businesses, in an effort to satisfy subsection C, could simply assert, without providing specific evidence on credit terms, that the industry norm is to extend credit, then every preference payment received by those businesses would satisfy subsection C.”

Id. at 1051.

4. **Fifth Circuit** - failure to offer evidence of payment practices in the industry beyond its own practices is fatal to the creditor’s proof of industry practices. *Gulf City Seafoods*, 296 F.3d 363, 366 (5th Cir. 2002).

Other courts hold the same. See also *In re Roblin Indus., Inc.*, 78 F.3d 30, 39 (2d Cir. 1996); *In re Molded Acoustical*, 18 F.3d 217 (3d. Cir. 1994); *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044, 1050 (4th Cir. 1994); *Logan v. Basic Distrib. Corp. (In re Fred Hawes*

Org., Inc.), 957 F.2d 239, 243-44 (6th Cir. 1992); *In re Midway Airlines, Inc.*, 69 F.3d 792, 797 (7th Cir. 1995); *Jones v. United Sav. & LoanAss'n (In re U.S.A. Inns of Eureka Springs, Arl., Inc.)*, 9 F.3d 680, 683 (8th Cir. 1993) *Sulmeyer v. Suzuki Pacific (In re Grand Chevrolet)*, 25 F.3d 728, 733 (9th Cir. 1994); *Clark v. Balcor Real Estate Finance, Inc. (In re Meredith Hoffman Partners)*, 12 F.3d 1549, 1553 (10th Cir. 1993); *In re A.W. & Assocs., Inc.*, 136 F.3d 1439, 1442-43 (11th Cir. 1998).

5. ***Seventh Circuit*** – “ordinary business terms” refers to the *range* of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage, and that only dealings so idiosyncratic as to fall outside that broad range should be deemed extraordinary and therefore outside the scope of subsection C.” *In re Tolona Pizza Products Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993).

6. ***Eighth Circuit*** – Creditor not required to establish the existence of a uniform set of business terms in the industry. Rather, creditor must present “evidence of a prevailing practice among similarly situated members of the industry facing same or similar problems.” *Jones v. United Sav. & LoanAss'n (In re U.S.A. Inns of Eureka Springs, Arl., Inc.)*, 9 F.3d 680, 685 (8th Cir. 1993).

7. ***Ninth Circuit*** – A court cannot limit “ordinary business terms” to the “average” transactions in the industry, but must consider the broad range of terms that encompasses the practices employed by similarly situated debtors and creditors facing the same or similar problems. *In re Jan Weilert RV, Inc.*, 315 F.3d 1192, 1200 (9th Cir. 2003), *amended in part* 326 F.3d 1028 (9th Cir. 2003).

E. Considerations and Recent Developments

1. Single source vendors
2. Critical vendors
3. Industry standards within multiple departments of one defendant

II. Section 547(c)(5) – The Creation of perfected security interest in inventory or a “floating lien”

A. What is it

A preferential transfer is not avoidable if it creates a perfected security interest in the debtor’s inventory or receivables, except to the extent that the creditor improves his position during the preference period or from the date within the preference period on which new value is given under a security agreement, compared to the creditor’s position on the petition date. Basically, a preference exists to the extent there is any reduction during the 90-day period of the amount by which the initial existing debt exceeded the security. *See In re Ebbler Furniture and Appliances, Inc.*, 804 F.2d 87, 90 (7th Cir. 1986).

Valuation of the collateral is the key to a successful defense under § 547(c)(5). Some Courts use a liquidation value while others use a “going concern” valuation. The value of the collateral is a fact question which may require the use of an expert. In any event, value the collateral immediately if it is in dispute.

B. Examples of its Application

TABLE I

Perfected Security Interest Avoidance Determination

<u>Example 1</u>	<u>Date 1</u>	<u>Date 2</u>
Debtor Amount Owed	\$100,000	\$150,000
Collateral Value	\$ 50,000	\$ 50,000
Deficiency Amount	\$ 50,000	\$100,000

Result: Creditor’s position worsens, no improvement, therefore, not avoidable

<u>Example 2</u>	<u>Date 1</u>	<u>Date 2</u>
Debtor Amount Owed	\$100,000	\$150,000
Collateral Value	\$ 50,000	\$100,000
Deficiency Amount	\$ 50,000	\$ 50,000

Result: Creditor’s position stays the same, no improvement, therefore, not avoidable

<u>Example 3</u>	<u>Date 1</u>	<u>Date 2</u>
Debtor Amount Owed	\$100,000	\$150,000
Collateral Value	\$ 50,000	\$125,000
Deficiency Amount	\$ 50,000	\$ 25,000

Result: Creditor’s position improves by \$25,000, therefore, avoidable to extent of \$25,000 only

C. Points for Consideration

1. timing of a potential action
2. negotiation strength
3. standing to raise the issue
4. fraudulent conveyance? vs. preferential transfer?

**PICPA Greater Philadelphia Chapter Committee
on Cooperation with the Bar Presents**

**Preferences, Fraudulent Transfers
and Miscellaneous Topics in Bankruptcy**

Thursday, December 6, 2001

Panelists

Honorable Kevin J. Carey
Bankruptcy Judge Eastern District of PA

Aris Karalis, Esq.
Ciardi, Maschmeyer & Karalis, PC

Gary Schildhorn, Esq.
Adelman, Lavine, Gold AND Levin

Edward Phillips, CPA, CIRA
Parente Randolph, LLC

Phil Seamon, CPA
PricewaterhouseCoopers, LLP

Moderator
Howard Cohen, CPA, CFE
Parente Randolph, LLC

11 U.S.C. §547 - Preferences

- Elements of an avoidable preference (§547(b))
- Defenses to preference actions

11 U.S.C. §548 – Fraudulent Transfers

- Elements of a fraudulent transfer

The Pennsylvania Fraudulent Transfer Act

- Actual intent
- Constructive intent

Course Example

The Wegolf Sweater Co., an S corporation, is a well-established leading manufacturer of men's sweaters. For 40 years, the Kline family has owned the Company. The founders, Harry and Emanuel Kline, are no longer with the Company, Emanuel having passed away and Harry having retired three years ago. Pursuant to the Company's Shareholder Agreement, the Company was compelled to repurchase the stock holdings of the founders for \$1,000,000 to each founder to be paid in equal installments over a five-year period. As of October 1, 2001, Emanuel's estate had received four payments and Harry had received two payments. Further, upon Harry's retirement, the company forgave Harry's officer loan in the amount of \$700,000, which was created over many years on account of advances made to Harry to cover his tax liabilities.

The Company did not realize its expected sales goal for 2001 and its lender failed to extend its credit line. On October 2, 2001, the Company filed a Chapter 11 proceeding in order to sell the Company to Sportsman, Inc., a diversified clothing company. Sportsman was interested in the acquisition because of Wegolf's long established reputation and sales relationship with major retail chains. Sportsman's offer of \$8,000,000 was submitted to the Court for approval, subject to the receipt of any higher or better offers. Sportsman requested, and Wegolf agreed, to a breakup fee to be paid to Sportsman of \$750,000 if, for any reason, Sportsman failed to close the transaction. Sportsman also requested that the initial overbid must be \$9,000,000 and bid increments be not less than \$100,000. After due diligence, Sportsman declined to purchase Wegolf and management converted the case to a Chapter 7 on December 5, 2001.

The Brightwool Company was a long-term supplier to Wegolf. After a number of years, the two companies established a course of dealing whereby Brightwool would be paid 15 days after Wegolf received payment from its customer for sweaters manufactured using Brightwool's wool. However, Brightwool's invoices reflected 30-day terms. Within 90 days prior to Wegolf's bankruptcy, Wegolf paid \$60,000 in two checks to Brightwool, which paid invoices 110 days and 140 days old respectively.

Course Example (cont.)

Wegolf's accountants, Brown, O'Malley & Schwartz, received \$94,000 in August, within 90 days of Wegolf's Chapter 11 filing. This payment was for work associated with the 2000 year-end audit and tax return. The firm usually received payment in May for this work. Wegolf sought to employ the firm in the Chapter 11 proceeding.

The current owners of Wegolf are Isaac, Steven and Stanley Kline. In June, the Company forgave the officer loans created as a result of tax advances made by the Company. As consideration, the Kline's executed six-month non-compete clauses in favor of the Company. The Company's attorney and accountant suggested these actions when it was learned that the bank was considering not renewing the revolving credit facility. In 2002, the Klines will receive substantial tax refunds on account of losses incurred by the Company during 2001. Further, in 1999, in order to induce Steven to work for the Company, they promised him a housing allowance of \$200,000. This payment was not made until February of 2001. Steven used the money as a down payment on a home in Villanova, which he owns with his wife.

The Company's balance sheet for the year ended December 31, 2000 was completed in April of 2001 and submitted to the Bank and circulated to Brightwool. The balance sheet reflected a shareholders net worth of \$5.4 million. In August, when Wegolf was seeking investment dollars and/or replacement financing, it prepared with its accountant's help a balance sheet reflecting a shareholders net worth of \$5.8 million. Key Vendors received and relied upon the August Balance Sheet.

Finally, assume that rather than filing a Chapter 11, the Company convinced its lender to forgive \$10,000,000 in debt. At the time each owner's tax basis was \$50,000. Each owner paid substantial amounts in taxes for the past three years. The Company had losses of \$6,000,000 for 2001.

The Wegolf Sweater Co.

- S corporation
- Wegolf is a well-established leading manufacturer of men's sweaters.
- The Kline family has owned the Company for over 40 years.
- The founders, Harry and Emanuel Kline, are no longer with the Company, Emanuel having passed away and Harry having retired three years ago.

Financial Condition at December 31, 2000

WEGOLF SWEATER COMPANY BALANCE SHEET DECEMBER 31, 2000

ASSETS

Current Assets	
Cash and cash equivalents	\$ 275
Trade receivables	4,779
Inventories	38,598
Prepaid expenses and other current assets	<u>1,721</u>
TOTAL CURRENT ASSETS	45,373
 Property, Plant and Equipment, net	 19,746
 Other Assets	
Advances to shareholders	250
Deferred financing costs	937
Other non-current assets	<u>1,416</u>
 Total other assets	 <u>2,603</u>
	<u><u>\$ 67,722</u></u>

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities	
Line of credit	\$ 19,995
Current portion of long-term debt	600
Current portion of note payable-former shareholders	400
Accounts payable and accrued expenses	<u>16,157</u>
TOTAL CURRENT LIABILITIES	37,152
 Long-Term Debt	 24,400
Notes payable-former shareholders	800
 Stockholders' Equity	
Common stock	100
Additional paid-in-capital	50
Retained earnings	7,220
Treasury stock	<u>(2,000)</u>
	<u>5,370</u>
	<u><u>\$ 67,722</u></u>

Buyouts of Emanuel and Harry

- Pursuant to the Company's Shareholder Agreement, the Company was compelled to repurchase the stock holdings of the founders for \$1,000,000 to each founder to be paid in equal installments over a five-year period.
- As of October 1, 2001, Emanuel's estate had received four payments and Harry had received two payments.
- Upon Harry's retirement, the Company forgave Harry's officer loan in the amount of \$700,000, which was created over many years on account of advances made to Harry to cover his tax liabilities.

Emanuel Stock Repurchase Transaction

WEGOLF SWEATER COMPANY
BALANCE SHEET DECEMBER 31, 1997

ASSETS	Before	After
Current Assets		
Cash and cash equivalents	\$ 1,076	\$ 1,076
Trade receivables	4,280	4,280
Inventories	35,747	35,747
Prepaid expenses and other current assets	1,593	1,593
TOTAL CURRENT ASSETS	42,696	42,696
Property, Plant and Equipment, net	24,260	24,260
Other Assets		
Note receivable-Harry	550	550
Advances to stockholders	150	150
Deferred financing costs	1,039	1,039
Other non-current assets	1,576	1,576
Total other assets	3,315	3,315
	\$ 70,271	\$ 70,271
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Line of credit	\$ 20,548	\$ 20,548
Current portion of long-term debt	543	543
Current portion of note payable-former shareholder	-	200
Accounts payable and accrued expenses	15,772	15,772
TOTAL CURRENT LIABILITIES	36,863	37,063
Long-Term Debt	25,600	25,600
Note Payable-former shareholder	-	800
Stockholders' Equity		
Common stock	100	100
Additional paid-in-capital	50	50
Retained earnings	7,658	7,658
Treasury stock	-	(1,000)
	7,808	6,808
	\$ 70,271	\$ 70,271

Harry Stock Repurchase Transaction

WEGOLF SWEATER COMPANY
BALANCE SHEET DECEMBER 31, 1999

ASSETS	Before	After
Current Assets		
Cash and cash equivalents	\$ 760	\$ 760
Trade receivables	4,425	4,425
Inventories	36,889	36,889
Prepaid expenses and other current assets	1,604	1,604
TOTAL CURRENT ASSETS	43,678	43,678
Property, Plant and Equipment, net	21,968	21,968
Other Assets		
Note receivable-Harry	700	-
Advances to stockholders	200	200
Deferred financing costs	987	987
Other non-current assets	1,441	1,441
Total other assets	3,328	2,628
	\$ 68,974	\$ 68,274
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Line of credit	\$ 21,164	\$ 21,164
Current portion of long-term debt	600	600
Current portion of note payable-former shareholder	200	400
Accounts payable and accrued expenses	14,763	14,763
TOTAL CURRENT LIABILITIES	36,727	36,927
Long-Term Debt	25,000	25,000
Note payable-former shareholder	400	1,200
Stockholders' Equity		
Common stock	100	100
Additional paid-in-capital	50	50
Retained earnings	7,697	6,997
Treasury stock	(1,000)	(2,000)
	6,847	5,147
	\$ 68,974	\$ 68,274

Auction Sale Issues

- The Company did not realize its expected sales goal for 2001 and its lender failed to extend its credit line.
- On October 2, 2001, the Company filed a Chapter 11 proceeding.
- Sportsman's offer of \$8,000,000 was submitted to the Court for approval.
- Breakup fee of \$750,000 to be paid if for any reason Sportsman failed to close the transaction.
- Initial overbid must be \$9,000,000 and bid increments be not less than \$100,000.
- After due diligence, Sportsman declined to purchase Wegolf.
- Wegolf management converted the case to a Chapter 7 on December 5, 2001.

Brightwool Preference

- The Brightwool Company was a long-term supplier to Wegolf.
- Over time, the two companies established a course of dealing whereby Brightwool would be paid 15 days after Wegolf received payment from its customer for sweaters manufactured using Brightwool's wool.
- Brightwool's invoices reflected 30-day terms.
- Within 90 days prior to Wegolf's bankruptcy, Wegolf paid \$60,000 in two checks to Brightwool, which paid invoices 110 days and 140 days old respectively.

Preference Period Payments to Brightwool

Wegolf, Inc.

Payments to Brightwool, Inc.

Filed: 10/02/2001

07/04/2001 to #####

Date Paid	Check Amount	Check No.	Date	Invoice No.	Amount	Amount Paid	Days to Pay
07/24/01	10,000.00	15486	04/05/01	87	87,474.00	10,000.00	110
08/23/01	50,000.00	15725	04/05/01	87	87,474.00	50,000.00	140

Brightwool One Year Payment History

Wegolf, Inc.

Payments to Brightwool, Inc.

Filed: 10/02/2001

07/04/2001 to #####

Date Paid	Check Amount	Check No.	Date	Invoice No.	Amount	Amount Paid	Days to Pay
07/11/00	252,684.95	11933	05/11/00	38	226,854.95	226,854.95	61
			05/11/00	39	25,830.00	25,830.00	61
08/06/00	25,057.46	12158	03/28/00	34	8,947.77	8,947.77	131
			06/07/00	41	12,916.75	12,916.75	60
			06/26/00	43	3,192.94	3,192.94	41
08/17/00	104,023.00	12227	06/25/00	42	104,023.00	104,023.00	53
09/05/00	13,692.85	12353	07/25/00	49	4,000.00	4,000.00	42
			07/25/00	50	3,000.00	3,000.00	42
			07/25/00	51	2,750.00	2,750.00	42
			07/25/00	52	3,942.85	3,942.85	42
10/01/00	154,217.50	12535	07/18/00	47	23,537.50	23,537.50	75
			07/27/00	54	130,680.00	130,680.00	66
10/18/00	50,000.00	12631	08/03/00	57	95,000.00	50,000.00	76
10/30/00	45,000.00	12689	08/03/00	57	95,000.00	45,000.00	88
11/16/00	89,663.63	12823	10/08/00	63	89,663.63	89,663.63	39
03/15/01	177,232.00	13877	12/13/00	66	88,900.00	88,900.00	92
			12/13/00	67	88,332.00	88,332.00	92
04/30/01	85,320.00	14366	02/22/01	72	96,000.00	85,320.00	67
05/10/01	97,494.67	14451	02/20/01	69	16,438.14	16,438.14	79
			02/20/01	71	18,253.62	18,253.62	79
			02/22/01	72	96,000.00	10,680.00	77
			02/22/01	73	52,122.91	52,122.91	77
05/18/01	67,295.48	14597	02/20/01	70	23,741.28	23,741.28	87
			03/18/01	78	3,500.00	3,500.00	61
			03/22/01	81	12,580.20	12,580.20	57
			04/05/01	87	87,474.00	27,474.00	43
06/28/01	100,190.40	14883	03/19/01	79	100,190.40	100,190.40	101
						1,261,871.94	
AVERAGE							67.8
WEIGHTED AVERAGE							70.6
MEDIAN							66.0

Preference Period Payments to Brightwool

Wegolf, Inc.

Payments to Brightwool, Inc.

Filed: 10/02/2001

Pref. Pd: 07/04/2001 to #####

Date Paid	Check Amount	Check No.	Date	Invoice No.	Amount	Amount Paid	Days to Pay
07/24/01	10,000.00	15486	04/05/01	87	87,474.00	10,000.00	110
08/23/01	50,000.00	15725	04/05/01	87	87,474.00	50,000.00	140

PRE-PETITION HISTORY

AVERAGE	67.8
WEIGHTED AVERAGE	70.6
MEDIAN	66.0

Preference Period Payments to Brightwool

Wegolf, Inc.

Payments to Brightwool, Inc.

Filed: 10/02/2001

07/04/2001 to #####

Date Paid	Check Amount	Check No.	Date	Invoice No.	Amount	Amount Paid	Days to Pay	Received By Wegolf	Days to Pay
07/24/01	10,000.00	15486	04/05/01	87	87,474.00	10,000.00	110	06/15/01	39
08/23/01	50,000.00	15725	04/05/01	87	87,474.00	50,000.00	140	06/15/01	69

Brightwool One Year Payment History

Wegolf, Inc.

Payments to Brightwool, Inc.

Filed: 10/02/2001

Pref. Pd: 07/04/2001 to #####

Date Paid	Check Amount	Check No.	Date	Invoice No.	Amount	Amount Paid	Days to Pay	Received By Wegolf	Days to Pay
07/11/00	252,684.95	11933	05/11/00	38	226,854.95	226,854.95	61	06/27/00	14
			05/11/00	39	25,830.00	25,830.00	61	06/27/00	14
08/06/00	25,057.46	12158	03/28/00	34	8,947.77	8,947.77	131	07/24/00	13
			06/07/00	41	12,916.75	12,916.75	60	07/20/00	17
			06/26/00	43	3,192.94	3,192.94	41	07/31/00	6
08/17/00	104,023.00	12227	06/25/00	42	104,023.00	104,023.00	53	07/30/00	18
09/05/00	13,692.85	12353	07/25/00	49	4,000.00	4,000.00	42	08/24/00	12
			07/25/00	50	3,000.00	3,000.00	42	08/24/00	12
			07/25/00	51	2,750.00	2,750.00	42	08/24/00	12
			07/25/00	52	3,942.85	3,942.85	42	08/24/00	12
10/01/00	154,217.50	12535	07/18/00	47	23,537.50	23,537.50	75	09/20/00	11
			07/27/00	54	130,680.00	130,680.00	66	09/17/00	14
10/18/00	50,000.00	12631	08/03/00	57	95,000.00	50,000.00	76	10/09/00	9
10/30/00	45,000.00	12689	08/03/00	57	95,000.00	45,000.00	88	10/09/00	21
11/16/00	89,663.63	12823	10/08/00	63	89,663.63	89,663.63	39	10/29/00	18
03/15/01	177,232.00	13877	12/13/00	66	88,900.00	88,900.00	92	02/26/01	17
			12/13/00	67	88,332.00	88,332.00	92	02/26/01	17
04/30/01	85,320.00	14366	02/22/01	72	96,000.00	85,320.00	67	04/18/01	12
05/10/01	97,494.67	14451	02/20/01	69	16,438.14	16,438.14	79	04/22/01	18
			02/20/01	71	18,253.62	18,253.62	79	04/22/01	20
			02/22/01	72	96,000.00	10,680.00	77	04/19/01	21
			02/22/01	73	52,122.91	52,122.91	77	04/22/01	20
05/18/01	67,295.48	14597	02/20/01	70	23,741.28	23,741.28	87	04/28/01	20
			03/18/01	78	3,500.00	3,500.00	61	05/09/01	9
			03/22/01	81	12,580.20	12,580.20	57	05/02/01	16
			04/05/01	87	87,474.00	27,474.00	43	04/30/01	18
06/28/01	100,190.40	14883	03/19/01	79	100,190.40	100,190.40	101	05/20/01	39
						1,261,871.94			
AVERAGE							67.8		15.9
WEIGHTED AVERAGE							70.6		17.5
MEDIAN							66.0		16.0

Preference Period Payments to Brightwool

Wegolf, Inc.

Payments to Brightwool, Inc.

Filed: 10/02/2001

Pref. Pd: 07/04/2001 to #####

Date Paid	Check Amount	Check No.	Date	Invoice No.	Amount	Amount Paid	Days to Pay	Received By Wegolf	Days to Pay
07/24/01	10,000.00	15486	04/05/01	87	87,474.00	10,000.00	110	06/15/01	39
08/23/01	50,000.00	15725	04/05/01	87	87,474.00	50,000.00	140	06/15/01	69

PRE-PETITION HISTORY

AVERAGE	67.8	15.9
WEIGHTED AVERAGE	70.6	17.5
MEDIAN	66.0	16.0

Problems Facing Accounting Firm

- Wegolf's accountants, Brown, O'Malley & Schwartz, received \$94,000 in August, within 90 days of Wegolf's Chapter 11 filing.
- This payment was for work associated with the 2000 year-end audit and tax return.
- The firm usually received payment in May for this work.
- Wegolf sought to employ the firm in the Chapter 11 proceeding.
- *11 U.S.C. §327 - Employment of professional persons*
- *11 U.S.C. §330 - Compensation of officers*

Issues Facing Sons

- The current Wegolf owners are Isaac, Steven and Stanley Kline.
- In June, Wegolf forgave the officer loans created as a result of tax advances made by the Company.
- As consideration, the Klines executed six-month non-compete clauses in favor of the Company. The Company's attorney and accountant suggested these actions when it was learned that the bank was considering not renewing the revolving credit facility.
- In 2002, the Klines will receive substantial tax refunds on account of losses incurred by the Company during 2001.
- Further, in 1999, in order to induce Steven to work for the Company, they promised him a \$200,000 housing allowance. This payment was not made until February of 2001. Steven used the money as a down payment on a home in Villanova, which he owns with his wife.

June 2001 Officer Loan Forgiveness

WEGOLF SWEATER COMPANY BALANCE SHEET JUNE 30, 2001

ASSETS	Before	After
Current Assets		
Cash and cash equivalents	\$ 65	\$ 65
Trade receivables	3,975	3,975
Inventories	37,576	37,576
Prepaid expenses and other current assets	1,336	1,336
	<hr/>	<hr/>
TOTAL CURRENT ASSETS	42,952	42,952
Property, Plant and Equipment, net	19,082	19,082
Other Assets		
Advances to shareholders	250	-
Deferred financing costs	916	916
Other non-current assets	1,385	1,385
	<hr/>	<hr/>
Total other assets	2,551	2,301
	<hr/>	<hr/>
	\$ 64,585	\$ 64,335
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Line of credit	\$ 23,109	\$ 23,109
Current portion of long-term debt	600	600
Current portion of note payable-former shareholders	400	400
Accounts payable and accrued expenses	14,779	14,779
	<hr/>	<hr/>
TOTAL CURRENT LIABILITIES	38,888	38,888
Long-Term Debt	24,100	24,100
Notes payable-former shareholders	400	400
Stockholders' Equity		
Common stock	100	100
Additional paid-in-capital	50	50
Retained earnings	3,047	2,797
Treasury stock	(2,000)	(2,000)
	<hr/>	<hr/>
	1,197	947
	<hr/>	<hr/>
	\$ 64,585	\$ 64,335
	<hr/>	<hr/>

August Balance Sheet

- The Company's balance sheet for the year ended December 31, 2000 was completed in April of 2001 and submitted to the Bank and circulated to Brightwool.
- The balance sheet reflected a shareholders net worth of \$5.4 million.
- In August, when Wegolf was seeking investment dollars and/or replacement financing, it prepared with its accountant's help a balance sheet reflecting a shareholders net worth of \$5.8 million.
- Key Vendors received and relied upon the August Balance Sheet.

August 31, 2001 Balance Sheet

WEGOLF SWEATER COMPANY BALANCE SHEET AUGUST 31, 2001

ASSETS

Current Assets	
Cash and cash equivalents	\$ 224
Trade receivables	5,548
Inventories	39,872
Prepaid expenses and other current assets	<u>1,294</u>
TOTAL CURRENT ASSETS	46,938
Property, Plant and Equipment, net	19,382
Other Assets	
Deferred financing costs	910
Other non-current assets	<u>1,378</u>
Total other assets	<u>2,288</u>
	<u>\$ 68,608</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities	
Line of credit	\$ 24,000
Current portion of long-term debt	600
Current portion of note payable-former shareholders	400
Accounts payable and accrued expenses	<u>13,415</u>
TOTAL CURRENT LIABILITIES	38,415
Long-Term Debt	24,000
Notes payable-former shareholders	400
Stockholders' Equity	
Common stock	100
Additional paid-in-capital	50
Retained earnings	7,643
Treasury stock	<u>(2,000)</u>
	<u>5,793</u>
	<u>\$ 68,608</u>

Forgiveness of Debt Issues

- Rather than filing a Chapter 11, the Company convinced its lender to forgive \$10,000,000 in debt.
- At the time, each owner's tax basis was \$50,000.
- Each owner paid substantial amounts in taxes for the past three years.
- The Company had losses of \$6,000,000 for 2001.

Potential Tax Implications Related to the Purchase of Stock in an Insolvent Pass-Through Entity

- IRC Sec. 269. Acquisitions made to evade or avoid income tax