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Rebutting the Presumption of Insolvency During a Pandemic

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Editor's Note: *To stay up to date on the COVID-19 pandemic, be sure to bookmark ABI's Coronavirus Resources for Bankruptcy Professionals website (abi.org/covid19).*

As the COVID-19 pandemic continues to cause harsh economic conditions throughout the U.S., many companies face the difficult prospect of bankruptcy. Smaller businesses in particular have had to endure significant pain as a result of state-mandated closures, stay-at-home orders, public fears about the virus and tighter lending conditions. Certain industries, such as leisure, dining and travel, have been hit especially hard by the pandemic.[1]

Recent studies suggest that 2 percent of small businesses — numbering more than 100,000 — and 3 percent of restaurant operators have already gone out of business.[2] Larger companies are not exempt from the devastation caused by COVID-19, either: One commentator predicted a record number of bankruptcies by companies with $1 billion or more in debt, and bankruptcies filed with more than $100 million in debt may approach the record set by the 2008 financial crisis.[3] According to Bloomberg, more than 100 companies that declared bankruptcy this year have expressly cited COVID-19, at least in part, as the cause.[4]

Many of these businesses will file for bankruptcy despite having sound finances at the beginning of March. These "sudden collapse" bankruptcy cases might call into question one of the key elements when analyzing a preferential transfer claim — the debtor's insolvency at the time of the transfer — as they could rebut the Bankruptcy Code's presumption, under § 547(f), that a debtor was insolvent 90 days before filing for bankruptcy. This article analyzes the presumption of insolvency and how it will apply to bankruptcies brought on by the rapid onset of the COVID-19 pandemic.

Background on Preferential Transfers

Section 547 of the Bankruptcy Code allows a trustee or debtor in bankruptcy to recover, or "avoid," certain payments made by the debtor in the 90 days (or in the case of a payment to an insider within one year) prior to the filing of a bankruptcy petition. For example, a trustee might be able to avoid an end-of-year distribution to a business owner or a payment to a restaurant supplier for goods.

Known as "preferences," a trustee or debtor is entitled to recover these payments so that the transferred funds may be returned to the bankruptcy estate for equal distributions to all similarly situated creditors. Often, creditors who received payments during the applicable look-back period become angered to learn that they may have to return to the debtor's estate the money they were paid. Adding insult to injury, a distressed company will often fall behind in paying its vendors, so it is common for preference payees to be owed significant sums by the debtor. However, § 547's preference provisions serve an important purpose in the bankruptcy scheme. It prevents the preferential treatment — hence, the name — of some creditors over others in the weeks and months leading up to the filing of a bankruptcy petition.

Five requirements must be met to constitute an avoidable preference under § 547(b). One such

1 Brad Moon, "24 Bankruptcy Filings Chalked Up to COVID-19," *Kiplinger* (Sept. 11, 2020), *available at* kiplinger.com/investing/601342/bankruptcy-filings-chalked-up-covid-19-coronavirus (unless otherwise specified, all links in this article were last visited on Sept. 24, 2020).

2 Heather Long, "Small Business Used to Define America's Economy. The Pandemic Could Change That Forever," *Washington Post* (May 12, 2020), *available at* washingtonpost.com/business/2020/05/12/small-business-used-define-americas-economy-pandemic-could-end-that-forever.

3 Mary Williams Walsh, "A Tidal Wave of Bankruptcies Is Coming," *New York Times* (June 18, 2020), *available at* nytimes.com/2020/06/18/business/corporate-bankruptcy-coronavirus.html.

4 Davide Scigliuzzo, Josh Saul, Shannon D. Harrington, Claire Boston & Demetrios Pogkas, "COVID-19 Is Bankrupting American Companies at a Relentless Pace," Bloomberg (July 9, 2020), *available at* bloomberg.com/graphics/2020-us-bankruptcies-coronavirus.

requirement, that the transfer be made while the debtor was insolvent, is generally a rebuttable presumption.[5] In light of the difficult economic conditions caused by COVID-19, this rebuttable presumption is especially relevant, as the pandemic presents the rare case where a debtor might have become insolvent only a short time before the bankruptcy filing.

The insolvency presumption usually prevents the debtor or trustee from having to present evidence of insolvency. This makes sense because, in almost all cases, a company does not transition from solvency to filing for bankruptcy during the look-back period. Usually, a company will attempt to ride out tough times — often for months or longer — before taking the extraordinary step of filing for bankruptcy. However, the typical presumptions might not be the case for businesses hit so hard and so suddenly by COVID-19.

Defining "Insolvency" Under the Code

Insolvency is a question of fact decided by the bankruptcy judge.[6] Thus, "the Bankruptcy Court has broad discretion when considering evidence to support a finding of insolvency."[7] To determine whether a debtor was insolvent, courts look to the statutory definition of this term. Under the Bankruptcy Code, a debtor is insolvent if "the sum of such entity's debts is greater than all of such entity's property, at fair valuation."[8] Thus, "In determining a 'fair valuation' of the entity's assets, an initial decision to be made is whether to value the assets on a going concern basis or a liquidation basis."[9] Finally, "If liquidation in bankruptcy was not clearly imminent on the transfer date, then the entity should be valued as a going concern."[10]

Evidence of the debtor's book value is generally only a "starting point" to the court's determination of insolvency, as "fair valuation" is the test under the definition set forth in § 101(32).[11] Even financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) are not viewed by the bankruptcy court as evidence of insolvency, as these statements record assets at historical cost rather than fair value.[12] Instead, courts have long held that "'fair valuation,' as used in the Bankruptcy Act, means the fair cash value or the fair market value of the property as between one who wants to purchase and one who wants to sell the property."[13]

In the context of an avoidance action, the relevant date of insolvency is the date of a given transfer that the debtor seeks to avoid — not the date on which the bankruptcy petition was filed.[14] Sometimes, it is difficult to ascertain whether a debtor was insolvent on a particular date. In such circumstances, courts have approved of the "retrojection" principle,[15] which 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 bankrupt between the retrojection dates, the debtor is deemed to have been insolvent at all intermediate times."[16]

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Rebutting the Presumption of Insolvency

The debtor/trustee bears the ultimate burden of proof and must prove insolvency by a preponderance of the evidence.[17] While § 547(f) provides a presumption that the debtor is insolvent during the look-back period, this presumption might be rebutted by the creditor. Thus, "To rebut a presumption of insolvency, a creditor must introduce some evidence that the debtor was not in fact insolvent at the time of the transfer."[18] In addition, "If the creditor introduces such evidence, then the trustee must satisfy its burden of proof of insolvency by a preponderance of the evidence."[19]

Generally, creditors attempt to present evidence from a valuation expert in order to show that the debtor's assets exceeded its liabilities at the time of the transfer, but the expert's methodology must be sufficiently reliable.[20] One of those methods, the discounted-cash-flow method of valuation, has been approved by bankruptcy courts for purposes of determining solvency.[21]

The insolvency presumption does not apply in actions to avoid transfers to insiders made more than 90 days but less than one year before the filing of the bankruptcy petition. In that case, the burden is on the trustee by default to demonstrate insolvency at the time of the insider preference payment.[22]

The Insolvency Presumption and Other Concerns in the Time of COVID-19

The insolvency requirement under § 547(b)(3), together with its presumption under § 547(f), present important issues for both debtors and creditors as companies declare bankruptcy as a result of the economic conditions imposed by the COVID-19 pandemic. Following government

5 11 U.S.C. § 547(f) states, "The debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition."
6 *In re Ames Dep't Stores Inc.*, 506 Fed. App'x 70, 72 (2d Cir. 2012).
7 *Id.*
8 11 U.S.C. § 101(32).
9 *In re Am. Classic Voyages Co.*, 367 B.R. 500, 508 (Bankr. D. Del. 2007).
10 *Id.*
11 *See In re Waccamaw's Homeplace*, 325 B.R. 524, 529 (Bankr. D. Del. 2005).
12 *Id.*
13 *Grandison v. Nat'l Bank of Commerce of Rochester*, 231 F. 800, 804 (2d Cir. 1918); *see also In re F & S Cent. Mfg. Corp.*, 53 B.R. 842, 849 ("Fair value is determined by estimating what the debtor's assets would realize if sold in a prudent manner in current market conditions.") (citing 2 *Collier on Bankruptcy* ¶ 101.26, p. 101-56 (15th ed. 1985)).
14 *In re Parker Steel Co.*, 149 B.R. 834 (Bankr. N.D. Ohio 1992).
15 *See, e.g., Briden v. Foley*, 776 F.2d 379, 382-83 (1st Cir. 1985).
16 *In re Terrific Seafoods Inc.*, 197 B.R. 724, 731 (Bankr. D. Mass. 1996).
17 *See In re Roblin Indus. Inc.*, 78 F.3d 30, 34 (2d Cir. 1996).
18 *Ames*, 506 Fed. App'x at 72 (citing *Roblin*, 78 F.3d at 34).
19 *Roblin*, 78 F.3d at 34.
20 *See, e.g., In re Lids Corp.*, 281 B.R. 535, 546 (Bankr. D. Del. 2002).
21 *See, e.g., In re Energy Co-Op. Inc.*, 109 B.R. 822 (Bankr. N.D. Ill. 1989).
22 *In re Perry*, 158 B.R. 694 (Bankr. N.D. Ohio 1993).

orders across the nation closing many brick-and-mortar, non-life-sustaining businesses, a number of companies, both large and small, have filed for bankruptcy in the past several months.

The date-of-insolvency question is crucial for businesses, their owners and their creditors, as prior to COVID-19 many businesses were profitable with no knowledge that bankruptcy was imminent. Indeed, but for the outbreak of COVID-19 and the resulting shutdown orders, many of these businesses would not have been insolvent. Unlike the typical bankruptcy case, in which a company that files for bankruptcy has been in a difficult financial situation for many months or even years prior to the filing of a petition, pandemic-related shutdowns are causing companies that might not have been insolvent to find themselves in need of initiating bankruptcy proceedings. In such circumstances, affected creditors might seek to rebut the presumption of insolvency, or use such a threat to negotiate a more favorable settlement of the dispute.

The rapid onset of bankruptcies due to COVID-19 is not entirely without precedent. Regrettably, the situation resembles the struggle faced by some businesses in the wake of the Sept. 11, 2001, terrorist attacks. These cases provide guidance as to how the insolvency presumption might be rebutted in bankruptcy cases stemming from the pandemic.

For example, take the bankruptcy filed by the domestic cruise ship company American Classic Voyages on Oct. 19, 2001.[23] In that case, American Classic sought to avoid a $29 million payment made to various banks on Aug. 14, 2001.[24] The banks presented expert testimony analyzing American Classic's financial statements in the months leading up to the Sept. 11, 2001, attacks, and the court found this evidence sufficient to rebut the insolvency presumption.[25]

As will likely be the case in bankruptcies stemming from COVID-19, the court considered the rapid onset of cancellations and closures experienced by American Classic and concluded that, despite any financial challenges before Sept. 11, 2001, it was the attacks themselves that struck the "fatal blow to their business."[26] Thus, the $29 million in payments were not avoidable as preferences because American Classic was not insolvent on Aug. 14, 2001, the date of the transfer.[27]

A similar issue was addressed in the *Irving Tanning Co.* bankruptcy. In adjudicating a $23.6 million fraudulent-transfer action, the U.S. Bankruptcy Court for the District of Maine addressed a similar insolvency fact pattern. Although the defendants prevailed for other reasons, the court noted that the plaintiff would not have been "able to convincingly link [the debtor's 2009 inability to pay its bills] with the 2007 payments to the Shareholder Defendants. A more likely culprit was the unforeseen, intervening, and devastating impact of the recession of late 2007 through 2009, about which several Defendants testified and of which I can take judicial notice."[28] This suggests that bankruptcy courts could similarly be willing to take judicial notice of the harsh impact that pandemic-related closures have had on American businesses.[29]

Conclusion

Courts might need to perform this same analysis in bankruptcies stemming from COVID-19 to determine whether a company was already insolvent before the pandemic. The rapid onset of closures and other difficult economic conditions as a result of the pandemic — especially in or around March 2020 — will present challenging issues for creditors and debtors as they seek to resolve the insolvency question. Many companies across the U.S. likely suffered steep financial losses from solvency in February to insolvency by April. The recipients of payments from such companies presumably had little reason to believe that such payments could eventually be deemed preferences in bankruptcy. Now, they could find themselves defendants to a preference avoidance action. Both creditors and debtors will have to deal with the presumption of insolvency as more and more bankruptcies are filed in COVID-19's wake. abi

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23 *See Am. Classic*, 367 B.R. at 502.
24 *Id.*
25 *Id.* at 509-14.
26 *Id.* at 513.
27 *Id.* at 516.
28 *Dev. Specialists Inc. v. Kaplan (In re Irving Tanning Co.)*, 555 B.R. 70, 85 n.11 (Bankr. D. Me. 2016) (citing *W. Coast Hotel Co. v. Parrish*, 300 U.S. 379, 399 (1937) (court may take judicial notice of well-known, widespread economic conditions)).

29 This article does not cover the ordinary-course defense being relevant in this aspect as it would take away from the focus of this discussion, which is solely on the insolvency presumption and COVID-19. That focus relates to § 547(b) (the requirement of insolvency) and (f) (the 90-day insolvency presumption). Under § 547(c), there are nine affirmative defenses, including the ordinary-course defense. Each of those defenses could apply in a COVID-caused bankruptcy the same as they could in a non-COVID-caused bankruptcy. As there have been numerous ABI articles written on the ordinary-course defense, as well as the new value defense and other § 547(c) affirmative defenses, the authors did not want to grow this article and have it cover any of those § 547(c) affirmative defenses.