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Second Circuit Defines Adequate Capitalization

Ruling in Fraudulent Transfer Case

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A debtor's pre-bankruptcy repurchase of its stock for $150 million was not a fraudulent transfer because the debtor "could have sold off enough of its assets or alternatively obtained sufficient credit to continue its business for the foreseeable future," held the U.S. Court of Appeals for the Second Circuit on June 15, 2016. *In re Adelphia Communications Corp.*, 2016 WL3315847, *2 (2d Cir. June 15, 2016). Affirming the lower courts, the Second Circuit stressed that "the issue of adequate capitalization," the "sole issue presented on appeal … came down to a battle of experts," with the "defendants' experts" being "more persuasive." *Id.* at *2.

Relevance

The creditors' "Recovery Trust" in *Adelphia* challenged the debtor's stock repurchase, made three years prior to bankruptcy, under the applicable Pennsylvania version of the Uniform Fraudulent Transfer Act (UFTA) because the transfer was made outside the relevant Bankruptcy Code reachback (Code § 546 (a)(1)). As the Second Circuit noted, "Recovery Trust brought a claim under [Code] § 544(b)[,] which allows it to avoid any transfer under applicable state law … ." *Id.* at *1. Further, "courts construe [UFTA] consistently with the provisions of the Bankruptcy Code that address constructive fraudulent transfers … ." For that reason, like the district court and the parties, it also relied on "decisions of other federal courts interpreting relevant provisions of the … Code." *Id. See, e.g., In re Solomon*, 299 B.R. 626, 633 (B.A.P. 10th Cir. 2003) (" … the … UFTA and § 548 are identical and cases construing the elements under § 548(a) are persuasive interpretations for the UFTA.").

Insolvency was not an issue on appeal because the Recovery Trust in the district court accepted the bankruptcy court's finding that the debtor "had an equity cushion of approximately $2.5 billion at the time of the challenged transaction." 2015 U.S. Dist. LEXIS, at *10. Under the relevant section of UFTA [§ 4(a)(2)(i)], "a [creditor or] trustee may avoid any transfer of an interest of the debtor if (1) the property is transferred for less than fair consideration and (2) either (a) the debtor was insolvent on the date of the transfer **or** (b) the debtor's remaining assets were unreasonably small in relation to the transaction." 2016 WL 3315847, at *1.

Code § 548(a)(1)(b)(i)(ii)(II) similarly enables a trustee to avoid a transfer by a debtor left with "unreasonably small capital," when the debtor "received less than reasonably equivalent value in exchange for [the] transfer… ." Thus, because the debtor in *Adelphia* admittedly received no "reasonably equivalent value" in exchange for its cash payment, 512 B.R. at 494, the only question here was whether the debtor's assets were "unreasonably small" at the time of the challenged transfer. *Id. See* 5 Collier on Bankruptcy ¶ 548.05[3][b], at 548-79 (16th ed. 2012) (" … a question of fact in each case.").

Analysis

The court stressed the factual nature of its analysis. "Generally 'adequacy of capital' presents a mixed question of law and fact.'" *Id.* at *1, citing *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1063 (3d Cir. 1992). Accordingly, it reviewed the "district court's relevant factual findings for clear error." *Id.*

Legal Standard

Other courts, explained the Second Circuit, have interpreted the UFTA's "unreasonably small" language "to

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describe a situation where a transaction leaves a debtor 'technically solvent but doomed to fail.'" *Id*. at *2, citing *MFS/Sun Life Tr. High-Yield Series v. Van Dusen Airport Srvs. Co.*, 910 F. Supp. 913, 944 (S.D.N.Y. 1995) (citing *Moody*, 971 F.2d at 1070 & n.22). Courts in this context focus "on reasonable foreseeability," and look at whether "the debtor had such minimal assets that insolvency was inevitable in the reasonably foreseeable future" at the time of the transfer. *Id*.

Among the facts that courts consider are the debtors' "debt to equity ratio, its historical capital cushion, and the need for working capital in the specific industry at issue." *Id*., citing *MFS/Sun Life Tr.* 910 F. Supp. at 944. "Also relevant are 'all reasonably anticipated relevant sources of operating funds, which may include new equity infusions, cash from operations, or cash from secured or unsecured loans over the relevant time period.'" *Id*., citing *Moody*, 971 F.2d at 1072 n. 24. *See also In re Jackson*, 459 F.3d 117, 123 (1st Cir. 2006) (under the New Hampshire version of UFTA, courts consider debtors' ability to "generate enough cash from operations and sales of assets to pay its debts and remain financially stable" after challenged transfer). Finally, "courts do not evaluate the financial condition of the debtor in isolation; they compare the subject company to peers in its industry." 2016 WL 331584 at *2.

Application to Facts

The court rejected the Recovery Trust's "argument that the district court improperly conflated its analysis of [the debtor's] solvency with its evaluation of whether [it] had unreasonably small capital, noting that the concepts are distinct, "but overlap." *Id*., citing *Moody*, 971 F.2d at 1069-71. "The district court … analyzed [the debtor's] solvency separately from the adequacy of its capital." *Id*.

Here, "at the time of the challenged transfer [the Debtor] needed approximately $600 million to meet its capital needs over the next 3 years and … [the challenged] transfer still left the company with an equity cushion of approximately $2.5 billion." *Id*. Despite the debtor's being over-leveraged with a negative cash flow, being in default under existing bond indentures, and "beset by ongoing fraud within the company," it "could have sold off enough of its assets or alternatively obtained sufficient credit to continue its business for the foreseeable future." *Id*. In fact, the defendants' experts showed with declarations and trial testimony that "similarly-situated companies in the [debtor's] industry were able to access capital markets despite having negative cash flows and/or having high leverage ratios, and that numerous other companies obtained access to capital markets after disclosing a fraud." *Id*. *See* 4 Collier, *supra*, at 548-80 ("Adequate capitalization [varies depending on] which specific industry … is involved.").

Comment

The *Adelphia* decision is consistent with the few appellate decisions handed down in this context. More important, it confirms that proving the debtor's insolvency is unnecessary. *In re Jackson*, 459 F.3d at 124 (held, "[t]his requirement in fraudulent transfer law does not require a finding of post-transfer insolvency."); *Steph v. Branch*, 255 F. Supp. 526 (E.D. Okla. 1966), aff'd, 389 F.2d 233 (10th Cir. 1968); *Moody*, 971 F.2d. at 1071-72 (3d Cir. 1992) ("unreasonably small capital denotes a financial condition short of equitable insolvency"; affirmed findings that financial projections of acquirer and acquisition lender were reasonable in view of debtor's prior performance; extrinsic factors caused debtor's demise; failed leveraged buyout not constructively fraudulent); *In re Semcrude, L.P.*, 2016 WL 1697085, *5 (3d Cir. Apr. 28, 2016). ("Absent the bias of hindsight, it … cannot be said that [debtor] was likely to be denied access to a credit facility that had been in place while it was engaging in … allegedly improper trading strategy.")

It is sufficient for the plaintiff trustee or creditors to show that the debtor was constantly behind in paying its bills or continued its business under serious financial risk. *Jackson*, 459 F.3d. at 123 (court should examine ability of debtor to generate enough cash from operations and sales of assets to pay its debts and remain financially stable); *In re Desert View Bldg. Supplies Inc.*, 475 F. Supp. 693 (D. Nev. 1978), aff'd without opinion 633 F. dd 225 (9th Cir. 1980) (parent pledged subsidiary stock to bank as collateral for loan and then defaulted on payments; to refinance, parent caused subsidiary to borrow from bank, with loan proceeds to pay off parent's initial loan; held loan left subsidiary with unreasonably small capital to operate in business; proof supplied by testimony of bank's lending officer that subsidiary had extremely low cash on hand for a business of its size).

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