

Constructing a Bank Holding Company Insolvency Model: Part I

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When a national bank is in financial distress, government regulators¹ typically encourage or require the bank's holding company to act as a source of strength by making loans, equity infusions and/or other asset transfers to the troubled institution.² If such measures heal the ailing bank, the banking system and the holding company's creditors and shareholders all are likely to benefit, at least in the long term. If the bank fails despite the holding company's transfers, the bank's assets are placed in a receivership administered by the Federal Deposit Insurance Corporation (FDIC) and the transfers end up enriching the FDIC at the expense of the holding company and its creditors.

The latter scenario unfolded in connection with the failure of the Bank of New England Corporation (BNEC), a Boston-based bank holding company, and the seizure of its subsidiary banks (BNEC banks).³ In 1989, bank regulators discovered fundamental asset-quality and control problems at BNEC's largest bank, Bank of New England NA (BNENA), that were so severe that it soon became apparent that its prospects for survival were bleak at best.

¹ The regulators primarily involved when national banks become deeply troubled are: the Office of the Comptroller of Currency (OCC), which regulates national banks; the Federal Reserve, which regulates bank-holding companies; and the FDIC, which oversees the Bank Insurance Fund (BIF) that insures deposits. Since BIF funds are at risk, the FDIC is consulted early and often by the Federal Reserve and the OCC when a bank becomes troubled, and great deference is often given to the FDIC's wishes with respect to the treatment of such banks and their holding companies.

² The Federal Reserve issued a policy statement in 1987 on the Source of Strength Doctrine, which provided that a bank holding company has an obligation to "use available resources to provide adequate capital funds to its subsidiary during periods of financial stress or adversity." 52 Fed. Reg. 15,707 (1987). See Christine Bradley and Kenneth Jones, "Loss Sharing Rules for Bank Holding Companies: An Assessment of the Federal Reserve's Source-of-Strength Policy and the FDIC's Cross-Guarantee Authority," Munich Personal RePec Archive (March 16, 2009) (discussion by FDIC staff members of history and application of Source of Strength Doctrine). Not all banks have holding companies; the Source of Strength Doctrine applies only to those that do.

³ The failure of the BNEC system was one of the largest in history and was the largest since the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) until the failure of IndyMac Bank FSB in July 2008.

About the Authors

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Despite BNENA's terminal condition, the regulators nevertheless encouraged BNEC to downstream cash to BNENA and other BNEC banks (BNENA's "sister banks") and compelled BNEC to merge nonbank subsidiaries into BNENA. After the downstreaming BNENA and its sister banks were closed, their assets were placed in FDIC receiverships, and the downstreamed assets that would have been available to

transfer claims.⁵ Such models will be particularly important in the current environment⁶ to trustees or debtors-in-possession of failed bank holding companies who have cause to pursue similar fraudulent transfer claims.⁷ This article discusses the legal and factual bases for the insolvency model constructed in the FDIC litigation, and is being published in two parts. The first part discusses the legal standards applicable for establishing insolvency and for establishing whether reasonably equivalent value is exchanged in transfers from parent companies to subsidiaries. The second part will discuss how the model was constructed and how it supported the trustee's fraudulent-transfer claims in the FDIC litigation.

The Insolvency Standard

Section 101(32) of the Bankruptcy Code defines "insolvent" as a "financial condition such that the sum of such

Financial Statements

pay BNEC's creditors wound up in the FDIC's coffers.

The BNEC chapter 7 bankruptcy trustee brought both "actual intent" and "constructive intent" fraudulent-transfer claims against the FDIC and against the banks to whom the FDIC subsequently transferred the property in question (the FDIC litigation). The actual-intent claim sought to avoid the transfers pursuant to Bankruptcy Code §548(a)(1)(A) on the grounds that they were made with "actual intent to hinder, delay or defraud" BNEC's creditors. The constructive-intent claim, based on §548(a)(1)(B), sought the return of such assets on the basis that BNEC was insolvent at the time the transfers were made and that BNEC did not receive reasonably equivalent value in exchange for the transfers.⁴

The trustee's insolvency model was a cornerstone of his success on the actual and constructive-intent fraudulent-

entity's debt is greater than all of such entity's property, at fair valuation." In virtually all instances, "fair value"

⁵ The trustee recovered \$140 million from the FDIC and used his insolvency model to support fraudulent-transfer and "deepening insolvency" claims he brought in an action against BNEC's former auditors, for which he recovered \$84 million.

⁶ After several years with no significant bank failures, the failure rate increased dramatically in 2008, when 25 banks with \$371.9 billion in assets failed. See 2009 FDIC Annual Report. From January through Aug. 15, 2009, 78 banks failed. See www.fdic.gov/bank/individual/failed/banklist.html. Scores of additional banks are predicted to fail as a result of the current economic downturn. Ari Levy, "Toxic Loans Topping 5 Percent May Push 150 Banks Past Point of No Return," *bloomberg.com*, Aug. 14, 2009.

⁷ After the FDIC litigation concluded, Congress passed the Gramm-Leach-Bliley Act (GLBA). Section 730 of the Act prohibits any person from bringing preference or constructive-intent fraudulent-transfer claims against the FDIC to avoid transfers to subsidiary banks that occur after a bank receives a written direction from a bank regulator to increase capital. 12 U.S.C. §1828(u)(1). There is, however, no restriction on bringing actual intent claims against the FDIC. *Id.* §1828(u)(2)(B). In addition, since §730 only limits claims against the FDIC and other bank regulators, it places no restriction on suits pursuant to Code §550 to recover avoidable transfers from banks or other subsequent transferees that obtain them from an FDIC receivership. See *Int'l Admin. Servs. Inc.*, 408 F.3d 689, 704-08 (11th Cir. 2005) (trustee may sue subsequent transferee under Code §550 without first suing initial and intermediate transferees); *Woods & Erickson v. Leonard*, 389 B.R. 721, 734-35 (9th Cir. 2008) (same); *In re Richmond Produce*, 195 B.R. 455, 463 (Bankr. N.D. Cal. 1996) (same). While only time will tell the extent to which GLBA §730 will affect fraudulent-transfer and preference claims against the FDIC, in at least one instance it has not acted as a barrier. Specifically, it does not appear that §730 was triggered before the failure of Washington Mutual Bank (WMB), a federal savings bank placed in FDIC receivership on Sept. 25, 2008, because it does not appear that a bank regulator ever issued a written direction to WMB to increase capital. As a result, Washington Mutual Inc. and WMI Investment Corp., holding companies of WMB, have brought preference and fraudulent-transfer claims against the FDIC to recover certain amounts transferred to WMB before its failure. See Complaint, ¶¶25-44, *Washington Mutual Inc. v. FDIC*, Case No. 1:09-cv-00533(RMC) (D. D.C. March 20, 2009).

⁴ In addition to fraudulent-transfer claims brought pursuant to §548(a)(1)(A) and (B), the trustee's complaint included claims for avoidance of fraudulent conveyances pursuant to Code §544(b) and the Massachusetts fraudulent-conveyance laws (109 Mass. Gen. Laws Ann. §§4-7), avoidance of preferential payments pursuant to Code §542 and 543, restitution of estate property in certain accounts and Rabbi Trusts, violation of §91 of the National Bank Act, and constructive trust and equitable lien.

under the Code is synonymous with fair-market value.⁸

The insolvency valuation methodology required by the Code often is referred to as a “balance-sheet test” because the assets in question typically are identified on the debtor’s balance sheet. This does not mean that the book value appearing on the balance sheet necessarily reflects an asset’s fair-market value. Financial statements of going-concerns prepared in accordance with Generally Accepted Accounting Principles do not record assets at fair-market value.⁹

Instead of relying on book values, asset values are measured by the amount of cash that would be generated if sold into the market that existed at the time of the transfer. If a debtor is on its deathbed and near-term failure is very likely, then a so-called “liquidation value” approach is used whereby one determines the amount for which the assets would sell over a short period in a forced or distressed sale.¹⁰ If failure was not imminent at the time of the transfer, a going-concern valuation approach is required, and fair value is the price that would be obtained for the debtor’s assets if they were sold in a prudent manner within a reasonable period of time to pay the debtor’s debts.¹¹ A reasonable period of time for a going-concern valuation is “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.”¹²

Courts have rejected “operational” valuation methodologies in which the

focus is not on how much cash assets would generate if they were sold to pay creditors, but on their value to the debtor if they are held indefinitely. In a seminal decision rendered in the *Trans World Airlines* bankruptcy, the Delaware bankruptcy court criticized the argument that a going-concern valuation does not require consideration of what the assets could produce to pay creditors, but a derivation of the “in place” value to the debtor assuming that the debtor would continue as a going-concern for an indeterminate time and with no time constraints to pay off its creditors.¹³ The court said, “I find nothing...to support [the] position that in making a ‘fair valuation’ determination, the so called ‘going concern’ approach does not involve a consideration of realizing value from the assets which value (cash) can be paid to creditors within a reasonable time period... fair market valuation entails a hypothetical sale, not a hypothetical company.”¹⁴

Depending on the circumstances, courts generally consider a variety of methodologies to determine fair-market value, including, but not limited to, actual sale price, discounted cash flow, market multiples, comparable transactions and market capitalization.¹⁵ Whether a particular methodology or methodologies are appropriate in an individual case depends on whether they reasonably and reliably calculate the amount of cash that would be generated if the asset were sold within a reasonable period of time.¹⁶

In some instances, an analysis of a hypothetical sale of a debtor as a whole operating concern may generate a premium over and above the sum of the values of the entity’s constituent parts.

Other times there may be no buyers for the entire enterprise, and the fair-market value of its individual assets may be far less than its recorded book value.

Insolvency and Reasonably-Equivalent Value

When a parent company makes a transfer to a solvent subsidiary, there typically is a presumption of an exchange for reasonably-equivalent value because the parent company’s investment in its subsidiary is increased by the amount transferred.¹⁷ However, if the subsidiary is insolvent, then there is no such presumption because there is no corresponding increase in equity, *i.e.*, the value of its investment in its subsidiary is “zero” both before and after the transfer.¹⁸ In such circumstances, when a transfer to or for the benefit of an insolvent subsidiary has the net effect of diminishing the parent company’s value, it is deemed to be for less-than-reasonably-equivalent value.¹⁹

The trustee’s insolvency model was designed to address whether both the transferor (BNEC) and the transferees (BNENA and its sister banks) were insolvent, thus providing proof for both the insolvency and reasonably-equivalent value elements of his constructive-intent claim. Since insolvency and lack of reasonably-equivalent value also are “badges” of fraud from which a conclusion of actual intent to hinder, delay or defraud can be drawn, the model also supported his actual-intent claim.²⁰

The second part of this article will discuss the specific components of the BNEC insolvency model. It covers why and how various methodologies were employed, the data that was available to and considered by the trustee’s experts, how banking laws affected the model and how a market capitalization approach like the one considered by the Third Circuit in *VFB LLC v. Campbell Soup Co.* would not have been a useful indicator of asset value for BNEC and BNENA. ■

⁸ See, e.g., *In re Trans World Airlines Inc.*, 134 F.3d 188, 194 (3d Cir. 1998) (“[o]verwhelming body of authority” provides that appropriate methodology is market valuation); *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 548-49 (1994) (“Fair market value” is “normal tool for determining what property is worth” under Bankruptcy Code).

⁹ See *In re Trans World Airlines Inc.*, 180 B.R. 389, 405 n.22 (Bankr. D. Del. 1994), *aff’d in part, rev’d in part on other grounds*, 203 B.R. 890 (D. Del. 1996), *aff’d in part, rev’d in part on other grounds*, 134 F.3d 188 (3d Cir. 1998); *Briden v. Foley*, 776 F.2d 379, 382 (1st Cir. 1985); *Nickless v. Golub*, 152 B.R. 394, 403 (Bankr. D. Mass. 1993). Book value was specifically rejected as an appropriate measure of the fair value of the assets of a bank and bank holding company in *Corbin v. Franklin Nat’l Bank*, 2 B.R. 687, 712 (E.D.N.Y. 1979), *aff’d*, 633 F.2d 203 (2d Cir. 1980).

¹⁰ See, e.g., *Diamond v. Osborne*, 102 Fed. Appx. 544, 548 (9th Cir. 2004); *In re Taxman Clothing Co.*, 905 F.2d 166, 170 (7th Cir. 1990); *Langham, Langston & Burnett v. Blanchard*, 246 F.2d 529, 532-33 (5th Cir. 1957); *In re DAK Indus. Inc.*, 195 B.R. 117, 125 (Bankr. D. Cal. 1996).

¹¹ See, e.g., *Lawson v. Ford Motor Co.*, 78 F.3d 30, 35 (2d Cir. 1996); *Constructora Maza Inc. v. Banco de Ponce*, 616 F.2d 573, 577 (1st Cir. 1980); *In re Iridium*, 373 B.R. 283, 344 (Bankr. S.D.N.Y. 2007); *Sleepy Valley Inc. v. Leisure Valley Inc.*, 93 B.R. 925, 927 (Bankr. W.D. Tex. 1988).

¹² *In re Trans World Airlines*, 134 F.3d at 195. In this case, 12-18 months was deemed reasonable. *Id.*

¹³ *In re Trans World Airlines*, 180 B.R. 389, 411 (Bankr. D. Del. 1994), *aff’d in part and rev’d in part on other grounds*, 203 B.R. 890, 893 (D. Del. 1996), *aff’d in part and rev’d in part*, 134 F.3d 188 (3d Cir. 1998).

¹⁴ *Id.* at 410 (citations omitted). See also *Lawson*, 78 F.3d at 35 (“Fair value, in the context of a going concern, is determined by the fair market price of the debtor’s assets that could be obtainable in the market if sold in a prudent manner over a reasonable period of time”); *Briden v. Foley*, 776 F.2d 379, 382 (1st Cir. 1985); *Constructora Maza*, 616 F.2d at 577; *Sleepy Valley*, 93 B.R. at 927. In considering the *Daubert* motions relating to expert testimony on asset valuation, the court held in the FDIC litigation that the trustee’s arguments regarding the necessity of a market-based valuation methodology were persuasive and prohibited the FDIC from proffering an inconsistent methodology at trial. See *Branch v. FDIC*, C.A. No. 91-10976 (RGS), *slip op.* at 1 (May 15, 1998).

¹⁵ See, e.g., *In re Iridium*, 373 B.R. 283, 344 (Bankr. S.D.N.Y. 2007) (listing various methodologies); *VFB LLC v. Campbell Soup Co.*, 482 F.2d 624, 631 (3d Cir. 2007) (market capitalization); *In re Coated Sales Inc.*, 144 B.R. 663, 670 (Bankr. S.D.N.Y. 1992) (actual sale); *MFS/Sun Life Trust-High Yield Sec. v. Van Dusen Airport Servs. Co.*, 910 F.Supp. 913, 939-43 (S.D.N.Y. 1995) (asset-purchase price, discounted cash flow and comparables); *In re Lids Corp.*, 281 B.R. 535, 541 (Bankr. D. Del. 2002) (market multiple and comparables); *In re Zenith Elec. Corp.*, 241 B.R. 92, 104 (Bankr. D. Del. 1999) (discounted cash flow).

¹⁶ See, e.g., *In re Trans World Airlines*, 134 F.3d at 194; *Lawson*, 78 F.3d at 35-36; *LaSalle Nat’l Bank Ass’n v. Palaoian*, 406 B.R. 299, 350-52 (N.D. Ill. 2009).

¹⁷ See, e.g., *Branch v. FDIC*, 825 F.Supp. 384, 399-400 (D. Mass. 1993); *In re Metro Communications Inc.*, 95 B.R. 921, 933 (Bankr. W.D. Pa. 1989), *rev’d on other grounds*, 945 F.2d 635 (3d Cir. 1991); *In re W.T. Grant Co.*, 699 F.2d 599, 608-09 (2d Cir. 1983); *In re First City Bancorporation of Tex. Inc.*, 1995 Bankr. Lexis 1683, at *34 n.9 (Bankr. N.D. Tex. May 15, 1995).

¹⁸ *In re First City*, 1995 Lexis 1683 at n.9; *Branch*, 825 F.Supp. at 399-400.

¹⁹ See, e.g., *In re First City*, 1995 Lexis 1683 at n.9; *Branch*, 825 F.Supp. at 399-400; *In re Duque Rodriguez*, 77 B.R. 937, 939 (Bankr. S.D. Fla. 1987), *aff’d*, 895 F.2d 725 (11th Cir. 1990); *Commerce Bank of Kansas City v. Achtenberg*, 1993 WL 476510, at *2-4 (W.D. Mo. Nov. 10, 1993).

²⁰ See, e.g., *Land O’Lakes Inc. v. Schaeffer*, No. 99-7147, *slip op.* at 5 (10th Cir. Jan. 19, 2001); *United States v. Fernon*, 640 F.2d 609, 613 (5th Cir. 1981); *Asareo LLC v. Am. Mining Corp.*, 396 B.R. 278, 370-74 (S.D. Tex. 2008).