

Presented:
VALCON 2009

FEBRUARY 26-27, 2009
LAS VEGAS, NEVADA

**Summary of Recent Cases on Valuation in the Context of
Avoidance Actions and the Fiduciary Exception to Privilege**

**Lisa G. Beckerman
Andrew I. Silfen
William Q. Derrough
Jack Williams**

Lisa G. Beckerman
Akin Gump Strauss Hauer & Feld LLP
New York, New York

lbeckerman@akingump.com
212-872-8012

**Summaries of Recent Cases on
Valuation in the Context of Avoidance Actions
and the Fiduciary Exception to Privilege**

1. **VFB, LLC v. Campbell Soup Co., 482 F.3d 624 (3d Cir. 2007).**

A. Summary of the Facts

Vlasic Foods International (“Vlasic”) was a wholly owned subsidiary of Campbell Soup Company (“Campbell”). In 1998, Campbell sold Vlasic several food companies which comprised the Specialty Foods Division. Vlasic’s shares were issued to Campbell’s shareholders as an in-kind dividend. Vlasic incurred \$500 million of debt to finance its acquisition of the Specialty Foods Division. In 2001, Vlasic filed for Chapter 11. As part of the bankruptcy, Vlasic assigned all of its legal claims against Campbell to VFB, LLC, a Delaware limited liability company whose members are Vlasic’s unsecured creditors. VFB, LLC sued Campbell in the United States Court for the District of Delaware (the “District Court”) seeking, among other remedies, to set aside the spin-off of Vlasic as a fraudulent transfer. The District Court held that Vlasic was not insolvent at the time of the asset sales and received reasonably equivalent value for the assets acquired by Vlasic from Campbell. VFB, LLC appealed the District Court’s decision and the United States Court of Appeals for the Third Circuit (the “Third Circuit”) affirmed the District Court’s decision.

B. Analysis

The District Court based its decision largely on Vlasic’s market capitalization. VFB, LLC argued that the District Court erred in holding that Vlasic’s market capitalization measured the value of its assets because Campbell manipulated the Specialty Foods Division’s sales and earnings prior to the transfer and spin-off. VFB, LLC argued that the market capitalization was not good evidence of value. The Third Circuit held that the District Court relied on the market

capitalization several months after the transfer and spin-off occurred when Campbell and Vlasic had publicly disclosed the information about the financials and did not rely on Vlasic's market capitalization at the time of the transfer and spin-off. *Id.* at 632. The Third Circuit held that “[a]bsent some reason to distrust it, the market price is ‘a more reliable measure of the stock’s value than the subjective estimates of one or two expert witnesses’”. *Id.* at 633. The Third Circuit noted that VFB, LLC’s expert witnesses focused on actual post-spin-off performance and that by using a discounted cash flow analysis “they are measuring the wrong thing. To the extent that they purport to reconstruct a reasonable valuation of the company in light of uncertain future performance, they are using inept tools.” *Id.* The Third Circuit further held that, for its appeal to succeed, VFB, LLC “must show that on March 30, 1998, the Specialty Foods Division was *clearly* worth less than \$500 million.” *Id.* The Third Circuit concluded that its experts had not done so and that Vlasic had received reasonably equivalent value for the assets transferred to it from Campbell.

2. **Iridium IP LLC v. Motorola, Inc. (In re Iridium Operating LLC), 373 B.R. 283 (Bankr. S.D.N.Y. 2007).**

A. Summary of the Facts

Iridium Operating LLC, Iridium Capital Corp., Iridium Roaming LLC, Iridium (Potomac) LLC and Iridium Promotions, Inc. (collectively, “Iridium”) were spun off from Motorola, Inc. (“Motorola”). Motorola and Iridium were parties to a contract for the development of a global telecommunications constellation of sixty-six low earth orbit satellites and related gateways. Motorola received approximately \$3.7 billion in transfers from Iridium over a four year period as payments under the contract. Iridium activated its service in November 1998 and ended up in

bankruptcy about nine months later. The Official Committee of Unsecured Creditors of Iridium (the “Creditors’ Committee”) sued Motorola to recover the payments as preferences and/or fraudulent transfers. The United States Bankruptcy Court for the Southern District of New York (the “Bankruptcy Court”) determined that it would first decide on whether Iridium was insolvent or had unreasonably small capital during the four year period from August 13, 1995 through August 13, 1999. The Bankruptcy Court conducted a fifty day trial which involved fifty two witnesses, including seven experts.

B. Analysis

Motorola relied on Iridium’s success in raising impressive amounts of debt and equity and on the trading values of Iridium’s public securities throughout the time period in question as evidence of Iridium’s solvency. In contrast, the Creditors’ Committee argued that the market data was flawed, given the failure of the Iridium phone system, and that its expert witnesses’ discounted cash flow analysis, taking into account the limitations of the Iridium phone system, demonstrated that Iridium was insolvent.

The Bankruptcy Court held that the “contemporaneous market data for Iridium’s publicly traded securities are both consistent with substantial enterprise value and inconsistent with insolvency.” *Id.* at 293. The Bankruptcy Court commented that the Creditors’ Committee’s “experts have been unable to account for, to adequately explain or to reconcile the abundant market data that conflicts with their opinion, other than to question what the market knew about service limitations and to claim market judgments were not meaningful for a start up company, particularly a company such as Iridium that required huge capital expenditures and a long

development stage before generating any revenue. They elected not to test and validate their valuation opinions by utilizing any accepted methodologies other than the discounted cash flow approach to value, and based their opinion on restated cash flow projections that were tailored for litigation purposes well after commencement of this adversary proceeding.” *Id.* at 293.

The Creditors’ Committee’s experts did not value the company as of any date later than March 31, 1997 and thus, there was no direct evidence regarding the company’s insolvency during the months immediately leading up to the bankruptcy filing. The Bankruptcy Court further commented that “[w]ith hindsight and (with what Motorola refers to as ‘hindsight bias’), the market value of Iridium securities during the relevant period turned out to be an unreliable indicator of future fair market value, but that does not justify ignoring this data.” *Id.*

Notwithstanding that the market data was not an accurate predictor of the future of Iridium, the Bankruptcy Court chose primarily to rely upon the market data. “This Court is not bound to accept the value that has been ascribed to Iridium’s securities by the public markets and has the broad discretion to find that the markets somehow were distorted and did not fairly represent the underlying enterprise value of Iridium, but to justify disregarding values placed on these securities in an efficient public trading market, the Court needs a substantial reason to depart from that standard and find that the value implied by an efficient market is not a trusty benchmark. No reason to disregard that benchmark is present here, and no persuasive evidence has been offered to justify any deviation from the valuation implied by the public trading markets.” *Id.* at 303-304. The Bankruptcy Court cited to VFB LLC v. Campbell Soup Co., 482 F.3d 634 (3d Cir. 2007) with approval in its decision.

In evaluating the unreasonably small capital claim, the Bankruptcy Court held that, based on the substantial work that went into the creation and testing of Iridium’s projections, the

projections were reasonable and prudent when made. The Bankruptcy Court noted that its job was to determine whether the projections were reasonable and prudent when made and not whether they projections were correct. *Id.* at 347. The Bankruptcy Court also noted that Iridium’s stock price was still above \$3 per share at the time of its bankruptcy filing. The Bankruptcy Court stated that the ability of a debtor to raise financing goes to the question of adequate capitalization. *Id.* at 347. The Bankruptcy Court held that “the fact that Iridium closed on three syndicated bank loans and raised over \$2 billion in the capital markets between 1996 and 1999 is an indication of both solvency and capital adequacy.” *Id.* Thus, the Bankruptcy Court held that the Creditors’ Committee had not proven that Iridium was insolvent pre-petition or left with unreasonably small capital.

3. **Reaves v. Comerica Bank-California (In re GTI Capital Holdings), 373 B.R. 671 (Bankr. D. Ariz. 2007).**

A. Summary of the Facts

In September 2001, a predecessor to Comerica Bank-California (“Comerica”) made four loans to GTI Capital Holdings, LLC (“GTI”). Comerica subsequently became the lender on the four loans. The loans were secured by a pledge of all of the personal property and real property of GTI. However, Comerica only recorded a deed of trust on GTI’s real property at the time that the loans were made. Ten months later, Comerica recorded UCC-1 financing statements. On May 8, 2003, GTI filed for Chapter 11 protection. On June 17, 2003, GTI filed the lawsuit against Comerica in the United States Bankruptcy Court for the District of Arizona (the “Bankruptcy Court”) seeking to avoid the liens on the personal property on the basis that they were a fraudulent conveyance.

B. Analysis

The Bankruptcy Court held that a separate transfer had occurred when the UCC-1 financing statements were filed. The Bankruptcy Court further held that “a debtor can receive reasonably equivalent value for the securing of an antecedent debt without receiving any ‘new value.’” Id. at 678. The Bankruptcy Court reasoned that GTI received “value” by having secured the creditor’s loan in an amount roughly equal to the value of GTI’s personal property. Id. at 680. The Bankruptcy Court commented that no unsecured creditors were harmed by the transfer because such unsecured creditors could have acquired a lien on GTI’s personal property prior to the transfer or refused to provide further goods or services to GTI. Id. The Bankruptcy Court further reasoned that the two transfers constituted a single transaction from a practical standpoint and that Comerica would have sued GTI for breach of contract if GTI had refused to execute the UCC-1 financing statements which would have resulted in a damage claim. Id. at 681. Accordingly, the Bankruptcy Court held that no fraudulent transfer had occurred by the recordation of the UCC-1 financing statements.

4. **Smith v. Am. Founders Fin. Corp., 365 B.R. 647 (S.D.Tex 2007).**

A. Summary of the Facts

IFS Financial Corporation (“IFS”), Circle Investors, Inc. (“Circle”), IFS Insurance Holdings, Inc. (“Insurance Holdings”) and Comstar Mortgage Corporation (“Comstar”) filed bankruptcy. W. Steve Smith (“Smith”) was appointed the Chapter 7 trustee for these debtors. Smith commenced a lawsuit in the United States District Court for the Southern District of Texas

(the “District Court”) seeking to avoid certain transfers as fraudulent under the Texas Uniform Fraudulent Transfer Act.

Blitz Holdings Corporation (“Blitz”) was a subsidiary of GCM. Interamericas Financial Holdings Corp. (“IFHC”) owned a majority of IFS’ stock. IFHC owed GCM \$95 million. On May 15, 2000, Blitz and IFS entered into a loan agreement. Pursuant to the loan agreement, Blitz became the holder of a promissory note from IFS in the amount of \$74,123,588.82. IFS then wrote a check for \$74,123,588.82 to GCM to pay off the debt of IFHC to GCM. Under a note purchase agreement, IFS became the owner of the promissory notes executed by IFHC and payable to GCM. The check IFS issued to GCM was never cashed but was marked cancelled. GCM received a credit in the amount of \$74,123,588.82 on its books. An accounts receivable entry was made in Blitz’s books in that amount and a corresponding accounts payable entry was made in IFS’ books. No actual cash was exchanged.

B. Analysis

The District Court held that IFS did not receive value reasonably equivalent to the \$74 million in debt that it incurred paying off the debt of its parent corporation, IFHC, which rendered IFS insolvent. The District Court noted that any benefit to IFS of IFHC’s debt to GCM being repaid was indirect and limited. The District Court held that “Courts are willing to consider indirect benefits received by a debtor only if those benefits are ‘fairly concrete’”. *Id.* at 667. The District Court held that “it is clear that IFHC’s obligation on the bearer note was substantially greater than IFS’s obligation under the preferred stock option held by GCM in exchange for which GCM had given” IFHC “an additional \$15 million in capital.” *Id.* at 670. The only benefit that was presented to the District Court which IFS received for incurring more

than \$74 million in debt was that it “got to live for several more years.” Id. The District Court rejected that argument and held that this benefit did not constitute reasonably equivalent value. The District Court stated that keeping “IFHC afloat while making IFS insolvent did not provide IFS any opportunity for future growth or make either entity attractive to a potential purchaser.” Id. at 671. Thus, the District Court concluded that Blitz was the transferee of a fraudulent transfer and section 502(d) of the Bankruptcy Code required that Blitz’s claim against IFS be disallowed.

5. Teleglobe USA, Inc. et al. v. BCE, Inc. et al., 392 B.R. 561 (Bankr. Del. 2008)

A. Summary of the Facts

Teleglobe USA, Inc. (“Teleglobe USA”) was a wholly owned subsidiary of a Canadian company, Teleglobe, Inc. (“Teleglobe”). Teleglobe, Teleglobe USA and its subsidiaries filed proceedings under the Canadian Companies Creditors Arrangement Act. In addition, Teleglobe USA and its subsidiaries filed under Chapter 11 (collectively, the “Debtors”) in the Bankruptcy Court for the District of Delaware (the “Bankruptcy Court”). Teleglobe is a wholly owned subsidiary of BCE, Inc. (“BCE”).

On or about May 26, 2004, the Debtors and the Official Committee of Unsecured Creditors (the “Creditors’ Committee”) (collectively, the “Plaintiffs”) commenced an adversary proceeding against BCE and various officers and directors (collectively, the “Defendants”) in the Bankruptcy Court for breach of contract, promissory estoppel, misrepresentation, breach of fiduciary duty and aiding and abetting a breach of fiduciary duty relating to BCE’s funding of, and subsequent abandoning of funding for, a fiber optic network called GlobeSystem.

Prior to commencing the adversary proceeding, the Plaintiffs conducted Rule 2004 discovery concerning BCE. In response to the discovery requests, BCE claimed common interest privilege and joint client privilege for certain documents, asserting that the BCE attorneys consulted with attorneys, officers and employees of Teleglobe and its subsidiaries to provide legal advice in matters where BCE, Teleglobe and its subsidiaries shared a common legal interest.

A great deal of litigation ensued over various discovery disputes and such disputes ended up before the Third Circuit Court of Appeals. One argument advanced by the Debtors as to why the Plaintiffs should have access to the disputed documents was the fiduciary exception to attorney-client privilege as articulated in Garner v. Wolfinger, 430 F.2d 1093 (5th Cir. 1970). Under Garner, shareholders of a corporation are permitted to invade the corporation's privilege in order to prove fiduciary breaches by those in control of the corporation upon showing of good cause. The Debtors argued that Garner should apply if the Debtors were insolvent or in the zone of insolvency. Certain of the discovery disputes were ultimately remanded and heard by the Bankruptcy Court.

B. Analysis

On remand before the Bankruptcy Court, the Plaintiffs argued that, if the Debtors were insolvent or in the zone of insolvency at the time of the privileged communications, then the Debtors on behalf of their creditors or the Creditors' Committee could pierce the attorney-client privilege and the documents in question should be produced. The Bankruptcy Court held that Garner does apply in Delaware and that, if the Debtors were insolvent at the time of the communications in question, then the privilege could be set aside by showing good cause. Id. at

597. The Bankruptcy Court held that the Plaintiffs must prove that the Debtors were insolvent and not just make a colorable showing of insolvency at the time that the attorney-client communications in question were made. The Plaintiffs argued that the Debtors were insolvent at the time that the privileged communications were made under either a balance sheet test or a cash flow test. The Bankruptcy Court held that, under applicable case law, the balance sheet test requires that the Plaintiffs demonstrate that the Debtors had a deficiency of assets below liabilities with no reasonable prospect that the business could be successfully continued in the face thereof in order to prove insolvency. The Bankruptcy Court specifically ruled that the Plaintiffs' expert's approach was flawed since it did not consider the likelihood that BCE would continue to fund the Debtors' operations, even if BCE was not contractually obligated to do so. The Bankruptcy Court held that, on a balance sheet basis, the Debtors were not insolvent until BCE actually ceased its funding of Teleglobe and the Debtors which was subsequent to the time when the privileged communications occurred. *Id.* at 601. The Plaintiffs' expert also prepared a cash flow analysis and, in his analysis, he assumed no financial support from the parent corporation to the Debtors. The Bankruptcy Court held that, even though the parent's financial support was not mandatory, it should have been taken into account in the solvency analysis at the point in time that the privileged communications were made. *Id.* at 603. Therefore, the Bankruptcy Court concluded that the Plaintiffs failed to prove insolvency in the relevant period where the privileged communications occurred under either the balance sheet test or the cash flow test. Thus, the Bankruptcy Court did not order the production of the privileged documents under the Garner fiduciary exception.