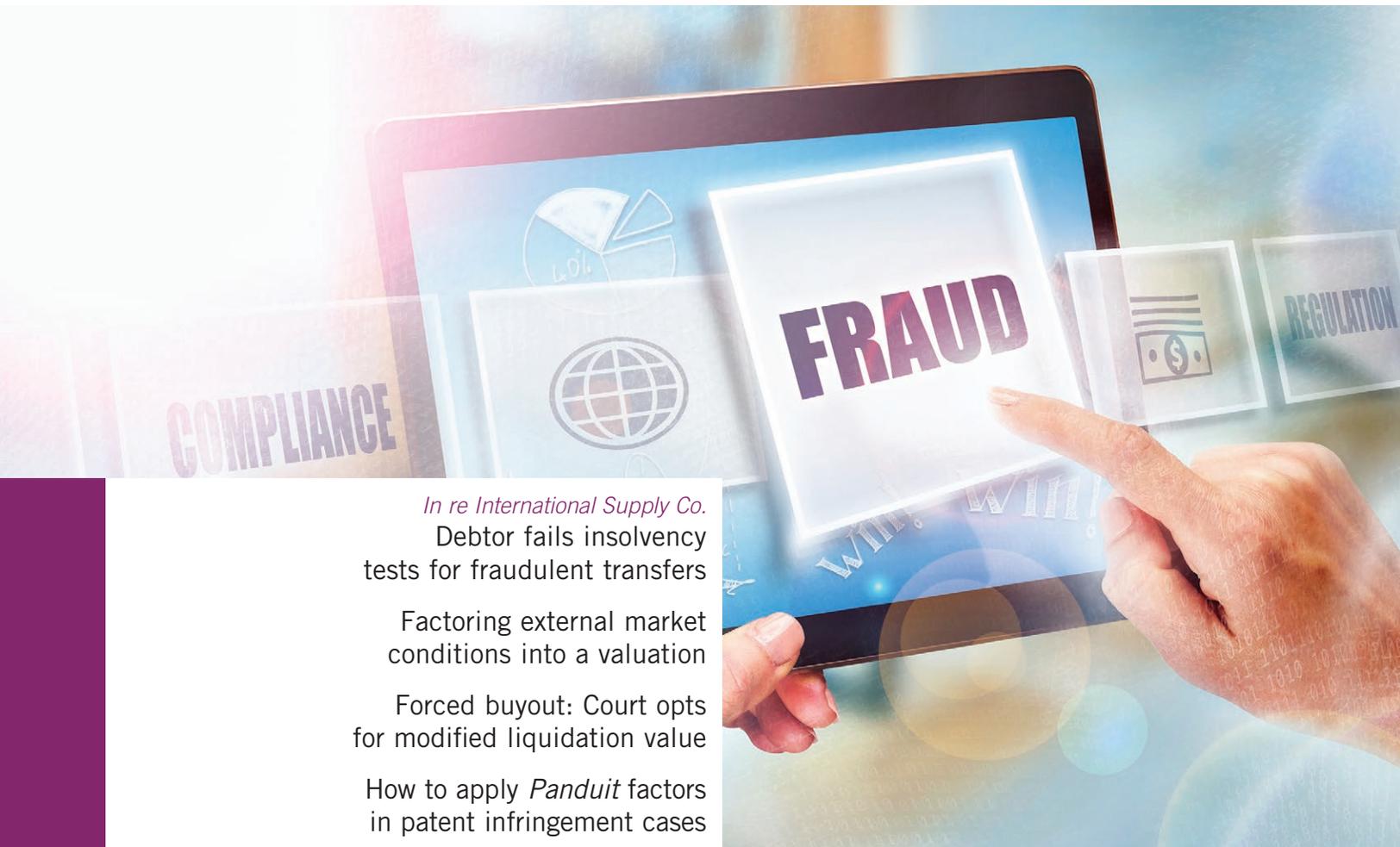


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# LITIGATION SUPPORT



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## *In re International Supply Co.*

# Debtor fails insolvency tests for fraudulent transfers

A recent bankruptcy case provides a helpful primer on the insolvency tests required to determine whether a debtor's pre-filing transfer can be rejected as fraudulent. *In re International Supply Co.* clarifies that a debtor may be solvent under one test but ultimately be found insolvent.

### Case facts

According to the U.S. Bankruptcy Court for the Northern District of Illinois, the debtor company appeared to be profitable and showed potential for significant growth. But over time, the company became the “personal piggy bank” of its controlling shareholder, who caused an asset liquidation to fund millions of dollars in distributions to him or on his behalf. When the assets were depleted, the company took on substantial debt to funnel him cash.



After the company filed for bankruptcy in September 2015, the trustee filed a lawsuit to avoid \$1.72 million in transfers to a credit union. The money was transferred in August 2013 under a settlement agreement involving a defaulted loan on which the controlling shareholder had a personal guarantee. The loan was made to a different company managed by the controlling shareholder's wife.

Under federal bankruptcy law, a trustee generally can avoid transfers made within two years before a bankruptcy filing if the debtor:

- Didn't receive a reasonably equivalent value for the transfer, and
- Was insolvent on the date of the transfer or became insolvent as a result of the transfer.

Here, the court considered the “materially identical” state law counterpart that has a four-year statute of limitations.

### 3 tests

To determine insolvency, the trustee and credit union hired financial experts who applied the following three tests:

**1. Balance sheet.** This test considers whether assets exceed liabilities. Both experts agreed that the company was solvent at the time of the transfers under the balance sheet test, but they diverged on the other two tests.

**2. Cash flow.** This evaluates whether the debtor has cash to pay its debts as they come due. In this case, cash flows were evaluated over the 12-month period within which most of the company's debt

## Avoiding fraudulent transfers in estate planning

Creditors can sometimes challenge gifts, trusts and other strategies for leaving assets to heirs as fraudulent transfers. Although laws vary from state to state, most have adopted the Uniform Fraudulent Transfer Act. It allows creditors to challenge transfers involving two types of fraud:

**Actual fraud.** This means making a transfer or incurring an obligation “with actual intent to hinder, delay or defraud any creditor.” Here, courts consider the surrounding facts and circumstances to determine whether a transfer involves fraudulent *intent*. Because courts can’t read the transferor’s mind, it’s important to consider how a court might view the transferor’s financial situation before making gifts or placing assets in a trust.

**Constructive fraud.** This is a more significant threat for most transfers because it doesn’t involve intent to defraud. A transfer or obligation is constructively fraudulent if it 1) was made without receiving a reasonably equivalent value in exchange for the transfer or obligation, *and* 2) the transferor was either insolvent at the time or became insolvent as a result of the transfer or obligation.

“Insolvent” means that the sum of an individual’s debts is greater than the sum of the fair values of all of his or her assets. Insolvency may be presumed if someone isn’t paying debts as they become due. To avoid these claims, transferors should calculate their net worth before making a gift. Individuals sometimes meet the technical definition of insolvency, even though they’re not having trouble repaying their debts.

was due. The trustee’s expert opined that the company was insolvent during the relevant years due to negative cash flow.

The credit union’s expert reached a different conclusion after making two adjustments to the sources of cash that differed significantly from the opposing expert’s calculations. First, he added in a new contract as a source of cash, deducting only the associated start-up costs. This resulted in an earnings figure higher than the company had ever achieved — a figure the court found “too high to pass a sanity check.”

Second, the court deemed the addition of \$3.6 million in refinanced debt by the credit union’s expert “problematic.” The expert assumed that the company would refinance the debt again when it came due. As the court described it, he effectively reduced current debt by the amount the company couldn’t pay. However, refinancing this current debt, which was always due within 12 months, didn’t make it long-term debt. The fact that the company needed to refinance the debt supported a finding of insolvency.

**3. Adequacy of capital.** This test assesses whether a debtor has sufficient available capital to pay its debts, operating expenses and capital expenditures within a specific period. The credit union’s expert determined that the company failed the cash flow test, so the company essentially was doomed to fail the adequacy of capital test. If the company didn’t have sufficient cash to pay its current debts as they came due, it also couldn’t pay other expenses for the period.

### Avoidance secured

Because the transfers benefited the controlling shareholder and not the company, the bankruptcy court easily found that the company didn’t receive equivalent value for them. Therefore, the transfers were avoided.

The three tests used to determine insolvency are applied based on the case-specific facts. Subtle differences in debtors’ situations may lead to markedly different outcomes. That’s why it’s critical for the parties to hire experts with experience in federal bankruptcy cases to support or defend against fraudulent transfer claims. ■

# Factoring external market conditions into a valuation

**P**redicting where a business is heading can be challenging in today's unprecedented economic conditions. Outside forces — such as government regulation, global competition, interest rates, labor supply and tax policy — could influence a company's estimated value.

## Evaluating risks

As of this writing, economists debate about whether we're in, heading toward or likely to avoid a recession. But few businesspeople would dispute that our economy is in the midst of a tumultuous and uncertain period. Businesses currently face many risks, including:

- Rising prices of goods for consumers and production,
- Higher labor costs and skilled worker shortages,
- High energy and health care costs,
- Supply chain constraints,
- A slowdown in mergers, acquisitions and initial public offerings,
- Waning investor confidence,
- Tighter credit supply and underwriting requirements,

- Rising interest rates,
- Increasing government and industry regulation, and
- Greater global competition from emerging markets.

These risks can affect all types of businesses, and many have the potential to slow revenue growth or erode profits. But their adverse effects are often more pronounced on private companies, which typically possess fewer resources than public ones to weather an economic downturn.

## Tailoring the analyses

External market conditions also can affect how valuers apply three valuation approaches:

**1. Market approach.** This technique relies on comparable public and private transactions. Here, *timing* is an important selection criterion. Comparables from when the economy was stronger or when an industry consolidated may overstate business value during an economic downturn. To remedy this, pricing multiples may require adjustment to reflect current market conditions.

Likewise, pricing multiples applied to the subject company's historic earnings may be less relevant if its expected performance likely will deviate from past results because of, say, lower growth and higher costs. But it's important to note that downturns are often temporary, and business owners are long-term investors. Valuers must consider a company's entire business cycle, including its ups and downs. Plus, not all changes are negative. Some companies have seized revenue-building opportunities in today's volatile marketplace that have enhanced their values.

**2. Income approach.** This approach derives value from *future* earnings. In today's



conditions, valuers might opt for more complex discounted cash flow (DCF) analyses over the single-period income capitalization method. A DCF model can provide greater flexibility when a company's revenue, costs and/or capital structure may be temporarily in flux.

Moreover, during an economic downturn, investors are generally wary about market conditions and may require higher returns to compensate them for additional risks. When quantifying the discount rate, valuers consider company-specific factors, such as management's awareness of market conditions, contingency planning and market exposure risks.

**3. Cost (or asset) approach.** Under this technique, value is a function of the fair market values of the business's assets and liabilities. This approach becomes increasingly relevant during an economic downturn, particularly if the subject company experiences financial distress. When contemplating bankruptcy or reorganization, a company's orderly and forced liquidation values become important

benchmarks. In some cases, a company's liquidation value may exceed its fair market value as a going concern entity.

Current economic conditions also are relevant when estimating economic damages over a finite period. Economic conditions are outside the control of both plaintiffs and defendants in damages cases. When estimating lost profits or decreased business value, the amount related to external factors (such as an economic downturn) must be separated from the amount directly attributable to the defendant's alleged tortious act.

### Keeping it real

In uncertain markets, consensus is rare. Individual owners and investors can be overly optimistic or pessimistic about where things are heading. That's why it's critical to use an experienced, objective business valuation professional who evaluates reliable sources of market data to project future earnings, evaluate risk and estimate value. ■

## Forced buyout: Court opts for modified liquidation value

The Michigan Court of Appeals recently issued a ruling in a 15-year legal battle over a forced buyout that's bounced back and forth between the trial and appellate courts. In *Pitsch v. Pitsch Holding Co.*, the court affirmed the "modified liquidation value" that the lower court assigned to the family-owned holding company — even though the valuation didn't account for certain assets and included liquidation expenses.

### The valuation

In the latest round of litigation, the case was remanded to the trial court to order dissolution of the company. The court appointed a special master to investigate the company's operations and make

a recommendation regarding asset valuation and proposed methods for disposition of the company.

The modified liquidation value was near the midpoint between the company's fair market value as a going concern and its liquidation value.

A year later, the special master informed the parties that they'd receive much less if the company dissolved and liquidated than if one side sold its shares to the other. He reached a valuation

of \$1.9 million per shareholder under a modified liquidation premise of value. (This premise of value differs from the “going concern” premise that’s applied in most business valuations.) Although the parties agreed to sell at that price, neither side was initially willing to purchase the opposing parties’ stock.

### Proposed solution

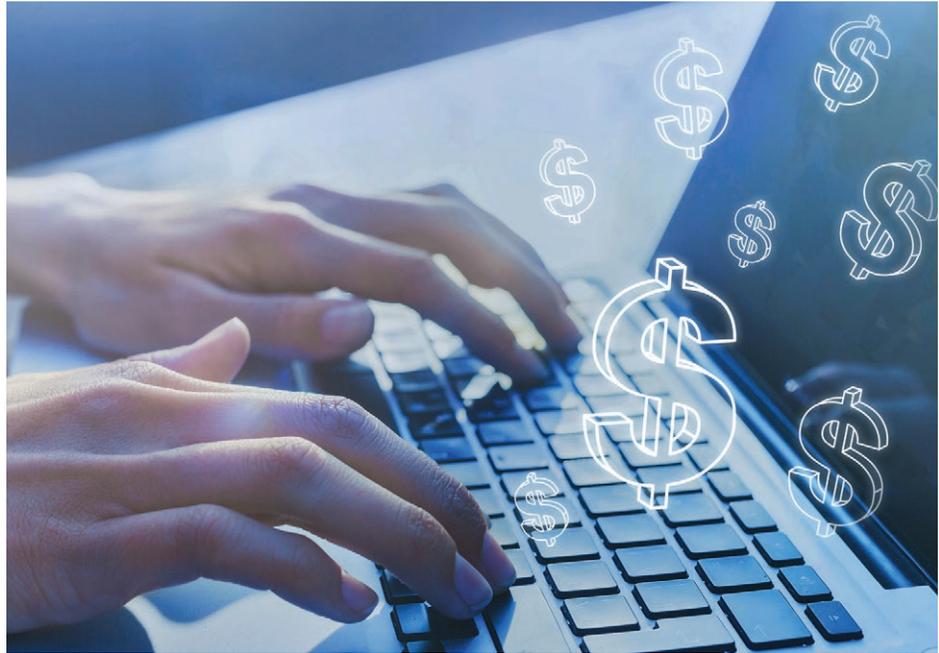
The special master eventually persuaded the defendants to purchase the plaintiffs’ stock, but there was a sticking point. The defendants began making cash advances to the plaintiffs toward the eventual purchase of their shares in 2007, to offset the future purchase price. However, the plaintiffs refused to sell unless the defendants waived the associated setoff and interest obligations.

The defendants sought to compel the plaintiffs’ sale. The trial court heard testimony from the special master on the basis for the valuation. He testified that the modified liquidation value was near the midpoint between the company’s fair market value as a going concern and its liquidation value. He further opined that a stock sale was the most effective, least expensive method of resolution.

However, the special master conceded that the valuation didn’t account for:

- Intangibles,
- Going concern value,
- Cash advance receivables, or
- Noncompete covenants with the defendants.

The valuation also included expenses that wouldn’t be incurred in a forced stock sale, such as real



estate and liquidation costs, and tax consequences that wouldn’t happen in the sale.

### The challenge

On appeal, the plaintiffs never cited any specific error in the special master’s reasoning, assumptions, valuation techniques or conclusions. Instead, their challenge focused on the value the trial court selected out of the methods the special master applied. Specifically, they contended that the trial court should have used a valuation of the company’s assets if sold at market prices.

The appellate court pointed out that the plaintiffs didn’t explain why they believed the company would net the appraised value of its assets at liquidation. They also failed to show how using the net appraised value of the assets was more likely to meet the goal of maximizing the company’s value.

### No error

Given the goal of maximizing value and both sides’ initial willingness to sell their stock for \$1.9 million, the appellate court wasn’t convinced that the trial court erred. So, in the absence of claiming specific errors in the special master’s analyses, the court upheld the lower court’s valuation. ■

# How to apply *Panduit* factors in patent infringement cases

The U.S. District Court for the Eastern District of Tennessee recently denied a defendant's attempt to exclude the opposing expert's testimony. The ruling in *Xodus Medical, Inc. v. Prime Medical, LLC* highlights how courts use the *Panduit* factors to determine lost profit damages in patent infringement cases.

## Substantiating damages

A landmark 1978 case, *Panduit Corp. v. Stahl Bros. Fibre Works, Inc.*, identified the following four factors a patentee must establish to recover lost profit damages:

1. Demand for the patented product as a whole,
2. The absence of acceptable noninfringing alternatives (that is, demand for particular features of the claimed invention),
3. Manufacturing and marketing capabilities to exploit the demand, and
4. The amount of profit it would have made but for the infringement.

In *Xodus Medical*, the federal district court found that all four *Panduit* factors favored the plaintiff.

## Applying the factors

On the first factor, the defendant claimed the expert failed to show that unpatented features of the infringing product don't drive consumers to purchase the product. However, the court found that standard applies to the entire market value rule for apportioning a reasonable royalty, not to the first *Panduit* factor.

As to the second factor, the defendant claimed the expert failed to establish that customers wouldn't have purchased a competing product. But the court found that his report discussed other products in

the market and why they aren't acceptable noninfringing alternatives.

The court also dismissed the defendant's contention that the expert didn't conduct any analysis of whether the plaintiff had the requisite manufacturing capability. The court held that the expert appropriately relied on the plaintiff's past activities to analyze whether the company had sufficient available manufacturing capability.

Finally, the defense challenged the calculation of the profit the plaintiff would have made absent the infringement. It argued the expert's analysis was unreliable because it didn't account for differences between the plaintiff's and the defendant's products. But the court pointed out that the defendant didn't cite any legal authority for why an expert must take such differences into account. It also rejected the argument that the expert didn't provide adequate support for assuming the defendant's customers would be willing to pay significantly higher prices.

## Not a matter of admissibility

The court shot down all of the defendant's arguments against the expert's testimony. Although some arguments may have raised factual disputes subject to cross examination, none warranted excluding the expert from testifying in this case. ■

