

Commercial Fraud Task Force Committee

ABI Committee News

Volume 5, Number 1 / January 2008

In This Issue:

- ABI's Annual Spring Meeting: Committee Educational Session
- Fraudulent Conveyances: S.D.N.Y. Bankruptcy Court Adopts Third Circuit's "Public Markets" Test
- Collusion in Bankruptcy Sales
- Fraudulent Financial Reporting on the Rise
- Former Counsel for Pearlman Ordered to Produce Computer, Cell Phone and PDA for Reconstruction of Data

Fraudulent Conveyances: Bankruptcy Court for the Southern District of New York Adopts Third Circuit's "Public Markets" Test for Determining Solvency/Unreasonably Small Capital

Written by: **Jason S. Brookner**

Andrews Kurth LLP; Dallas

On Aug. 31, 2007, the U.S. Bankruptcy Court for the Southern District of New York (Hon. James M. Peck, presiding) issued its "Opinion Regarding Insolvency and Unreasonably Small Capital" in the *Iridium* case. *Statutory Committee of Unsecured Creditors v. Motorola Inc. (In re Iridium Operating LLC)*, 373 B.R. 283 (Bankr. S.D.N.Y. 2007). Therein, the court adopts the public market valuation principles set forth by the Third Circuit in *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007). For publicly-traded companies that file for bankruptcy within the Third Circuit or in the Southern District of New York, it will be much harder to prove insolvency or unreasonably small capital if, at the time of the transfers in question, the debtor had a positive market cap.

Background

The *Iridium* case arose out of Motorola's development and deployment of a "global telecommunications constellation of 66 low Earth orbit satellites and related gateways." *Iridium*, 373 B.R. at 290. Originally, the

- [Committee Officers](#)
- [Upcoming Events](#)
- [Contribute to the Newsletter](#)
- [ABI World](#)
- [Newsletter Archives](#)



idea for the Iridium concept was developed by Motorola engineers, and a special Motorola business unit was formed to pursue the idea. Iridium was incorporated in 1991 and then, in 1993, through a private placement, the ownership of Iridium was transferred from Motorola to a consortium of private investors. In July 1996, Iridium Inc. changed its corporate form and became a Delaware LLC, with the shareholders of Iridium Inc. becoming members of the LLC. *Id.* at 305-306. Iridium and Motorola entered into a Space System Contract (SSC), pursuant to which Motorola was the prime contractor for developing the space-related portions of the Iridium system, including the satellite constellation and system control functions. *Id.* at 306. Motorola was paid approximately \$3.7 billion under the SSC in accordance with the milestone payment schedule. *Id.* at 290.

In 1999, approximately nine months after its satellite service was commercially activated, Iridium filed for bankruptcy in what the court described as a “huge and embarrassing failure,” and a “business failure of epic proportions,” *Id.* at 290, 291. Thereafter, the official committee of unsecured creditors filed an adversary proceeding against Motorola in 2001, on behalf of the Iridium estate, seeking to recover the approximately \$3.7 billion paid to Motorola under the SSC during the period Aug. 13, 1995 through Aug. 13, 1999 as alleged preferential payments and fraudulent transfers.

The trial was bifurcated, with the first phase addressing only the question of whether Iridium was insolvent or had unreasonably small capital in the four years prior to bankruptcy. Phase one consumed 50 trial days, with 52 witnesses (seven of whom were experts) and 866 exhibits. Eventually, the bankruptcy court determined that the committee failed to carry its burden of proof to establish that Iridium was insolvent or had unreasonably small capital at the time of the transfers to Motorola.

Bankruptcy Court’s Decision

The bankruptcy court was presented with a large amount of data, from both the committee and Motorola, on Iridium’s solvency. Motorola relied upon the fact that, during the relevant period, Iridium had great success in raising a tremendous amount of debt and equity in the public markets, and that during the same time period, Iridium’s securities traded within ranges that indicated a substantial enterprise value. *Id.* at 292.

The committee, on the other hand, disputed the validity of the market data submitted by Motorola,

essentially contending that the market was uninformed and the market data was thus unreliable. Among other things, the committee asserted that Iridium had fundamental weaknesses that were not fully understood by the public markets, had no reportable earnings, and was a start up enterprise preparing to operate in a new and unproven part of the telecom industry. In a nutshell, the committee contended that there was a “mismatch between market research that predicted a robust market for the new service and a system reality so incapable of servicing its target market that such research must have been seriously flawed.” *Id.* Thus, the committee urged the court to disregard the market data and instead, accept the testimony and conclusions of expert witnesses who performed discounted cash flow analyses using adjusted cash flow projections. *Id.*

At the end of the day, the court determined that “contemporaneous market data for Iridium’s publicly traded securities are both consistent with substantial enterprise value and inconsistent with insolvency. The market evidence is simply too voluminous and compelling to reach any other conclusion.” *Id.* at 293. The major issue the court identified with the committee’s case and experts was the failure to explain or reconcile the market data with their opinions, other than to simply claim that the market was not well informed, did not understand or know about the service limitations, and that the market judgments were not meaningful for a start up company. *Id.* at 293. Further, the court found that “[a]s a result of not confronting the valuations implied by the public markets concerning the enterprise valuation of Iridium and other comparable companies in the mobile satellite communications industry and of dismissing the market data as inapplicable to their analysis, the committee’s experts narrowed their focus to the point that they did not testify convincingly regarding all of the evidence that the court needed to evaluate and, in the process, diminished the usefulness and credibility of their opinions.” *Id.* The court also found that the committee’s expert’s hindsight reconstruction of Iridium’s projections, solely for the purposes of litigation, was “of uncertain reliability and of doubtful credibility” in light of the tremendous amount of diligence and analysis performed by Iridium’s consultants (and its lenders’ consultants) for testing the reliability of Iridium’s projections at the time.

The court spent a large part of the opinion reviewing the documentary evidence and witness testimony to support its conclusions and findings that all along, Iridium made public disclosure of the risks of system and service, and various Iridium consultants (investment banks, marketing experts, etc.) and the consultants of third parties tested and validated Iridium’s projections and business plan.

The Third Circuit's *VFB* Opinion

The SDNY bankruptcy court relied heavily on the Third Circuit's *VFB* opinion, *Iridium*, 373 B.R. at 291, 346-47, which was issued on March 30, 2007, five months prior to the *Iridium* opinion and prior to conclusion of the *Iridium* trial (closing arguments occurred on June 5, 2007).

As set forth in the Third Circuit's opinion, in 1998, Campbell Soup Company (Campbell) spun off its Specialty Foods Division (comprised of, among others, Vlasic, the famed pickles and Swanson TV dinners). Vlasic Foods International Inc. (VFI) was formed as a wholly-owned subsidiary of Campbell, which divvied to Campbell \$500 million in bank loan proceeds to essentially "purchase" the division from Campbell. Campbell then gave the stock in VFI to its shareholders as an in-kind dividend. *VFB*, 482 F.3d at 626-27. For the two years prior to the spin transaction, Campbell "massaged" the division's operating results, ostensibly misleading the public about its operating record and future prospects. This was accomplished through, among others, a number of techniques used to increase short-term sales and earnings. *Id.* at 627. As a result, Campbell's public SEC filings for fiscal years 1997 and 1998 were unreliable and misled the public securities markets as well as the banks providing the funds to VFI in the spin transaction. *Id.* at 627-28. Shortly following the spin, the division's inflated figures corrected themselves and the banks agreed to a new loan agreement with VFI (to avoid a default under the original loan agreement). *Id.* at 628.

Notwithstanding these publicly reported problems, the price of VFI's shares remained fairly steady for the period March 30, 1998 (the date the spin closed) through Jan. 1, 1999, and VFI's market cap did not drop below \$1.1 billion. *Id.* In January 2000, VFI realized that it had not properly accounted for certain discounts and accrued trade spending in fiscal year 1999, which drove down VFI's fiscal year 2000 earnings, triggered a default under the new (late 1998) loan agreement and resulted in a drop in the price of VFI's publicly-traded debt below par. VFI filed for bankruptcy one year later. *VFB, LLC*, a litigation vehicle in the VFI chapter 11 case, later sued Campbell claiming, among other things, that the spin transaction was constructively fraudulent as to VFI's creditors, in that VFI was insolvent at the time of the spin and reasonably equivalent value was not received in exchange for the \$500 million dividend. *Id.* at 628-629.

In the litigation, *VFB* claimed that the value of the division at the time of the spin was between \$270 million

and \$569 million, and presented three experts who used discounted cash flow analyses. The district court found for Campbell, finding, *inter alia*, that VFI's stock price remained high even after the financial manipulations were publicly disclosed, and that at the time of the spin and thereafter, following disclosure, there was an enterprise value (as measured by stock price) in excess of \$500 million.

The court of appeals affirmed, finding that market capitalization is "a classic example of . . . an anchored projection, as it reflects all the information that is publicly available about a company at the relevant time of valuation." *Id.* at 631.

Ramifications

Although both the *Iridium* and *VFB* courts found that the market price of the debtors' publicly traded securities at the time of the transfers were the best measure of value for the companies at the time of the transfers, both courts left the door open for ways to show that the market value was "not a trust worthy benchmark." For example, the *VFB* court stated that VFB failed to "engage the numbers in any detail, explaining by how much Campbell's various manipulation techniques affected its statistics, or by how much the statistical inflation affected VFI's market capitalization. Its approach is simply to note that Campbell played with its operations and suggest that the market capitalization numbers may have been wrong to some undetermined degree." *Id.* at 634. Similarly, the *Iridium* court stated that the committee "failed to show that there was a concealment of relevant circumstances at the time of the transfers or that there was a subsequent discovery of such circumstances that must be taken into account when determining Iridium's value," *Iridium*, 373 B.R. at 345-46, or "credibly explain away" the conflicting market data during the relevant period. *Id.* at 352.

As a result, although it appears that courts in the Third Circuit and the Southern District of New York are trending towards looking at market capitalization when determining solvency/adequacy of capital for publicly traded debtors, there is still room to argue that the market price is an inaccurate measure. Public markets can be infected by what Alan Greenspan once referred to as "irrational exuberance," and the recent sub-prime crisis has shown us once again that public markets can be wrong.

Reprinted with permission of the American Bankruptcy Institute.