Constructing a Bank Holding Company Insolvency Model: Part I

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Editor’s Note: This is Part I of a two-part series.

When a national bank is in financial distress, government regulators 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. If such measures heal the ailing bank, 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 bank’s wishes with respect to the treatment of such banks and their holding companies.

The latter scenario unfolded in connection with the failure of the Bank of New England Corporation (BNEC), a Boston-based bank holding company, that it soon became apparent that its prospects for survival were bleak at best. Despite BNEC’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 of BNEC and its sister banks were closed, their assets were placed in FDIC receiverships, and the downstreamed assets that would have been available to 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 bank holding company and its seizure of its subsidiary banks (BNEC banks). 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 particularly important in the current environment to trustees or debtors-in-possession of failed bank holding companies who have cause to pursue similar fraudulent transfer claims. 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

About the Authors

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Financial Statements

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 §§547 and 549, reformation of collective accounts and Rabbi Trusts, violation of §91 of the National Bank Act, and constructive trust and equitable lien.

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.

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 entity’s debt is greater than all of such entity’s property, at fair valuation.” In virtually all instances, “fair value” 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.

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 valuation, 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 period 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. 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.15

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.16 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.17 In such circumstances, when a transfer takes place as such 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.18

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8 See, e.g., In re Trans World Airlines, Inc., 134 F.3d 188, 194 (3d Cir. 1998) (“[o]bjective body of authority” provides that appropriate methodology is mark-to-market); In re 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.


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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.

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