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Distressed Mergers and Acquisitions

Second Ruling Cites Markets In Determining Solvency

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Recently, in *Statutory Committee of Unsecured Creditors v. Motorola, Inc., (In re Iridium Operating LLC)*,[1] Southern District of New York Bankruptcy Judge James M. Peck dismissed fraudulent conveyance and preference actions commenced against the former corporate parent of the bankrupt debtors based on the plaintiff's inability, in the face of the debtors' positive market capitalization at the time of the transfers, to demonstrate that the debtors were insolvent. The opinion comes roughly five months after the Third Circuit's decision in *VFB LLC v. Campbell Soup Co.*,[2] which also relied on market data to determine that a bankrupt debtor was solvent at the time of certain allegedly fraudulent transfers. The *VFB* decision clearly played a role in the *Iridium* Court's analysis. According to Judge Peck, *VFB* and its use of the public markets in valuing public companies was a "pertinent and influential precedent" and instructive in his thinking process. Though these remarks certainly underscore the importance of *VFB*, *Iridium* is itself significant, particularly for those likely to be hailed in front of the Bankruptcy Court for the Southern District of New York. Because *Iridium* will make it easier for a former corporate parent to fend off claims brought by, or on behalf of, a failed spun-off company or its creditors, the decision represents a favorable precedent for companies wishing to use spin-offs as a divestiture tool.

Background

The Iridium bankruptcies involved the spectacular failure of a global satellite telecommunications system that was designed to provide voice communication and paging services anywhere in the world. The idea for the satellite-based telephone system, which would later become known as Iridium, was originally conceived of and developed by Motorola engineers in the late 1980's. In roughly 1990, a special business unit was formed at Motorola to pursue the Iridium design and development, and in 1991 a separate Iridium entity was incorporated. In 1993, the ownership of Iridium was transferred from being wholly-owned by Motorola to a consortium of private investors.

However, Iridium and Motorola's relationship did not end there. The two entered into several agreements with each other related to the Iridium satellite system, pursuant to which, Motorola acted as a contractor for the development of certain space-related portions of the system. The agreements also required Motorola to develop and sell Iridium handsets and provide equipment systems by agreed deadlines. From these contracts, Motorola receive approximately $3.7 billion in transfers from Iridium during the four-year period preceding Iridium's bankruptcy.

After years of development, Iridium announced that it had commenced commercial voice and paging service in November 1998. The launch was a spectacular failure for a variety of reasons: the rapid advancement of competing cellular technologies, the expense and bulk of the Iridium headset, the company's decision to proceed with activation before the system was running perfectly, improper marketing, and poor quality and performance of the satellite telephone service. Approximately nine months after the launch, the Iridium entities filed for bankruptcy.

Based on the circumstances leading up to the bankruptcy petitions and the magnitude of the company's failure, the Statutory Committee of Unsecured Creditors for the Iridium debtors brought suit against Motorola alleging liability for fraudulent and preferential transfers. The trial was bifurcated, and the questions of insolvency and unreasonably small capital were heard first. Under the Bankruptcy Code and applicable law, to prevail on its preference and fraudulent transfer claims, the committee was required to demonstrate, among other elements, that the debtors were insolvent (or, alternatively, with respect to the fraudulent transfer claim that the debtors had unreasonably small capital) at the time of the alleged transfers.

However, the committee had a sizable, and ultimately insurmountable, obstacle to overcome: the public markets indicated that Iridium was solvent. For instance, during the relevant time period, Iridium's stock price reflected a positive enterprise value. In addition, Iridium was able to borrow money, access the public and private equity markets, access the public debt markets, and maintain favorable credit ratings. Iridium's stock prices, though declining sharply between the time of commercial activation and bankruptcy, reflected a positive enterprise value at all times prior to the petition date. Between 1997 and 1998, Iridium's stock price ranged from $17 to $70, implying an equity value between $2.3 and $10.0 billion. One day after commercial activation, Iridium's stock traded at $48.75, six months later it traded at $14.00, and on the petition date it traded at $3.06—an amount which still reflected a positive enterprise value.

Further, Iridium was able to borrow money from sophisticated lenders during the relevant time period. In December 1997 Iridium entered into a $1 billion credit facility with a syndicate of banks. A year later, Iridium entered into additional loans aggregating over $1.5 billion. In connection with the granting of such loans, numerous sophisticated parties performed due diligence and believed that Iridium had the capability to either repay or refinance the loans.

The company was also able to access funds from both public and private equity sources. From 1992 to 1996, Iridium engaged in a series of private placements with a consortium of private investors, raising almost $2 billion. Also, from 1997 to 1999, equity underwriters assessed Iridium and believed that it had a positive equity value. In 1997 and 1999, an Iridium entity

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successfully engaged in public equity offerings. The initial public offering was successful and oversubscribed, while the secondary offering (which closed after commercial activation and only months before the bankruptcy filings), resulted in proceeds of $242 million. Again, market players extended monies to the debtors after performing due diligence.

Iridium entities also tapped the public debt markets. In 1997 and 1998 Iridium engaged in three public debt offerings, which aggregated to almost $1.4 billion. From 1995 until early 1999, Iridium's bonds generally traded at or near par, indicating the market's belief that Iridium would be able to repay its debts. Finally, Iridium's credit rating was not downgraded until March of 1999—less than a year prior to the filings.

Together, the above represented strong evidence from the most sophisticated market players that Iridium was solvent at all relevant times. Nevertheless, the committee asserted that Iridium was insolvent. To support this assertion, the committee put forward two arguments: a commonsense argument and an argument based on expert testimony. The commonsense argument was essentially that the Iridium technology was flawed and that the business concept was doomed from the get-go. The Iridium system worked well in a field or on a mountain but not so well in an automobile (without a rooftop mounted antenna) or a building. The committee further argued that these limitations made the Iridium system simply undesirable for its intended market, that the business always lacked the potential for making enough money to pay off its debts, and that the company was therefore insolvent. Put differently, "the business concept effectively was bankrupt before the company itself was." In addition to this commonsense argument, the committee presented two solvency experts, who considered all of the standard valuation methodologies, but concluded that only the discounted cash flow methodology should be used to value Iridium. Based on this method, the experts concluded that Iridium was insolvent at the relevant times.

Insolvency

The committee had the burden of proof to show that Iridium was insolvent (or that it had unreasonably small capital) for the four-year period preceding the bankruptcy. The committee took the position that the burden had shifted to Motorola because Iridium was not paying its debts as they became due. Specifically, the committee argued that Iridium had failed to pay one of its outstanding debts and that Iridium was consensually deferring payment to Motorola. The court rejected the argument: a failure to pay one outstanding debt did not necessarily constitute not paying one's debts as they become due. Further, deferring payment to Motorola was not necessarily problematic: Although deferring payment to an insider can be evidence of a failure to pay debts as they become due, deferring payment to a non-insider was not the same. Here, simply no evidence was adduced at trial to indicate that Motorola was an insider. Accordingly, the committee's argument that the burden of proof shifted to Motorola failed.

Alternatively, the court reasoned that even if there was a presumption in favor of insolvency in the fraudulent transfer context, such presumption was rebutted by the evidence. Similarly, with respect to the preference action, the court found that the presumption of insolvency for the 90-day period preceding bankruptcy was rebutted. Thus, the burden of proving insolvency fell on the committee.

In the Second Circuit, courts take a "flexible approach" to the insolvency analysis. In general terms, a plaintiff must demonstrate that the sum of a debtor's debts exceeded a fair valuation of all of its assets. A fair valuation for a company conducting operations is the company's going-concern value, that is, the fair market value of the company's assets if sold within a reasonable amount of time to pay the company's debts. A related, but distinct, concept is capital adequacy. To determine capital adequacy, courts have looked to a variety of factors including the "company's debt to equity ratio, its historical capital cushion, and the needs for working capital."

Applying these tests, the court determined that the committee had failed to prove insolvency or inadequate capitalization. Although there is case law supporting the proposition that a significant business failure and gross insolvency on the petition date may indicate insolvency for a short time prior to the bankruptcy, such a business failure alone does not prove insolvency months and years prior to the company's demise. Moreover, the overwhelming market data indicated that Iridium was solvent during the relevant period. The committee simply failed to show that there was any concealment of relevant data from the markets or any subsequent discoveries that should have been taken into account. On the contrary, the record demonstrated that the market was fully aware of the Iridium technology's limitations and nonetheless considered Iridium wildly solvent. Given a fully-informed market, the court was unwilling to hold that the market was incorrect based on plaintiff's commonsense argument or on plaintiff's experts' testimony.

Conclusion

Iridium may be somewhat unique in its path to chapter 11 insofar as six years passed after its spin-off from Motorola and the commencement of its chapter 11 case. Motorola may have prolonged that period by deferring amounts that were owed to it. There can be little doubt that the passage of time materially increased the difficulty for the plaintiffs in establishing insolvency and enabled Motorola to point to a number of intervening transactions reaffirming Iridium's solvency. Yet, Iridium also points to other potentially precedential factors for spinoffs or divestitures which have ongoing contractual relationships or transitional arrangements with the seller or former parent. Judge Peck's decision relies on post-separation history between Motorola and Iridium that has arms length transactions, transparency and lengthy periodic public disclosure ostensibly verified by an independent financial institution. Judge Peck could find no evidence of "insider" transactions with Motorola. To the contrary he highlighted post-spin transactions indicating that Iridium had taken and, in fact, exercised substantial control over its business, certainly its finances, independent of Motorola at least as far as the officers and directors of Iridium taking responsibility for post spin securities issuances and ongoing reporting under the '34 Act. Equally significant, the ongoing relationship with Motorola as well as the business plan of Iridium were repeatedly disclosed in great detail in every public filing. There was transparency as to both the ongoing business relationships and agreements with Motorola as well as the intended business plan and related risks. That transparency was renewed each time Iridium went to the public debt markets. The market reaction to the detailed level of disclosure indicated solvency. Additionally that market reaction was confirmed by a later major bank financing that was completed significantly after the spin and fairly close to Iridium's bankruptcy. Again while these developments were the building blocks in finding that the plaintiffs had failed to establish insolvency or unreasonably small capital, the Iridium relationship with Motorola was viewed in the context of facts which established objectively verifiable indicia of independence, transparency and arms length transactions. Certainly, this decision will be important for its deference to market determined valuation, but the relevance of the transparency and independence should not be underestimated.

1. 373 B.R. 283 (Bankr. S.D.N.Y. 2007).
2. 482 F.3d 624 (3d Cir. 2007).

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