

Variations on a Theme.

FAIR MARKET VALUE AND REASONABLY EQUIVALENT VALUE. ARE THEY THE SAME?

Standards of Value, Premises of Value

The standard-of-value terminology applicable to valuations in bankruptcy may differ from the terminology in traditional valuation circumstances, and it is often the case that value is not clearly defined in the Bankruptcy Code or applicable state statutes. Moreover, the premise-of-value decision in certain bankruptcy matters is not straightforward and may require consideration of court precedent, characteristics specific to the subject company, and the circumstances related to and the intended use of the valuation.

In these cases, the choice of the applicable premise of value may have the single largest impact on valuation results, and therefore, the outcome of the matter. Addressed in further detail below are the different standards and premises of value that merit consideration in bankruptcy matters.

Traditional business enterprise and asset valuations are typically performed under one of three basic standards of value: (a) fair market value, (b) Investment value, or (3) fair value.

Standards of Value Often Encountered in Bankruptcy Matters	
Source: AICPA Consulting Services Practice Aid 02-1, Business Valuation in Bankruptcy (New York: AICPA, 2002), p. 5.02.	
Bankruptcy code and Case Law:	Fair Value (often interpreted as Fair Market Value in Case Law) Reasonably Equivalent Value Present Fair Salable Value
State Fraudulent Transfer Act:	Fair Valuation
State Fraudulent Conveyance Act:	Present Fair Salable Value

The premise of value used should reflect the facts and circumstances underlying each valuation engagement. In the bankruptcy context, valuations are performed under a going concern premise of value or a liquidation premise of value. Assets are typically valued under the going concern premise of value, unless a debtor was on its deathbed at the time or liquidation in bankruptcy was clearly imminent, in which case, a liquidation premise of value will be applicable. Under the liquidation premise of value, either an orderly disposition or forced liquidation premise is utilized.

Alternative Premises of Value

Source: Shannon P. Pratt, Robert F. Reilly, Robert P. Schweths, "Valuing a Business, The Analysis and Appraisal of Closely Held Companies," Fourth Edition, McGraw-Hill, 2000, pp. 33 and 34.

Going Concern:	Value in continued use, as a mass assemblage of income producing assets, and as a going concern business enterprise.
State Fraudulent Transfer Act:	Value-in-exchange, on a piecemeal basis (not part of a mass assemblage of assets), as part of an orderly disposition; this premise contemplates that all of the assets of the business enterprise will be sold individually and that they will enjoy normal exposure to their appropriate secondary market.
State Fraudulent Conveyance Act:	Value-in-exchange, on a piecemeal basis, (not part of a mass assemblage of assets), as part of a forced liquidation; this premise contemplates that the assets of the business enterprise will be sold individually, and that they will experience less than normal exposure to their appropriate secondary market.

In order for a reasonably equivalent value to apply, the elements of Fraudulent Conveyance, Section 548, must be met.

FRAUDULENT CONVEYANCE - SECTION 548

Source: Finkel Law Firm LLC

Section 548(a)(1) provides that:

The Trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition , if the debtor voluntarily or involuntarily:

(A) made such transfer or incurred such obligation with actual intent to hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or

(B)(i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and (ii)(I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was unreasonably small capital; or (III) intended to incur, or

believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

Per 11 U.S.C. §548(a)(1), the plaintiff must prove a (1) transfer, (2) of an interest of the debtor in property or any obligation incurred by the debtor, (3) made or incurred within one year of the filing of the petition, that was (4) either voluntary or involuntary. After the plaintiff proves these elements, there are two different ways to set aside the transfer. The plaintiff may demonstrate (5) the transfer was made with the actual intent to hinder, delay, or defraud a creditor, or (6) the debtor received less than (6.1) reasonably equivalent value at a time when (6.2) the debtor was insolvent or made insolvent by the transfer, or (6.3) the debtor would become insolvent because of a business or transaction to be engaged in or the debtor intended to incur or would incur debts beyond its ability to pay.

REASONABLY EQUIVALENT VALUE AND FAIR CONSIDERATION

Source: International Law Office

Per Section 548 of the code, a guarantor must receive reasonably equivalent value in exchange for a transfer or obligation to a creditor. In cases where a creditor receives less than a reasonably equivalent value, a trustee in bankruptcy or debtor in possession may set aside the transfer as fraudulent if the debtor "was insolvent...or became insolvent as a result of such transfer or obligation." Under Section 544(b) of the code, a trustee may also attack transfers under state law using a reasonably equivalent value standard in states governed by the Uniform Fraudulent Transfer Act and a fair consideration standard in Uniform Fraudulent Conveyance Act states such as New York.

Under the Uniform Fraudulent Transfer Act, the determination as to whether reasonably equivalent value has been received is a two-step inquiry into (i) whether value was received by the transferor, and (ii) whether the value was reasonably equivalent to the value transferred by the transferor. "Value is given for a transfer...if, in exchange for the transfer...property is transferred or an antecedent debt is secured or satisfied." After the court determines whether value was given to the transferor, it must then determine whether the value was reasonably equivalent to the value transferred, taking into account the totality of the circumstances surrounding the transfer.

Similar to the Uniform Fraudulent Transfer Act, the Uniform Fraudulent Conveyance Act also allows for the voiding of constructive fraudulent conveyances, but the standard used by the Uniform Fraudulent Conveyance Act is that of fair consideration. Under the Uniform Fraudulent Conveyance Act, 'fair consideration' exists when:

"such property...is received in good faith to secure a present advance or antecedent debt in amount not disproportionately small as compared with the value of the property, or obligation obtained."

Thus, the Uniform Fraudulent Conveyance Act requires a finding that the transferee acted in good faith (with no constructive or actual knowledge of any fraudulent intent or scheme).

'Reasonably equivalent value' and 'fair consideration' are considered to have essentially the same meaning, and both are ambiguous terms that are not defined by the code or the correlating state statutes. Rather, "Congress left to the courts the obligation of making the scope and meaning of" these terms. In defining this scope, courts have kept one eye on the purpose of fraudulent transfer law: the preservation of the debtor's estate for the benefit of its unsecured creditors. "Consequently, what constitutes 'reasonably equivalent value' must be determined from the standpoint of the debtor's creditors." Further, the courts will only consider the portion of the value either directly or indirectly received by the transferee.

Historically, courts have never required "mathematical precision" or a "penny-for-penny" exchange in order to find reasonably equivalent value. "Something less than the actual market value of the asset should be acceptable so long as the values exchanged do not shock the conscience." However, courts generally keep the equitable purposes behind fraudulent transfer law in mind, recognizing that any significant disparity between the value received and the value surrendered will significantly harm innocent creditors.

Rather than apply a dogmatic standard of law, courts treat reasonably equivalent value as a question of fact. Both federal and state courts determine whether a value is reasonably equivalent or fair on a case-by-case basis. To make this factual determination, courts consider the totality of circumstances of a transfer, emphasizing fair market value as a starting point for such review.

Even though fair market value is an extremely important factor to be used in courts' analyses, the concept of 'reasonable equivalence' is not wholly synonymous with 'fair market value.' Other important elements include:

- whether the transaction was conducted at arm's length;
- the difference between the amount paid and the fair market value;
- the percentage of the fair market value paid;
- good faith by the parties;
- what property or rights were transferred to the debtor;
- whether the debtor received additional valuable benefits as a result of the transaction; and
- whether the debtor was rendered "execution proof."

WHAT REASONABLE EQUIVALENCE SHOULD BE

Source: Irina Fox - U. S. Federal Courts

Although Congress defined "value" in §548, it failed to provide guidance on how to measure its reasonable equivalence. Perhaps, one reason why no definition was provided by Congress is that the inquiry is inevitably fact specific. It is impossible to devise a precise formula that will uniformly establish what is and what is not reasonably equivalent, and fair market value, although helpful, is not always the benchmark.¹

One measure of a commercial transaction's legitimacy is whether the debtor received reasonably equivalent value in this transaction.² In short, the avoidability of a transaction under §548 turns on how courts apply the concept of "reasonably equivalent value" to the facts present in a

specific case.³ The Chandler Act originally used the term "fair consideration," but the Bankruptcy Code replaced it with "reasonably equivalent value."⁴ It is clear that under the present-day version of §548, good faith and absence of collusion will not automatically shield the transaction from avoidance. However, both good faith and collusion may be considered in establishing reasonable equivalence.

Although the present version of the Bankruptcy Code does not define the concept of reasonably equivalent value in its entirety, §548 does contain a definition of "value." For purposes of fraudulent transfer avoidance, value is defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor."⁵ In today's complex commercial transactions the real issue becomes whether some non-quantifiable indirect economic benefit to the debtor can constitute "property" within the meaning of §548.

Analytical Framework

In establishing whether the debtor received reasonably equivalent value in exchange for the transfer sought to be avoided under §548, the court should first inquire whether the debtor received any value at all. Once it is determined that the debtor did receive some value, the next question becomes whether the value was indeed reasonably equivalent. Thus, the proposed framework incorporates two distinct steps for the analysis. At all states of the analysis, the burden of proof should be on the proponent of avoidance.⁶

Did the Debtor Receive Any Value?

Where the debtor receives some tangible property in exchange for transferring his interest, the answer to this question may be apparent. However, in many circumstance, the situation is not as clear cut.

Value from the Point of View of the Creditors

The analysis of value must be conducted from the standpoint of the creditors. The purpose of the laws on avoidance of fraudulent conveyances is estate preservation. Such laws aim to prevent the debtor from funneling away funds on the eve of bankruptcy which may prejudice the then existing creditors. "The proper focus is on the net effect of the transfers on the debtor's estate, [and] the funds available to the unsecured creditors."⁷

Value at the Time of the Transfer

In addition to the fact that the inquiry regarding value must be made from the standpoint of the creditors, another important preliminary observation is that upon evaluating whether a transfer is avoidable under §548 courts must look at the value received by the debtor at the time the transfer was made. When dealing with a financially incapacitated entity, it is tempting to use hindsight, i.e., the value is determined by the operations of the buyers. However, even an investment that ultimately failed to result in a net gain to the debtor may have been otherwise beneficial to the debtor at the time of the transfer. It would be unduly restrictive to require that each transaction the debtor enters prove to be successful.⁸ Thus, the critical time is when the transfer is made.

Neither subsequent depreciation in nor appreciation in value of the consideration affects the value question whether reasonable equivalent value was given."⁹

Value as Direct and Indirect Benefits

Value is generally not an issue when the debtor exchanges his tangible property for another piece of tangible property or cash.¹⁰ In such cases, value is fairly easily ascertainable and does not cause a lot of debate.¹¹ However, in other situations where the debtor receives intangible property or an indirect benefit in exchange for a transfer of its interest in property, the inquiry as to whether any value at all was conferred on the debtor becomes more complex.¹² The analysis of value may be exacerbated by the fact that the transferee gives value not to the debtor, but to a third party.¹³ Courts have noted that where the debtor's value as a going concern increased as a result of the transaction, it is possible to conclude that a debtor received a direct, tangible economic benefit.¹⁴ However, no such direct, intangible economic benefit need be received by the debtor in order for the court to find that some value was received.¹⁵ Even indirect benefits to the debtor-transferor may constitute reasonably equivalent value if direct benefits accrue to "the transferor's solvent subsidiary, the transferor's alter ego, or an entity with which the transferor shares 'community of interests.'

The bankruptcy court in *R.M.L.* applied the "totality of the circumstances" test, considering factors such as the transferor's good faith, the price paid relative to the fair market value, and the arm's length nature of the transaction, to assess whether the debtor had received reasonably equivalent value.¹⁶ The bankruptcy court explained that reasonably equivalent value is not necessarily an even dollar-for-dollar exchange; rather, the fair value of services, although difficult to quantify, could also constitute reasonably equivalent value.¹⁷

Courts generally recognize the breadth of the term value as it is used in §548 and apply it very liberally as long as there is some benefit to the debtor when viewed from the standpoint of the creditors. As demonstrated by the jurisprudence, a benefit to a third party is not in and of itself sufficient unless the debtor receives some advantage indirectly as well.

Was the Value Received Reasonably Equivalent?

Addressing the concept of reasonable equivalency is one of the most problematic aspects one confronts when applying the law of fraudulent conveyances. "Reasonably equivalent value" means that "the debtor has received value that is substantially comparable to the worth of the transferred property."¹⁸ This definition supplied by the United States Supreme Court unfortunately does not explicate how courts should apply it. Even in situations where a debtor trades his interest in property for cash or other tangible property, the uncertainty involved in *post facto* valuation complicates the task. Fair market value of the exchanged property may not always be the standard for the application of §548 reasonably equivalent value.

CONCLUSION

There is no concrete formula for 'reasonably equivalent value' or 'fair consideration' under federal and state fraudulent conveyance law. Rather, courts remain flexible and determine

*whether a value is reasonably equivalent or fair on a case-by-case basis. Courts consider the totality of the circumstances of a transfer, including the difference between the amount paid and the fair market value, whether the transaction was conducted at arm's length, whether the parties demonstrated good faith and what valuable benefits the parties received.*¹⁹

Although courts do have significant room in applying the concept, they must be guarded in the process by the need for a delicate balance between the fair treatment of creditors and the protection of legitimate business transactions.

The framework in this article can assist practitioners with consistent application of the reasonably equivalent value element of avoidance actions. In summary, the framework consists of two steps. During the first step, the court must determine whether the debtor received any value at all at the time of the transaction.²⁰ This inquiry is performed from the standpoint of the creditors keeping in mind the goal behind avoidance powers and estate preservation.²¹ Notably, "value" for purposes of §548(a)(1)(B) may be represented not only by tangible property, payment on account of antecedent debt and direct benefits to the debtor, but also by some non-quantifiable indirect economic benefits received by the debtor in the transaction.²² If the court concludes that the debtor did obtain some benefit in the transfer, the court should move to the second step, or determining whether any such benefit constituted reasonably equivalent value.²³ Where the exchange was for some tangible property, traditional methods of valuation may be of assistance. However, where the value was some indirect economic benefit, the court must look at the totality of the circumstances to determine the fairness of the transactions.²⁴ Most importantly, throughout the stages of the analysis, the court should resist the temptation of using hindsight.

Hindsight in reviewing potentially fraudulent conveyances would sweep up a significant number of legitimate business transactions, making them avoidable.²⁵ In the absence of fraud, courts should not second-guess the debtor's legitimate decisions. The goal of avoidance powers is to combat fraud, whether actual or constructive. Excessive resort to avoidance powers may switch their focus from being anti-fraud provisions to serving as insurance against financial failure. With the concept of reasonably equivalent value being so flexible, courts have the necessary tools to achieve the desired balance between fraud prevention and preserving commercial transactions.

1 BFP v. Resolution Trust Corp., 511 U. S. 531, 548 (1994). *See generally* Norton, *supra* note 9, at §67:2 (discussing the concept of "reasonably equivalent value").
2 9C AM.JUR.2D *Bankruptcy* §2233 (2011).
3 *Id.*
4 Reilly, *supra* note 16, at 266. "Section 548 is derived from in large part from section 67(d) of the Bankruptcy Act of 1898. Section 67(d) was codified at section 107(d) of old Title 11, prior to the enactment of the Bankruptcy Code." Lara R. Sheikh, *Sections 548 and 550 - Developments in the Law of Fraudulent Transfers and Recoveries*, 2010 ANN. SURV. OF BANKR.LAW 8 (2010).
5 11 U.S.C. §548(d)(2)(A) (2011).

6 The burden was assigned to the party advocating avoidance even under the precursor
of §548--§67(d)(6) of the Act, 11 U.S.C. §107(d)(6). *See* Rubin v. Manufacturers
Hanover Trust Co. 661 F.2d 979, 989 (2d Cir. 1981) (noting the burden is not on the
trustee to show all elements of avoidance have been met).

7 Stanley v. U. S. Bank Nat'l Assn. (*In re* TransTexas Gas Corp.), 597 F.3d 298, 306
(5th Cir. 2010) (citing *In re* Hinsley, 201 F.3d 638, 644 (5th Cir. 2000)).

8 Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (*In re*
R.M.L., Inc.), 92 F.3d 139, 151 (3d Cir. 1996).

9 COLLIER ON BANKRUPTCY, §548.09, P. 116 (15TH ED. 1984).

10 Norton, *supra* note 9, at §67:2.

11 *Id.*

12 *See generally id.* (discussing the concept of "value").

13 *Id.* at §67:4.

14 Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (*In re*
R.M.L., Inc.), 92F.3d 139, 151 (3d Cir. 1996) (citing Mellon Bank, N.A. v. Metro
Comm'n, Inc., 945 F.2d 635, 647 (3d Cir. 1991)).

15 *Id.*

16 *Id.* at 145.

17 *Id.*

18 BFP v. Resolution Trust Corp., 511 U.S. 531, 548 (1994).

19 www.internationallawoffice.com

20 *See supra* discussion accompanying notes 128-235.

21 *See e.g.*, R.M.L. at 150 (noting that "the question whether the debtor *received*
reasonable value must be determined from the standpoint of the creditors").

22 *See e.g.*, *In re TOUSA, Inc.*, 444 B.R. 613 and discussion accompanying notes 35-127.

23 *See supra* discussion accompanying notes 236-302.

24 *In re R.M.L., Inc.*, 92 F.3d at 145.

25 Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, the
Problem of Hindsight Bias, and the Credit Default Swap Solution*, 2011 COLUM.
BUS. L. REV. 118 (2011) (discussing "recent legal and financial innovations that may
aid bankruptcy courts in assessing fraudulent transfer claims in large business
bankruptcies" without the bias of hindsight).

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