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indicated that OGI would not have to order any units and would still be in compliance with the terms of the letter.

***The April 13 Letter Was Not A Valid Requirements Contract***

In conclusion, the Court found that although Konica's agent bound Konica to the terms of the April 13 letter through her apparent authority, nonetheless, the letter was not an enforceable requirements contract because it did not indicate how a

quantity term could be derived and further the letter did not evidence an exclusive requirements contract which would render the quantity term unnecessary.

**CLR**

## Third Circuit Finds TWA Insolvent

by Andrew Geier

In *In re Trans World Airlines, Inc. Nos. 97-7037, 97-7082, 1998 WL 15848 (3rd Cir. Jan. 20, 1998)*, the Third Circuit affirmed a bankruptcy court's finding that Trans World Airlines ("TWA") was insolvent under the formula prescribed by 11 U.S.C. § 101(32)(A) because the face value of its liabilities exceeded the fair market value of its assets. The Third Circuit ruled that, because TWA was insolvent on the date it deposited \$13.7 million with the clerk of the district court, the deposit constituted a transfer which was a voidable preference under 11 U.S.C. § 547(b) and was therefore unreachable by TWA's creditors.

***TWA Filed for Chapter 11 Bankruptcy***

In October, 1991, the United States District Court for the Southern District of New York awarded Travellers International A.G. ("Travellers") \$12.3 million for damages it incurred as a result of

TWA's breach of contract. *See Travellers Int'l A.G. v. Robinson*, 982 F.2d 96, 97 (3d Cir. 1992). The following November, TWA deposited \$13.7 million (which represented a recalculation of the judgment amount plus an eleven percent interest factor) with the clerk of the district court to obtain a stay of enforcement of the judgment. *See In re Trans World Airlines*, 180 B.R. 389, 392 (Bankr. D.Del. 1994).

In January, 1992, TWA filed a timely petition for reorganization under Chapter 11. TWA then attempted to prevent Travellers from making a claim to the deposit to satisfy its judgment by filing a complaint against Travellers in bankruptcy court. TWA sought a declaration that the \$13.7 million deposit was a voidable preferential transfer under 11 U.S.C. § 547(b) and could not be reached by Travellers in satisfaction of its judgment. *See Robinson*, 982 F.2d at 97. This section, commonly known as the "preference statute", provides in relevant part that:

"[a] trustee may avoid any

transfer of an interest of the debtor in property — (1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before the transfer was made; (3) made while the debtor was insolvent; (4) made within 90 days before the date of the filing of the petition; (5) that enables such creditor to receive more than such creditor would receive if — (A) the case were a case under Chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title."

***Travellers Makes a Claim to TWA's Deposit***

Travellers contended that TWA's deposit did not fall within the preference statute because not all elements of the statute were satisfied. Specifically, Travellers argued

that TWA had not met the third element because it was solvent on the date of the deposit. In determining TWA's solvency position, Travellers applied the formula of § 101(32)(A) which provides that a corporation is insolvent when "the sum of [its] debts is greater than all of [its] property, at a fair valuation."

In determining a "fair valuation" of TWA's operating assets, Travellers used market-value figures as the basis for its calculations. Travellers argued that a fair valuation of these assets required the use of market values, assuming a sale of these assets absent any time constraints. Therefore, Travellers' valuation reflected an assumption that TWA would obtain the best available price since it would have an indefinite period of time in which to sell. Travellers added the resulting value to TWA's other assets and valued TWA's total assets at over five billion dollars.

Travellers again applied the "fair valuation" language of § 101(32)(A) in calculating TWA's liabilities. Interpreting the phrase "fair valuation" to apply to both assets and liabilities, Travellers assigned TWA's publicly traded debt its current market value instead of its face value. The value of TWA's publicly traded debt was affected by the threat of TWA's insolvency, so the market value of the debt was much lower than its face value. When Travellers added the market value of this debt to TWA's other liabilities, it arrived at a figure of about three and a half billion dollars. Since Travellers valuation reflected that TWA's assets exceeded its liabilities, Travellers contended that TWA was solvent on the day of the deposit and

therefore the transfer was not void under the preference statute. Accordingly, Travellers asserted that it had the right to reach TWA's deposit in satisfaction of its judgment.

TWA, on the other hand, argued that it was insolvent on the date of the transfer. It contended that a "fair valuation" of its operating assets was achieved by a hypothetical sale of the assets within a reasonable time. TWA asserted that a "reasonable time" constituted anywhere from 12 to 18 months. TWA reasoned that this time frame reflected a reasonable estimate of the value of its assets based on what could be realized from the assets by converting them into cash. Applying this method, TWA valued its assets at about two and a half billion dollars.

Contrary to Travellers' assertion, TWA argued that the "fair valuation" language of § 101(32)(A) only applied to assets, not liabilities. Accordingly, it used the face value of its publicly traded debt, which was higher than its market value, as the starting point for its liability valuation. In addition to its other liabilities, TWA also considered "contingent liabilities" in its calculations. These contingent liabilities represented additional costs that TWA would incur if it ceased operations in the near future. In total, TWA valued its liabilities at between five and five and a half billion dollars. Since TWA's calculations reflected that its liabilities exceeded its assets, it argued that the bankruptcy court should find that it was insolvent, that its \$13.7 million deposit was a voidable preference, and therefore that Travellers could

not reach the deposit in satisfaction of its judgment.

### ***Bankruptcy Court Finds TWA Insolvent***

In examining whether TWA's transfer was a voidable preference, the bankruptcy court relied primarily on the insolvency element of the preference statute to make its determination. In doing so, it used the insolvency formula of 11 U.S.C. § 101(32)(A). The bankruptcy court agreed with TWA's assertion that the "fair valuation" language of § 101(32)(A) permitted a valuation of TWA's operating assets based on their hypothetical sale within a reasonable time. It further agreed that 12 to 18 months was a "reasonable time." The court went on to reject Travellers argument, that TWA's operating assets should be valued without consideration of a time period for their sale, as "unrealistic."

On the issue of TWA's liabilities, the bankruptcy court again agreed with TWA's calculations. It concluded that the "fair valuation" language of § 101(32)(A) did not apply to TWA's publicly traded debt and therefore its liabilities should include the face value, not the market value, of the debt. The bankruptcy court also accepted TWA's other liability figures, including contingent liabilities, on the premise that it expected TWA to go out of business in the near future. The bankruptcy court determined that TWA was insolvent under § 101(32)(A) and therefore found that TWA's deposit of \$13.7 million was void as a preferential transfer under the preference statute. The bank-

ruptcy court ruled that the deposit could not be used by Travellers to satisfy its judgment against TWA.

### ***Travellers Appeals the Bankruptcy Court's Ruling***

The United States District Court for the District of Delaware heard Travellers appeal of the bankruptcy court's decision. The district court agreed with TWA's valuation of its operating assets, but disagreed with TWA's valuation of its public debt. It rejected TWA's argument that the "fair valuation" language of § 101(32)(A) did not apply to liabilities, holding that both assets and liabilities were subject to the fair valuation requirement. Consequently, the district court found that the bankruptcy court erred in allowing TWA to value its public debt at face value when calculating its liabilities. The district court reversed that part of the bankruptcy court's decision and remanded the case with instructions to recalculate TWA's liabilities.

### ***Third Circuit Reviews Lower Courts' Findings on the Basis of a "Going Concern"***

Both Travellers and TWA appealed the district court's decision. The Third Circuit, like the lower courts, focused on the question of TWA's solvency on the day of the \$13.7 million deposit with the clerk of the district court. The court also relied on the language of § 101(32)(A) in measuring TWA's assets against its liabilities. In doing so, the court determined that TWA should be viewed in the context of a

going concern because its "liquidation in bankruptcy was not clearly imminent on the date of the challenged transfer." Since this conclusion affected the analysis of TWA's solvency position, the court re-examined the valuation of TWA's assets and liabilities in the context of a "going concern."

The Court first analyzed TWA's valuation of its assets. The court opined that a time frame was necessary for a fair valuation of a company's assets stating that "[l]ogic and common sense inform us that the amount that can be realized from the sale of an asset varies as a function of the time period over which the asset must be sold." Having established that a fair valuation of assets required a reasonable time frame, the Third Circuit turned to the question of what constitutes a "reasonable time."

The Third Circuit rejected Travellers' contention that a reasonable time was any amount of time required for a company to sell its assets at the highest possible price. It stated that "the overwhelming body of authority" supported TWA's position "that a fair valuation of assets contemplates a conversion of assets into cash during a reasonable period of time." It held that "reasonable time" should be defined in relation to the financial interests of a debtor company's creditors. Essentially, from the perspective of the creditor, a "reasonable time" would constitute a balance of the time it would take to sell off the debtor's assets so that the assets are not undervalued and soon enough so that the creditor achieves adequate satisfaction of his claim when considering the time value of money

and his business needs. The court believed that this approach to defining a reasonable time represented the creditors' "desire to maximize the dollar figure from the assets to be sold and the desire to have the assets sold off quickly to satisfy creditor's claims sooner rather than later." The court accepted TWA's 12 to 18 month definition of "reasonable time" stating that it "reflects the period in which a diligent administrator, concerned with the interests of TWA's creditors, could inventory, prepare, and sell TWA's considerable assets in a reasonable fashion."

The Third Circuit next analyzed the valuation of TWA's liabilities. In doing so it considered three specific issues: (1) the proper valuation of TWA's public debts; (2) whether TWA should be allowed to include liquidation costs in its liabilities; and (3) Travellers' argument that TWA's liabilities should be reduced by one billion dollars because of its agreements with its creditors to reduce its public debt prior to TWA's deposit with the clerk of the district court.

The court approached the first question as a matter of statutory interpretation. TWA maintained that the phrase "fair valuation" in § 101(32)(A) modified only the word "property", not "debts." It argued, therefore, that its debt should be measured at face value. In support this position, TWA pointed to an earlier draft of § 101(32)(A) which, it contended, made clear that "fair valuation" was only meant to apply to property. It argued further that § 101(32)(B), which governs insolvency of partnerships, clearly states that the fair valuation requirement

applies only to property, and that the legislature did not mean for partnerships and corporations to be treated differently. *See* 11 U.S.C. § 101(32)(B) (“ ‘insolvent’ means... that the sum of such partnership’s debts is greater than the aggregate of, at fair valuation... all of such partnership’s property...”).

The Third Circuit ruled that TWA’s debts should be given their face value in light of its finding that TWA was a going concern. Because the court viewed TWA as a going concern, it found that TWA’s debt should not be assigned the lower market value which resulted from the threat of its insolvency. The court reasoned that “ ‘fair valuation’ does not mean fair market valuation.” Instead, it stated that a fair measurement of TWA’s public debt, on a going concern basis, is the face value of that debt.

Next, the court considered the question of whether costs relating to the cessation of TWA’s operations should be included in its “contingent liabilities.” Having already determined that TWA was a going concern, the court disagreed with

the bankruptcy court’s decision to allow TWA to include liabilities associated with liquidation in its contingent liabilities. The court stated that contingent liabilities should be limited to “costs arising from foreseeable events that might occur while the debtor remained a going concern.” A going concern continues to conduct its ordinary business activities, so, according to the court, inclusion of liquidation costs as a contingent liability would be “the antithesis of a going concern valuation.” Therefore, it concluded that the bankruptcy court erred in permitting TWA to include these costs in its liabilities.

Last, the court examined Travellers’ argument that TWA had reached an agreement with its creditors to reduce its public debt by one billion dollars. Travellers claimed that TWA had reached such an agreement before it deposited the \$13.7 million and consequently its total liabilities should be reduced by one billion dollars. The court, however, quickly rejected this argument and agreed with the bankruptcy court’s finding that no

such agreement existed on that date. It stated that, although negotiations had begun, no such agreement had been finalized by the date of the deposit. Accordingly, the court accordingly held that the bankruptcy court did not err on this issue.

### **Conclusion**

Since the Third Circuit found that all of the bankruptcy court’s calculations were correct, except with regard to TWA’s contingent liabilities, it reduced the amount of liabilities by the amount incorrectly included by the bankruptcy court. However, despite this reduction in liabilities, TWA’s total liabilities still exceeded its total assets so the court held that TWA was insolvent on the date of the transfer. Accordingly, it ruled that the \$13.7 million deposit was a void preferential transfer under the preference statute and was unavailable for satisfaction of Travellers’ claim against TWA.

**CLR**