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Bankruptcy Court Relies on Market Approach to Determine Prepetition Solvency

In a closely watched case against Motorola, Inc. arising out of the *Iridium* chapter 11 case, Judge James M. Peck of the Bankruptcy Court for the Southern District of New York has adopted a market approach to determining prepetition solvency, finding "insufficient cause to set aside the verdict of solvency and capital adequacy already given to Iridium by the public markets." In his 111-page opinion[1] Judge Peck agreed with the Third Circuit's approach in *VFB LLC v. Campbell Soup Co.*[2] which, in Judge Peck's words, "validates the use of market data for purposes of valuing a public company for fraudulent conveyance purposes and makes clear that the public markets constitute a better guide to fair value than the opinion of hired litigation experts whose valuation work is performed after the fact and from an advocate's point of view." After considering the testimony of 52 witnesses, including 7 experts, and admitting into evidence 866 exhibits during a 50-day trial, Judge Peck found that the plaintiff creditors committee had not sustained its burden of proving that Iridium was insolvent or had unreasonably small capital during the 4-year prepetition period at issue.

Motorola had developed and deployed for Iridium a global telecommunications network which utilized 66 low earth orbit satellites and related gateways. The system was designed to work anywhere in the world provided that the antenna on the subscriber's portable telephone handset was positioned to make contact with one of Iridium's satellites. Although launched with much fanfare in 1998, the Iridium system was a spectacular failure and landed in bankruptcy approximately 9 months later. Ultimately, Iridium's assets were sold for a small fraction of their cost, although the Court noted that "oddly missing from the voluminous record is any credible proof as to what actually caused Iridium to fail." The Official Creditors Committee was authorized to pursue claims against Motorola and did so alleging, among other things, that $3.7 billion of payments made to Motorola under prepetition agreements were received at a time when Iridium was insolvent or had unreasonably small capital and thus were recoverable as fraudulent conveyances.

Motorola spun Iridium off in a private placement in 1993. Further private placements followed in 1994 and 1996. The Court found that the related offering documents contained "reasonable and accurate" descriptions of Iridium's projected performance, including the limitations of satellite voice service. Indeed, the Court devoted considerable attention to detailing

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1 *Statutory Committee of Unsecured Creditors v. Motorola, Inc. (In re Iridium Operating LLC)*, Adv. Pro. No. 01-02952 (JMP), Case No. 99-45005 (JMP)(Bankr. S.D.N.Y., Aug. 31, 2007).

2 482 F.3d 624 (3d Cir. 2007).

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the information concerning the Iridium system and its prospects known to or developed by, among others, Iridium internally, including its Technical Advisory Committee and Board of Directors, outside market research experts, consultants retained to develop financial models for Iridium's various business plans, the arrangers for Iridium's various bank loans between 1996 and 1998 and their advisors, purchasers of Iridium's convertible preferred stock and other securities in 1996, and the placement agent for Iridium's 1992 and 1994 private equity offerings. Given the extensive information available to them, the Court concluded that the substantial private equity contributions by such investors from 1992 to 1996 supported a finding of Iridium's solvency during that period.

Further valuations of the business by Iridium and others were performed between 1997 and 1999 which showed that it had a large positive equity value. Although the court did not accept such valuations as true, Judge Peck held that they tended to rebut arguments of insolvency.

More significantly, Iridium conducted two highly successful public equity offerings and three public debt offerings between 1997 and 1999. Throughout 1997 and 1998 Iridium's stock prices ranged from \$17 to more than \$70 per share, implying an equity valuation of between \$2.3 and \$10 billion. Stock analysts confirmed that Iridium's stock price was evidence of the company's value in contemporaneously prepared reports. In addition, Iridium's bonds generally traded at or near par during the same period; indeed Iridium's bond and bank debt were not downgraded by Moody's and Standard and Poor's until 5 months prior to the bankruptcy. In light of these facts Judge Peck characterized the plaintiff's case as asking "the Court to disregard historical market data as manifestly unreliable and accept the conclusions of expert witnesses who performed a discounted cash flow analysis using adjusted cash flow projections prepared in contemplation of litigation." Elsewhere Judge Peck observed that the "Committee's insolvency case is grounded in the 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."

In rejecting the Committee's case on insolvency and unreasonably small capital, Judge Peck ruled that the "market evidence is simply too voluminous and compelling" to be ignored and that "contemporaneous market data for Iridium's publicly traded securities are both consistent with substantial enterprise value and inconsistent with insolvency." To prevail, the Court ruled, the Committee would need to demonstrate "why all of the market participants were so terribly mistaken in assessing Iridium's value." The Court observed that it could not make the "logical leap that Iridium's failure leads to the conclusion that the [company's] projections must have been unreasonable when they were prepared" even though they "were not even close to being an accurate forecast of future performance." In the end, the Committee could not demonstrate any reason for not treating public market data as the "best indicator of value, notwithstanding that the market was plainly wrong as an indicator of future value and badly misjudged the likelihood of Iridium's success." Finally, Judge Peck held that the Court would need a "substantial reason" supported by persuasive evidence to depart from values placed on securities in an efficient public trading market. "The failure of the Committee's experts to reconcile their conclusions with the prevailing market judgment or to cast serious doubt on the reliability of that market judgment provides sufficient reason . . .to seriously question the reliability of their opinions." In a phrase that is likely to be repeated often by defendants in similar situations, Judge Peck observed that "[t]he failure of a business, even a monumental failure, does not alone prove the insolvency of the business in the months and years prior to its demise."

Thus, Judge Peck has joined the Third Circuit in raising the bar that plaintiffs must clear in proving insolvency when market data indicate otherwise, even where the ultimate business failure is “monumental.” The intriguing issue remains whether the “market” approach will find judicial support where the debtor’s securities have been privately placed and traded.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any of the following:

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