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Clearing a Path to Retirement Planning

Meet Sam, an Orange County business owner, who was just named as a defendant in a lawsuit. Although Sam is now 50 years old and has spent the last few years thinking about his future retirement and his desire to establish a Private Retirement Trust, Sam, like many people, just never got around to formalizing a retirement plan. And now, with litigation pending, Sam wants to move fast to establish a Private Retirement Trust in order to take advantage of the exemption protection of the Cal. C.C.P. § 704.115(b). Can he? Or does the pending lawsuit preclude him from retirement planning? What is the most responsible approach to clearing a path for Sam to be able to create a retirement plan?

A significant part of the process in determining whether a client is a proper candidate for a Private Retirement Trust ("PRT") is to verify that the client is solvent and financially (as well as legally) able to fund the PRT. If a client is not solvent and the exemption protection of the PRT is challenged, any assets transferred to the PRT could be voidable pursuant to the Uniform Voidable Transactions Act ("UVTA"). For purposes of UVTA, "[a] debtor is insolvent if, at a fair valuation, the sum of the debtor's debts is greater than the sum of the debtor's assets."[1] Thus, it is important to make certain that a client's glass is fuller than not before pouring funds into a PRT. If the client's glass is near empty, the funds transferred to the PRT may not benefit from the exemption protection of Cal. C.C.P. § 704.115(b), and such transfers will be subject to attack under UVTA and costly to defend against.

Accordingly, the most responsible approach to clearing a path for Sam to initiate a retirement plan and to protect him from unnecessary complications, is to perform an extensive due diligence analysis of the client's balance sheet. For some clients, it is an easy task to determine whether the sum of their assets is greater than the sum of their debts. However, for clients who face potential personal liability that may result from pending or threatened litigation, claims, or possible future liability for guarantor agreements that have not been called upon, determining solvency is not so cut and dry. For example, assume Sam has assets worth $2 million, liabilities of $1 million, and the damages sought in the lawsuit against him is $1 million. Is Sam's glass considered half full since it contains $1 million worth of assets? Or should the potential lawsuit liability of $1 million be reflected in the solvency analysis therefore leaving Sam's glass empty and rendering him insolvent.

Unfortunately, UVTA does not directly address the issue of pending litigation in the context of solvency. However, the Legislative Committee Comment (7) found in the Cal. Civ. Code § 3439.02 does discuss the valuation of an obligation incurred by a debtor as surety for another and states in relevant part:

> [I]n determining solvency under this section, in placing a fair valuation on the debts of the debtor (surety), appropriate weight should be given to the then prospective likelihood, and the extent thereof, that the debtor (surety) will be called upon to perform under the suretyship agreement, and in placing a fair valuation on the assets of the debtor (surety) at that time, appropriate value should be placed on the rights of the debtor (surety), including subrogation, exoneration, and indemnification. The valuation of these debts and assets of the debtor (surety) should include consideration of such relevant factors as the then

[1] Cal. Civ. Code § 3439.02(a).

> prospective ability of the principal debtor to respond to the exercise of the rights of the debtor (surety).

The Legislative Committee's comment about valuation of a surety is similar to the valuation of a pending litigation case, since both a surety and a pending litigation case share the common trait of being a *contingent liability*. A contingent liability only results in actual liability upon the happening of an event. For the surety, that event would be the debtor being called upon to perform; for the litigation case that event would be the entry of a judgment against the debtor.

Understandably contingent liabilities must be taken into consideration when determining solvency, but the question remains as to how such liability is fairly valued. Due to the lack of guidance under UVTA regarding the valuation of contingent liabilities, as well as the informational comment from the Legislative Committee that "Subdivision (a) is derived from the definition of 'insolvent' in Section 101(29)(A) of the Bankruptcy Code," we turn our attention to federal law for further (yet not controlling) guidance.[2]

In the context of a corporation subject to the bankruptcy code, the valuation of contingent liabilities is well settled. Case precedent provides that contingent liabilities must be taken into consideration when determining solvency, however, contingent liabilities are not considered at face value but instead must be discounted by the probability that the liability will materialize. In the noteworthy case of *Xonics Photochemical, Inc. ("Xonics")*, the court stated:

> There is a compelling reason not to value contingent liabilities on the balance sheet at their face amounts, even if that would be possible to do because the liability, despite being contingent, is for a specified amount (that is, even if there is no uncertainty about what the firm will owe if the contingency materializes). By definition, a contingent liability is not certain—and often is highly unlikely—ever to become an actual liability. To value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real.[3]

Although the *Xonics* case sets forth the method for calculating contingent liability, the case has been criticized for its improper application of its own method because it applied the probability percentage to the company's net book value instead of the face amount of the contingent liability. In the case of *Covey v. Commercial Nat. Bank of Peoria ("Covey")*,[4] the court determined that from the point of view of the debtor,[5] the amount of the debt guaranteed should be used for the valuation of the contingent liability rather than the company's net book value. The court stated that:

> If we use net assets as the maximum value of a contingent liability, it follows that no contingent liability ever renders any firm insolvent. A $5 million note issued by a firm with $4 million in assets propels the firm into insolvency, but a $5 billion guarantee by the same firm, on which the beneficiary is 99% certain to draw, would not: instead of multiplying $5 billion by 0.99, the court would multiply $4 million by 0.99.[6]

Thus, the proper formula to calculate contingent liability from the debtor's perspective is:

> value of contingent liability = face value of liability x probability of occurrence.

[2] Cal. Civ. Code § 3439.02(a), Comment (1); internal citations modified.
[3] *Matter of Xonics Photochemical, Inc.*, 841 F.2d 198, 200 (7th Cir. 1988).
[4] *Covey v. Commercial Nat. Bank of Peoria*, 960 F.2d 657, 660 (7th Cir. 1992).
[5] "*Xonics* used an illustration to demonstrate discounting; the parties did not debate, the case did not depend on, and we therefore did not decide, whether the creditor's perspective is the right one. The subject is open to initial decision. [¶] The Bankruptcy Code requires us to assess things from the debtor's perspective." (*Covey v. Commercial Nat. Bank of Peoria*, 960 F.2d 657, 660 (7th Cir. 1992)).
[6] *Covey v. Commercial Nat. Bank of Peoria* 960 F.2d 657, 660 (7th Cir. 1992).

In determining the reasonableness of the resulting value of the contingent liability, "a court looks at the circumstances as they appeared to the debtor and determines whether the debtor's belief that a future event would occur was reasonable. The less reasonable a debtor's belief, the more a court is justified in reducing the assets (or raising liabilities) to reflect the debtor's true financial condition at the time of the alleged transfers." [7]

Looking back to the case of Sam, let us assume there is a 50% probability that a $1 million judgment will be entered against Sam in the litigation case and that this probability is reasonable based on the underlying facts of the case and viable defenses. If the discounting formula is applied, Sam's contingent liability would be calculated as follows:

> $500,000 (contingent liability) = $1,000,000 (face value of liability) x 50% (probability of occurrence).

After determining the value of the contingent liability, that value is added to Sam's liabilities for purposes of the solvency analysis as follows:

> $2 million assets – ($1 million liability + $500,000 contingent liability) = $500,000.

This application of the discounting formula to Sam's case renders Sam solvent with assets of $500,000, which means that Sam is financially (as well as legally) able to fund a PRT. Without the discounting formula, Sam is insolvent and unable to financially or legally fund a PRT, since his balance sheet would be as follows:

> $2 million assets – ($1 million actual liability + $1 million contingent liability) = $0.

Although the discounting formula set forth in the *Xonics* and *Covey* cases is applied to entities in a bankruptcy context and we have not yet located any direct authority authorizing an individual subject to state law to utilize the discounting formula, we are not aware of any direct authority preventing this application. In fact, this exact issue was raised in the case of *In re Ponce Nicasio Broadcasting, LP ("Ponce")*.[8] In *Ponce*, the debtors claimed that the value of the debt owed to Plaintiff should be discounted by 50% because the liability at the time of the disputed transfers was only contingent in nature. As a basis for their position, the debtors turn to an earlier determination by the Superior Court that vacated an order of examination obtained by the Plaintiff and stayed further attempts by the Plaintiff to collect a commission pending the outcome of an evidentiary hearing. The debtors argue that this stay could only be imposed if the Superior Court found that PNB LP and PNB Inc. had demonstrated a probability of success on the merits, and "assert that this finding should be interpreted as a finding that PNB LP and PNB Inc.'s chances of success were "more likely than not" and that this should be equated with a "preponderance of the evidence" standard that justifies a fifty percent reduction in the amount of the potential debt to Plaintiff for the purposes of the insolvency analysis."[9]

Ultimately, the court found that the debtors "have not presented sufficient evidence that such a discount is warranted," and thus rejected the debtor's attempt to utilize the discounting formula. In particular, the court stated that the:

> [Debtors] have presented no California state authority regarding the method by which contingent liabilities should be valued for the purposes of an insolvency analysis. Their citations to federal case law, including In re Xonics Photochemical, […], while interesting, are not controlling, as Plaintiff is proceeding under a cause of action created by state law, not federal law.

[7] *In re R.M.L., Inc.*, 92 F.3d 139, 156 (3d Cir. 1996).
[8] *In re Ponce Nicasio Broadcasting, LP*, No. 04-26256-B-7, 2008 WL 361081 (Bankr. E.D. CA. Feb. 7, 2008).
[9] *In re Ponce Nicasio Broadcasting, LP*, supra, at *12.

As pointed out by the court, the discounting method set forth in the *Xonics* case is interesting, and although it is not controlling, it appears as if the court in *Ponce* provided the debtors with a good faith opportunity to defend the discounting method they used, but the debtor's fell short. The court was not persuaded by the debtor's claim that the granting of the stay conclusively established that PNB LP and PNB Inc. were "more likely than not" to prevail since the order references no such findings and the likelihood that a party will prevail on the merits of a claim is not the only factor assessed in determining whether to issue a preliminary injunction. The court further found that a 50% discount to the contingent liability was inconsistent with the manner in which PNB LP and PNB Inc. treated the liability at the time that the former partners were bought out. At that time, the preliminary capital balance of PNB LP was adjusted to account for the possibility that the contingency would occur and the former partners agreed to be bought out for less than the full amount of their interests which left $700,000 in the limited partnership for the satisfaction of any judgment. Thus, discounting the $531,750 liability by 50% would result in an amount less than the $700,000 originally set aside for the satisfaction of the potential judgment is inconsistent.

In conclusion the Court in *Ponce* stated:

> Therefore, because [individual debtors] have not set forth an **adequate basis on which to discount the contingent liability** owed to Plaintiff, there is a genuine issue of material fact as to whether PNB Inc. was insolvent at the time that [individual debtors] received the transfers made to them (emphasis added).[10]

Based on the findings in the case of *Ponce*, application of the discounting formula to an individual debtor subject to state law appears to be a viable option if the debtor can set forth an **adequate basis on which to discount the contingent liability**. What constitutes an "adequate basis" is fact driven and thus subject to interpretation by the trier of fact and will vary from case to case depending on the particular circumstances. Thus, before relying on the discounting formula for purposes of a solvency analysis under state law, ensure that an adequate basis to discount the contingent liability exists. If an adequate basis for discounting a contingent liability exists, even a client holding a glass more than half empty can (legally) pour funds into a Private Retirement Trust and enjoy the exemption protection of CCP § 704.115(b).

The key to successfully (and legally) funding a Private Retirement Trust is to, prior to funding, ensure all liabilities are taken into account *(whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent)*, and enough money is set aside to cover potential future liability.

[10] *In re Ponce Nicasio Broadcasting, LP,* supra at *14.