BYU Law Review

Volume 1989 | Issue 4 Article 8

11-1-1989

Estimating Contingent Liabilities to Determine Insolvency in Bankruptcy Proceedings: In re Xonics Photochemical, Inc.

Kathryn Ogden Balmforth

NOTES

Estimating Contingent Liabilities to Determine Insolvency in Bankruptcy Proceedings: *In re Xonics Photochemical, Inc.*

I. Introduction

The Seventh Circuit devoted roughly one-third of its opinion in *In re Xonics Photochemical, Inc.*,[1] to a lengthy, detailed dictum explaining how to properly handle contingent liabilities when making a "balance sheet" test[2] to determine whether an entity is insolvent within the meaning of the Bankruptcy Code ("the Code"). This topic was, admittedly, a "non-issue,"[3] because the case was decided on other grounds. Nevertheless, Judge Posner, writing for the court, seized the opportunity to expound on the matter. He did so because he found it "startling" that both parties assumed that contingent liabilities, in this case a loan guarantee and a co-signature on a note, were included on the balance sheet at their full face amounts.[4]

Xonics states unequivocally that a contingent asset or liability should not be listed on the balance sheet at its full face amount.[5] Instead, the court states: "the asset or liability *must* be reduced to its present, or expected, value before a determination

1. 841 F.2d 198 (7th Cir. 1988).

2. As defined in the Bankruptcy Code, at 11 U.S.C. § 101(31) (Supp. IV 1986), "insolvent" means, "with reference to an entity other than a partnership, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation . . . ." This is the "traditional bankruptcy balance sheet test of insolvency." S. Rep. No. 989, 95th Cong., 2d Sess. 25, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5811.

3. *Xonics*, 841 F.2d at 201.

4. *Id.* at 199.

5. *Id.* at 200.

can be made whether the firm's assets exceed its liabilities."[6] The court also suggests a formula for making that reduction.[7]

The guidance offered in *Xonics* is welcome. Previous case law contains little authority on how to handle contingent liabilities in insolvency calculations. If one does not discount a contingent liability, the alternative is to simply include the liability at its full face amount. This practice has been rigidly followed in some cases, producing anomalous results. This note discusses a few of those cases.

However, this note suggests that the rule laid down in *Xonics* is also too rigid. The *Xonics* case, itself, is an example of an instance in which application of the *Xonics* rule will produce an anomalous result. Furthermore, the case overstates support for the *Xonics* rule and formula found in generally accepted accounting principles. Therefore, this note concludes, while the *Xonics* rule is a useful guide, its application should be left to the discretion of the court, and should not be mandatory as the language of the rule suggests.

II. Legal Background

The insolvency determination in *Xonics* took place in an action to recover a preferential transfer for the benefit of a chapter 11 bankruptcy estate.[8] If an insolvent entity transfers funds within ninety days before it files a petition in bankruptcy, that transfer may be a voidable preference.[9] When a transfer is determined to be a voidable preference, the transferee must return the funds to

---

6. *Id.* (emphasis added). *See infra* note 41 and accompanying text.

7. *Xonics*, 841 F.2d at 200. *See also infra* note 40 and accompanying text.

8. *Xonics*, 841 F.2d at 199.

9. The elements of a voidable preference are contained in 11 U.S.C. § 547(b)(Supp. IV 1986), which states in pertinent part that the 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 such transfer was made;
> (3) made while the debtor was insolvent;
> (4) made—
> (A) on or 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.

the bankruptcy estate.[10] An entity is insolvent if its debts exceed its property.[11] Contingent liabilities must be included in the insolvency calculation.[12]

The voidable preference action is only one of several contexts in which the court must make calculations which include contingent liabilities. For example, the Code requires that contingent liabilities be allowed as claims against the estate.[13] The Code further requires that such contingent claims be estimated by the court, if such estimation is necessary to prevent delay of the proceedings.[14]

Contingent liabilities must also be considered in fraudulent conveyance[15] and fraudulent transfer[16] actions, which may take place inside or outside of bankruptcy cases.[17] These types of actions may also require proof of insolvency of the transferor.[18] Just as in bankruptcy actions, the transferor's contingent liabilities must be included when insolvency is determined in nonbankruptcy cases.[19]

---

10. 11 U.S.C. § 551 (1982).

11. *See supra* note 2.

12. The Code defines "debt" as "liability on a claim." 11 U.S.C. § 101(11)(Supp. IV 1986). A "claim," under the Code, includes any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, *contingent*, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(4)(A) (Supp. IV 1986)(emphasis added).

13. *See supra* note 12.

14. 11 U.S.C. § 502(c)(1) (Supp. IV 1986).

15. SEE, *e.g.*, UNIFORM FRAUDULENT CONVEYANCE ACT (1918).

16. *See, e.g.*, UNIF. FRAUDULENT TRANSFER ACT (1984).

17. State fraudulent conveyance and fraudulent transfer laws are incorporated into the Code by 11 U.S.C. § 544(b)(1982). Also, the Code has a fraudulent transfer provision of its own. *See* 11 U.S.C. § 548 (1982 & Supp. IV 1986).

18. *See, e.g.*, UNIFORM FRAUDULENT CONVEYANCE ACT § 4 (1918); UNIF. FRAUDULENT TRANSFER ACT § 5 (1984); 11 U.S.C. § 548(a)(1)(B)(i) (1982 & Supp. IV 1986).

19. Under § 2(1) of the Uniform Fraudulent Conveyance Act, "[a] person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." Section 1 of the Uniform Fraudulent Conveyance Act defines "debt" as "any legal liability, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or *contingent*." (Emphasis added).

Similarly, under the Uniform Fraudulent Transfer Act § 2(a), "[a] debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation." Section 1(5) of that Act defines "debt" as "liability on a claim," and § 1(3) defines "claim" as "a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, *contingent*, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." (Emphasis added).

For the Bankruptcy Code definition of insolvency and the inclusion of contingent claims under that definition, see *supra* notes 2 & 12. These definitions would apply to fraudulent transfer claims made under § 548 of the Code.

But in spite of the fact that contingent liabilities are routinely considered in all of these contexts, neither the current case law, the Bankruptcy Code, nor the Bankruptcy Rules set out procedures for the consistent handling of contingencies.[20] Because of this lack of clear guidance, the rule stated in *Xonics* has received attention.[21] In the preferential transfer context, *Xonics* is the only case cited by Collier's treatise on bankruptcy for a rule on dealing with contingent liabilities.[22]

---

20. Note, *Procedures for Estimating Contingent or Unliquidated Claims in Bankruptcy*, 35 STAN. L. REV. 153, 156 (1982). The Stanford note deals specifically with estimation of contingent claims for allowance purposes, which the Code expressly requires. 11 U.S.C. § 502(c)(1)(Supp. IV 1986). But there is just as little guidance in other areas of the Code in which contingent claims must often be considered, such as preferences and fraudulent transfers. The Second Circuit stated, in the preferential transfer context, that "valuation of contingent assets and liabilities is an arduous task, and on occasions only approximations can be made." *In re* Ollag Const. Equip. Corp., 578 F.2d 904, 909 (2d Cir. 1978). Other courts have acknowledged that they may, in the determination of the question of insolvency, value doubtful or contingent claims at less than face value. *See infra* notes 59-62 and accompanying text.

Commenting on the estimation of contingent claims required under § 502(c)(1), the Third Circuit noted that judges have almost unlimited discretion in choosing a method by which to estimate:

> Despite the lack of express direction on the matter, we are persuaded that Congress intended the procedure to be undertaken initially by the bankruptcy judges, using whatever method is best suited to the particular contingencies at issue. . . . [W]here there is sufficient evidence on which to base a reasonable estimate of the claim, the bankruptcy judge should determine the value. In so doing, the court is bound by the legal rules which may govern the ultimate value of the claim. For example, when the claim is based on an alleged breach of contract, the court must estimate its worth in accordance with accepted contract law. . . . However, there are no other limitations on the court's authority to evaluate the claim save those general principles which should inform all decisions made pursuant to the Code.

Bittner v. Borne Chemical Co., 691 F.2d 134, 135-36 (3d Cir. 1982). *Accord In re* Brints Cotton Marketing, Inc., 737 F.2d 1338, 1341 (5th Cir. 1984).

Consistent rules are equally lacking outside of bankruptcy in the fraudulent conveyance context. One commentator discussed three methods of treating loan guarantees for balance sheet purposes:

> they may be included in full, under all circumstances, as liabilities without offset; they may be left off the balance sheet under all circumstances or included with off-setting assets; or their inclusion and the extent thereof may be made dependent on the likelihood that the liability will be incurred [the *Xonics* approach].

Rosenberg, *Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware*, 125 U. PA. L. REV. 235, 257 (1977). Professor Rosenberg prefers the approach based on probabilities, which is the approach used in *Xonics*. But he acknowledges that "[n]one of [the three approaches] is particularly pleasing." *Id.* He then adds that "[e]ven more disturbing, however, is the absence of any recent precedent in the area and any precedent at all specifically relating to fraudulent conveyances." *Id.*

21. *See, e.g.*, 4 COLLIER ON BANKRUPTCY ¶ 547.06 (15th ed. 1988).

22. *Id.*

III. Facts and Procedure of *Xonics*

Xonics Photochemical, Inc. ("Xonics Photochemical"), the debtor in this chapter 11 bankruptcy proceeding, is one of several wholly-owned subsidiaries of Xonics, Inc.[23] In 1982 and 1983, the parent company caused Xonics Photochemical to guarantee a $25 million credit line and to co-sign a $3 million note (hereinafter referred to as "the loan guarantees") for another subsidiary, Xonics Medical Systems, Inc. ("Xonics Medical").[24] The loan guarantees created contingent liabilities totalling $28 million.[25] Xonics Photochemical had assets of only $1.7 million.[26]

In 1983, not long after Xonics Photochemical guaranteed the loans, it received $124,000 worth of chemicals from Mitsui & Co. (U.S.A.), Inc. ("Mitsui").[27] Xonics Photochemical did not pay Mitsui until January 1984.[28] Within ninety days after the payment to Mitsui, Xonics Medical defaulted on its bank loan, triggering Xonics Photochemical's liability, and Xonics Photochemical filed a petition in bankruptcy.[29] Xonics Photochemical then brought an adversary proceeding against Mitsui to recover the $124,000, claiming that the payment was a voidable preference under the Bankruptcy Code.[30]

In order for the payment to Mitsui to have been a preference, Xonics Photochemical must have been insolvent at the time the payment was made.[31] Under the bankruptcy "balance sheet" test, Xonics Photochemical was insolvent if its debts exceeded its assets.[32] As the Code requires,[33] the $28 million in

---

23. *Xonics*, 841 F.2d at 199.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.* There was a network of similar guarantees among the Xonics affiliates. The total liabilities of all companies far exceeded the total assets, and the entire Xonics family, including the parent, was in bankruptcy. *Id.*

30. See *supra* note 9 for the elements of a voidable preference, by which the trustee in bankruptcy may recover funds for the benefit of the bankruptcy estate. Xonics Photochemical brought this preference action against Mitsui under the authority of 11 U.S.C. § 1107(a) (Supp. IV 1986), which confers the powers of a trustee upon the debtor in possession.

31. *See* 11 U.S.C. § 547(b)(3)(Supp. IV 1986), cited *supra* note 9.

32. *See supra* note 2. Under the Code, there is a rebuttable presumption of insolvency during the ninety days immediately preceding the date of filing of the petition. 11 U.S.C. § 547(f) (1982 & Supp. IV 1986).

33. *See supra* notes 2 and 12.

loan guarantees was included on the balance sheet. The bankruptcy court ruled that Xonics Photochemical was, indeed, insolvent at the time of the payment to Mitsui. Since all other elements of a preference had been satisfied,[34] Mitsui had to return the payment.[35]

Mitsui appealed, claiming that the loan guarantees between Xonics Photochemical and Xonics Medical Systems were either void under applicable state law or voidable as fraudulent conveyances. If either theory were correct, the $28 million dollar liability would not be included in the "balance sheet" calculation, and Xonics Photochemical would not have been insolvent at the time of the payment to Mitsui.[36]

The court's attention was captured by the parties' assumption that, if the guarantees were valid, they would count against Xonics Photochemical to the full amount of $28 million.[37] Since the company only had assets of $1.7 million, this liability would clearly render it insolvent under the "balance sheet" test. The court thought this proposition was "absurd,"[38] and set forth the rule and formula which follow.

IV. The *Xonics* Rule and Formula

The *Xonics* court, using the imperative, stated that a contingent asset or liability "must be reduced to its present or expected value."[39] This statement is referred to in this note as the "*Xonics* rule."

The court explained that "[t]o value the contingent liability it is necessary to discount it by the probability that the contingency will occur and the liability become real"[40] (Face Amount of Liability X Probability of Occurrence = Discounted Amount). This is the "*Xonics* formula."[41]

34. *See supra* note 9.

35. *Xonics*, 841 F.2d at 199.

36. *Id.*

37. The *Xonics* court eventually upheld the validity of the transfers against Mitsui's attacks and affirmed the bankruptcy court. Because Mitsui had not challenged the amount of the contingent liabilities, only their validity, the court made no attempt to apply the test it enunciated, nor did it remand to have the bankruptcy court apply it. *Id.* at 203.

38. *Id.*

39. *Id.* at 200.

40. *Id.* The *Xonics* court did not offer any suggestions as to how the "probability of occurrence" is determined.

41. The court made a hypothetical application of the rule and formula to the facts of the *Xonics* case:

V. Use of the *Xonics* Rule Can Prevent Anomalous Results in Some Cases

The court felt that including contingent liabilities at their full face amounts was "absurd," because

> it would mean that every individual or firm that had contingent liabilities greater than his or its net assets was insolvent—something that no one believes. Every firm that is being sued or that may be sued, every individual who has signed an accommodation note, every bank that has issued a letter of credit, has a contingent liability.[42]

An example of the problem which the court foresaw is an otherwise financially sound company against which a lawsuit has been filed. The pending lawsuit is a contingent liability,[43] even though the suit might be meritless or seek exorbitant, unrealistic damages. If some effort is not made to adjust the face amount of the liability, the mere filing of the lawsuit may render the company insolvent under the "balance sheet" test.[44]

Because there has been little guidance on handling contingent liabilities in insolvency determinations, both inside[45] and outside[46] of bankruptcy, the case law has produced anomalies

---

> Suppose that on the date the obligations were assumed there was a 1 percent chance that Xonics Photochemical would ever be called on to yield up its assets to creditors of Xonics Medical Systems . . . . Then the true measure of the liability created by these obligations on the date they were assumed would not be $28 million; it would be a paltry $17,000. For at worst Xonics Photochemical would have to yield up all of its assets (net of other liabilities), that is, $1.7 million, and the probability of this outcome is by assumption only 1 percent . . . . Discounted, the obligations would not make Xonics insolvent, and section 547(b) would not come into play unless events occurring between the assumption of the obligations in 1982 and 1983 and the bankruptcy in 1984 had altered the picture.

Id. In making this application of the formula to the facts, the court added another wrinkle. It first reduced the face amount of the liability, $28 million, to the amount of the net assets of the company, $1.7 million. *Id.* ((Face Amount of Liability - Amount in Excess of Net Assets of Entity) X Probability of Occurrence = Discounted Amount). The implications of this permutation of the *Xonics* formula are discussed *infra* note 95.

42. *Id.* at 199.

43. *See, e.g., In re* Kucharek, 79 Bankr. 393 (Bankr. E.D. Wis. 1987)(pending tort claim included in insolvency calculation).

44. *See supra* note 2.

45. *See supra* notes 20-22 and accompanying text.

46. One possible reason for the scarcity of case law on the handling of contingent liabilities in fraudulent conveyance actions outside of bankruptcy is that these actions have been brought primarily by judgment creditors. *See, e.g.*, Continental Bank v. Marcus, 242 Pa. Super. 371, 363 A.2d 1318 (1976); Baker v. Geist, 457 Pa. 73, 321 A.2d 634 (1974). In that situation, courts seem to have simply looked to the amount of the judg-

which prove the court's point. For example, a line of cases has arisen under the Uniform Fraudulent Conveyance Act[47] in which the practice of valuing contingent claims at their face amount was rigidly followed, with results that do seem, in the *Xonics* court's word, "absurd."[48]

A Washington court held that indebtedness on certain promissory notes was properly included as a liability in establishing insolvency, in spite of the fact that, by the time the suit commenced, recovery on the notes appeared to be barred by the statute of limitations.[49] A California court included certain pending lawsuits in the insolvency calculation, even though, by the time of the fraudulent conveyance action, the suits had been proved unfounded.[50]

Perhaps the most unsatisfactory result occurred in another California case, *Matter of Estate of Anderson*, in which the probate court cut off a widow's living allowance because the estate was insolvent due to a pending lawsuit.[51] The *Anderson* court acknowledged that it was "unlikely" that the pending suit would succeed, and there was "scant likelihood" that the treble damages being sought would be awarded.[52] The court also noted that the claimants had overvalued the claim in other ways.[53] However, the court of appeals upheld the probate court's application of a "rigid definition of insolvency, analogizing to the definition of insolvency under the Uniform Fraudulent Conveyance Act." The appellate court added that "mere pendency of claims against the transferor, however far-fetched, constitutes sufficient evidence to support a finding of probable insolvency for pur-

---

ment to determine the amount of the contingent liability at the time of the allegedly fraudulent conveyance. *See, e.g.*, Tri-Continental Leasing Corp. v. Zimmerman, 485 F. Supp. 495, 500 (N.D. Cal. 1980).

47. *See supra* notes 17-19 and accompanying text.

48. *See, e.g.*, Matter of Estate of Anderson, 68 Cal. App. 3d 1010, 1014-16, 137 Cal. Rptr. 727, 729-31 (1977); Neumeyer v. Crown Funding Corp., 56 Cal. App. 3d 178, 190, 128 Cal. Rptr. 366, 370 (1976); Babcock v. Omansky, 31 Cal. App. 3d 625, 632, 107 Cal. Rptr. 512, 517 (1973); Davis v. Nielson, 9 Wash. App. 864, 515 P.2d 995, 1003 (1973). All of these cases are discussed in the text, except *Neumeyer*, which merely recognizes the rule enunciated in *Babcock*.

49. *Davis*, 9 Wash. App. at 876-77, 515 P.2d at 1003.

50. *Babcock*, 31 Cal. App. 3d at 632, 107 Cal. Rptr. at 517.

51. *Anderson*, 68 Cal. App. 3d at 1014-16, 137 Cal. Rptr. at 731.

52. *Id.* at 1012-13, 137 Cal. Rptr. at 729.

53. *Id.*

poses of determining the validity of a conveyance during the pendency of such litigation."[54]

Proper application of the *Xonics* rule can prevent results such as these.

VI. THE *Xonics* RULE, IF APPLIED TOO RIGIDLY, WILL PRODUCE ANOMALOUS RESULTS OF ITS OWN

It is important to note that the extreme cases cited above arose outside of bankruptcy.[55] Those non-bankruptcy courts clung to the rigid rule because they were reluctant to evaluate the merits of contingent claims and adjust the rights of parties without proper proceedings.[56] Bankruptcy courts are, of necessity, much more flexible in their approach to such matters and are expected to settle them in a summary fashion.[57]

Because of this flexibility, the problems cited above and anticipated by the *Xonics* court[58] seem less likely to arise in bankruptcy. In fact, the bankruptcy case law reveals that, even though there have been few authoritative statements on the matter, bankruptcy courts do, at their discretion, adjust the face amounts of contingent claims when making a "balance sheet" test for insolvency. Sometimes the bankruptcy courts employ methods resembling the *Xonics* formula,[59] and sometimes they use other methods.[60]

---

54. *Id.*

55. *See supra* notes 47-54 and accompanying text.

56. *Anderson*, 68 Cal. App. 3d at 1015, 137 Cal. Rptr. at 731.

57. Efficient administration of bankruptcy estates is a primary purpose of bankruptcy law. The Supreme Court has acknowledged that the "bankruptcy court has full power to inquire into the validity of any alleged debt . . . or obligation of the bankrupt upon which a claim or demand against the estate" is based. Lesser v. Gray, 236 U.S. 70, 74 (1915). In *Katchen v. Landy*, the Court made a strong policy statement in favor of "prompt and effectual administration and settlement of the estate of all bankrupts within a limited period," and held that allowance of and "reconsideration" of claims "is to be exercised in summary proceedings and not by the slower and more expensive processes of a plenary suit." 382 U.S. 323, 328-29 (1966).

58. *See supra* notes 42-44 and accompanying text.

59. *See In re* Kucharek, 79 Bankr. 393 (Bankr. E.D. Wis. 1987)(acknowledging that a pending tort claim, even if discounted by 99%, would render debtor insolvent).

60. One method of handling loan guarantees is to include the guarantee as a contingent liability, then to include any related rights to subrogation or contribution as contingent assets. *See* Rosenberg, *supra* note 20. This is the method used in several cases cited as authority in *Xonics*: *In re* Ollag Construction Equipment Corp., 578 F.2d 904, 908-09 (2d Cir. 1978); Syracuse Engineering Co. v. Haight, 97 F.2d 573, 576 (2d Cir. 1938); *In re* Hemphill, 18 Bankr. 38, 47 (Bankr. S.D. Iowa 1982). 841 F.2d at 200. This method is actually more consistent with the handling of loan guarantees suggested by the Financial Accounting Standards Board, discussed *infra* at notes 94-95 and accompanying text.

Before *Xonics*, cases discussing estimation of contingent claims for determining insolvency used permissive, rather than mandatory, language. Courts have acknowledged that they "may" reduce contingent claims to an amount less than face value.[61] One court used the phrase, "[i]t is appropriate . . . to value doubtful or contingent claims at less than face value."[62] In contrast, the mandatory language of *Xonics* is unnecessarily rigid. A flexible approach, which is the hallmark of the bankruptcy courts, is preferable. Application of the *Xonics* rule should be within the discretion of the court. This discretion should be exercised in harmony with the facts of each case.

A. *The* Xonics *Rule Should Not Be Applied When The Contingent Liability Has Become Absolute Before the Bankruptcy Proceeding*

A contingent liability is one which will not become absolute, or "real," as the *Xonics* case puts it, until some event occurs to trigger liability.[63] In this case, Xonics Medical's loan default triggered Xonics Photochemical's liability on the loan guarantees.[64] The default occurred after the payment to Mitsui, but before the filing of Xonics Photochemical's petition in bankruptcy.[65] When, as in this case, the triggering event has already occurred before the proceedings, making the liability absolute at the time of the proceedings, courts should not apply the *Xonics* rule. Rather, the court should include the liability at its face value in the insolvency calculation.

---

61. *See Kucharek*, 79 Bankr. at 397. *Accord In re* Join-In Int'l, (U.S.A.) Ltd., 56 Bankr. 555, 560 (Bankr. S.D.N.Y. 1986).

62. *In re* Carousel Candy Co., 38 Bankr. 927, 937 (Bankr. E.D.N.Y. 1984)(citing Coyle v. Archibald McNeil & Sons, 284 F.298 (S.D.N.Y. 1922)).

63. *In re* Xonics Photochemical, Inc., 841 F.2d 198, 200 (7th Cir. 1988). According to the Financial Accounting Standards Board, "a contingency is defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain. . . or loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur." ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5, § 1 (Fin. Accounting Standards Bd. 1986) [hereinafter ACCOUNTING].

64. *Xonics*, 841 F.2d at 199.

65. *Id.*

1. When the triggering event has occurred, post hoc determinations of that event's probability are pointless.

Application of the *Xonics* rule and formula to the facts of *Xonics*, forces one to conjure up a figure representing the "probability that the contingency will occur and the liability become real," so that it could then multiply that figure by the amount of the contingent liability.[66] This probability figure would be based on circumstances as they had appeared at some point in time prior to the proceedings. It is unclear from the *Xonics* opinion exactly when that point in time would be. The court makes reference to "the date the obligations were assumed."[67] Yet, later the court says that "maybe Xonics Medical Systems was really insolvent by the time Mitsui received the payments in issue . . . so that the contingent liability was no longer contingent."[68] This passage seems to suggest that the probability figure should be fixed as of the time the transfer was made.[69]

Whichever prior date is correct in the court's view, the court knew by the time of the proceeding that default had occurred. Therefore, attempting to stand, *post hoc*, in the shoes of someone at some prior date to make a hypothetical determination of the probability that default would occur, seems pointless. Even if someone had tried to make such a determination on the actual date of the transfer, such a determination would have been nothing more than an educated guess about the future. Any such prediction would be useful only as a poor substitute for certain knowledge about the future. Just as a matter of common sense, if the court now knows of a certainty that the liability would, with the passage of time, become absolute, why should it step back and replace that certainty with a *post hoc* approximation of a prior "best guess"?

In short, the line of fraudulent conveyance cases discussed in section V produced anomalous results because the courts rigidly followed the practice of including contingent liabilities at their face amounts, even when it was clear that the contingencies would never occur.[70] Conversely, if the courts rigidly apply

66. *Id.* at 200. *See supra* notes 40-41 and accompanying text.

67. *Xonics*, 841 F.2d at 200.

68. *Id.* at 201.

69. The passage is also technically incorrect, since the triggering event was the default by Xonics Medical, not the occurrence of insolvency.

70. *See supra* notes 47-54 and accompanying text.

the rule that contingent liabilities must be discounted by the probability of occurrence, even when the contingency already has occurred, the result is equally anomalous.

2. The parties' belief as to whether a transferor is insolvent because of a contingent liability has no relevance.

Under the *Xonics* rule, courts must discount a contingent liability even after the triggering event has occurred.[71] In other words, the court must use a transferor's prior "best guess" as to the probability of occurrence of the liability, rather than what the court now knows has actually occurred.[72] This proposition suggests that the belief of the parties as to whether the transferor is insolvent is somehow relevant. However, under the Code, the state of mind of the parties has no relevance at all to the finding of a preference. Likewise, in the fraudulent conveyance context a finding of insolvency rests on objective, not subjective, considerations.

While the former Bankruptcy Act did require a showing that the transferee knew or should have known that the debtor was insolvent, that element of a preferential transfer was deliberately omitted from the present Code.[73] The transferor's knowledge of its own insolvency has never been at issue, under either former or current bankruptcy law. Therefore, the state of mind of either party as to whether the debtor is insolvent at the time of a transfer is irrelevant to the finding of a preference.[74]

Similarly, in the fraudulent conveyance context, the question of insolvency rests on purely objective considerations.[75] For example, in *Tcherepnin v. Franz* a transferor argued that a tort suit which had been pending at the time of an alleged fraudulent conveyance did not render him insolvent.[76] By the time of the

---

71. *See supra* notes 39-41 and accompanying text.

72. *See supra* notes 66-68 and accompanying text.

73. Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 726 (1985). The element of the transferee's knowledge of the transferor's insolvency was omitted largely because the state of mind of the transferee was so difficult to prove. *Id.*

74. *Id.* at 725-32.

75. Tri-Continental Leasing Corp., Inc. v. Zimmerman, 485 F. Supp. 495, 498 (N.D. Cal. 1980)(fraudulent conveyance action). The Uniform Fraudulent Conveyance Act speaks in terms of "probable liability on existing debts." *See supra* note 19. But when claims which were contingent at the time of a transfer have been reduced to judgment by the time of the fraudulent conveyance action, the amount of the judgment is used in the insolvency calculation. *See, e.g.*, *Tri-Continental Leasing*, 485 F. Supp at 500.

76. 457 F. Supp. 832, 839 (N.D. Ill. 1978)(applying Illinois law).

fraudulent conveyance action, judgment had been rendered against the transferor on the tort claim.[77] But the transferor argued that, at the time of the transfer, he was relying on the advice of his attorney that liability on the tort suit was unlikely because the transferor supposedly was immune.[78] The court responded, "[Transferor's] belief as to the likelihood of liability on the suit . . . is irrelevant to a determination of the legal effect of his conveyance . . . ."[79]

In sum, when a contingent liability has become absolute and fixed by the time of the insolvency determination, the court can easily determine the amount of that liability by objective means. In *Xonics*, for example, Xonics Medical had defaulted on its loans, and Xonics Photochemical had become liable for the full amount of the loan guarantees. Even if Xonics Medical had subjectively believed that default would never occur when it made the payment to Mitsui, that belief would be irrelevant. Any *post hoc* discounting of the guarantees by application of the *Xonics* rule and formula would necessarily derive from those former subjective beliefs. Therefore, any discounted amount would be irrelevant.

3. Xonics *own case authority suggests that the* Xonics *rule should not be applied when the triggering event has already occurred.*

Xonics cites *In re* Waters[80] for the proposition that the existence of remote contingencies should not be deemed to make an otherwise solvent firm bankrupt.[81] But *Waters* states, in somewhat convoluted language, that

> in testing the solvency of one who has made a voluntary conveyance of property, his endorsements or suretyship on the obligations of others, not matured at the time of the conveyance, should not be counted as his debts *where it does not appear*

---

77. *Id.*

78. *Id.*

79. *Id. Accord* Indiana National Bank v. Gamble, 612 F. Supp. 1272, 1277 (N.D. Ill. 1984)("That [Transferor] believed the . . . suit to be without merit and believed that he owed no taxes is irrelevant to the existence of those debts.").

80. 8 Bankr. 163 (Bankr. N.D. Ga. 1981) *cited in Xonics*, 841 F.2d at 201. *Waters* is a fraudulent conveyance action brought under 11 U.S.C. § 544(b).

81. *Xonics*, 841 F.2d at 201.

> *that his contingent liability was at that time likely to become absolute or in fact became so.*[82]

At issue in *Waters* were various loan guarantees executed by the debtor. The court included some guarantees in the insolvency calculation, apparently because there had already been default on the debts.[83] Nothing in *Waters* indicates that the guarantees were valued at anything less than their actual face amount.

The *Waters* court did refuse to include other guarantees in the calculation, but only because there was a question of fact as to whether there had been a default on those debts. *Waters* states that the issue of default "is determinative of whether [the] indebtedness . . . may be counted as a liability of the Debtor's."[84]

The *Waters* case indicates that, in a fact situation such as *Xonics*, where the event triggering liability has already occurred, the court should not discount contingent liabilities using the *Xonics* rule and formula. Rather, the court should include them at their face value.[85]

B. *The* Xonics *Case Overstates the Support for Its Rule Found in Generally Accepted Accounting Principles.*

While *Xonics* does not specifically state that generally accepted accounting principles militate in favor of the application of the *Xonics* rule and formula, it does so imply. The case discusses "proper accounting treatment" of contingencies at some length.[86] It explains the procedure as follows:

> Such liabilities are occasionally listed on the firm's balance sheet, for example by earmarking a portion of surplus for contingent liabilities. They are supposed to be listed "if the future event is *likely to occur* and if its amount can be *reasonably estimated.*" [citation omitted] More often they are listed in a footnote, thus leaving the firm's stated net worth undisturbed. Often they are not listed at all, when they are remote or when they are too small to affect net worth substantially.[87]

---

82. *Waters*, 8 Bankr. at 166 (emphasis added).
83. *Id.* at 167.
84. *Id.*
85. *See also* Tri-Continental Leasing Corp. v. Zimmerman, 485 F. Supp. 495 (N.D. Cal. 1980).
86. *Xonics*, 841 F.2d at 200.
87. *Id.* at 199-200 (emphasis in original).

The court emphasizes, further, that "Xonics did not in fact list these obligations as liabilities on its balance sheet."[88] The court implies that since, under generally accepted accounting principles, the guarantees were not even required to be disclosed on the firm's balance sheets, *a fortiori* they should not be included at their face amounts in the insolvency calculation.

To the extent it relies on general accounting principles, *Xonics* is vulnerable on two grounds. First, the "reasonable estimation" mentioned in the case does not, in the accounting context, refer to the sort of discounting described by the *Xonics* rule and formula. Second, failure to disclose loan guarantees on the balance sheet is a violation of financial accounting standards.[89]

1. "Reasonable estimation" of contingent liabilities does not refer to the discounting process described in Xonics.

The Financial Accounting Standards Board statement cited by the court[90] divides contingent liabilities into three categories: probable, reasonably possible, and remote.[91] If a contingent liability is both probable and capable of reasonable estimation, it must be accrued,[92] or in *Xonics'* terminology, a portion of the funds are earmarked to cover that contingency.[93] But "reasonable estimation," as that term is used by the Financial Accounting Standards Board, does not necessarily refer to the discounting procedure introduced by the court.

The professional literature does not introduce the discounting method in *Xonics* as a method of "reasonable estimation" for accounting purposes.[94] Instead, the discounting procedure described by the *Xonics* formula is usually used in other contexts, such as capital budgeting, buying of long-term assets, or profit plans.[95]

---

88. *Id.* at 200.

89. ACCOUNTING, *supra* note 63, at § 12.

90. *Id.*

91. *Id.* at § 3.

92. *Id.* at § 8.

93. *Xonics*, 841 F. 2d at 198.

94. Interview with Dr. James B. Cameron, Professor of Accounting, Brigham Young University School of Accounting (Feb. 13, 1988). *See generally* REASONABLE ESTIMATION OF THE AMOUNT OF A LOSS: AN INTERPRETATION OF FASB STATEMENT NO. 5, FASB Interpretation No. 14 (Fin. Accounting Standards Bd. 1986); H. GOODMAN & L. LORENSEN, ILLUSTRATIONS OF ACCOUNTING FOR CONTINGENCIES (1976).

95. Cameron, *supra* note 94. Furthermore, as the formula is hypothetically applied

None of the foregoing discussion suggests that using the *Xonics* rule and formula is improper in a legal setting, or even in accounting for that matter. It simply shows that industry standards in accounting do not militate for the use of the *Xonics* rule and formula as "proper accounting treatment" of contingent liabilities.

2. *Failure to disclose loan guarantees is a violation of accounting standards.*

Xonics correctly stated that contingent liabilities are often listed in a footnote,[96] or are not listed at all.[97] The court further emphasized that Xonics Photochemical did not list its loan guarantees as contingent liabilities, presumably because Xonics Photochemical did not anticipate liability on the guarantees.[98] The court implies that since "proper accounting treatment" does not require even the listing of remotely possible contingencies, and since Xonics Photochemical did not list or disclose their loan guarantees, there is little reason to include those guarantees at their full value in the "balance sheet" test. However, loan guarantees constitute an exception to the general rule. The existence and amounts of loan guarantees are required to be disclosed under all circumstances, even if liability on those guarantees is only remotely possible.[99] Their omission from the Xonics Photochemical balance sheet was a violation of financial accounting standards. If, as *Xonics* implies, "proper accounting treatment" of contingent liabilities should guide the court, the *Xonics* rule and formula should not be applied here, and the loan guarantees should be included at their full face amounts.[100]

---

in this case, the court first eliminates the entire amount of the claim which exceeds the net assets of the company. *See supra* note 41. This step would make more sense in a setting in which one is analyzing risks and wants a practical estimate of the company's maximum exposure. It does not seem consistent with the idea of balance sheet accounting, or with determining insolvency in bankruptcy. In bankruptcy, liabilities routinely exceed assets, and the ratio of liabilities to assets is significant in many contexts.

96. *Xonics*, 841 F.2d at 200. When there is a reasonable possibility that a contingency will occur, accrual is not required, but disclosure is. ACCOUNTING, *supra* note 63, at § 10.

97. *Xonics*, 841 F.2d at 200. Disclosure is not required in most cases when the probability that the contingency will occur is only remote. J. WILLIAMS, K. STANGA & W. HOLDER, INTERMEDIATE ACCOUNTING 681 (2d Ed. 1987).

98. *Xonics*, 841 F.2d at 200.

99. ACCOUNTING, *supra* note 63, at § 12.

100. In fact, § 12 of FASB Statement 5 states that "[c]onsideration should be given to disclosing, if estimable, the value of any recovery that could be expected to result,

VII. Conclusion

The instructions given in *Xonics* will be useful tools, particularly in cases where contingent liabilities have not become absolute and fixed by the time the court is trying to make an insolvency determination. However, application of the *Xonics* rule should be permissive, not mandatory as the language of the case suggests. One instance in which it should not be applied is in a case such as *Xonics* itself, where the triggering event has already occurred, and the liability has become absolute and fixed by the time of the bankruptcy proceeding.

Likewise, the *Xonics* formula is a useful authoritative statement of a procedure for reducing contingent liabilities. But it is, by no means, the only proper procedure. Nor is it the procedure most consistent with proper accounting treatment of contingent liabilities.[101] Reduction of a contingent liability should occur, as it has in the past, at the discretion of the court, using the method best suited to the facts of the case.

Kathryn Ogden Balmforth

---

such as from the guarantor's right to proceed against an outside party." *Id.* This indicates that accounting standards are more consistent with the handling of contingent loan guarantees set forth in *Ollag* and *Haight*, *supra* note 60, than with the *Xonics* rule and formula.

101. *See supra* note 100.