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Zaretsky: Fraudulent Transfer Law as the Arbiter of Unreasonable Risk

FRAUDULENT TRANSFER LAW

AS THE ARBITER OF UNREASONABLE RISK

Barry L. Zaretsky*

Fraudulent transfer law is hot. A body of law that originated to prevent deadbeat debtors from putting their property beyond the reach of creditors has, in recent years, been applied to a wide range of modern business transactions that do not appear to reflect the motivation of the original fraudulent transfer laws. Such extended application has focused interest on this old body of law, with courts and commentators questioning its proper scope.

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3. Baird & Jackson, supra note 1; David G. Carlson, Is Fraudulent Conveyance Law

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In its original form, the fraudulent transfer law proscribed transactions intended to hinder, delay, or defraud creditors. It addressed transactions in which the debtor, by engaging in a transaction, had a specific intent to prevent or interfere improperly with collection efforts in order to retain some benefit for the debtor. Thus, a transaction intended primarily to hide assets from creditors, or to put assets beyond creditors’ reach but within the debtor’s reach, could easily be viewed as one intended to hinder, delay, or defraud.

However, intent to defraud is difficult to prove. Recognizing the difficulty of proving a transferor’s specific intent, courts developed principles of constructive fraud under which a transaction might be avoidable as fraudulent even in the absence of a showing of actual intent to hinder, delay, or defraud. The drafters of the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act included these principles in several “constructive fraud” provisions, addressing transactions that might be considered wrongful toward creditors even if it could not be proven that the debtor had actual intent to hinder, delay, or defraud its creditors.

The constructive fraud provisions generally render avoidable those transactions in which the debtor did not receive reasonably equivalent value for a transfer or obligation and was financially impaired, or rendered financially impaired, by the transaction. In part, these provisions seem

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4. See 13 Eliz., ch. 5, § 1 (1570) (Eng.).
5. See, e.g., Reade v. Livingston, 3 Johns. Ch. 481 (N.Y. Ch. 1818); Townsend v. Windham, 28 Eng. Rep. 1 (Ch. 1750); Boyd v. Dunlap, 1 Johns. Ch. 478, 482 (N.Y. Ch. 1815) (distinguishing between a transfer “fraudulent in fact” and one “only constructively fraudulent”). See generally Kennedy, supra note 2, at 535-36.
8. In the Prefatory Note to the Uniform Fraudulent Conveyance Act, the drafters observed that in the absence of constructive fraud provisions, courts had been forced to resort to presumptions of intent to defraud, even in transactions where it was clear that there was no such intent. See UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 427, 428 (1918). The constructive fraud provisions were intended to offer a more direct and intellectually honest means of attacking transactions that appear improperly to affect adversely creditors’ abilities to collect their claims. Id.
intended to identify transactions that might have been driven by fraudulent intent, even if actual fraudulent intent could not be proven.9 In addition, courts and commentators have suggested that, even in the absence of fraudulent intent, some transactions may be improper toward creditors. For example, some have suggested the idea that a debtor should be just before it is generous.10 This ideal of justice before generosity explains the application of fraudulent transfer law to a wide range of transactions, including gifts by insolvents and one-shot sales or transfers for clearly inadequate consideration.11

However, constructive fraud provisions have been applied to certain modern transactions that do not fall clearly within either the implied fraud model or the justice ideal.12 In this Article, I embark upon the first stage of

9. The Uniform Act provisions are generally consistent with presumptions created by courts applying the actual fraud standard in the absence of a constructive fraud standard. See, e.g., Lobstein v. Lehn, 12 N.E. 68 (Ill. 1887); Worthington v. Bullitt, 6 Md. 172 (1854). One approach that was superseded by the Uniform Acts, derived from Reade, 3 Johns. Ch. at 481, and Townsend, 28 Eng. Rep. at 1, considered fraudulent a transfer for inadequate consideration by a person that was indebted, even if the transferee retained sufficient property to pay its debts, if subsequently the transferee became unable to pay its debts. See, e.g., Bibb v. Freeman, 59 Ala. 612 (1877); Glasgow v. Turner, 18 S.W. 261 (Tenn. 1892). See also 1 GARRARD GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES §§ 266-69 (rev. ed. 1940); James A. McLaughlin, Application of the Uniform Fraudulent Conveyance Act, 46 Harv. L. Rev. 404 (1933).

10. See, e.g., Reade, 3 Johns. Ch. at 505 (stating that "[a debtor] must be taught . . . that the claims of justice are prior to those of affection"); Clark, supra note 3, at 510-11 (stating that one of the ideals served by fraudulent transfer law "can be captured by a cliche: be just before you are generous. The debtor has a moral duty in transferring his property to give primacy to so-called legal obligations, which are usually the legitimate, conventional claims of standard contract and tort creditors, as opposed to the interests of self, family, friends, shareholders, and shrewder or more powerful bargaining parties" (footnotes omitted)).

11. The drafters of the Uniform Acts seem to have adopted this traditional justification, although they offered little explanation for their adoption of constructive fraud principles. See UNIF. FRAUDULENT CONVEYANCE ACT, §§ 4-6, 7A U.L.A. 474, 504, 507 (1918); UNIF. FRAUDULENT TRANSFER ACT, §§ 4-5, 7A U.L.A. 652-53, 657 (1984). The Prefatory Note to the Uniform Fraudulent Conveyance Act indicates that the Uniform Act was intended to clarify the law of fraudulent conveyances as well as to overturn the view in some jurisdictions that a gift by a debtor was fraudulent as to existing creditors if the debtor thereafter became insolvent. UNIF. FRAUDULENT CONVEYANCE ACT, 7A U.L.A. 427, 428-29 (1918).

12. See cases cited supra note 2. Two applications that have generated particular controversy are the use of fraudulent transfer law to attack foreclosure sales and leveraged buyouts. Prior to the Supreme Court's decision in BFP v. Resolution Trust Corp., 114 S. Ct. 1757 (1994), holding that the price obtained at a properly conducted foreclosure sale is the reasonably equivalent value, id. at 1765, some courts had held that a properly conducted foreclosure sale could be attacked as a fraudulent transfer if the price obtained at the sale was less than a judicially determined fair market value of the property. See, e.g., Walker v. Littleton (In re Littleton), 888 F.2d 90 (11th Cir. 1989); Bundles v. Baker (In re Bundles), 856 F.2d 815 (7th Cir. 1988); Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980). Commentators
an exploration of the purpose of fraudulent transfer law and, in particular, the purpose of the constructive fraud tests, by considering the role of fraudulent transfer law in regulating the level of risk taken by debtors. I suggest that fraudulent transfer law addresses a range of transactions that, although not engaged in with any malevolent intent, necessarily have the effect of improperly or unfairly interfering with creditors’ abilities to collect on their claims by unreasonably increasing the risk faced by creditors. By monitoring the level of risk undertaken by debtors, application of the constructive fraud provisions to modern transactions may serve an important purpose not explicitly contemplated when these provisions were initially promulgated.

In Part I of this Article, I describe the general principles of fraudulent transfer law. In Part II, I consider the role of fraudulent transfer law in monitoring risks taken by debtors. In Part III, I consider two increasingly common types of business transactions, leveraged buyouts and intercorporate guarantees, and discuss the use of fraudulent transfer law to regulate the risks imposed on creditors. I analyze the application of the constructive fraud tests as illustrative of the policy of permitting debtors to take risks, but not unreasonable risks, at the expense of their creditors. Finally, I explain in Part IV that although the recognition of fraudulent transfer law as a means of monitoring risks taken by debtors can assist in analyzing particular cases, many questions remain to be analyzed. The questions include whether fraudulent transfer law is the optimal vehicle for monitoring these transactions, whether the concept of value in the fraudulent transfer law and the standards of constructive fraud provide adequate measures of risks, and whether remedies provided by fraudulent transfer law are appropriate in the context of these transactions.

PART I
OVERVIEW OF FRAUDULENT TRANSFER LAW

Fraudulent transfer law developed under the common law and was codified in the Statute of Elizabeth. The Statute of Elizabeth provided for

disagreed vigorously about whether this was a proper use of fraudulent transfer law. Compare Thomas H. Jackson, Avoiding Powers in Bankruptcy, 36 Stan. L. Rev. 725, 777-86 (1984) (arguing that foreclosure sales should be analyzed under preference law instead of fraudulent conveyance law) and Robert M. Zinman et al., Fraudulent Transfers According to Alden, Gross, & Borowitz: A Tale of Two Circuits, 39 Bus. Law. 977 (1984) (arguing that Durrett misinterpreted the law of fraudulent transfer) with Kennedy, supra note 2, at 535 (arguing that applying fraudulent transfer law to foreclosure sales is “wholly consonant with the course of development of creditors’ remedies against injurious transfers of their debtors’ assets”). BFP resolved this dispute in favor of accepting the price obtained at a properly conducted sale. The application of fraudulent transfer law to leveraged buyouts is discussed infra in Part III.

13. 13 Eliz., ch. 5 (1571) (Eng.). See also GLENN, supra note 9, §§ 58-62.
the avoidance and punishment of transfers made "to the end, purpo[s]e and intent, to delay, hinder or defraud creditors." This early fraudulent transfer statute was apparently in part a criminal law, in part a revenue measure (the Crown could receive a portion of any recovery), and only in part a creditor protection. However, when the English courts held that a judgment creditor could disregard a fraudulent conveyance and levy execution on the property transferred, the fraudulent conveyance law became primarily one of creditor protection.

Twyne's Case is considered the seminal fraudulent transfer case describing standards for applying the Statute of Elizabeth. It also represents a typical fact situation to which the law would apply. In Twyne's Case, the debtor, Pierce, owed C. two hundred pounds and owed Twyne four hundred pounds. Pierce secretly transferred his property to Twyne but retained use and possession of the property. Indeed, Pierce subsequently sold some of the sheep involved, sheared and marked others, and generally treated the property transferred as if it still belonged to him. C. sent the sheriff to levy on what he thought was Pierce's property, but friends of Twyne prevented the sheriff from doing so, pointing out that the property no longer belonged to Pierce.

The court held that the transfer was fraudulent and void (or, more likely, voidable) as against Pierce's creditors. The court pointed out six aspects of the transaction that indicated Pierce's fraudulent intent: (1) The gift was general; Pierce transferred even his necessities; (2) Pierce retained possession of the property and used it as his own; (3) the transaction was secret; (4) it was made pending C.'s writ; (5) there was a trust between the parties; and (6) the deed explicitly recited that the transfer was made "honestly, truly, and bona fide." These factors came to be known as badges of fraud, which could be used to identify transactions engaged in with intent to hinder, delay, or defraud creditors.

The focus of Twyne's Case and of fraudulent transfer jurisprudence at that time seems to have been debtors' bad conduct intended to protect their interests in property at the expense of their creditors. Thus, the problem in Twyne's Case was not simply that the debtor had transferred property or that the debtor had preferred one creditor, Pierce, over another, C. Rather, the problem was that the debtor actively hid the transfer from his creditors and, in addition, seemed to set up the transaction so that the debtor could retain the

14. 13 Eliz., ch. 5, § 1 (1571) (Eng.).
15. GLENN, supra note 9, § 61a-c.
16. Id. § 61d.
17. 76 Eng. Rep. 809 (Star Chamber 1601).
18. Id. at 812.
19. Id. at 812-14.
benefit of the property and, eventually, probably recover the property from the transferee.20

It is reasonable to ask why, in addition to protecting the Crown's rights to property, the law would develop to protect third parties' debt collection rights. After all, creditors who did not want their debtors putting property beyond their reach could have proscribed such behavior in their agreements. However, merely proscribing wrongful behavior in a credit agreement would not assure creditors a remedy if the debtor violated the agreement. Moreover, as the court in Twyne's Case acknowledged, the range of potential debtor misconduct is virtually limitless. Creditors unable to predict the latest scheme would fall prey to their debtors' misconduct.

Fraudulent transfer law appears to have developed to imply a term in all credit arrangements barring the debtor from defrauding its creditors. Such an implied term is consistent with other implied contractual provisions, such as those proscribing unconscionability or requiring good faith.21 The fraudulent transfer law also appears to have been intended to provide a viable remedy for violation of the implied term. An action against a judgment-proof debtor like Pierce would not suffice. Fraudulent transfer law addressed the issue by recognizing an action against the transferee to recover the property improperly transferred.

But what does it mean to intend to hinder, delay, or defraud creditors? Surely, if Pierce had used his creditors' money to buy sheep that later died from an unexpected disease, the purchase of the sheep would not be considered fraudulent notwithstanding that their death may have prevented creditors from collecting on their claims. Similarly, if Pierce had invested the money in seeds that failed to sprout and grow because of a drought or in a roadside stand that failed to prosper for lack of customers, it seems unlikely that the court would have labeled those transactions fraudulent, notwithstanding that they might have adversely affected creditors' rights. The problem with Pierce's transaction in Twyne's Case was that it was not a normal, reasonably expectable business investment, nor was it above board. Instead, it was an unusual, suspicious transaction that directly impeded other creditors in their attempts to obtain satisfaction of their claims.

The badges of fraud listed in Twyne's Case, along with other badges that have developed over the years, assisted courts in determining whether a

20. According to Professor Glenn, this was analogous to the fairly typical pattern of debtors putting their assets beyond the reach of their creditors prior to embarking overseas or otherwise engaging in conduct or transactions that might lead to loss of their property. GLENN, supra note 9, § 61. The fraudulent transfer law may have been originally intended to protect the Crown's right to that property, but it evolved into protection for creditors as well.

transfer or obligation involved the type of unusual, suspicious, injurious transaction that could be considered to be based on actual fraudulent intent. However, they could not entirely cure the problem that intent, particularly the type of malevolent intent purposely and actually to hinder, delay, or defraud creditors, is difficult to prove.

In part to address this problem, courts, and subsequently Uniform Acts, developed principles of constructive fraud that rendered avoidable transactions for which actual fraud might not be proven but that were likely to have involved improper intent. Implicit in these constructive fraud principles is the recognition of a broader view of intent that may have motivated the court’s analysis in Twyne’s Case. This view encompasses acts that by their nature will improperly and unreasonably harm creditors even if the debtor did not have clear malevolent intent to cause harm.

Although the exact technical content of the constructive fraud provisions has varied as fraudulent transfer law has developed, the basic principles have not changed significantly. The constructive fraud provisions address transactions under which the transferor or obligor did not receive reasonably equivalent value in exchange for a transfer or the incurring of an obligation at a time when, or after which, the transferor or obligor was insolvent, had unreasonably small capital or assets to continue in its business, or intended or believed that it would incur debts beyond its ability to pay as the debts became due. The essence of these provisions is a depletion of the debtor’s estate at a time when the debtor is seriously financially impaired, or which renders the debtor seriously financially impaired.

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22. See supra note 5.
23. See supra notes 6-7.
PART II
REGULATION OF RISK

In general, the constructive fraud provisions are intended to address transfers that, although perhaps not made with any malevolent intent, necessarily have the effect of improperly and adversely affecting creditors. For example, gifts by insolvents, even if done without any fraudulent intent, are objectionable because they can only harm creditors by reducing the already insufficient property available. 27 Similarly, other transactions by financially impaired debtors who receive less than reasonably equivalent value may unfairly or improperly harm creditors even when the debtor did not have any intention to cause harm to its creditors. 28

Commentators have generally recognized that fraudulent transfer law addresses transactions that unfairly or improperly harm creditors in addition to those that are actually intended to harm creditors. 29 However, most commentators fail to define adequately the concept of unfair or improper harm. Instead, they tend to engage in circular reasoning by asserting that a transaction is improper or unfair if it fails a constructive fraud test and that, therefore, the constructive fraud tests describe unfair or improper transactions. They do not generally identify what the impropriety or unfairness is or why the constructive fraud tests might represent a reasonable approximation of those transactions that are unfair or improper toward creditors. 30

27. Baird & Jackson, supra note 1, at 832.
28. In this regard, a fair question is what exactly is meant by intent. Must the debtor have actual intent to cause harm to its creditors, or is it sufficient if the debtor knows or should know that the necessary result of its actions will be to cause harm? For example, a financially impaired debtor giving a gift may do so out of mere generosity or charitable instinct, see Christians vs. Crystal Evangelical Free Church (In re Young), 148 B.R. 886 (Bankr. D. Minn. 1992) (applying the law of fraudulent transfer to charitable contributions), aff'd, 152 B.R. 939 (D. Minn. 1993), for silly reasons, or for no reason. Yet, knowing that the gift will cause a loss that will eventually fall on its creditors, is there intent to hinder, delay, or defraud the creditors? In an analogous line of cases, some courts construing the "willful and malicious" standard of Bankruptcy Code § 523(a)(6), 11 U.S.C. § 523(a)(6) (1988), have in recent years interpreted it as requiring an intentional act, the necessary result of which will be harm, regardless of whether the debtor actually intended to cause harm. See, e.g., Impulsora Del Territorio Sur, S.A. v. Cecchini (In re Cecchini), 780 F.2d 1440 (9th Cir. 1986).
29. See, e.g., Glenn, supra note 9, § 275 (stating that "the test is whether, as a result of the transaction, the debtor's estate was unfairly diminished" (emphasis added)); Kennedy, supra note 2, at 562 (stating that "fraudulent transfer law . . . condemns injurious transfers out of debtors' estates"); Williams, Revisiting, supra note 3, at 59 (stating that "most commentators agree that the thrust of fraudulent transfer law is to protect [against] the unjust diminution of the debtor's estate").
30. One notable exception to this statement is Clark, supra note 3, at 506-17 (suggesting several principles underlying fraudulent transfer law).
What does it mean, then, to characterize a transaction as improperly or unfairly interfering with creditors? I suspect that there is a range of improper and unfair interferences. The mere diminution (at least unjustified) of the debtor’s estate when the debtor is financially impaired, depriving creditors of the ability to collect on their claims, suggests impropriety or, at least, unfairness, at least when there is no justification for the diminution. This is the traditional type of transaction from which the constructive fraud principles have been derived. The improper or unfair interference results simply because a financially impaired debtor transfers property in a manner that reduces the property available to creditors. The transactions to which this paradigm has been applied typically have been one-shot deals in which the debtor transferred some property and received inadequate consideration in return.

The traditional cases did not consider some of the situations that arise in modern cases, where the transfer or obligation is part of a larger investment transaction. These involve not merely transfers of property, but the undertaking of business risks that, in some cases, may not be entirely unusual or improper.

Professor McCoid gave the example several years ago of the debtor who, “while hoping to pay his creditors, is ‘gambling with their money.’”32 The debtor might, for example, “sell at a low price to get desperately needed liquidity.”33 Professor McCoid concluded that “if gambling with another’s money is wrong, then it would be logical to outlaw credit transactions.”34 Similarly, Professors Baird and Jackson correctly point out that creditors lend money to debtors to take advantage of debtors’ “entrepreneurial skills,” which requires that debtors have some freedom to take risks with their creditors’ funds.35 Creditors expect their debtors to take risks and should not be heard to complain when risks are taken.

Thus, fraudulent transfer law does not bar debtors from taking risks with their creditors’ funds. It does, however, regulate the permissible degree of risk. Under this view, the improper and unfair interference with creditors’

31. Professors Baird and Jackson observed the following in 1985:
   Much of the case law under the Uniform Fraudulent Conveyance Act and federal bankruptcy law has concerned individual rather than corporate debtors and most of the transfers attacked as fraudulent conveyances have been between relatives, friends, or other insiders. . . . For this reason, the reach of fraudulent conveyance law has not been an issue for much of this century.

Baird & Jackson, supra note 1, at 832.


33. Id.

34. Id.

35. Baird & Jackson, supra note 1, at 834.
rights that is addressed by fraudulent transfer law occurs when a debtor takes not merely risks, but unreasonable risks, with assets that would otherwise be available to satisfy creditors’ claims.\textsuperscript{36}

This approach assures that analysis of a transaction through the prism of fraudulent transfer law need not lead necessarily to avoidance of a transaction. A court may find that a risky transaction ultimately depriving creditors of satisfaction of their claims was not unreasonably risky when it occurred. If the constructive fraud tests adequately reflect the policy of addressing only unreasonable risk, then a transaction that is not unreasonably risky would not be avoidable under fraudulent transfer law.

By addressing unreasonable risks, fraudulent transfer law can be viewed as providing credit transactions and agreements with an off-the-rack term requiring the debtor to limit itself to reasonable business or financial risks. This limitation is very likely consistent with the terms that creditors and a debtor would negotiate were they sufficiently prescient and sophisticated to do so.\textsuperscript{37} In effect, then, fraudulent transfer law defines not only those transactions that are likely to involve fraudulent intent or that under any conceivable set of facts will injure creditors, but also those transactions that represent unreasonable risks beyond the level that creditors can be presumed to have accepted.

This implied term represents an important creditor protection. When creditors extend credit to debtors, they expect the debtors to take risks with their money. To the extent that the parties can predict the types of risks that might be taken, the parties may limit the debtor’s ability to take risks through

\textsuperscript{36}Finance economists have identified two types of investment risk. First, the expected return of a transaction, calculated as “the arithmetic mean of the possible outcomes of an investment with each such outcome being weighted by the probability of its occurrence,” may be less than the cost of the investment. V. Brudney and W. Bratton, CASES AND MATERIALS ON CORPORATE FINANCE 57 (4th ed. 1993). Second, the relative dispersion of the probability distribution associated with each outcome may be too great. In evaluating the riskiness of a transaction, it will be necessary to consider both the expected return and the dispersion of possible outcomes. Id. at 57-64. An analysis of the effect of each type of risk on the reasonableness of a transaction is beyond the scope of this article. It is, however, obviously of great importance ultimately in determining how fraudulent transfer law should evaluate the question of unreasonable risk.

\textsuperscript{37}If fraudulent transfer law is viewed as providing an implied contractual term prohibiting debtors from taking unreasonable risks, the question arises whether creditors can waive that term. The answer is not entirely clear. It would seem that by agreeing that a debtor may engage in transactions otherwise prohibited by fraudulent transfer law, or in a particular transaction that might be prohibited, a creditor may be able to waive effectively its right to object subsequently to the transaction. Such a waiver would not, of course, bind other creditors, and a debtor should not be able to impose a waiver on creditors. Moreover, a waiver will not necessarily prevent a creditor from benefiting from avoidance in a bankruptcy proceeding. That, however, is a function of federal bankruptcy law, not fraudulent transfer law. See Moore v. Bay, 284 U.S. 4 (1931); see also 11 U.S.C.A. § 548 (1993 & Supp. 1995).
the use of covenants in a loan agreement. In some cases, however, such limitations may be commercially or practically unrealistic. Moreover, the parties probably cannot predict all possible risks that a debtor might take with a creditor’s funds. As the court observed in Twyne’s Case, the range of potential fraud, or unreasonable risks, is enormous and unpredictable.

Additionally, a term implied through fraudulent transfer law yields remedies that would be unavailable in a debtor-creditor agreement. A debtor-creditor agreement would enable creditors to declare a default and enforce their remedies against the debtor if the debtor violated the agreement. However, if the debtor transferred property to a good faith purchaser, unsecured creditors could not recover it merely because the credit agreement was violated. The agreement risks creating a wrong without a remedy. Fraudulent transfer law seeks to identify the wrong and to provide a meaningful remedy.

Thus, just as the law has evolved to protect creditors against a debtor’s intentional fraud and misbehavior, and in many cases, to imply a good faith requirement, particularly in many commercial dealings, fraudulent transfer

38. See, e.g., United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1297 n.2 (3d Cir. 1986) (noting that involuntary creditors, and creditors who extended credit before the type of transaction at issue became common, probably cannot contractually protect themselves, cert. denied, 483 U.S. 1005 (1987); see also Kevin J. Liss, Note, Fraudulent Conveyance Law and Leveraged Buyouts, 87 COLUM. L. REV. 1491 (1987) (arguing that powerful creditors who could restrict the debtor’s ability to engage in an LBO are more likely to take a security interest in the debtor’s assets and that smaller trade creditors are unlikely to have sufficient leverage to restrict the debtor’s behavior).

39. Recovery would normally be available if creditors had perfected security interests in the property. See, e.g. U.C.C. §§ 9-201 (1990). Absent, a security interest, there would be little protection for a creditor against transfers by the debtor. Even a creditor with a security interest in the debtor’s property might be injured by the debtor’s incurring of additional debt, which might make it more difficult for the debtor to pay its obligations. Although an agreement might contain negative covenants prohibiting additional debt, violation of such covenants would not normally represent a ground for avoiding the new debt.

40. The remedy provided by fraudulent transfer law, however, is not necessarily the ideal remedy. There has been considerable disagreement about the proper reach of fraudulent transfer remedies. See, e.g., Carlson, Leveraged Buyouts, supra note 3; Robert J. White, Leveraged Buyouts and Fraudulent Conveyance Laws Under the Bankruptcy Code—Like Oil and Water, They Just Don’t Mix, 1991 ANN. SURV. AM. L. 357 (1991).

One of the most troubling remedy issues is the degree to which recovery should be available from a good faith transferee who gave value for the transfer. For example, suppose that a debtor makes an investment with an expected return equivalent to the cost of the investment but with a wide dispersion of possible outcomes. The investment might be viewed as unreasonably risky notwithstanding an equivalent expected return. Should the transferee be subject to a fraudulent transfer action because the risk was unreasonable vis a vis the particular debtor involved?

law may be viewed as implying a requirement that a debtor taking risks with its creditor's funds limit itself to reasonable risks.\(^{42}\) It may also provide the meaningful remedy that would otherwise be unavailable to the injured parties.

The constructive fraud standards attempt to describe these unreasonably risky transactions. Notice what transactions are included in the constructive fraud provisions: transfers for which the debtor fails to receive reasonably equivalent value and after which the debtor (1) is insolvent; (2) is left with unreasonably small assets to continue its business; or (3) intends or expects to incur debts beyond its ability to pay as the debts become due. A transaction fitting any of these tests is not simply risky, it is unreasonably risky because there is a high probability that the transaction will inhibit the debtor's ability to pay its creditors. These are transactions that are unreasonably detrimental to creditors because they create an unreasonably high degree of risk.

The unreasonable risk flows from the substantial impairment of the debtor's ability to service its debt after the transaction. If a debtor has failed to receive reasonably equivalent value in a transaction, then the value of the remaining property available to creditors is reduced. This means that there is a greater risk that creditors' claims will not be satisfied.\(^{43}\) If in addition the debtor is financially impaired when it engages in the transaction that reduces available property (or is rendered financially impaired by the transaction), then the risk that the debtor's finances will be unable to turn around is further increased. The constructive fraud provisions suggest that when a debtor puts at unreasonable risk the property needed to satisfy its creditors, the transaction in which it does so may be avoided by the adversely affected creditors.

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\(^{43}\) It should be noted that if fraudulent transfer law is to serve effectively as a check on unreasonable risk, then the concept of value may need to be viewed in a manner different from the conventional understanding. For example, suppose that an insolvent debtor has the opportunity to purchase for $100 a lottery ticket giving it a one in a million chance of receiving $100 million. The expected return of the "investment" is $100, the amount paid for the opportunity. Yet a transaction with such a high probability of failure probably represents an unreasonable risk for an insolvent debtor. Although beyond the scope of this essay, further examination of the measure of risk and the concept of value in fraudulent transfer law is necessary. It may be that risk and value should be measured from the creditors' perspective, see, e.g. American Surety Co. v. Conner, 251 N.Y. 1, 166 N.E. 783 (1929), or, perhaps, that value for fraudulent transfer purposes might be measured as the utility of an investment rather than simply the expected return. See Brudney & Bratton, supra note 36, at 57-64.
Viewed in this light, it is possible to reconcile the application of fraudulent transfer law to a wide range of corporate as well as individual transactions.

Evaluation of the utility of the constructive fraud standards as regulators of unreasonable risk can be based on the application of those standards to modern transactions. In Part III of this Article, I examine the application of the constructive fraud standards to two modern types of transactions. This examination illustrates the use of fraudulent transfer law as a regulator of risk taking by debtors.

PART III
APPLICATION OF CONSTRUCTIVE FRAUD STANDARDS

In general, the actual fraud standard in fraudulent transfer law has served a useful and uncontroversial purpose. It authorizes the avoidance of transactions that were specifically intended to hinder, delay, or defraud creditors and restores to the extent possible the status quo that existed prior to the transaction. By focusing on the debtor-transferor’s intent, the actual fraud standard addresses the malevolent behavior that unfairly places beyond the reach of creditors property that should be available to satisfy their claims.44

As they were originally applied, the constructive fraud standards also were relatively uncontroversial. They typically were used to permit the avoidance of fairly straightforward transactions in which debtors engaged in behavior that appeared clearly to be objectionable from the perspective of the creditor body.

In recent years, however, these provisions have been applied to types of transactions that are not as obviously objectionable. For example, fraudulent transfer law has been used to evaluate such increasingly common business transactions as leveraged buyouts and corporate guarantees.45 It has also been applied to other common business transactions that are not generically objectionable.46

44. One interesting question that remains is why fraudulent transfer law places the interests of the transferee’s creditors over the interests of an innocent transferee. Avoidance of a fraudulent transfer may in some cases deprive the transferee of its expectation even if the transferee was not a party to the fraud. See UFCA § 9 UFTA §§ 7, 8.


46. See, e.g., BFP v. ResolutionTrust Corp., 114 S. Ct. 1757, 1765 (1994) (recognizing that fraudulent transfer law applies to foreclosure sales, although normally the price received at the sale is reasonably equivalent value and sale is not, therefore, avoidable as fraudulent transfer); Besing v. Hawthorne (In re Besing), 981 F.2d 1488 (5th Cir.) (evaluating a lawsuit termination),
Many transactions that have been examined through the lens of fraudulent transfer law have not involved actual fraudulent intent nor were they, by their generic nature, necessarily doomed to fail and consequently to harm creditors. Some of these transactions may have been so unobjectionable in theory that, if asked in advance if a debtor should be permitted to engage in the type of transaction at issue, creditors might have been expected to say yes.

In some cases, however, the financial condition of the debtor may have made these transactions not merely risky, but so unreasonably risky as to become objectionable even to creditors who recognize that their debtor will take risks with their funds. A review of the application of fraudulent transfer law to leveraged buyouts and intercorporate guarantees illustrates how it can be applied to transactions in a manner that permits risky transactions to proceed without objection, but also protects creditors against truly unreasonable risks.

**a. Leveraged Buyouts**

One of the most controversial extensions of fraudulent transfer law beyond actually fraudulent transactions involves leveraged buyouts (LBOs). In an LBO, a target company’s stock is purchased and paid for by a third-party acquiror, primarily using financing secured by the assets of the target. The transaction can be structured in one of several general forms with myriad variations.

Under one structure the target borrows money, typically secured by its assets, uses the funds to buy its stock from its old shareholders (or makes available to the acquiror the funds necessary to acquire the stock), and then transfers the stock or issues new stock to the acquiror.47 Another structure has the acquiror borrow money, guaranteed or ultimately assumed by the target and secured by the target’s assets, and use the money to purchase the target’s stock from the old shareholders.48 A variety of other structures have been used as well.49

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49. See, e.g., Moody, 971 F.2d at 1058-62 (applying fraudulent transfer law where the acquiror
The common theme in these transactions is that the old shareholders are cashed out, the new shareholders put up little of their own funds, and the target's assets secure the claims of the lenders who supplied the funds for the purchase. By securing with its assets the LBO debt and using the proceeds primarily to cash out the old shareholders, the target reduces the unsecured creditors, who previously were senior to the shareholders, to a position that is junior to the financier of the transaction and, in effect, to the old shareholders who have been satisfied ahead of the creditors. The priority positions of the old shareholders and the creditors thus are reversed.

An LBO offers several potential benefits for parties to the transaction. It enables the old shareholders to cash out their interests and, perhaps, invest their money elsewhere. Sometimes this cashing out of shareholders is part of a necessary or desirable restructuring of ownership. In addition, a successful transaction may generate substantial profits for the target's new owners. Moreover, the LBO may have the effect of strengthening the target by forcing it to operate more efficiently and effectively. Therefore, if the LBO works as planned, the LBO may not adversely affect creditors and others who deal with the target because they may eventually face a stronger debtor or customer.

However, a transaction involving substantial leverage is inherently risky. High leverage ratios increase the possibility of business failure. If the

borrowed funds to acquire stock and where, subsequently, the target borrowed funds and used the funds to repay the acquiror's debt); *Mellon*, 945 F.2d at 637-40 (applying fraudulent transfer law where the acquiror borrowed money for acquisition with a loan guaranteed by the target, the target borrowed working capital with a loan guaranteed by the acquiror, and related corporations guaranteed repayment of both loans). *See generally* Carlson, *Leveraged Buyouts*, *supra* note 3, at 80-83 (describing six different ways of structuring leveraged buyouts).

50. As one court described it:

The effect of an LBO is that a corporation's shareholders are replaced by secured creditors. Put simply, stockholders' equity is supplanted by corporate debt. The level of risk facing the newly structured corporation rises significantly due to the increased debt to equity ratio. This added risk is borne primarily by the unsecured creditors, those who will most likely not be paid in the event of bankruptcy. *Mellon Bank*, 945 F.2d at 645-46.

In some cases, a portion of the financing may be provided on an unsecured basis. Although the unsecured LBO debt would not take priority over other unsecured creditors of the target, the position of non-LBO creditors is diluted by the addition of substantial debt. *See, e.g.*, *In re Revco D.S.*, Inc., 118 B.R. 468 (Bankr. N.D. Ohio 1990).

51. *See, e.g.*, *Kupetz*, 845 F.2d at 843-44 (describing an LBO that provided a means of buying out the interest of a shareholder who was seeking to retire); *Vadnais Lumber Supply, Inc.*, 100 B.R. at 129-30 (describing an LBO that enabled one partner to buy out the others where there was a falling out between partners). Some commentators have suggested that an LBO may provide shareholders with a "remedy for past suboptimal reinvestment of earnings by entrenched managers. *See, e.g.*, V. Brudney and W. Bratton, *CASES AND MATERIALS ON CORPORATE FINANCE* 57-64 (4th ed. 1993).

52. *See, e.g.*, *Mellon Bank*, 945 F.2d at 645-46 (describing the added risk imposed by a
business does fail, the non-LBO creditors, some of whom may have unsecured claims against the target predating the LBO, are likely to share the cost of failure.

Although an LBO imposes risk on creditors, creditors who lend on an unsecured basis must recognize that the debtor will take risks that may affect them adversely. One potential risk is that the debtor will use assets otherwise available to creditors generally to secure new obligations and that the debtor will more highly leverage itself. This alone is not objectionable; leverage is not unusual in business and may, under appropriate circumstances, enable a business to increase its return on equity. Thus, some commentators have concluded that LBOs, which take advantage of high leverage ratios, are simply not a type of transaction that, absent actual fraud, should be subject to attack under fraudulent transfer law.

This conclusion, however, flows from a narrow view of fraudulent transfer law that would limit its scope to transactions involving fraudulent intent. Under this view, the constructive fraud provisions primarily provide the evidence of fraudulent intent that was sought under early fraudulent transfer law. Indeed, when the constructive fraud principles first developed, a constructively fraudulent transaction probably would have raised a suspicion of fraudulent intent, or at least would have violated the principle of justice before generosity.

Adopting an originalist view of fraudulent transfer law, some courts repeated Professors Baird and Jackson's observation that "[a] firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethian deadbeat who sells his sheep to his brother for a pittance." This mantra suggests that if, notwithstanding the constructive fraud provisions, a transaction appeared to be "above board," fraudulent transfer law was not an appropriate vehicle for interfering with the transaction. Under this approach if the constructive fraud provisions applied at all, it would be only when the transaction already appeared suspicious.

This narrow originalist view of fraudulent transfer law also seems to have been based on an assumption that application of fraudulent transfer law to LBOs would lead to invalidation of all LBOs. Because most LBOs occur for nonfraudulent business reasons, courts adopting an originalist view resisted

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54. See, e.g., Baird & Jackson, supra note 1.
56. See Kupetz v. Wolf, 845 F.2d 842, 847 (9th Cir. 1988).
57. See, e.g., id. at 848 (refusing "to utilize constructive intent to brand most, if not all, LBOs as illegitimate").
the idea that these potentially useful transactions could be hindered by the threat of application of a body of law over 400 years old.\textsuperscript{58} Thus, under this originalist view, in the absence of some reason to believe that there was fraudulent intent, the constructive fraud provisions appear overly broad, potentially taking in transactions that were not intended to be covered by fraudulent transfer law.\textsuperscript{59}

Instead of this narrow view of fraudulent transfer law, limiting its reach to transactions actually or constructively intended to hinder, delay, or defraud creditors, a broader purpose may be recognized. Fraudulent transfer law may represent a useful means of distinguishing between those legitimate business transactions that present reasonable, acceptable risks and those that present an unreasonable level of risk. When the risk is unreasonable, the transaction is one that clearly would be unacceptable to an ordinary creditor \textit{ab initio}. This is the type of transaction that is objectionable under fraudulent transfer law.

Under this approach, high leverage ratios caused by an LBO would not render an LBO transaction avoidable per se. However, unreasonably high leverage is another matter. Unreasonably high leverage shifts virtually all of the risk of failure to creditors, instead of the sharing of risk between creditors and equity that exists in more reasonable transactions.\textsuperscript{60} This is the type of transaction proscribed by the constructive fraud provisions. Thus, fraudulent transfer law seems to suggest that there is a level of unreasonable risk to which creditors should not be subjected.

This rationale may not be far from the original purposes of fraudulent transfer law. Early law proscribed not only transactions intended to defraud, but those intended to hinder or delay creditors. A transaction with unreasonably high leverage, or one that imposes unreasonable risk, may be viewed as one that was intentionally done and, because of its unreasonable level of risk, one that hinders, delays, or perhaps, defrauds creditors. Certainly, there is a level of leverage or risk that virtually assures that creditors will be unlikely to recover in a timely fashion.

Cases considering the application of fraudulent transfer law to LBOs seem to have begun to recognize that fraudulent transfer law provides a standard for distinguishing between transactions that are so risky as to be objectionable from the perspective of creditors and those that represent reasonable business risk. The Third Circuit has been particularly active in this regard. In one

\textsuperscript{58} See id. (stating that “we hesitate to utilize constructive intent to frustrate the purposes intended to be served by what appears to us to be a legitimate LBO . . . . We cannot believe that virtually all LBOs are designed to ‘hinder, delay, or defraud creditors’")

\textsuperscript{59} Underlying the move to limit the scope of fraudulent transfer law is the view that mere risk of fraudulent transfer attack, even if the transaction might on its facts be defended, will discourage transactions.

early case it found that a complex leveraged buyout was actionable under fraudulent transfer law. In two other cases, however, the court determined that, notwithstanding subsequent business failure, the transactions were not actionable under fraudulent transfer law. In each case, the court's analysis implicitly recognizes that risk is not objectionable per se, but may be objectionable if it is unreasonable.

In United States v. Tabor Court Realty Corp., a large coal producer was purchased in a leveraged buyout. The acquirer formed a holding company that obtained a loan of approximately $8.5 million, most of which was used to acquire the coal producer. The loan was secured by virtually all of the target's assets. Unfortunately, the target's financial condition was precarious before the transaction, and because the acquirer mortgaged the target's assets with restrictions on their sale and the use of any proceeds, further financing of the target's operations became even more difficult. Eventually, the lender foreclosed on the mortgages and sold the properties to a buyer who had knowledge of the earlier transactions and their problems.

The United States sought to avoid the property transfers, arguing that the leveraged buyout and the mortgages granted as part of the transaction were avoidable under fraudulent transfer law. The Third Circuit Court of Appeals agreed and held that the transaction was avoidable.

The Court of Appeals rejected policy arguments against the application of fraudulent transfer law to leveraged buyouts, but found that even if fraudulent transfer law should not apply to some buyout transactions, it would still be appropriate to apply it to the transaction at issue. The court's following observation is worth repeating:

In the instant case, . . . the severe economic circumstances in which the [target] found itself, the obligation, without benefit, incurred by the [target], and the small number of shareholders benefitted by the transaction suggest that the transaction was not entered in the ordinary course, that fair consideration was not exchanged, and that the transaction was anything but unsuspicious. The policy arguments set forth in opposition to the application of fraudulent conveyance law to leveraged buyouts do not justify the exemption of transactions such as this.

64. Tabor, 803 F.2d 1291-94.
65. Id. at 1295-96.
66. Id. at 1297 (footnote omitted).
The Court of Appeals certainly did not suggest that all leveraged buyouts would be avoidable as fraudulent transfers. Instead, the Court of Appeals seemed influenced by the target’s impaired financial condition and by the lower court’s finding that the transaction viewed in its entirety was sufficiently suspicious to suggest intent to defraud.

In *Mellon Bank, N.A. v. Metro Communications, Inc.*, a corporate group involved in broadcasting acquired the stock of Metro, a television and radio sports syndicator, in a highly leveraged transaction. Mellon Bank financed the acquisition by lending $1.85 million to the acquiror. Metro and the members of the corporate group guaranteed the loan. Simultaneously, Mellon loaned $2.3 million to Metro as working capital under a line of credit. This loan was guaranteed by the acquiror as well as the other members of the corporate group. Mellon also financed Metro’s purchase of certain broadcast rights through a letter of credit. Metro was responsible for reimbursing Mellon for disbursements under the letter of credit.

All of Metro’s obligations to Mellon, including the guaranty obligation for the acquisition loan, were secured by substantially all of Metro’s assets. The following year, after a creditor levied on some of Metro’s accounts in a dispute over broadcast rights, Metro commenced a bankruptcy case. The creditors’ committee sought to avoid Mellon’s liens on Metro’s assets as, *inter alia*, fraudulent transfers.

In analyzing the applicability of fraudulent transfer law to an LBO, the Third Circuit Court of Appeals acknowledged that it might appear anomalous to apply a law originally aimed at fraudulent transactions to what had become, in the court’s view, “a common, arms-length transaction” in which there normally is no intentional fraud and in which the lender whose security interest is being attacked has parted with real value in exchange for the interest. Nevertheless, the court identified in LBOs a potential for abuse, particularly of unsecured creditors. The court explained that an LBO normally substitutes a secured creditor for the target corporation’s shareholders. From the perspective of unsecured creditors, the formerly junior interest of shareholders is replaced by the senior interest of a secured lender. The target’s debt to equity ratio is increased substantially and, with that increase, the unsecured creditors experience significantly increased risk. The Court of Appeals

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68. *Id.* at 638-39.
69. *Id.* at 639. In addition to the fraudulent transfer issue, the creditors’ committee also argued that Mellon had perfected its security interest improperly by filing in the wrong jurisdiction. *Id.* at 642. *see also* U.C.C. § 9-103, 3 U.L.A. 142 (1990). The court held that the security interest was properly perfected. *See Mellon*, 945 F.2d at 642-44.
70. *Mellon*, 945 F.2d at 645.
71. *Id.* at 645-46.
seemed to view fraudulent transfer law as a means of monitoring the level of increased risk.

Interestingly, although the Court of Appeals accepted the applicability of fraudulent transfer law to this type of transaction, it did not find that the transaction was avoidable as a fraudulent transfer. The Court of Appeals analyzed the transaction under the two prongs of the constructive fraud test: (1) reasonably equivalent value and (2) financial impairment.\textsuperscript{72} It found that the transaction passed the test.\textsuperscript{73} The court’s analysis of the constructive fraud provisions reflects an understanding that fraudulent transfer law is aimed at transactions that create an \textit{unreasonable} risk to creditors.

By finding the transaction unobjectionable under fraudulent transfer law even after acknowledging that the LBO increased the risk faced by unsecured creditors, the court seemed to appreciate that increased risk is permissible as long as it is not unreasonable. Indeed, the court seemed to recognize the purpose of the constructive fraud test by analyzing its factors with an appreciation of the underlying nature of the transaction and the reasonable expectations of the various parties.\textsuperscript{74}

For example, in analyzing whether the debtor received reasonably equivalent value in exchange for the security interests that it granted to the LBO lender, the Court of Appeals recognized that the debtor did not receive the loan proceeds (which flowed through to the old shareholders) and, therefore, received no direct benefit. Nevertheless, the court found that value may be created in forms other than receipt of the loan proceeds. By becoming part of a corporate group, the debtor could borrow additional working capital that would not otherwise have been available.\textsuperscript{75} According to the court, this increased borrowing ability could constitute value, although the extent of that value would depend on “the business opportunities the additional credit makes available to the borrowing corporation and on other imponderables in the operation or expansion of its business.”\textsuperscript{76}

The court also found value in the synergy created when the debtor joined the corporate group. According to the court, “The complementary nature of the two corporations’ businesses would appear to create a stronger and more profitable combination.”\textsuperscript{77}

The court’s acknowledgement that a debtor may receive substantial value in exchange for undertaking obligations even when the debtor fails to receive the proceeds of the loan is of great significance. These indirect forms of value

\textsuperscript{73} See Mellon, 945 F.2d at 645-50.
\textsuperscript{74} See id.
\textsuperscript{75} See id. at 646-47.
\textsuperscript{76} Id. at 647.
\textsuperscript{77} Id.
received by the debtor, increased credit availability and corporate group synergies, can decrease the risk to unsecured creditors initially created by the transaction. Thus, although the court ultimately failed to ascribe a definite value to these benefits (because no evidence of value had been presented), its analysis represents a recognition that risk does not necessarily increase in direct proportion to the obligation undertaken by the debtor.

In evaluating the increased risk to creditors, the Court of Appeals also focused on the liability imposed on the debtor by the transaction. This was important in evaluating whether the debtor received reasonably equivalent value and in determining the debtor's solvency after the transaction. The debtor had guaranteed the acquisition debt incurred by the acquiror, which was a shell corporation formed to acquire the debtor. In this regard, the guaranty was not significantly different from a principal obligation because the principal debtor had no assets with which to pay the debt, and it was clear that the guarantor would be called upon to pay. Indeed, all of the parties assumed that the debtor would service the debt.79

However, the debtor was not the only guarantor of the acquisition debt. The other members of the corporate group also guaranteed the obligation.80 If the debtor were forced to pay the debt, it would be entitled to contribution from the coguarantors. Therefore, the amount of actual predicted liability undertaken by the debtor would be less than the face amount of the debt if the other guarantors were capable of contributing to the satisfaction of the obligation.

As with the court's analysis of the value received by the debtor, its analysis of the obligation undertaken by the debtor seemed to evaluate the actual amount of increased risk created by the transaction. In this regard, the court recognized that the existence of other parties that might share the liability reduced the risk imposed on creditors of the debtor.81

Even if the debtor had reduced its available assets by failing to receive reasonably equivalent value for its secured guaranty obligation, the transaction would be objectionable under fraudulent transfer law only if the transaction financially impaired the debtor.82 If the debtor was not financially impaired after the transaction, the depletion of assets would not create an unreasonable risk for creditors. Instead, the absence of financial impairment would assure sufficient ability to satisfy creditor claims even after the leveraged transaction.

As with its reasonably equivalent value analysis, the Court of Appeals approached the question of financial impairment from the perspective of the

78. See Mellon, 945 F.2d at 647-48.
79. Id. at 638.
80. Id.
81. See id. at 649.
actual risk that the transaction imposed on creditors. It specifically rejected
the lower court’s analysis that had found insolvency merely because the debtor
guaranteed the entire acquisition debt on a secured basis.\textsuperscript{83} The lower court
had maintained that because the acquisition price could be assumed to
represent the actual value of the debtor’s equity, a pledge of all of the debtor’s
assets to secure a debt in that amount plus interest necessarily meant that the
debtor must have been rendered insolvent.\textsuperscript{84}

The Third Circuit Court of Appeals recognized that the lower court’s
approach would amount “to a \textit{per se} rule that LBO loans collateralized with
the target’s assets are fraudulent.”\textsuperscript{85} The Court of Appeals properly rejected
that analysis, asserting that the actual value of the liability undertaken by the
debtor probably was less than the face amount of the guaranty because the
debtor was entitled to contribution from the other members of the corporate
group. Additionally, the court analyzed the debtor’s tax returns and balance
sheets, prepared not long after the transaction, and found reason to believe that
the debtor was solvent after the transaction.\textsuperscript{86} The court attributed this in
part to the value gained by increased credit availability as well as corporate
group synergies.\textsuperscript{87} Indeed, the court found that the debtor’s net worth may
actually have increased after the transaction as a result of these advantages.\textsuperscript{88}
The court implied from this outcome that the transaction was not unreasonably
risky to unsecured creditors and, in fact, might have been beneficial. It
suggested that the debtor’s demise was caused by subsequent unexpected
events, rather by the LBO.\textsuperscript{89} Thus, in the court’s view, because the LBO did
not cause the failure, no action was available under fraudulent transfer law.

Although the general approach of applying the constructive fraud tests to
evaluate the actual amount of increased risk imposed by a transaction has
merit, the court may have failed to appreciate fully the risk imposed on
creditors of the debtor. For example, the Court of Appeals determined the
debtor’s solvency based on the debtor’s tax returns and balance sheets.\textsuperscript{90}
These do not necessarily reflect the actual value of the assets that would be
available to creditors. To the extent that the Court of Appeals was limited by

\textsuperscript{83} Mellon, 945 F.2d at 648-49.
\textsuperscript{84} Mellon Bank, N.A. v. Metro Communications, Inc. (\textit{In re} Metro Communication, Inc.),
\textsuperscript{85} Mellon, 945 F.2d at 649.
\textsuperscript{86} \textit{See id.} at 649-50.
\textsuperscript{87} \textit{Id.} at 649 n.4.
\textsuperscript{88} \textit{Id.} at 650.
\textsuperscript{89} \textit{See id.} at 647; \textit{see also} NCAA v. Board of Regents of the Univ. of Okla., 468 U.S. 85
(1984) (holding that certain NCAA restrictions on the broadcast of college games violated
antitrust laws, increased competition, and severely decreased revenues from advertising).
\textsuperscript{90} \textit{See Mellon}, 945 F.2d at 649-50.
the creditors’ committee’s failure to present more compelling evidence of value, one cannot fault the court for relying on the information before it. Indeed, the court acknowledged that it could not find that the debtor was solvent, after the LBO, but only that the committee failed to prove insolvency. Nevertheless, it is important to recognize that ultimately the risk imposed on creditors cannot be determined without realistic appraisal of the actual effect of the transaction.

Similarly, when the court suggested that the debtor’s difficulties may have been attributable to unforeseen events subsequent to the LBO rather than to the financial strain of the LBO itself, it may not have given sufficient consideration to the extent to which the LBO might have reduced the debtor’s resistance to financial setbacks. The court noted, “The problem universal to all LBOs—transactions characterized by their high debt relative to equity interest—is that they are less able to weather temporary financial storms because debt demands are less flexible than equity interest.” However, the question of how much cushion a debtor should have for unforeseen events is difficult, particularly in analyzing a highly leveraged transaction.

The underlying question is whether a debtor’s weakened ability to “weather temporary financial storms” is so severe as to present an unreasonable risk of failure. The appropriate answer requires analysis of whether the financial reserves projected by the parties appear sufficient, at the time of the transaction and without knowledge of exactly what future difficulties will arise, to enable the debtor to deal with at least some unexpected circumstances. After all, the future always holds some uncertainties, and a debtor whose financial state is so weakened that it cannot deal with any unexpected event cannot reasonably expect to succeed in its venture. By failing to engage in this analysis, the Court of Appeals did not analyze fully whether the transaction might have imposed on creditors an unreasonable level of risk.

The Third Circuit Court of Appeals adopted an approach similar to that in Mellon when applying the constructive fraud provisions in another LBO case, Moody v. Security Pacific Business Credit, Inc. Moody did not involve the purchase of a target for integration into a corporate group; it was a straight purchase of an enterprise, using the assets of the enterprise to secure

91. See id. at 650.
92. Mellon, 945 F.2d at 647.
93. Id.
94. In evaluating this risk, it is important to remember that if a transaction is all-encompassing as an LBO fails, creditors’ losses will be significant. A failure to reserve sufficiently for unexpected future events may increase the probability of failure to a level that renders the transaction unreasonably risky even if the expected value of the transaction, based on large potential profits if it succeeds, is acceptable.
95. 971 F.2d 1056 (3d Cir. 1992).
the acquisition debt. After the enterprise failed, the bankruptcy trustee sought to avoid the lender’s liens as fraudulent transfers. 96

As in Mellon, the Moody court recognized that fraudulent transfer law applies to an LBO. 97 However, also as in Mellon, the court refused to invalidate the transaction under fraudulent transfer law. 98

In analyzing the constructive fraud issue, the court explained that the “constructive fraud provisions furnish a standard of causation that attempts to link the challenged conveyance with the debtor’s bankruptcy.” 99 Significantly, the Court of Appeals suggested that because an LBO involves high stakes and the imposition of substantial risk on unsecured creditors, the potential for abuse might require a level of scrutiny similar to that imposed on intrafamily transactions. 100 In effect, the Court of Appeals seemed willing to treat the leveraged buyout as a badge of fraud, subjecting the transaction to increased scrutiny. Nevertheless, even under this more rigorous scrutiny the court found that the transaction was not avoidable under fraudulent transfer law. It found that even if the debtor-target failed to receive reasonably equivalent value in exchange for the grant of security interests to the LBO lender, the debtor was solvent and had reasonable capital after the transaction. Therefore, the transaction was not constructively fraudulent. 101

The Court of Appeals applied the constructive fraud standards in a manner that evaluated the actual risk imposed on creditors. For example, in analyzing the debtor’s solvency, the court found that assets could be valued on a higher going-concern basis, rather than on a liquidation basis, because the business was clearly operational after the transaction. The court distinguished this from a debtor for which bankruptcy is “clearly imminent”, for which a liquidation valuation might be more appropriate. 102 Implicit in this analysis is the idea that valuation of the debtor should reflect the reality faced by creditors immediately after the transaction. This reflects the court’s sensitivity to the concept that fraudulent transfer law seeks to evaluate the actual risk imposed on creditors by the transaction. 103

96. See id. at 1059-62.
97. Id. 1064 & n.10 (citing Mellon, 945 F.2d at 635; United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), cert. denied, 483 U.S. 1005 (1987)) (citations omitted).
98. See Moody 971 F.2d at 1076.
99. Id. at 1064.
100. Id. at 1065.
101. See id. at 1076. The lower court had found that the LBO was without fair consideration to the debtor because the debtor had taken on substantial debt secured by its assets and had received only new management and the opportunity to borrow more money in return. This finding was not challenged on appeal. Moody, 971 F.2d at 1065 (citing Moody v. Security Pac. Business Credit, Inc., 127 B.R. 958 (Bankr. W.D. Pa. 1991), aff'd, 971 F.2d 1056 (3d Cir. 1992).
102. Id. at 1067 (citations omitted).
103. The court found “particularly probative” the debtor’s receipt in the liquidation of its
Similarly, in analyzing the unreasonably small capital test, the Court of Appeals implicitly recognized that the issue is whether the transaction imposed on creditors an unreasonable risk of failure. The court described the test as whether the debtor would be able “to generate sufficient profits to sustain operations.”104 Under this test, a failure need not occur immediately; instead, the Court of Appeals seemed to be measuring whether the risk of failure in the future was so great as to be unreasonable. The court explained: “Because an inability to generate enough cash flow to sustain operations must precede an inability to pay obligations as they become due, unreasonably small capital would seem to encompass financial difficulties short of equitable [in]solvency.”105

The court then described a method for evaluating whether the debtor was left with unreasonably small capital after the LBO. Following the analysis of the court in Credit Managers Ass’n v. Federal Co.,106 the Moody court evaluated the parties’ cash flow projections, including the availability of credit, to determine whether the projections were based on reasonable assumptions and whether they showed sufficient cash flow to maintain the business. The Moody court recognized that “because projections tend to be optimistic, their reasonableness must be tested by an objective standard anchored in the company’s actual performance.”107 In addition, the court suggested that some cushion for risk must be included, stating that “parties must also account for difficulties that are likely to arise, including interest rate fluctuations and general economic downturns, and otherwise incorporate some margin for error.”108 Thus, the court found that it could use the parties’ projections, if they were reasonable, to determine whether the transaction presented an unreasonable risk of failure or whether it posed a reasonable business risk that only failed as a result of unanticipated problems.109

The Moody court found that although the projections used in the LBO before it “were not entirely on the mark,”110 they were not unreasonable.

divisions and subsidiaries of an amount roughly equal to the valuation that the lower court placed on the debtor’s property, plant, and equipment. According to the court, “although these assets were sold long after the leveraged buyout, the conditions under which they were sold approximated, and may have been more immediate than, that required by the UFCA’s ‘present fair salable value’ language.” Moody, 971 F.2d at 1069.

104. Id. at 1070.

105. Id. Nevertheless, the court found that the concepts of unreasonably small capital and equitable insolvency are sufficiently related that it was not error for the lower court to consider the two issues together. See id. at 1071.


108. Id. (citing James F. Queenan, Jr., The Collapsed Leveraged Buyout and the Trustee in Bankruptcy, 11 Cardozo L. Rev. 1(1989)).

109. See at 1074-75.

110. Id. at 1074.
The projections were generally consistent with the debtor’s performance before the LBO and, in fact, were borne out in part by the debtor’s profitable performance during the first five months after the LBO. Rather than attributing the debtor’s failure to the LBO, the court concluded that the district court did not err in finding that mismanagement, coupled with substantially increased competition and an economic recession, led to a “drastic decline in sales [that] was unforeseeable as of the date of the leveraged buyout.”111 In effect, the court found that the debtor undertook a reasonable business risk that went bad, rather than an unreasonable risk that was doomed to fail from the beginning.

Both the Mellon and Moody courts seem to have recognized that fraudulent transfer law is aimed only at transactions that represent an unreasonable risk from the perspective of unsecured creditors when the transaction occurs. By upholding the risky transactions at issue in Mellon and Moody, the Third Circuit Court of Appeals appeared to acknowledge that debtors may engage in risks that might adversely affect their creditors as long as the risk is not unreasonable. After all, both transactions were risky and both were accepted by the courts. Arguably, the chance of success in each transaction appeared to be sufficient to suggest that the risk imposed by the transaction was not unreasonable.

One might argue that in modern arms-length transactions, the parties would never take unreasonable risks in the absence of some fraud. After all, those who acquire companies in LBOs often invest at least some of their own funds.112 They project substantial profits if the transaction succeeds and understand that they will lose their investment if the transaction fails. Similarly, lenders part with real value in financing these transactions and face the risk that they will not be repaid or will at least face substantial delay and expense if the transaction fails. It seems unlikely that investors or lenders would knowingly and intentionally place their funds at unreasonable risk. This suggests that although these transactions may be subjected to fraudulent transfer analysis if the business ultimately fails, many should pass the fraudulent transfer test.

Yet the cases suggest that even in the absence of actual fraudulent intent, sophisticated commercial parties may sometimes induce a debtor to take unreasonable risk. In some transactions the parties may simply fail adequately to analyze the transaction and the debtor’s financial condition in order to appreciate the level of risk that they are undertaking. This may result from

111. Id. at 1075.
a failure to use sufficient care in evaluating the transaction. In some cases the deal may be so far along and have so much invested already that by the time warning signs appear the parties choose to ignore the warnings and proceed with the deal.\textsuperscript{113} Other institutional interests also may propel a deal forward even after it no longer seems well advised.\textsuperscript{114}

Inadequate analysis was a concern addressed by the Third Circuit Court of Appeals in \textit{Moody} when the court suggested that an analysis of the sufficiency of the debtor’s capital turns largely on the reasonableness of the projections with which the parties worked and that reasonableness requires some relation between the projections and the debtor’s historical performance. If the parties essentially ignored reality to project cash flows and profits that may have looked good but likely were unattainable, then the transaction may have involved unreasonable risk, failing the fraudulent transfer test. On the other hand, if the parties evaluated realistically the finances, then it may be reasonable to assume that factors other than the transaction itself led to the debtor’s subsequent inability to service its debt and that the risk taken was not unreasonable.

This analysis is reflected in \textit{In re O’Day Corp.},\textsuperscript{115} in which the court found that an LBO was a fraudulent transfer. In \textit{O’Day} the court found, \textit{inter alia}, that the acquiror and the lender had essentially ignored the debtor’s declining performance just prior to the LBO, relying instead on overly optimistic projections developed before the declining performance became clear.\textsuperscript{116}

As the examiner in \textit{In re Revco D.S., Inc.}, I found evidence of a similar failure to take account of a debtor’s inability to meet targeted performance just prior to an LBO and reliance on projections developed without attention to this failure.\textsuperscript{117} These types of situations, in which parties, without fraudulent

\textsuperscript{113} See, e.g., \textit{Best}, 168 B.R. at 40-41 & n.5 (involving concerns expressed during due diligence phase that assumptions underlying projections might be too favorable; involving concerns discounted as “‘business issues’” with thought that “‘new management [would be] able to implement the business processes to meet these projections’” (alteration in original) (citation omitted)); Final Report of Examiner Professor Barry L. Zaretsky, \textit{In re Revco D.S., Inc.}, 118 B.R. 468 (Bankr. N.D. Ohio 1990) at 86, 197 (on file with South Carolina Law Review) (hereinafter Report) (finding no revisions to projections or to terms of LBO deal even after it became clear that the target’s actual preclosing performance was weaker than expected).

\textsuperscript{114} A party might take additional risks to enter into an area of business in which it had not previously been active. Sometimes compensation is tied to deals that are closed so that there is incentive to complete a deal even if, after close analysis, the deal looks less attractive. Sometimes there may be a desire to not disappoint an important client who wants to see the deal completed. Other concerns may also lead parties to disregard indications of problems in completing a transaction.


\textsuperscript{116} See id. at 412.

\textsuperscript{117} See Report, \textit{supra} note 87, at 86, 197 (observing that there were no revisions to
intent, fail to heed warning signs in their zeal to complete the deal, may be exactly the situations in which fraudulent transfer law can regulate the risk imposed on creditors by these failures. 118

Even when the parties accurately evaluate a transaction, there is incentive for investors to engage in a transaction that may be unreasonably risky. This is because the risk-reward ratio faced by LBO investors may be more favorable than that faced by non-LBO creditors. An equity investor in an LBO will typically invest few if any of its own assets. That is the nature of leverage. If the deal fails, the investor loses relatively little. Yet if the deal succeeds the investor may reap substantial profits. Similarly, an LBO lender will often receive collateral as well as a high interest rate and substantial fees. The risk that this senior collateralized lender will not be repaid is relatively small while the potential profits are large. Thus, these investors may pursue a transaction even if there is a relatively high risk of failure if the expected return for them is significantly higher than the cost of investing.

However, from the perspective of non-LBO creditors, the loss upon failure of the enterprise is likely to be substantial while the potential reward from success is small. Prior to the LBO these creditors stood to be repaid in full by a healthy debtor. After the LBO they could receive no more than full payment but face greater risk of non-payment. If this increased risk, the probability that the enterprise might fail, is unreasonably high, fraudulent transfer law may provide some remedy.

b. Corporate Guarantees

An approach to fraudulent transfer law that seeks to distinguish between reasonably and unreasonably risky transactions can also aid in the analysis of intercorporate guarantees. Lenders to members of a corporate group often require credit support, or guarantees, from other members of the group.

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118. This analysis does not answer the question of who should ultimately bear the loss caused by this unreasonably risky transaction. The traditional remedy of fraudulent transfer law is invalidation of the transaction. With a complex LBO, of course, the eggs cannot be unscrambled and the parties cannot be put back in the positions they were in just prior to the LBO. Courts and commentators have reached no consensus on where this loss should fall, and resolution of this issue is beyond the scope of this article. I would note, however, that there are cases and commentaries suggesting placement of the loss on (1) the acquiror; (2) the lenders; (3) general creditors; and (4) some or all of the old shareholders of an acquired company. See White, supra note 40 at 371-93. Similarly, courts and commentators have reached no consensus on who should benefit from a fraudulent transfer recovery. For example, should post-LBO lenders, who presumably can price the new level of risk that they face be entitled to recover? See Id. Resolution of these remedy issues must await further study.
Consider, for example, a loan to a parent corporation with four operating subsidiaries, where the loan is to be used to provide working capital to the subsidiaries. Often, the parent corporation's only significant asset is the stock of the subsidiaries, with the real assets existing at the subsidiary level. If the loan is simply to the parent, the lender will be subordinate to all creditors of the operating entities because its only security will be the equity in those entities. Yet, the loan is intended to flow through the parent to the subsidiaries. The lender might reasonably want to be treated on an equal basis with the creditors of the subsidiaries; in fact, it is more likely that the lender will want collateral from each of the subsidiaries.

The transaction might be structured so that each subsidiary guarantees the parent's obligation only to the extent that funds flow to the particular subsidiary. However, in many corporate groups there will be continual intragroup transactions and it may be difficult to quantify the exact amount flowing to each subsidiary. Moreover, members of the corporate group may benefit from the strengthening of other members. Indeed, creditors may well expect that the corporate group will operate as a family in which members are responsible for each other. Thus, it is increasingly common for subsidiaries not only to guarantee their parents' obligations, but also to guarantee or cross guarantee, the obligations of other subsidiaries.

Typically, the subsidiaries will not be of equal financial strength. Creditors of a stronger subsidiary may be adversely affected by its cross guaranty of the obligation of a weaker sibling. If the group ultimately fails, these creditors undoubtedly will complain that but for the cross guarantees they could have recovered most or all of their claims. Thus, the creditors will maintain that they should be able to disregard the guaranty liability as fraudulent, having been incurred for less than reasonably equivalent value and perhaps having rendered their debtor financially impaired. Similarly, creditors will likely object to a subsidiary's guarantee of a parent's obligation unless it can be shown that the subsidiary received an equivalent benefit from the loan to the parent.

119. For example, the parent might take a note from each subsidiary and a security interest in each subsidiary's assets to secure advances to that subsidiary and assign the notes and security interests to the lender. Under that structure, each subsidiary would be liable only for the funds lent to it. Some lenders have taken so-called "net worth guarantees," under which each subsidiary guarantees the debt only to the extent of its net worth, so that the subsidiary cannot be rendered insolvent by the guarantee. See Brad R. Godshall & Robert A. Klyman, Wading "Upstream" in Leveraged Transactions: Traditional Guarantees v. "Net Worth" Guarantees, 46 BUS. LAW. 391 (1991).


121. There may also be corporate law issues concerning the guarantor's ability to enter into the transaction. See generally, Kriedmann, The Corporate Guaranty, 13 Vand. L. Rev. 229 (1959).
An approach to fraudulent transfer law that seeks to determine whether a transaction was unreasonably risky provides a useful framework for analysis of these intercorporate guarantees. When the loan at issue is a working capital loan to a group that historically has operated as a corporate group, upstream or cross-stream guarantees normally will not be the unexpected, unreasonably risky type of transaction that is objectionable under fraudulent transfer law. Creditors of individual subsidiaries should not be surprised to learn that their debtor also is responsible jointly for some relatively normal business debts of the other members of the corporate group. This arrangement is common for a modern corporate group and is valuable for all of the members. All may find additional credit availability, resources, and synergies as a result of their group membership, making the risk more reasonable from the perspective of creditors of each of the subsidiaries. This was the analysis of the Mellon court, which found that the debtor may have received reasonably equivalent value in exchange for its guaranty of the debt of members of the corporate group because the debtor received the potential benefit of synergy with the group and increased credit availability.

Another way to analyze these guarantees is to consider whether they are a type of obligation that is reasonably expected by creditors, one to which creditors likely would agree if they were asked when they extended credit to the debtor. If the guaranty is part of a transaction that is ordinary and reasonably expectable and that strengthens the corporate group as a whole, then it should not normally be objectionable from the perspective of creditors. Nevertheless, even though the guaranty transaction may be reasonably expectable and should normally be unobjectionable, the transaction may become unreasonable and objectionable if the financial structure of the corporate group is such that unreasonable risk is imposed on creditors of particular members of the group. In terms used by fraudulent transfer law, if certain corporate group members receive no reasonably equivalent benefit and the new liability renders them financially impaired, the guaranty may create the type of unreasonable risk to creditors of those members that is proscribed.

122. See Williams, Fallacies, supra note 3.
123. See 945 F.2d at 647. See also Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 991-92 (2d Cir. 1981) (finding that an indirect benefit may constitute reasonably equivalent value).
by fraudulent transfer law. This might result, for example, if the financial strength of some subsidiaries was being diverted to prop up other subsidiaries with seriously troubled finances.

Intragroup guarantees of loans that are not for working capital may be less expectable and may have to satisfy a higher financial standard to be found to involve reasonable risk.\(^{125}\) When the obligation guaranteed is not a working capital loan for the group, but is a more unusual transaction, the additional obligation may not be reasonably expectable by creditors and, therefore, may require a more careful showing that the guarantor received actual value reasonably equivalent to the obligation undertaken or that the guarantor was financially sound after the transaction. Thus, for example, the guaranty of an LBO loan might properly receive closer scrutiny than an ordinary working capital loan in determining whether the guaranty involved imposes an unreasonable risk on the guarantor and its creditors.

Of course, courts have recognized that this analysis must consider the actual nature of the obligation undertaken by the guarantor in determining the degree of risk and whether any value it received was reasonably equivalent to the obligation assumed.\(^{126}\) This requires an analysis, as of the time that the transaction was entered into, of the likelihood that the debt will be repaid by the principal debtor and the availability of contribution from other members of the corporate group. The face amount of the debt guaranteed is unlikely, upon analysis, to be equal to the amount of actual detriment undertaken by the guarantor. Thus, the amount of value that the guarantor received in exchange for the guaranty may be considered reasonably equivalent to the liability undertaken even if the value is less than the face amount of the debt guaranteed.

The detriment to the guarantor may nevertheless outweigh the benefit received by the guarantor. This is particularly evident in, for example, LBO cases in which there often is little direct or even indirect value to the target, which guarantees the LBO debt. In such cases, the financial impairment prong of the fraudulent transfer test must be analyzed to determine whether the target has been put at unreasonable risk by the transaction. The question is whether the new debt guaranty obligation imposed on the corporate group member creates a risk of failure that is unreasonable from the perspective of other creditors.

To analyze the risk issue, courts have, as with the equivalent value issue, recognized that they must consider the actual effect of the guaranty liability on the particular corporate group member. After considering the likelihood that


\(^{126}\) Mellon, 945 F.2d at 646-48.
the principal debtor, as opposed to the guarantor, might pay the debt and the possibility of contribution from coguarantors if the guarantor failed to pay, a court might find that the predicted ultimate liability is less than the face amount of the debt. This might support a finding that the debtor-guarantor was not financially impaired after the transaction or that the transaction was risky but not unreasonably risky to creditors of the guarantor. Alternatively, this analysis might result in a finding that the guaranty did financially impair the guarantor, in which case fraudulent transfer law would suggest that the transaction, unexpected by creditors and unreasonably risky to them, should be avoidable.

One factor in determining whether the guarantor received reasonably equivalent value is the economic viability of the corporate group. If no viable enterprise exists, so that the ultimate effect of the guaranty is simply to shift assets from creditors of the guarantor to creditors of the principal debtor, then it will be difficult to find that the guarantor received value in exchange for undertaking an obligation and, perhaps, transferring property to secure that obligation. This was essentially the analysis in *General Elec. Credit Corp. v. Murphy (In re Rodriguez)*. In *Rodriguez*, the parent paid the debt of the subsidiary, although it had not guaranteed it. The Eleventh Circuit Court of Appeals found that where the parent was insolvent and the subsidiary was hopelessly insolvent, the parent received no reasonably equivalent value for the payment. Similarly, in *Commerce Bank, N.A. v. Achtenberg* the Missouri District Court held that an insolvent shareholder did not receive reasonably equivalent value for a guaranty of corporate debt when the corporation was insolvent at the time of the guaranty.

The thrust of this analysis is that normally a parent corporation receives value from the guaranty of a subsidiary's debt because the funds borrowed by the subsidiary increase the value of the parent's equity interest in the subsidiary. If the subsidiary is insolvent, the additional funds cannot add to the parent's equity interest an amount equal to the obligation assumed by the parent because the funds borrowed by the subsidiary must first be applied to satisfy the claims of creditors of the subsidiary before the parent-equity holder

127. 895 F.2d 725 (11th Cir. 1990).
128. See id. at 727-28.
130. See *Commerce*, 1993 WL at *4*. Of course, mere insolvency of the principal debtor may not, by itself, require a finding that the guarantor did not receive value. The loan might have been intended to create viable corporate opportunities that, if successful, would enable the subsidiary to pay its debts and return a profit to its parent. Thus, the question more properly is whether the subsidiary's condition is such that further investment in the subsidiary represents an unreasonable risk from the perspective of the parent. Insolvency may be an indication of such risk but it need not be conclusive.
can receive any benefit. In a recent article, Professor Jack Williams suggested that if the subsidiary was not commercially viable, then the parent would not effectively receive any value for its guaranty. Rather, the parent would become liable for an obligation of its subsidiary and, because the subsidiary was not viable, would receive no increase in the value of its ownership interest in the subsidiary. He added, “This is no less the case where such a contract may constitute an honest attempt to revive the troubled subsidiary’s prospects for survival.”

This is correct, but only as far as it goes. That is, if the investment is obviously a loser from the start, the guaranty represents an unreasonable risk because there is little or no potential benefit for the parent in assuming the guaranty liability. Alternatively, if the investment had some reasonable prospect of success, then the parent might still have received value in the form of the opportunity to make the investment and take the risk in the first place even if the venture later failed without ultimate benefit to the parent. This might be so even if the subsidiary was insolvent, if the subsidiary was an appropriate vehicle for making the investment. Thus, the question is not solely whether the subsidiary was solvent or whether the venture succeeded, but whether the risk that the enterprise took was reasonable enough to be viewed as adding value at the time it was originally commenced.

This analysis is reflected in *Butler Aviation Int’l, Inc. v. Whyte (In re Fairchild Aircraft Corp.*). In that case the debtor, Fairchild, manufactured and sold commuter aircraft. Fairchild identified a potential customer, Air Kentucky, which flew under a code sharing agreement with USAir. Fairchild believed that it could sell a substantial number of aircraft to Air Kentucky at a substantial profit, but only if it could resolve Air Kentucky’s financial difficulties. Fairchild’s owner, Metro, also owned one-third of the stock of Air Kentucky’s parent corporation, MPM. As part of the rescue operation, Metro’s owner, GMFI, purchased the remaining two-thirds of the MPM stock. Thus, Fairchild and Air Kentucky were affiliated entities, albeit indirectly, with GMFI as the ultimate parent.

Unfortunately, USAir objected to GMFI’s ownership of both an aircraft manufacturer and a USAir affiliated commuter airline. Consequently, it gave notice of its intention to end the code-sharing arrangement with Air Kentucky, which would effectively destroy Air Kentucky. At about the same time, Air Kentucky’s fuel suppliers refused to supply fuel on credit any further. Without fuel, Air Kentucky could not fly. If its planes were grounded, there

132. For example, the subsidiary might be the appropriate vehicle because of its existing business or experience. Synergies between the parent and the subsidiary might create value for the parent even if its equity interest in the subsidiary had no direct economic value.
133. 6 F.3d 1119 (5th Cir. 1993).
134. *Id.* at 1123-24.
was little doubt that Air Kentucky would fail, destroying Fairchild’s opportunity to sell aircraft to Air Kentucky. Moreover, USAir likely would have blamed Fairchild and its parent for the failure and would be unlikely to buy aircraft from Fairchild in the future.\textsuperscript{135} 

To keep Air Kentucky flying, Fairchild agreed to pay for fuel delivered to Air Kentucky. In the meantime, GMFI unsuccessfully sought a buyer for Air Kentucky. Ultimately, Air Kentucky failed, and nine months later Fairchild commenced its own Chapter 11 case. The unsecured creditors’ representative in the Fairchild bankruptcy sought to recover from the fuel supplier payments made by Fairchild for the benefit of Air Kentucky, contending that the payments were fraudulent transfers.\textsuperscript{136}

The representative argued that because Air Kentucky failed, Fairchild received no reasonably equivalent value for the payments and, because it was financially impaired when the payments were made, the payments were recoverable as fraudulent transfers.\textsuperscript{137} The Fifth Circuit Court of Appeals disagreed, holding that at least with respect to payments made before the demise of Air Kentucky, Fairchild received reasonably equivalent value. The Court of Appeals acknowledged that ultimately Fairchild received nothing as a result of its investment in Air Kentucky, but that did not mean that it received no value in exchange for the payments. The court emphasized that the value of the payments must be evaluated as of the time each payment was made, without the benefit of hindsight.\textsuperscript{138} Thus, according to the Fifth Circuit Court of Appeals, the question was “whether keeping Air Kentucky operating during this period was worth $16,000-$20,000 a week, or its ‘reasonable equivalent,’ to Fairchild.”\textsuperscript{139} The court found several benefits for Fairchild, including the maintenance of good relations with USAir, a potential customer, and the continued marketability of Air Kentucky, sale of which might result in a continuing customer relationship as well as an opportunity to recoup some of the substantial investment Fairchild already had made in Air Kentucky.\textsuperscript{140}

The Court of Appeals explicitly rejected the representative’s argument that the value of Fairchild’s investment must be measured by the actual payoff on the investment. Instead, the court essentially adopted an approach that recognized the validity of Fairchild’s paying to play.\textsuperscript{141} In effect, as long as Fairchild’s decision to invest in Air Kentucky was not unreasonably risky

\textsuperscript{135} Id.
\textsuperscript{136} Id. at 1124.
\textsuperscript{137} Id. at 1124-25.
\textsuperscript{138} See Fairchild, 6 F.3d at 1127.
\textsuperscript{139} Id. at 1126.
\textsuperscript{140} See id. at 1126-27.
\textsuperscript{141} See id. at 1126-27.
or certainly doomed to fail, the court was willing to recognize the value of the investment opportunity.

Interestingly, the court distinguished between payments Fairchild made before Air Kentucky ceased operations and payments made after the cessation of operations. The Court of Appeals found that Fairchild had no legal obligation to pay for fuel delivered to Air Kentucky; therefore, payments could be for reasonably equivalent value only if Fairchild received some benefit other than release of an antecedent obligation. While Air Kentucky was flying, the benefit to Fairchild was the continuation of Air Kentucky's operations with the attendant possibility of marketing Air Kentucky and of maintaining good relations with USAir. Once Air Kentucky ceased operations, however, there was no further benefit to Fairchild in paying for fuel that had been delivered to Air Kentucky. After cessation of operations, there was virtually no hope that Fairchild could gain from its continued payments. Those payments were almost in the nature of a gift and because Fairchild's financial condition was impaired, were recoverable as fraudulent transfers.

Although Fairchild did not concern directly an intercorporate guaranty, the principle of recognizing the value of corporate opportunities should apply to guaranty cases as well. That value, however, exists only when there is some reasonable chance that the risk or investment undertaken could yield a meaningful return. Again, a debtor may take reasonable risks with its creditors' funds, but fraudulent transfer law proscribes the taking of unreasonable risks.

PART IV
LIMITATIONS OF UNREASONABLE RISK ANALYSIS

Recognition that fraudulent transfer law is intended to regulate unreasonable risk but to permit reasonable risk-taking by debtors ameliorates some of the problems with applying fraudulent transfer law to modern transactions. However, this does not eliminate all problems created by this body of law.

142. See at 1127.
143. See Fairchild, 6 F.3d at 1127-28.
144. The court did not seem to be concerned with whether Air Kentucky was insolvent at the time Fairchild paid for the fuel. Instead, the court seemed to view this as a question of corporate opportunity; if there was reasonable potential for gain, then the investment was worth making, even if with the benefit of hindsight we know that it failed. See id. at 1127.
145. Id. at 1129.
146. The fuel supplier had argued that Fairchild had guaranteed Air Kentucky's obligation, but the court found the oral guaranty was unenforceable. See id. at 1128-29. Consequently, although there was a guaranty involved, the case did not concern enforcement of or payment on an enforceable guaranty.
In particular, the application of fraudulent transfer law to relatively normal business transactions may increase the cost or inhibit the completion of some of those transactions by forcing a lender to increase its price for a loan to account for the increased risk imposed by fraudulent transfer law. For example, a lender to an LBO or to a corporate group offering upstream and cross-stream guarantees must engage in extra due diligence in order to be ready to prove that the transaction met the financial and reasonably equivalent value standards of the constructive fraud provisions. However, no amount of due diligence will assure the lender that its liens or guarantees will be enforceable in the event that the LBO target, or a member of the corporate group, fails. Moreover, the debtor and its other creditors cannot offer absolute protection from fraudulent transfer law even if they purport to waive its benefits. Consequently, otherwise beneficial transactions may be deterred because of the increased risk imposed by fraudulent transfer law.

The risk of fraudulent transfer avoidance is particularly difficult for parties to quantify because fraudulent transfer law permits an after-the-fact re-evaluation of the value given and of the debtor’s financial standing, both of which may be colored by hindsight. Of course, a transaction may also be subject to after-the-fact determinations of good faith, unconscionability, reasonableness, and other nonquantifiable factors. Nevertheless, to say that fraudulent transfer law is not the only risk factor does not diminish the need for critical analysis of whether the costs imposed by fraudulent transfer law’s regulation are worth the benefits.

Even if some level of regulation seems appropriate, it will be necessary to analyze whether the constructive fraud standards are the optimal measure of unreasonable risk. Moreover, more careful analysis is needed to determine whether fraudulent transfer costs are imposed on the correct parties and whether the remedies provided by fraudulent transfer law effectively implement its policies. At this point, it may be of some value simply to recognize why fraudulent transfer law considers some transactions “unfair” and authorizes attacks on them. Further analysis might suggest that other limitations on the reach of fraudulent transfer law are necessary to encourage efficient application of this body of law or that remedies must be adjusted to

147. There is always the risk that there will be one remaining creditor who might offer a basis for avoiding the entire transaction. See Moore v. Bay, 284 U.S. 4 (1931); see also 11 U.S.C.A. § 548 (1993 & Supp. 1995).

148. Courts have, however, at least paid lip service to the need to evaluate the transaction as of the time it was entered into rather than with the benefit of hindsight. See, e.g., Moody v. Security Pac. Business Credit, Inc., 971 F.2d 1056 (3d Cir. 1992).

149. In this regard, further analysis of the effect of different types or risks, and in particular of any need to regulate transactions with widely dispersed outcomes, is also needed. See note 36 supra.

150. See David G. Carlson, Leveraged Buyouts, supra note 3; White, supra note 40.
address inefficiencies created by fraudulent transfer law.